BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1997

THE GOVERNOR'S CONCLUDING REMARKS

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Since the time of the last Annual Report, the economic variables that are the main objectives for the operations of the central bank have improved significantly.

Producer prices have remained broadly unchanged; consumer price inflation has fallen from 4 per cent in the early months of 1996 to 2 per cent. The effective exchange rate of the lira has remained stable.

Yesterday the reserves of the Bank of Italy and the Italian Foreign Exchange Office stood at 114.9 trillion lire, of which 41.6 trillion consisted of gold.

The yield on ten-year Treasury bonds has fallen from an average of 9.7 per cent in May 1996 to one of 7.3 per cent in May of this year. The official discount rate has been lowered in three stages from 9 to 6.75 per cent.

On 25 November the lira rejoined the Exchange Rate Mechanism of the European Monetary System at a central rate of 1,906.48 lire to the ecu and 990 lire to the German mark.

Supervision of the banking system and the financial markets has remained intensive. Last year 200 inspections of banks and financial intermediaries were undertaken, an activity that involved 450 officials in the Central Inspectorate and the branches.

The Bank currently employs a staff of 9,200, the same number as in the second half of the eighties. The personnel engaged in operational activities is tending to decrease as a result of automation. Close attention is being paid to the selection and development of specialist staff and to both initial and subsequent training.

At every level of the Bank there is a keen awareness that the tasks of the institution must be performed in accordance with principles of economy.

A corporate plan has been drawn up in order to define the objectives of administrative activities more precisely and to plan the use of resources effectively. It will come into effect in 1998 and will cover a period of three years; it will be reviewed and revised annually.

The information set out in the Bank's budget estimates has been increased and the coordination between the various stages in the procedure for the approval of expenditure has been improved. Accounting procedures are being modified in line with the requirements laid down by the European Union.

The organization and technical facilities of the branches have been strengthened. Our network of offices throughout the country enables us to gain a better knowledge of the economic situation in each region, to improve the services we provide and to work productively with businesses and local authorities.

The programme of measures to improve the quality of currency in circulation, which is being implemented in cooperation with the banks, is nearing completion. The issue of banknotes in denominations of 500,000 lire, which will be introduced next September, forms part of this programme.

The Bank publishes information and analyses on the performance and prospects of the economy and the financial system and on the conception and implementation of economic policies, thereby simultaneously fulfilling its obligation to give public account of its operations. The publications produced for this purpose – first and foremost the Annual Report, the Economic Bulletin and the Statistical Bulletin – are being enhanced.

The Bank is cooperating increasingly with the authorities in the fight against financial crime, for the good of the country and the international community.

The Bank is actively involved in the preparations for Italy's participation in Economic and Monetary Union.

The personal qualities and professional skills of the staff are a resource placed at the service of the Bank and the country. On behalf of the Board of Directors, I wish to express our gratitude and appreciation to the staff of every grade and rank for their work during the past year and for the continuous commitment they displayed in performing the tasks entrusted to them.

On 10 April of this year the Deputy Director General, Tommaso Padoa-Schioppa, was appointed Chairman of the Companies and Stock Exchange Commission. He joined the Bank in 1968, working initially in the Research Department; he subsequently occupied many important positions in international organizations on behalf of the Bank and in the interests of the country.

In 1984 he became a member of the Directorate, where he had responsibility for projects aimed at improving the Bank's information facilities and developing the payment system.

Over the past four years he had responsibility within the Directorate for monitoring the foreign exchange markets and activities in the money and financial markets.

From 1993 onwards he was Chairman of the Basle Committee on Banking Supervision, made up of representatives from the Group of Ten countries.

We wish to express our gratitude to Dr. Padoa-Schioppa for the valuable contribution he made to the performance of the Bank's institutional functions, especially as regards monetary policy decisions.

We wish him every success in his new post. We are certain that together with the other members of the Commission he will make a decisive contribution to the development of the Italian financial system.

On 11 April the Board of Directors appointed Antonio Finocchiaro, the Secretary General, to the post of Deputy Director General.

