BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1994

THE GOVERNOR'S CONCLUDING REMARKS

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Ladies and Gentlemen,

The Bank of Italy completed its first hundred years in 1993. The high regard in which the institution is held was demonstrated by the participation of the President of the Republic, the highest civil, military and religious personalities of the country, academics and representatives of banking and business at the official celebrations last December. The presence of the governors of the central banks of the leading countries testified to the esteem of the international financial community.

The results of research into the history of the Bank of Italy were presented at a symposium preceding the official ceremony. The purpose of the series of historical publications is to make documents and information available to those seeking to write the economic history of our country.

The Bank has established a Foundation to provide assistance to the Bank's pensioners and the spouses and children of members of the staff in cases of grave adversity. The Bank will also support the creation of an international centre for paediatric neuro-oncology and a project in favour of the Italian Leukaemia Association.

The adaptation of the Bank's organizational structure to changes in the external environment continued last year.

The reorganization of the Banking Supervision Departments in 1991 both reflected and stimulated the changes in the performance of their functions, which have become more complex on account of the increase in competition, the opening-up of markets and financial innovation. Further measures are being taken to improve the resources deployed in overseeing the efficiency and stability of the banking and financial system, especially the quality of human resources.

The modernization of payment services has long been directed towards making cashless payment instruments easier and more rapid to use and improving the efficiency and reliability of the interbank payment system.

Measures to safeguard the circulation of money and the quality of banknotes, which are the form of money most commonly used by the general public, remain a fundamental responsibility. Working procedures have been reorganized and the latest technology introduced, thereby eliminating the capacity and flexibility constraints on banknote production. Worn notes are not being replaced quickly enough. Action has been taken to improve the quality of notes in circulation; the cooperation of the banks has been sought in this regard, and we are certain that it will be fruitful.

The importance attached to relations with users of our services and the specific features of our network lay behind the project to overhaul the technical facilities and organization of the Bank's branches. One of the key aspects of the reform of accounting operations was the complete automation of counter services, an innovation that will have a positive effect on the organization of work as well as bringing advantages for users. Twelve districts have been defined on the basis of operational criteria, and the branches in the provincial capitals have been given responsibility for the local coordination of banking supervision, economic analysis and staff training.

Today as in the past hundred years, the Bank can successfully pursue the general interests entrusted to it, thanks to the diligent commitment of staff of every rank and grade, who are conscious of the Bank's heritage in the form of service to the nation, intellectual independence and efficiency.

I wish to express my sincere thanks and appreciation to all members of the staff for their dedication to the Bank and to the country.

This May Lamberto Dini was appointed to the high office of Treasury Minister in the new Government. He has therefore left the post of Director General that he had occupied since October 1979.

The wealth of expertise that Mr. Dini brought to the Bank of Italy, especially on complex issues of international finance, was the result of academic study and twenty years' experience at the International Monetary Fund, where he had become Executive Director for Italy.

During the years he spent at the Bank of Italy, Mr. Dini's qualities were deployed to the benefit of the Bank and the country, especially in the fora for international financial cooperation. He was Italy's Alternate Governor at the International Monetary Fund and the Inter-American Development Bank and a Member of the Monetary Committee of the European Community; in 1993 he became Vice-Chairman of the Board of Directors of the Bank for International Settlements.

In the demanding post of Chairman of the Committee of Alternates of the Group of Ten, which he occupied from 1981 onwards, Mr. Dini put his name to documents of the highest importance on the problems of the international institutions and international finance.

We owe him profound gratitude for the care he exercised in the management of the internal affairs of the Bank. His positive attitude accelerated the changes in organization and administration. In Lamberto Dini, the commitment of the guardian of the public good is combined with an entrepreneurial dynamism, which during his years here were coupled with a generous understanding of the human side of those who perform their daily work in the Bank.

I wish to extend to him my warmest thanks and my best wishes for success in his new post. The traditional close cooperation between the Treasury and the Bank of Italy cannot fail to be strengthened, with beneficial effects on the attainment of their respective institutional objectives.

Vincenzo Desario was appointed Deputy Director General in June 1993. He had been Central Director for Banking Supervision since 1983. He brings to the Directorate the experience of more than thirty years' work in the Bank.

The world economy

Economic and financial disequilibria

During 1993 and the first few months of this year the financial and foreign exchange markets were again dominated by the serious imbalances that have prevailed for so long between the major economic and monetary areas, within which there remain pronounced disequilibria between savings formation and savings demand and between the demand for and supply of credit. Transfers of long-term capital were substantial and flows of bank funds intensified.

In the United States the deficit on the current account of the balance of payments, which has persisted since 1982, widened last year to $109 billion, compared with $66 billion in 1992. The deterioration was attributable to the recovery in demand and investment at a time when economic activity in Japan and Europe was stagnating. The net foreign debt of the United States, which was a creditor country until the mid-eighties, rose to about $600 billion, or almost 10 per cent of gross domestic product. The private sector's propensity to save remains extremely low; that of households is no more than 5 per cent of disposable income. The public sector continues to absorb a high proportion of savings; the budget deficit amounted to $255 billion in 1993.

The deficit on the current account of the balance of payments was accompanied by substantial outflows of capital, encouraged by the expansionary monetary policy and expectations of interest rate reductions in Europe.

The imbalance in the United States' external accounts is partly mirrored in Japan's current account surplus, which totaled $131 billion last year, against $118 billion in 1992. About half of last year's surplus was reinvested abroad in long-term securities. Households' saving remains particularly high. The low level of short-term interest rates, the decline in economic activity and the state of the public finances encouraged the outflow of funds, countering the upward pressure on the yen. Net external assets have risen rapidly over the last fifteen years, despite the loss of competitiveness due to the strong appreciation of the currency; today they exceed $600 billion, equal to 15 per cent of the country's gross national product.