The world economy

Exchange rates, the business cycle and economic policies

Developments in the foreign exchange market were more orderly last year, with limited fluctuations in the exchange rates of the leading currencies.

It is to be hoped that the turbulence of the European market in the past few days will rapidly subside.

In 1996 the dollar, sterling and the lira appreciated by 5, 15 and 9 per cent respectively, reversing the previous trend. The yen continued to fluctuate widely, depreciating by 14 per cent between the end of 1995 and April of this year and recovering significantly since then to a more realistic level against the dollar. The mark and the French franc weakened moderately.

The appreciation of the dollar and sterling became more pronounced from late 1996 onwards in connection with the continued upturn in the United States and the United Kingdom and the widening of short-term interest rate differentials vis-à-vis the other currencies.

The expansion that has been under way in the United States since 1992 continued without jeopardizing price stability. Investment, which was intense in the high-technology sectors, sustained the economy's growth of 2.4 per cent in 1996 and boosted productivity, especially in industry. The brisk pace of investment is at once a consequence and a cause of the high return on capital and the favourable level of business confidence.

The improvement in the public finances, which had been initiated in recent years with the benefit of a growing economy, allowed greater freedom of manoeuvre for monetary policy. However, the deficit on the cuiTent account of the balance of payments increased and external debt continued to mount.

The expansion of the US economy spilled over onto most of the countries integrated with it commercially, especially those in Latin America. In the United Kingdom the pace of growth moderated, but nevertheless exceeded that achieved by the other European countries.

The growth in activity was again disappointing in continental Europe — around 1.5 per cent in Germany and France and barely 0.7 per cent in Italy. The gain in competitiveness against the dollar benefited exports; it did not promote a significant recovery in production.

In Japan output revived strongly at first under the stimulus of the fiscal measures adopted towards the end of 1995 and a monetary policy that has long been expansionary, but it gradually slackened in the course of the year. The prospect of a deficit in the social security system and an increase in public debt due to the ageing of the population is giving rise to concern.

In the United States the creation of almost 2.5 million jobs, which was fostered by the market's flexibility, sustained demand and made it possible to reduce the unemployment rate further in spite of an increase in the supply of labour.

In continental Europe the number of workers in industry continued to contract. The growth of the service sector prevented total employment from falling.

Further measures to reduce budget deficits were taken in most of the industrial countries. General government net borrowing diminished from 5 to 4.3 per cent of gross output in the European Union; the balance excluding interest payments turned slightly positive.

Inflation continued to subside. Consumer prices rose by an average of 2.3 per cent over the year in the industrial countries as a whole and by 2.5 per cent in the European Union. The fall in inflation was substantial in the developing countries.

The progress made in the past few years is the result of monetary policies firmly aimed at restoring the stability of the value of money on an enduring basis. Wage restraint, keener competition in the global market and technological advances have contributed in this regard. There are still risks, however. Long-term interest rates in the industrial countries remain high, in real as well as nominal terms.

Monetary policies were eased in 1996, thanks to the restrictive stance adopted in earlier years and in response to the progress towards fiscal consolidation and greater exchange rate stability.

A more cautious stance was adopted in the United States and the United Kingdom in view of the sustained increase in aggregate demand. Inflation expectations generated by the growth in activity provoked a rise in long-term yields in the first half of the year, which checked the decline in those in the other leading financial markets. In the second half of the year long-term rates fell markedly in the industrial countries where yields where highest, such as Italy, Spain, Sweden and Canada; the reduction in budget deficits and, in Europe, expectations that monetary union would be achieved gave impetus in this direction.

In the countries with more stable currencies, monetary policy had the effect of lowering the yields on shorter-term securities and allowed the currency to depreciate against the dollar. The yield curve took on a steep upward slope, especially in Germany.

The decline in interest rates in the European markets during 1996 was facilitated by the non-restrictive monetary policy in the United States and the strongly expansionary stance of the Japanese central bank.

In the United States, fears of inflation due to the acceleration in demand were reflected in a rise in long-term rates in the early part of this year and prompted the monetary authorities to raise the federal funds rate by 25 basis points at the end of March. This caused a temporary reversal of trend in all markets; long-term rates have now fallen back close to the values recorded in the days before the move by the Federal Reserve.

Real long-term interest rates are well above the rate of economic growth in all the industrial countries. As a result, the ratio of public debt to GDP is tending to rise, especially in continental Europe. In Italy, the heavy burden of public debt on the economy began to decrease in 1995, thanks to the increase in the primary budget surplus.

The European economy and the globalization of markets

The performance of the European economies in recent years has reflected the slowdown in households' disposable income caused by modest wage growth and declining employment on the one hand and the reduction in budget deficits on the other. Fiscal policies have been tightened in order to satisfy the criteria laid down in the Treaty on Economic and Monetary Union.

The corrective measures taken to date do not appear sufficient to achieve structural budgetary consolidation in most of the leading countries. The prospects for growth remain uncertain; investment in Germany and France, which had recovered in 1994 and 1995, diminished slightly last year.

The European Union's balance of payments on current account with the rest of the world showed a small surplus in 1996. Among the results for individual countries, the most outstanding are the surpluses recorded by France and, above all, Italy. Germany again ran a deficit.

According to estimates from international organizations, the Union's current account surplus will increase slightly this year.

In the light of the relatively depressed state of economic activity, the improvement appears modest; it reflects a structurally inadequate capacity to compete.

From 1992 to 1996 the economy of the European Union grew by 8 per cent, that of the United States by 14 per cent. The output of the newly industrialized countries of Asia rose by 38 per cent.

In the last ten years world economic growth has been driven by trade in goods and services, which has expanded at twice the rate of output.

The acceleration in the imports and exports of the newly industrialized countries is the long-term effect of the trade liberalization resulting from the Tokyo Round agreements of 1979.

In the first half of the eighties there had been a pause in the expansion of the world economy and trade, in connection with the new monetary policy stance in the United States. In the second half of the decade the fall in inflation and the consequent easing of monetary conditions allowed economic activity to recover.

The exports of the developing countries have grown at an annual rate of 10 per cent since the mid-eighties, despite being constrained by tariff and non-tariff barriers.

In 1996 world trade in goods and services exceeded \$6 trillion, equal to around 20 per cent of the value of world output.

The growth in world trade has been accompanied by a rapid increase in direct investment by US, Japanese and European firms in other industrial countries and in the developing economies. In 1996 these flows amounted to almost \$300 billion.

The turnover of multinational companies' foreign subsidiaries and factories, which account for a substantial proportion of direct investment, exceeds the value of world trade. Most of their output is intended for the local market. A conspicuous share of world trade – more than 50 per cent – is attributable to the multinationals.

In the seventies the United States accounted for more than 40 per cent of direct investment; in the nineties it still provides around one third of the total flow.

Japanese overseas investment grew rapidly in the eighties and now represents around one tenth of the total. The share of operations originating in the London financial market stands at approximately 15 per cent. Direct foreign investment by German firms has increased considerably, and that by French enterprises even more markedly. The amount coming from Italy is small, ranging between $5 billion and $10 billion a year.

Since the end of the eighties direct investment between the countries of the European Union has increased significantly as a result of the progressive implementation of the single market.

The prolonged industrial growth that had produced gains in both productivity and employment in the industrial countries gradually slackened in the course of the eighties. In Europe demand for consumer durables and capital goods entered a period of stagnation, owing in part to the low rate of demographic growth and the steady ageing of the population.

In the current decade industrial production has continued to increase at a rapid pace in the United States, whereas it has slowed down in Europe. Industrial output in the United States is now 15 per cent higher than it was in 1992; in Germany and France it is unchanged with respect to the initial levels. In Italy and the United Kingdom it has grown appreciably since the early nineties, partly as a result of the depreciation of the currency.