In Germany, notwithstanding the continued weakness of economic activity, the monetary authorities kept interest rates comparatively high in the face of a deterioration in the public finances and strong demand for credit in the eastern regions. Inflows of long-term capital were substantial, greatly exceeding the current account deficit, owing partly to the underlying soundness of the German economy. United Germany has preserved much of the net asset position vis-à-vis the rest of the world that West Germany had accumulated since the fifties; it now stands at around 14 per cent of GDP, compared with more than 20 per cent in 1990.

The current account deficit of the European Union, which amounted to about $67 billion in 1992, was eliminated last year, owing partly to the cyclical weakness of the economy. The pegging of currencies to the Deutschemark had caused a gradual but continuous erosion of the area's competitiveness since 1987. Between 1992 and 1993 the depreciation of the pound sterling and the lira, followed by that of other currencies, produced an improvement of 9 per cent in the area's average competitiveness.

In the long run the value of a currency reflects the economy's growth prospects and potential, its competitiveness and its foreign debtor or creditor position. The domestic and external values of a currency influence one another and tend to converge over the long term.

The correction of the economies' underlying imbalances calls for the operation of market forces to be supplemented by economic policies that are well balanced, incisive and more closely coordinated at the international level. When budgetary, structural and incomes policies are inadequate, domestic costs and prices can be curbed by means of monetary policy, but only with difficulty and at great sacrifice.

Monetary policies and economic developments in the industrial countries

In the second half of the eighties, and most notably from 1988 onwards, prices were affected by the cyclical expansion in the industrial countries. Monetary policy was tightened. In the United States short-term interest rates rose to almost 9 per cent at the beginning of 1989. In Germany, where they had fallen below 4 per cent, they stood at more than 8 per cent by the end of that year. The increase in interest rates was even larger in the United Kingdom and Canada, and appreciable in France and Italy.

The restrictive monetary stance in the Anglo-Saxon countries adversely affected economic activity between 1989 and 1990; after about a year it significantly curbed the rise in prices.

German unification had a profound impact on economic developments in continental Europe. Economic events in Germany initially prolonged the expansionary phase of the cycle, but high interest rates, exchange rate tensions and the crisis within the European Monetary System subsequently contributed to a decline in demand and economic activity.

Monetary policies were effective in containing price increases in most of the industrial countries. Inflation has come down in recent months to 2.4 per cent in the United States, 1.3 per cent in Japan, 2.9 per cent in the western regions of Germany and 1.7 per cent in France; in Italy it is still around 4 per cent.

However, output and investment have declined. In 1993 output fell by 1.2 per cent in united Germany and by 0.7 per cent in France and Italy. Investment contracted by 5 per cent in France and by 11 per cent in Italy, where it declined to its lowest level since the Second World War as a percentage of output.

The problems of employment have become a serious cause for concern everywhere. The number of unemployed in the OECD area rose to 34 million last year.

The economic recovery under way in the Anglo-Saxon countries since 1992 has begun to take up the slack in the labour market. The situation remains grave in the European Union. In 1990 the unemployment rate was just over 8 per cent, which may be considered the structural component of unemployment that is unlikely to be reduced by economic recovery alone. By the end of 1993 the rate had risen to 11.4 per cent; the increase can be reversed by an expansion in investment and a return to normal levels of economic activity.

The economic situation in the industrial countries as a whole was reflected in a slowdown in the growth of world trade to 2.4 per cent and a fall in the prices of raw materials; world trade would have stagnated had it not been for the increase in production and trade in the developing countries.

Interest rates

Monetary policy in the United States, which had been made less restrictive in mid-1989, became decidedly expansionary in the years that followed, with the discount rate declining to 3 per cent in mid-1992. Japan also reduced its discount rate, to 3.25 per cent in 1992 and 1.75 per cent in September 1993. In Europe the relaxation of monetary policy began after the crisis in the European Monetary System and the withdrawal of the pound sterling and the lira from the Exchange Rate Mechanism in September 1992.

Until the summer of 1993 France and the other remaining participants in the ERM encountered increasing problems in maintaining the central rates. They responded by raising interest rates and intervening on an exceptionally large scale in support of the currencies in difficulty. These measures were insufficient to withstand the pressure, and on 2 August the margins of fluctuation were widened to 15 per cent. Only limited use was made of the new wider band, however. The Deutschemark appreciated temporarily; the gradual decline in interest rates then resumed. By early 1994 nominal short-term rates in nearly all the countries were significantly lower than at any time in the previous decade.

Long-term interest rates were high everywhere during the eighties, even when adjusted for inflation expectations. In nominal terms they began to fall in 1990-91, in close conjunction with the slowdown in inflation, the downturn in economic activity and the change in monetary policy stance. In real terms, however, they remained high and continued to exceed the rates of economic growth, squeezing corporate profit margins, raising the cost of the public debt and increasing budget deficits.

In the Anglo-Saxon countries and Japan short-term rates were brought well below those at long term. In Germany, France and Italy the inverted yield curve that is characteristic of tight monetary conditions prevailed for some time longer.

The decline in long-term yields accelerated during 1993, and at times it was excessively rapid. The rise in bond prices was amplified by the activities of international securities traders, who financed their substantial purchases by borrowing in the currencies that had become most plentiful and least costly. The process was partly self-propelled, engendering investor expectations of a further decline in yields.

The rise in bond prices ceased in the United States in mid-October, when the possibility of an adjustment in monetary policy was first perceived. The sharp acceleration in US economic growth at the beginning of 1994 made a change in the Federal Reserve's stance a certainty, prompted by fears of a resurgence of inflation and of an excessive rise in securities prices. The decline in bond prices gathered momentum and spread to the rest of the industrial countries; it became disorderly in early March when the release of figures on the growth in the German money supply aroused fears that the gradual easing of monetary conditions in Europe would come to a halt.

At the end of February long-term yields were between 60 and 110 basis points higher than the lows recorded at the beginning of the year; the size of the increases appeared to be largely independent of the initial level of interest rates in the respective countries. In two months nearly half of the progress made in the whole of 1993 was undone.

At their meeting in early March at the Bank for International Settlements, the central bank Governors of the Group of Ten specifically examined the behaviour of interest rates and the activities of intermediaries, who had first accentuated the rise in bond prices and then caused them to fall by making a sudden portfolio adjustment.

Faced with the transmission of higher long term interest rates from the United States to Europe, the Council of the European Monetary Institute reaffirmed at its March meeting the intention to continue to make prudent reductions in interest rates in line with fundamental developments in the various economies.

Yields on long-term securities have risen further in the United States and are now higher than at the end of 1992. The rate on ten-year bonds is around 7 per cent. The yield curve has steepened, probably in response to investors' expectations of more rapid economic growth and higher inflation.

By contrast, all the European countries have continued to make substantial reductions in official interest rates, with further adjustments recently in Germany, Italy and elsewhere. In the United States the discount rate was raised to 3.5 per cent in mid-May, but the beneficial effect on the financial markets was short-lived; subsequently, securities prices fell. In keeping with the cyclical difference between Europe and the United States, there continues to be a divergence in short-term interest rate trends and a contrast in monetary policy stance; European long-term interest rates are still being influenced by movements in US rates.

The outlook

The cyclical disparities that have been evident of late among the industrial countries seem likely to diminish but not disappear, producing only a limited adjustment of the payments imbalances between the major areas; these imbalances are a source of uncertainty about exchange rates and interest rates and potentially harmful to free trade in goods and services.

The countries of Central and Eastern Europe, which are engaged in the difficult transition to a market economy, are still wrestling with a deep and widespread crisis. Their population numbers more than 400 million, and yet their output, which declined drastically in recent years, is now no more than a third of that of the European Union. These countries represent an immense untapped reserve of demand and growth, especially for the European economy. In the emerging economies, especially those in Asia, growth continues at a rapid pace.

In the OECD countries inflation is still declining. Economic expansion is well under way in the United States, accompanied by an increase in employment. The recovery is clearly discernible in the United Kingdom and Canada, albeit proceeding more slowly. It is still weak in continental Europe; the growth in output forecast for 1994 may prove insufficient to generate additional employment.

If the recovery in Europe is to strengthen, the conditions for a reduction in long-term interest rates must be created by pursuing rigorous fiscal policies and maintaining wage moderation.

Signs of a revival in economic activity have yet to appear in Japan. Stimulus to domestic demand from the public sector and measures to increase access to the Japanese market are necessary preconditions for eliminating imbalances in international economic relations and placing the recovery in the industrial economies on a sounder footing.

The Italian economy

Over the past decade Italian economic policy was of necessity centred on monetary control owing to the shortcomings of fiscal and incomes policies.

For many years, high interest rates made it possible to maintain a stable exchange rate, thus reducing inflation. Excessive budget deficits and wage increases that outstripped productivity gains prevented interest rates from declining to the levels prevailing in other countries; this itself further increased public expenditure and debt and depressed investment. The balance of payments remained in deficit, and by the end of 1992 Italy's net debtor position with the rest of the world amounted to more than 11 per cent of GDP.

The last two years have witnessed a reversal of the trend in the public finances and a pronounced moderation of wage growth.

The balance of payments

At the beginning of 1993 the external value of the lira was 17 per cent lower than in the previous August; in the course of the year the currency depreciated by 7 per cent.

The depreciation benefited exports, which had already begun to rise sharply in the second half of 1992. They increased in volume by 8.5 per cent during the year, while imports fell by 10.4 per cent. Export manufacturers enjoyed considerably wider profit margins, as their lira prices rose by an average of 11.4 per cent.

The almost continuous sequence of balance-of-payments deficits since 1980 was broken. The current account, which had recorded a deficit of 34 trillion lire in 1992, closed with a surplus of 18 trillion lire last year.

Since the mid-eighties both Italian investment abroad and foreign investment in Italy have increased significantly. Outward investment has generally been at longer term, while inward investment has consisted largely of bank capital. The net external foreign currency liabilities of Italian banks rose from the equivalent of 3 per cent of GDP in 1985 to 8 per cent in the summer of 1992.

There were substantial capital inflows in the last few months of 1992 as funds that had left the country during the currency crisis in the summer were repatriated. Foreign currency swaps by the Bank of Italy partially replenished the official reserves.

In 1993 and the first few months of 1994 the current account surplus and large-scale foreign investment in Italian securities allowed the banks substantially to reduce their net foreign currency debtor position, which diminished from $115 billion in August 1992 to $62 billion at the end of April of this year.

In view of the reduction in the cost of credit, foreign investors financed a significant portion of their securities purchases by borrowing in lire from Italian banks or in international markets, thus limiting their exchange risk. The share of lira-denominated assets in their portfolios increased, contributing to the development of the Eurolira market.

The reduction in the banks' foreign currency indebtedness vis-à-vis non-residents was one of the causes of the depreciation of the lira last year. Italy's overall external position improved significantly for the first time in a decade, with net foreign debt declining from 175 trillion lire at the end of 1992 to 150 trillion, or 9.6 per cent of GDP. A further reduction should occur this year, owing to the expected current account surplus. The improvement needs to continue in the coming years in order to underpin the currency.

Investment and employment

The strong growth in exports in 1993 was not sufficient to offset the weakening of domestic demand and enable output to recover from the level to which it had fallen at the end of the previous year.

The contraction in demand, which had begun in the second half of 1992, reflected the prospect of an increase in unemployment, the fiscal measures that had been announced and fears of a financial crisis. The restrictive monetary stance, which was accentuated as the strains increased within the exchange rate mechanism, also played a role. Households' efforts to increase their saving led to a further reduction in aggregate demand, aggravating the fall in output.

Real household consumption declined by 3 per cent in 1993 and disposable income by 5 per cent. Fixed investment fell by 11 per cent.

The significant reduction in jobs that had begun in the second half of 1992 owing to the slowdown in economic activity and the deterioriation of expectations accelerated in the early months of last year. Macroeconomic forecasts, announcements of retrenchment by major industrial groups and the difficulties facing a number of industries worldwide indicated that the contraction in employment would continue throughout the year and was likely to spread to medium-sized and small businesses. Restructuring also began to occur in the services sector, which in the past had continuously created jobs, even in times of recession.