Europe has displayed much less ability to create jobs than the United States. The number of employed workers has risen by barely 0.3 per cent a year since the beginning of the nineties, compared with 1.1 per cent in the United States. The number of persons out of work in the European Union, which already stood at 12 million in 1990, rose to 19 million in 1996 and from 7.8 to 11 per cent of the labour force.

Europe's unsatisfactory performance reflects both the smaller rise in employment in market services and the larger decline in the number of industrial workers.

The faster growth in employment in the United States has been facilitated by the flexibility of the labour market and of employment conditions; it has been accompanied not only by low growth in real wages, but also by increasing inequalities.

The developing countries' share of world output has risen rapidly in the past ten years, reaching 40 per cent in 1996. The penetration of EU exports in these countries is declining; the positions of the United States, especially in Latin America, and of Japan in Asia are still dominant.

Competition from the emerging market economies is becoming keener. It is gradually spreading from labour-intensive goods to high-technology products and in the future will extend to business services. These countries have the advantage of very low labour costs; the quality of human capital in several of them is not much lower than in the European economies.

Trade in services is set to grow more rapidly than trade in goods, thanks partly to further liberalization. This will give fresh impetus to the expansion of commerce and the reduction of costs. Competition will enhance consumers' purchasing power and welfare.

The intensification of trade will continue to propel the world economy. The improvement in living standards in the emerging market economies will offer industry in the advanced countries opportunities for a new season of growth. The trend now under way will lead to a geographic redistribution of new investment; it will force the developed countries to review the organization of production and reshape their institutions.

A global financial system

The liberalization of capital movements has contributed to very rapid growth in domestic and international financial assets. After increasing swiftly in the second half of the eighties, they rose from 5 to nearly 6 times the value of annual output between 1990 and 1995.

The financial assets held by residents of the leading industrial countries amount to more than $100 trillion, 90 times the GDP of Italy and almost 15 times that of the United States. A growing share of these assets, equal to some 10 per cent of the total, involves counterparties resident in different countries.

Dollar-denominated assets make up around half of the total; this accounts for the international importance of the Federal Reserve's policy.

The growth in banking business has more or less kept pace with that in economic activity.

The activity of the institutional investors of the industrial countries has become much more extensive. They manage and allocate funds amounting to more than $20 trillion worldwide. The volume of resources intermediated is growing rapidly, at an annual rate of 13 per cent. Cross-border investments in shares and bonds total more than $3 trillion.

The scale and worldwide scope of these investors' operations condition developments in national markets.

The prices of financial instruments in the global market reflect underlying trends in the leading economies, first and foremost the United States, and those in the countries of issue. Increasing integration has led to greater uniformity of long-run financial trends and cycles than was the case in past decades.

Institutional investors are able to modify the composition of their portfolios swiftly; they give depth to the market and significance to the prices of financial instruments, and contribute to more efficient resource allocation. When expectations change abruptly, they adopt a uniform stance, giving rise to one-way movements that in extreme cases may overwhelm the markets.

A healthy external position with inflation and public debt under control and an economic policy directed towards stability enable national economies to benefit from being part of the global market, in terms of the availability of funds and the cost of borrowing, thus attenuating the repercussions of sudden reversals of trend.

The current configuration of the international monetary system is similar to that which obtained at the national level during the initial development of banking and financial systems. The experiences of the early decades of this century down to the Great Depression of the thirties led all countries to adopt specific regulations for banks and the financial sector; the central banks' powers of supervision and monetary control were strengthened.

The abandonment of even the indirect link to gold in 1971 and the liberalization of bank as well as non-bank capital movements in a system with purely fiduciary money have created a situation for which there is no historical precedent, bringing notable benefits but also risks, problems and new financial factors of instability.

The risks must be tackled by means of rigorous monetary and budgetary policy in each country, by reinforcing international cooperation, by establishing more effective coordination in the foreign exchange markets and scrutinizing them more closely, and by extending banking and financial market supervision to the emerging market economies and harmonizing it within the limits permitted by the great variety of legal arrangements.