The decline in employment first affected the regions of the North and Centre. A similar development could also be expected in the South, where it would exacerbate the already high rate of youth unemployment and have adverse social repercussions.

The extent of the reduction in employment was seriously underestimated by several official bodies, owing in part to statistical difficulties and uncertainties. Nevertheless, the problem was recognized and faced.

The agreement on labour costs signed in July 1993 demonstrates a keen awareness of the significance of the employment problem. It is a fundamental prerequisite for reducing inflation expectations. On several occasions we have emphasized its crucial importance for Italy's international competitiveness and for reducing unemployment in the future.

The gratifying output and earnings performance of exporters, who are located mainly in the North-East and Centre, and the increasing difficulties of government suppliers and contractors have amplified intersectoral and interregional divergences. The contraction in output and the loss of jobs are especially pronounced in the South.

Public works activity was checked above all by the revelation of a series of cases of bribery and corruption, which are now under investigation. Public works investment had already declined in 1992, and the available figures indicate a further fall last year, estimated at 16 per cent in real terms. Only part of the funds lent by international organizations and the reduced volume of loans from the Deposits and Loans Fund has actually been spent.

The new law on public procurement is designed first and foremost to ensure competition in the award of contracts. It requires contractors to submit a comprehensive initial plan to prevent unwarranted cost overruns in the course of the project. The law needs to be completed by issuing the implementing regulations. A swift revival of activity in this sector is important for economic recovery and employment; that was the purpose of the recent Cabinet decision in this regard. It remains essential that the standards of transparency and rectitude which underlie the law be attained.

Italy has less infrastructure than the European average. Compared with the more highly developed countries of the European Union, the overall difference is estimated at about one third, but the discrepancy is even greater in the worst endowed regions of the South.

Economic development cannot be generated by infrastructure investment alone, but orderly development is impossible without it. Private capital can help finance infrastructure projects where charges are to be levied for their use; the involvement of the public authorities remains indispensable to evaluate the costs and benefits of projects and to regulate their use.

Monetary policy and the exchange rate of the lira

During the currency crisis in the summer of 1992 interest rates on three-month Treasury bills rose to more than 18 per cent and short-term funds were strictly rationed by the Bank of Italy. The securities market and the money market continued to function normally, even in these extreme conditions, ensuring continuity of trading and correctly transmitting the signals and impulses originating from the central bank.

Monetary conditions were eased after the crisis had passed, but only gradually; they remained very restrictive until the early months of 1993. In order to give the markets a precise quantitative indication, the ordinary instruments of monetary control were supplemented from November 1992 to March 1993 by mechanisms for limiting and monitoring the expansion of credit; lending was not to exceed a volume compatible with production forecasts and the progressive slowdown in inflation. The objective was to prevent the depreciation of the lira from having an impact on prices and incomes, thereby triggering an inflationary spiral that would have necessitated further action, with more serious consequences for economic activity.

The rise in interest rates and the restriction of credit, which were required to contain inflation, affected the already depressed level of economic activity.

The agreement of July 1992 on labour costs and the weakness of domestic demand contributed significantly to curbing inflation. The month-to-month rise in prices was moderate during the first quarter of 1993; it accelerated in the second, reflecting the increase in the lira prices of imported goods, but the deterioration proved to be temporary. Consumer prices rose by 4.3 per cent between December 1992 and December 1993. In the following months the twelve-month increase in the cost of living remained at around 4 per cent.

The moderation of inflation was assisted by the growing conviction that prices would continue to slow down. The programmes framed by the Government and the new agreement on labour costs strengthened expectations of price stability.

The system for monitoring the growth of credit had made it possible to reduce official interest rates even before the end of 1992: the rate on fixed-term advances fell from 16.5 per cent in September 1992 to 13 per cent at the end of the year and 12 per cent in April 1993; over the same period the discount rate was lowered from 15 to 11 per cent.

With inflation slowing down and the balance of payments showing a marked improvement, monetary policy could be directed towards relieving the difficult situation of firms and alleviating unemployment by progressively reducing the cost of money.

Interest rate differentials vis-à-vis Germany and France narrowed appreciably. Official rates were reduced by half a point in May and again in June. In July the discount rate and the rate on advances were lowered by a full point in conjunction with the signing of the agreement on labour costs.

In contrast with events in other European countries in connection with the turbulence in the foreign exchange markets last summer, in Italy the downward movement of official rates was not reversed. The tensions were absorbed by liquidity control, exchange rate flexibility and temporary increases in market rates.

Further reductions in the discount rate and the rate on advances in the autumn of 1993 and early 1994 brought them to their current levels of 7 and 8 per cent respectively. There was a parallel decline of 7.5 percentage points in the banks' average lending rate between October 1992 and April 1994; at its current level of 11.2 per cent it is 3 points lower than in the period immediately preceding the crisis. The difference in relation to official and money market rates is wider than it was then, mainly owing to the increased riskiness of banks' assets.

The narrowing of the interest rate differential between Italy and the other European countries fostered a reduction in the banks' external debtor position denominated in foreign currency.

The effective exchange rate of the lira fluctuated widely in 1993. In real terms it was very depressed in the second half of the year, even by comparison with 1987. The limited depth of the lira market and the activities of international dealers disposed to take positions in foreign currency contributed to the variability of the exchange rate. In the first few months of this year the undervaluation of the lira diminished slightly.

The money supply grew by 7.9 per cent in 1993. The expansion was due largely to the growth in the less liquid components, consisting of certificates of deposit; by contrast, there was a steady slowdown in bank lending.

The weakness of the demand for credit justified and to an extent necessitated the policy of reducing official rates and set the parameters for the regulation of market liquidity.

Total finance to the non-state sector grew by a little more than 1 per cent in 1993. The deceleration of 6 percentage points compared with the previous year was due initially to the recession and the fall in investment; subsequently it also reflected the improvement in firms' profit margins.