The European monetary and financial area

The creation of an efficient area for European finance, the endeavour to establish stable exchange rate relationships within the area and the prospective introduction of a single currency are designed to restore growth with stability in the economies of the Union. These developments should be viewed in the context of the wider scenario that has been taking shape in the world economy.

The financial assets held by the four largest EU countries represent around one quarter of those of the leading industrial countries. With the achievement of monetary union and the convergence not only of the economies of member countries but also of their institutions and legislation, the European financial area will be able to present itself as a force for stability in the wider framework of the international monetary system.

Significant progress has been made in the implemention of the single market; Community legislation on the freedom of movement of goods, persons and savings and the provision of banking and financial services is being transposed into national law. Increasingly close cooperation has been established among supervisory authorities.

The homogeneity of the EU economies is founded first and foremost on the stability of the value of money in each country. The progress of the last few years must be consolidated. It is necessary to continue to reduce budget deficits, not least in order to allow fiscal policy to be used more flexibly again. It is essential to break down the barriers to labour mobility, which are primarily institutional and cultural. It is indispensable and urgent to harmonize the regulations and tax treatment applied to companies and savings.

The European economy as a whole does not appear capable of ensuring the full employment of productive resources in conditions of internal and external stability. Efforts to secure sustainable equilibrium must not rely on depreciation of the currency, especially against the dollar.

The way to enhance the prospects for growth is to increase the competitiveness of the European economy through product innovation, new methods of organizing production and the development of technologically advanced services.

The tax and contributions burden in Europe is around one third higher than in the United States and Japan; far-reaching reform of the social security system is necessary in order to make the cost sustainable over the long term and to ensure distributional fairness.

Decisive action is needed to bring labour contracts into line with the changing and more competitive climate prevailing both in Italy and in the world economy.

The measures our country must take with regard to the budget, employment conditions and legislation on business activities are dictated by the new configuration of commercial and financial relations in the global market. The economy will have to become more responsive if it is to return to a path of sustained growth in these new conditions.

The Italian economy

Exports and the balance of payments

The recovery in competitiveness following the withdrawal of the lira from the European Exchange Rate Mechanism enabled exporters to take advantage of the expansion in world demand and to regain market share, to the benefit of output.

Exports increased strongly until 1995, rising by 35 per cent in volume terms by comparison with 1992.

The lira rejoined the ERM last November. At the time of re-entry, competitiveness was 8 per cent higher than in 1992 on the basis of producer prices and 15 per cent higher in terms of labour costs. The rise in profit margins from the low level of the early nineties impeded disinflation and curbed consumer spending; however, it strengthens the financial position of Italian firms and in the long run enhances their competitiveness.

Last year the volume of exports remained at the same level as in 1995, owing partly to price increases applied in foreign markets. Sales within Europe, which account for 55 per cent of the total, were affected by the weakness of demand, but those to non-EU countries continued to increase.

In view of the weakness of domestic demand, the slowdown in exports translated directly into a contraction of output in all branches of manufacturing industry.

Average daily output was 3.2 per cent less than in 1995, and declined steadily throughout the year; in the fourth quarter the fall in relation to the same period of 1995 was nearly 6 per cent. The contraction was accentuated by the simultaneous downturns in Italy and in other continental European countries, both overall and at sectoral level. Expenditure on capital goods and consumer durables was weak everywhere.

The slowdown in domestic demand affected the volume of imports, despite the greater competitiveness of foreign goods. Imports decreased by 3 per cent last year, after having risen by more than 8 per cent in 1994 and nearly 10 per cent in 1995; they declined steadily and continuously until mid-year.

The appreciation of the lira contributed to a significant improvement in the terms of trade.

The current account of the balance of payments has been in surplus since 1993 owing to the increase in exports as a share of total demand. The surplus increased to 63 trillion lire last year, or 3.4 per cent of GDP. Merchandise trade produced net inflows of 94 trillion lire.

Strong competitiveness is a guarantee for the soundness of the lira, to the benefit of incomes and interest rates. The continued ability to compete depends above all on the stability of unit production costs.

The external position and the exchange rate

Italy's net debtor position vis-à-vis the rest of the world should be eliminated this year. It emerged in the second half of the eighties, fueled by budget deficits and increases in nominal incomes far in excess of productivity growth, and rose steadily to 11 per cent of GDP at the end of 1992.

Public debt held by non-residents, mainly in the form of government securities purchased on the domestic market, rose from 110 trillion lire at the end of 1992 to 420 trillion last year.

The net external position of the private sector, comprising households and firms, had already returned close to zero by the end of 1993.

The foreign exchange deriving from the current account surplus and foreign investment in Italy was used initially to reduce firms' foreign indebtedness; households and firms subsequently also increased their holdings of foreign securities and financial assets. The private sector's net external creditor position rose from 96 trillion lire at the end of 1994 to 187 trillion in 1995 and 250 trillion in December of last year.

The foreign currency component amounted to the equivalent of 120 trillion lire at the end of 1995. In 1996 most of the additional funds generated by the trade surplus were invested in lira-denominated assets abroad.

From the summer of 1995 onwards firms steadily increased their sales of foreign exchange, contributing to the exceptional recovery of the lira. Total sales intensified last year in response to the clarification of the political situation, the confirmation of the restrictive fiscal stance and the firmness of monetary policy.

By the end of 1995 the effective exchange rate of the lira was 13 per cent above the low point reached in March of that year; it rose by a further 9 per cent in 1996.

Last year the central bank acquired a large part of the foreign exchange inflow deriving from the current account surplus and substantial inward portfolio investment, net of the outflow for the purchase of external financial assets.

Reserves worth over 60 trillion lire in dollars and German marks were purchased in the market. These interventions did not prevent the gradual appreciation of the lira. Part of the foreign exchange was used to meet the needs of government. The net short-term creditor position of the Bank of Italy and the Italian Foreign Exchange Office in foreign currency improved by 42 trillion lire; 7 trillion lire of the increase represented the repurchase of official ecus utilized in 1992 to defend the lira, about 27 trillion lire consisted of a reduction in liabilities in respect of currency swaps and 8 trillion lire represented an increase in liquid assets.

The purchase of lira-denominated external assets by firms and households, an increase in investment in Italian securities by non-residents and an expansion in Italian banks' international operations contributed to the development of the eurolira market, aided by the prospect of a stable lira exchange rate and the trend in yields.

The eurolira market has now grown to over $240 billion. This larger and more efficient market enhances the liquidity of lira-denominated instruments. Under normal circumstances it attenuates exchange rate fluctuations and has a moderating influence on interest rates. It increases the growth potential of Italian businesses.

Italy is now on the verge of achieving a net external creditor position. The savings accumulated in the economy will once again exceed the very large public debt and the stock of private real assets.

The abundance of savings, the stability of prices and costs and the availability of factors of production provide the basis for renewed growth; it is up to economic policy to trigger it, to the benefit of employment and national prosperity.

Interest rates, monetary policy and disinflation

The behaviour of long-term interest rates reflects the progress made with regard to inflation, the budget deficit and the external foreign exchange position.

Since the spring of 1995 the yield on ten-year Treasury bonds has fallen steadily. The differential with respect to corresponding German issues, which touched a peak of 650 basis points on 20 March 1995, decreased to less than 500 basis points at the end of that year, less than 180 at the end of 1996 and 145 this week.

By keeping short-term interest rates high, the restrictive monetary policy initiated in mid-1994 induced a sharp slowdown in credit and money supply growth. Monetary base grew by 1.2 per cent in 1995 and 2.5 per cent last year. The money supply grew by around 2 per cent in each year.

Inflation and inflationary expectations have been tamed.

Against the background of wage restraint and restrictive fiscal policy, our raising of official and money market rates in early 1995 and our re-affirmation of the Bank's anti-inflationary commitment two years ago at this same gathering, with the explicit indication of a path for a rapid reduction in the rate of price increases, succeeded in halting the deterioration of expectations and the depreciation of the lira.