The public finances

Notwithstanding the adverse economic conditions, further progress was made last year in redressing the public finances. The total state sector borrowing requirement fell from 10.6 to 9.8 per cent of gross domestic product; the surplus net of interest payments rose from 0.6 to 1.8 per cent of GDP.

The progress achieved was less than had been planned, however. Excluding loans deposited with the Treasury, the borrowing requirement overshot the ceiling set in September 1992 by more than 10 trillion lire. The surplus net of interest payments was 24 trillion lire less than the original target. The recession and the failure to carry out the sales of state assets that had been included in forecast revenue contributed to the shortfall.

The innovations introduced in parallel with the budgets for 1993 and 1994 will make it possible to moderate the growth in expenditure and rationalize the public sector.

Unless additional measures are taken, these innovations cannot ensure that expenditure and revenue trends are compatible with a significant reduction in the absorption of savings by the public sector and with the objective of first halting and then reversing the growth in the public debt.

An analysis of the outlook for the public finances must begin with an examination of the underlying tendencies of the main categories of expenditure and revenue.

The ratio of public expenditure to GDP rose from 55.8 per cent in 1992 to 57.2 per cent in 1993; interest on the public debt accounts for 12 percentage points of this figure. The ratio was roughly 50 per cent in Germany, Spain and Portugal and 55 per cent in France, and ranged between 57 and 63 per cent in the Netherlands, Belgium and Denmark. In relation to GDP, overall expenditure and revenue are much lower in the United States, the United Kingdom and Japan, primarily because of the smaller expenditure of the public social security and health care systems.

By international standards, expenditure in Italy is not out of line in the areas of general public services, defence and public order, education, health and welfare; it is higher than the average not only for interest payments but also for pensions, particularly from the standpoint of future outlays.

The public pension system as it now stands was designed at a time when national income was growing rapidly and the age structure of the population was more favourable than today; contributions are now manifestly insufficient to cover benefits. The reform introduced in December 1992 considerably reduced the imbalance between benefits and contributions by gradually raising the age of retirement, lengthening the reference period for computing pensionable earnings and limiting the automatic adjustment of pensions to prices by excluding the indexation of benefits to real wages. Assuming that the link between benefits and rises in real wages is not restored, the savings in expenditure will increase and are estimated by the National Social Security Institute at 25 per cent over 15 years. However, in the absence of corrective measures, the improper burdens placed on the system and the relatively generous criteria for awarding pensions will cause expenditure to continue to grow more rapidly than national income in the years to come.

An international comparison of the size of the public pension system in relation to that of the economy can be obtained by computing the present discounted value of future benefits payable on the basis of existing entitlements. According to estimates by the OECD, the ratio of the resulting value to gross domestic product is 2.2 in France, 1.6 in Germany, the United Kingdom and Japan, and 1.2 in Canada and the United States. In Italy the present value of future commitments fell to 2.4 times GDP following the 1992 reform; according to national statistical sources, the ratio had previously been 3.

The capital that in theory would have to be earmarked to cover current commitments on a funded basis would be equal to around half the national wealth; it is therefore inevitable that benefits will continue to be paid out of current contributions. The growing imbalances in the pension system need to be rectified by further limiting pensions, albeit gradually, and encouraging widespread recourse to a funded supplementary pension system that can enable workers to achieve the desired level of retirement income.

At the macroeconomic level, the combination of a funded scheme with a pay-as-you-go system initially entails an effort to ensure the accumulation of additional savings; appropriate tax treatment is indispensable to this end.

In 1993 the tax burden rose to 44 per cent of gross domestic product, similar to the level in France and Germany; the figure is around 50 per cent in the Netherlands, Belgium and Denmark. After increasing last year, the ratio in Italy will decline by more than one percentage point owing to the expiry of temporary tax-raising measures that yielded revenue of 25 trillion lire a year. The tax rates on households' and individuals' incomes are among the highest by international standards. The rates of tax on corporate income are also high, but account has to be taken of exemptions and allowances, which are particularly large in Italy.

The comparison of tax rates and the average ratio of taxation to GDP confirms the magnitude of tax avoidance and evasion. Measures to rationalize and redistribute the tax burden may be appropriate, but it is essential first to improve the effectiveness of tax assessment and collection, in order to reduce the scale of evasion substantially and permit rates for honest taxpayers to be lowered.

Scope for appropriate measures to support investment, small and medium-sized enterprises and employment must be created by making budgetary savings and bringing tax evaders back into the net. In the present circumstances, reducing the overall tax burden would lead to an increase in the deficit and more rapid growth in the public debt.

In the past, too much reliance has been placed on temporary measures to adjust the imbalances in the public finances. The reduction of the deficit must be based on a configuration of spending procedures that will correct the systematic tendency for expenditure in some sectors to outstrip the growth in national income.

Reducing the ratio of the public debt to national income remains the key to lessening the cost of public borrowing and expanding the room for the growth of private initiative and investment.

The recovery

The trough of the economic cycle was reached in the third quarter of last year; in the fourth quarter GDP was slightly higher both in relation to the preceding quarter and compared with a year earlier. Investment showed signs of reviving after the steep decline that lasted until the summer, but capital spending on construction was still diminishing.

In the first few months of 1994 the data on domestic as well as foreign orders continued to indicate rising demand.

The stability of labour costs, the reduction in interest rates and the depreciation of the lira have led to wider profit margins for the corporate sector.

Export industries are increasing their sales, with the best results being recorded by firms oriented towards the sectors of the American market in which demand is expanding. Exports to the newly industrialized and developing countries have also increased. These areas offer outlets for capital goods and durable consumer goods that are superior to competing products in terms of quality and better meet the needs of purchasers.

Exports will continue to perform well in 1994, permitting a further increase in the current account surplus.

Consolidation of the positions that have been gained in international markets requires a constant commitment to improving the quality of products and developing innovative ones; a new phase of investment is needed, including investment to expand productive capacity, in order to increase productivity and employment.

If the recovery in domestic demand were to lead mainly to higher consumption, the Italian economy would again face the risk of more rapid inflation and balance-of-payments difficulties in the not too distant future.