The fall in inflation was hesitant at first. Until the middle of 1996 the average rise in the cost of living remained above 4 per cent. From then onwards, in response to the deceleration in producer prices, it slowed down decisively, and more rapidly than market expectations, so that actual inflation fell below expected inflation.

From that moment onwards we began to make prudent and regular reductions in interest rates, paying close attention to the progress of disinflation and the improvement in expectations. Real short-term interest rates, based on expected price increases, have declined by comparison with 1995.

The rise in the cost of living decreased to around 2 per cent in the third quarter of 1996 and fell below that figure in the fourth. Since July official interest rates have been lowered in three steps by a total of 2.25 percentage points.

In the first five months of 1997 the average annual inflation rate, based on seasonally adjusted monthly data, has remained below 2 per cent.

The policy followed with regard to interest rates and the control of the monetary and credit aggregates hinges on the need to convince workers, businessmen and the financial markets that increases in income can be achieved only by expanding economic activity.

The wage claims lodged last year in major industries were justified in terms of the past behaviour of prices and profits, but were excessive in relation to the lower inflation expectations.

During all of 1996 and the first three months of this year industrial producer prices increased by less than 1 per cent. Over the same period the average interest rate on bank loans in lire came down by nearly 3 percentage points.

More firms than in the past reduced the prices of their products. On average, however, the level of producer prices did not decline, notwithstanding the exceptional appreciation of the lira.

The cost of imported intermediate goods fell, after having increased substantially in the previous three years. By contrast, the prices of domestic inputs continued to rise. Unit labour costs rose significantly, owing not only to some large contractual wage increases but also to a temporary halt in productivity gains.

In 1997 price stability will lead to a modest narrowing of profit margins, in a year of uncertain cyclical prospects.

The recent period of price stability is still short compared with the previous period of high inflation. Medium-term expectations deduced from securities yields on the secondary market still indicate a substantial inflation differential in relation to the other industrial countries, albeit much smaller than in the past.

The embers of inflation have not been fully extinguished.

After more than two decades of high and variable inflation, it is essential that confidence in restored monetary stability become firmly rooted in market expectations and behaviour.

Economic developments, investment and employment

The weakness of economic activity in Europe, the ending of the investment cycle, the smallness of the rise in disposable incomes and the uncertain outlook for incomes and employment dampened all the components of demand. After growing by 3 per cent in 1994 and 4 per cent in 1995, demand remained unchanged in 1996 as a whole; it continued to expand in the first half of the year but contracted in the second.

Although sustained by the fall in inflation, the increase in households' disposable incomes did not stimulate faster growth in consumption. Uncertainty about employment and concern about future income in connection with the growing imbalances in the pension and health systems and the consequent proposals for reform induced consumers to adopt a cautious attitude towards spending decisions. Final domestic consumption increased by only 0.7 per cent, significantly less than in the two previous years.

Spending on durable consumer goods, which had decreased sharply in 1993, recovered only slightly. Car sales began to rise at the end of 1996, and have been boosted this year by temporary government incentives.

Investment in machinery, equipment and transport equipment slowed down markedly; in the fourth quarter, spending was 3 per cent lower than in the corresponding period of 1995. Investment in the manufacturing sector fell sharply.

Spending on construction declined in the first half of the year but began to increase again in the third and fourth quarters, benefiting from the lower interest rates.

In Europe the decline in investment began in the seventies. In the eighties in Italy it was still equal to more than 20 per cent of GDP; the downward trend continued and became more pronounced.

In relation to GDP, capital spending in Italy reached a low of 17.1 per cent in 1994; last year the ratio was 17.9 per cent. The outlook for 1997 indicates a modest increase, slightly larger than that in output.

Investment in residential construction fell steadily from around 7 per cent of GDP in the early eighties to 4.7 per cent in 1996. The fall in property values over the last several years reflects a structural decline in demand caused by the deterioration in the outlook for growth, demographic factors and higher taxes. This is a new phenomenon as regards its extent and duration, but one that other industrial countries have already experienced.