In this delicate transitional phase and during the foreseeable expansion of economic activity, it is necessary to persevere with policies aimed at further curbing the budget deficit and reducing inflation. An unduly rapid and consumption-led recovery would require immediate adjustments in fiscal policy.

While continuing to sustain economic activity and employment, the central bank is taking care to prevent cost and price pressures from developing. If the behaviour of the economy were incompatible with a non-inflationary recovery, monetary policy would necessarily address the objective of slowing down the rise in prices through a return to higher interest rates.

The banking system and the financial markets

This is a particularly important juncture on account of the changes occurring in the economy and in resource allocation, and in view of the contribution that the banking and financial system can and must provide.

The 1993 Banking Law, which came into force on 1 January 1994, codifies the provisions contained in the 1936 Banking Law and the many measures that had updated and supplemented it, especially in the last decade. The Italian banking system has been brought into line with the Second Banking Directive of the European Economic Community by eliminating the operational and maturity specialization that was at the heart of the previous regime.

Supervisory powers are exercised having regard to the sound and prudent management of intermediaries, competition and the stability and efficiency of the banking system. The purpose of bank capital is to safeguard the stability of the institution and serve as a yardstick by which to measure its operational capacity.

Between June 1993 and March 1994 the Interministerial Committee for Credit and Savings, which is chaired by the Minister of the Treasury, took the necessary decisions to permit the new operational opportunities opened up by the Law to be exploited without delay.

Banks have been given wider scope for medium and long-term lending, the issue of bonds and investment in non-financial enterprises, while firms have been granted increased access to the capital market.

The legislation modifies the form and range of banking intermediation; it promotes the development of a deep and efficient securities market able to supplement the financing of the economy by the banks.

The changes in the structure of the banking system and the supervisory activities performed in the course of the year are described in the Annual Report.

The economic cycle and the capital situation of the banks

Lower company profits, increased corporate indebtedness and higher interest charges characterized the situation facing banks at the beginning of 1993.

In 1992 the Company Accounts Data Service held information on some 34,000 non-financial enterprises, which are the recipients of about half of total bank lending to firms. Of these, no fewer than 8,000 reported operating profits that were insufficient to cover their interest charges; in 1993 a quarter of their indebtedness was under strain owing to liquidity or solvency problems. A number of large industrial groups experienced particularly severe difficulties and the adverse situation also began to affect firms in the services sector.

The deteriorating condition of the corporate sector was reflected in an increase in the risk attaching to bank loans. Bad and doubtful debts were equal to 6.2 per cent of total lending at the end of 1993, rising to 7 per cent in March of this year. This is a high level, but not out of line with previous peaks.

Bad and doubtful debts will continue to increase for some time, owing to the lag with which borrowers' difficulties are reflected in banks' balance sheets. Nevertheless, the outlook for firms is clearly improving: heightened competitiveness, the slow rise in labour costs, the reduction in interest rates and the first signs of economic recovery promise greater profitability and sounder corporate finances.

The increase in credit risk is not a purely Italian phenomenon. The banking systems in the United Kingdom and the United States are slowly overcoming the difficulties of recent years; in France, Germany and Spain there are signs of a deterioration in the quality of bank assets in connection with the recession.

In Italy the strengthening of banks' capital bases since the previous recession, from 15.9 per cent of loans in 1983 to 19.4 per cent today, has enhanced their ability to cover losses. In March 1994 bad and doubtful debts amounted to 37 per cent of own funds, close to the highest levels recorded in the early eighties.

Banks were able to facilitate the restructuring of the liabilities of industrial groups in difficulty by lengthening loan maturities, lowering interest rates and waiving part of the arrears of interest. The supervisory authorities examined four plans providing for the partial conversion of debt into equity capital. In respect of loans amounting to about 26 trillion lire, banks acquired shareholdings valued at 2.4 trillion lire, wrote off about 1.4 trillion lire against profits for 1993 and foresee further write-offs with a present value of not more than 1 trillion lire in subsequent years. Other debt restructuring plans involve firms with about 34 trillion lire in debts to Italian banks.

The ability of banks to continue to support fundamentally sound undertakings when times are bad and to finance investment once recovery has begun depends on their profitability and capital base. After declining in 1992, operating profits improved in 1993, rising from 1.38 to 1.63 per cent of total assets, thanks to capital gains on securities trading and the containment of operating costs. Much of the result was erased by loan losses and higher taxes.

It is easier for banks in the form of limited companies to raise equity capital; the market provided virtually all of the 10,020 billion lire in new capital as calculated for supervisory purposes, a rise of 6.4 per cent with respect to the previous year.

The capitalization of the Italian banking system is in line with the average for the other leading countries. The number of banks that failed to meet the minimum capital requirement fell from 19 to 15 last year, and the total capital shortfall decreased from 750 to 400 billion lire; the excess capital held by banks satisfying the requirement rose from 50 to 60 trillion lire.

A crisis at a bank has more severe secondary effects than the failure of any other enterprise, owing to the typically high ratio of loans to capital. Such a crisis may even have repercussions for economically sound undertakings financed by the bank. The protection of savings and good management of the economy require that performing loans, which usually far outweigh bad debts, be safeguarded even if the credit institution cannot be saved; viable loans must be transferred to banks with the capital and management abilities to use them to best advantage. The resolution of the crisis does not prevent the total or partial loss of capital, the replacement of the directors and the prosecution of those who may be responsible.

Intervention by the supervisory authorities is aimed at preventing crises from spreading to other intermediaries. Each such operation moves the system towards a structure that is stronger and better suited to the needs of the economy, but without being part of a predetermined plan for bank amalgamations.

The larger the bank involved, the more difficult it is to arrange a merger. In 1993 and early 1994 the absorption of troubled banks by other institutions involved larger undertakings than in the past; an estimated 4 per cent of the Italian banking sector was placed under sounder management. In some cases transfers of ownership took the form of the sale of parts of an institution or components of a group. Financial support was also sought from a plurality of banks to cover the lengthy process of restructuring.

The new operational opportunities

The new banking legislation should help create more unified, better informed and more stable relationships between banks and individual firms or groups.

The prospect of increased access to the capital market by non-financial enterprises makes it all the more important for banks to have a thorough knowledge of the structure of the groups with which they deal.

The ramified, international and at times extremely complex organization of some industrial groups makes it more difficult for intermediaries to know the final destination of credit and hinders the accurate appraisal of firms' finances; this should prompt banks to seek the information necessary to limit the concentration of risks.

Most industrial concerns with more than 100 employees belong to a group. In collaboration with the Bank of Italy, Consob is planning to organize information on shareholdings in a manner that will be useful for those who require it, and especially for banks in connection with their lending operations.

The widespread practice of borrowing from more than one credit institution is only partly attributable to the small average size of Italian banks. It may help spread credit risk and enhance competition, but the fact that most firms do not have a principal bank reduces the credit system's ability to exert a degree of discipline over enterprises that is consistent with the total volume of lending.

The greater scope for banks to hold shares in non-financial enterprises and to provide long-term finance should help them acquire more detailed information on investment plans and prompt them to improve the assessment of creditworthiness.

The volume of shares that banks may acquire, given the size of their capital and their existing investments, amounts to about 39 trillion lire. The increase in long-term assets permitted by the regulations totals 150 trillion lire. The non-financial enterprises covered by the Company Accounts Data Service have fixed assets worth about 50 trillion lire financed by debt that is formally at short term.

A significant number of banks have sufficient capital to take full advantage of the opportunities offered by the Banking Law. Appropriate professional resources and organizational structures are necessary. The opening of the Italian economy to foreign competition and the greater finance Italian businesses will require during the period of development and profound transformation that must take place in the coming years demand an adequate response from the banking system.

The financial markets

The gain in competitiveness associated with the depreciation of the lira offered firms the opportunity to eliminate accumulated competitive disadvantages by making new investment. The restructuring carried out in the last decade, which concentrated largely on process innovation, enabled firms to maintain their positions in traditional sectors but did not improve the position of high technology industries.

Endemic lags and cyclical factors combined to produce the present generally unsatisfactory financial situation of businesses large and small, despite an improvement in the last year.

Sustained investment in fixed capital and research calls for a flexible and efficient financial system. The market offers firms a competitive environment in which to seek capital; at the same time it provides an assessment of their efficiency by assigning them a market value.

Banking continues to play a crucial role, which cannot be limited to ordinary lending but must also include corporate finance and advisory services. Without well-developed financial markets, cyclical downturns and structural change may have especially serious repercussions on the stability of individual banks and much of the banking system. Greater recourse to the capital market in addition to bank credit gives firms a better balanced financial structure and spreads risk more widely through the flexibility provided by variations in securities prices. In order to ensure that investors have a substantial and lasting commitment to the enterprises they finance, they must be assured of adequate long-term returns; firms must implement policies of transparency and disclosure, which are also necessary to achieve higher levels of efficiency.

The capital market in Italy has made considerable progress. The ratio of Italian firms' market capitalization to gross domestic product rose from 6 per cent in the early eighties to 15 per cent in 1993. However, international comparisons confirm that Italy still lags behind other economies, even those in which banks play a major role.

The contribution of risk capital to the financing of firms in Italy is no less than in the other leading economies; the peculiarity of the Italian situation lies in the limited role of the official market. Listed companies accounted for 15 per cent of the total net worth of non-financial enterprises in 1992. A large number of companies satisfy Consob's minimum requirements for admission to the stock exchange: 1,700 of the non-financial enterprises covered by the Company Accounts Data Service, including 600 medium-to-large firms, with a total net worth of more than 55 trillion lire.

The privatization of publicly-owned assets is an important element in raising the efficiency of the economy; it is also an opportunity to increase the breadth and quality of the official market. Sound companies with good earnings prospects should attract large numbers of small investors.

The development of the capital market, and especially the equity market, may be boosted by the spread of funded supplementary pension schemes, which invest the contributions they receive. Pension funds will encourage capital formation by generating large and steady flows of savings and will facilitate the reallocation of households' wealth towards longer-term financial assets.

The banks can make a decisive contribution to the development of the financial market by exploiting the scope offered by the new legislation. Intermediaries have important functions to perform in connection with the greater opportunities for firms to issue debt securities: bringing profitable firms to the market, organizing issues and their placement with customers and guaranteeing the securities of unlisted companies.

A broad and robust market will be a source of funds for the banks themselves as they seek to strengthen their capital bases.

The ratio of total financial assets to gross domestic product has risen only slightly in Italy in recent decades. The financial assets held by households and businesses were equivalent to about twice GDP in 1992, similar to the figure for Germany. In the same year, the ratio was nearly four times GDP in Japan and more than three times GDP in France, the United States and the United Kingdom.

There is considerable room for growth, as the ownership of shares in firms directly or through intermediaries is still limited and the volume of private bonds in issue is small; the value of real estate directly owned by households is especially large. Financial intermediation can be expected to intensify in response to the increased circulation of the various forms of wealth.

The Bank of Italy has taken an active role in the organization of the markets most closely related to its responsibilities for monetary control. It has collaborated with the Treasury and Consob in developing a broader and more efficient market for private securities.

In the last twenty years the international capital markets and the financial sector in general have recorded a considerable rise in the volume of business, accompanied by the emergence of new market participants and instruments. These developments have permitted better risk management and fostered the creation of highly liquid markets; however, they have also provided ample scope for speculative activity. They pose new problems for the supervision of the banking system, on which the other markets are ultimately based, and that of other intermediaries and the markets themselves.

In view of competition from more advanced economies in a regime of completely free capital movements, Italy must raise the quality of its financial services substantially. The development of a complex financial industry requires considerable investment in organization and human capital. Success in facing this challenge can only redound to the advantage of the Italian economy as a whole.

Ladies and Gentlemen,

The difficulties encountered by the industrial economies in recent years are the result of far-reaching changes in the organization and composition of production.

Monetary policy has been more decisive in repressing inflation, in the light of the damage the latter has caused in the past and as a reflection of changes in intellectual approach. In the late eighties and early nineties monetary policy was instrumental in regaining control over prices, but because of the deficiencies of other economic policies it left a legacy of high interest rates. The scale of budget deficits and, above all, the increase in debt constrained the conduct of monetary policy, thereby contributing to the high level of interest rates. The already large number of persons without work was swollen by a substantial element of cyclical unemployment.

The imbalances between the different areas of the world economy have become more pronounced; monetary policies alone cannot correct them, even if they are actively pursued at national level and coordinated internationally. Exchange rate adjustments between the leading currencies have been substantial, but not sufficient to eliminate the imbalances. On occasion, exchange rate movements have become disorderly and have adversely affected national policies, especially in small and medium-sized countries.

There is an urgent need for a profound re-examination of the relationship between monetary, structural and budgetary policies at national level, and between economic policies at international level. Closer coordination is necessary to improve the utilization of labour, plant and potential savings and to counteract cyclical variations generated by market forces.

The recent world trade agreement, which brought the long-running Uruguay Round of negotiations to a close, offers the prospect of further substantial improvements in efficiency; its implementation also makes it necessary to tackle the problems of restructuring in sectors where competitiveness is weakest.

The European Union's White Paper on growth and employment calls for substantial investment in infrastructure, improvements in the allocation mechanisms of the labour market and full implementation of the single market; if promptly implemented, it could help reduce cyclical unemployment, as well as having an impact over the medium term.

The trade agreement and the European Union's plan could strengthen and prolong the recovery in Europe, which is still weak.

Nineteen ninety-three was a doubly difficult year for the Italian economy. The cyclical and structural problems due to developments in the world economy were compounded by domestic problems arising from the need to make large adjustments in the public finances and prevent the depreciation of the lira from affecting prices.

The fall in the exchange rate could have caused an upsurge in domestic inflation. In a country that has been afflicted by inflation many times in the past, this would have damaged the performance of the economy for years to come; it would have led to a renewed rise in interest rates, created the risk of a financial crisis, seriously harmed the public finances and undermined the stability of businesses and banks.

The scale of the public finance measures and the severity of the monetary restrictions prevented a rekindling of inflation and thus allowed the slowdown in prices to continue. The new agreement on labour costs and the depressed state of consumer spending had a positive effect.

The cost of the crisis and of the subsequent stabilization measures was high; the contraction in households' consumption, disposable income and saving and the fall in investment were without precedent in Italy over the past four decades. The distribution and size of the fall in employment confirm that the cost of the crisis and the reduction in living standards are heavily concentrated in the poorer regions of the country and among certain social groups.

Had the economic measures I have described not been taken, the harm to the economy would have been greater.

Looking to the future, the profound changes of the past year and the crisis itself can be viewed as an opportunity to adjust the major aggregates of our economy and initiate a period of growth.

The economic problems that could re-emerge if the growth in demand were predominantly consumption-led, and hence once again had an adverse effect on the balance of payments and inflation, and the need to tackle them by means of resolute fiscal and monetary measures, make it essential to ensure that the recovery, which is already well under way in the export sector, spreads to private and public capital formation as well.

Continued efforts to balance the budget, a favourable export performance and a reduction in the country's external debt are fundamental preconditions for channeling savings into productive investment, stimulating a lasting economic recovery and consolidating the value of the currency.

The maintenance of wage restraint, which has been confirmed in the pronouncements of trade union and political representatives, remains essential to prolonging the period of stability in unit labour costs; it could reduce inflation, which has not yet been eradicated from our economy, to the lowest levels in Europe.

Correct credit allocation by the banks performs a crucial role in non-inflationary growth. If the purchasing power generated by lending translates into productive activities and investment that increase the supply of useful goods, monetary expansion will not have a harmful effect; indeed, it will reduce inflation.

The recent lowering of reserve requirements is a further contribution to reducing the cost of corporate credit, particularly that of longer-term borrowing and investment finance and especially for small and medium-sized firms with a higher labour intensity.

Unemployment in some regions of southern Italy has reached levels similar to those experienced in the immediate postwar period. Unemployment is now less bearable owing to the differences in economic and social status between those in work and those who feel excluded from all opportunities for productive employment. Prolonged unemployment among the young is an enormous waste of human resources and has detrimental effects on the social structure and on the sense of participation in society and community life, and in extreme cases provides recruits for organized crime.

The ultimate purpose of the economy can only be to permit all those able to contribute their labour to participate in the creation of national wealth.

Our nation has the entrepreneurs and labour necessary to achieve sustained growth, and our saving rate is among the highest in the world. New investment is needed to release the potential saving inherent in the underutilization of resources. A transfer of funds amounting to only a few percentage points of national income from the current budget deficit to investment would substantially increase the stock of productive capital.

A resumption in public works projects would contribute to the recovery in investment and employment. Even in the more prosperous parts of the country, let alone the less developed areas, there is a long-standing need for an increase in infrastructure, with which Italy is poorly endowed by comparison with its competitors in Europe. In this domain, the improper use of public money has borne all too heavily on the level, quality and efficiency of public expenditure. The principles and guidelines underlying standards of good conduct and the selection of projects itself must be based entirely on appropriate procedures established by authorities whose sole objective is to serve the common good.

Acting exclusively in the national interest, the Bank of Italy remains vigilant to prevent any erosion of the value of the currency with the aim of contributing to the orderly development of the economy.

Bank deposits constitute a large proportion of the money supply. The soundness of this component of money, both domestically and externally, is assessed in terms of the quality of the loans they finance. Banking supervision, which the new Banking Law has made more consistent with the needs of the economy, is designed to ensure that lending is conducted in accordance with the principles of efficient resource allocation and directed towards sustaining output.

The Bank traditionally combines its tasks in the fields of monetary policy and banking supervision with analysis and advice to foster the growth of the economy and the development of society. In all the international organizations and bodies in which it is represented, the Bank plays its full part in seeking to promote the growth of the world economy, in which Italy is ever more closely integrated.