The fall in total investment was also partly due to the decline in general government spending. Expenditure by central government and local authorities, mainly on public works, fell from 2 per cent of GDP in 1989 to 1.2 per cent last year.

The dramatic fall in employment has paralleled the decline in the rate of investment.

Between the second half of 1991 and the beginning of 1995 the number of persons employed fell by nearly 1,300,000; the reduction in the Centre and North amounted to 700,000, or 4.5 per cent, and that in the South to nearly 600,000, or 9 per cent.

Between then and January 1997 employment rose only slightly, by about 140,000, with most of the increase occurring in the Centre and North.

The deterioration in the labour market has been similar in size and duration to that in the other large European economies. In Italy the unemployment rate rose from 8.8 per cent of the labour force in 1992 to 12.1 per cent in 1996. There are sharp regional disparities: unemployment last year was 7.7 per cent in the Centre and North and 21.7 per cent in the South.

The decline in employment and the rise in unemployment has not been accompanied by a decrease in the large number of workers who have not been registered by their employers for tax and social security. In the construction industry the proportion of irregular workers is estimated to be one in three; in manufacturing and services the ratio is nearly one in ten. Overall, 2,400,000 jobs are irregular.

Irregular employment introduces a sort of de facto flexibility to the labour market. Lower wages and costs allow marginal firms to survive, but expose workers to serious risks and sometimes abuse. Such workers usually do not receive the level of pay and other conditions laid down in collective labour agreements.

Competition is distorted, the growth of firms is hindered and the efficiency of the entire economy is reduced.

De facto flexibility is unacceptable and harmful. It is partly the consequence of excessive rigidity in the protection of regular employment.

In the South, the proportion of irregular jobs is much higher; in recent years it has increased as a consequence of the stagnation of the economy.

The question of development and the problem of employment and the quality of jobs cannot be tackled by means of macroeconomic fiscal and monetary policies alone, since these are necessarily geared to the economy as a whole.

What is required is a targeted regional policy that fully exploits the instruments provided by the Government.

In order to bring irregular employees into the official economy, as well as for other reasons, it is necessary to remove the obstacles to public and private investment and to establish and encourage forms of labour and wage flexibility.

It is essential to reduce external diseconomies, improve economic and social conditions and raise the level of legality.

The inefficiency of central and local government in designing infrastructure and public works projects has prevented the use of the considerable grants and loans available from the European Union. Their investment in projects of use to the community and industry would reduce the inadequacies of public infrastructure, which are severe in the South, and improve a particularly depressed employment situation.

The resources needed to finance infrastructure projects can be raised not only by drawing on funds provided by the European Union but also by extensively involving the private sector and imposing more stringent curbs on current public expenditure.

The public finances

Since 1993 the reversal of the rising trend in the budget deficit has been facilitated by the public's greater awareness of the grave state of the public finances.

Significant progress was made in 1995 as a result of major corrective measures and the rapid growth in economic activity. The primary budget surplus reached 4.4 per cent of GDP, halting the increase in the burden of the public debt on the economy. A temporary slowdown in the spending of some areas of government also contributed.

Despite the fall in interest rates, there was a pause in the adjustment of the public finances in 1996. Not only was the growth in output significantly lower than forecast, but the corrective fiscal measures were also less effective than expected and spending on a current programmes basis was higher than estimated. The primary surplus amounted to 75 trillion lire, less in absolute terms than the previous year. Excluding interest payments, total expenditure increased significantly, rising by 8 per cent.

In its Forecasting and Planning Report published last September, the Government decided to comply with the limits on budget deficits for 1997 for the purposes of participation in Economic and Monetary Union. This required the size of the budget adjustment to be increased from the planned 32.5 trillion lire to 62.5 trillion lire.

Despite a larger-than-expected fall in interest rates, in the first few months of this year the significant overshooting of the planned deficit for 1996, the revision of the estimated impact of the corrective measures and, above all, the poor performance of the economy revealed the need for additional budget measures.

In the Quarterly Report on the Borrowing Requirement presented to Parliament in early April, the Government estimated the budget deficit overshoot at 24 trillion lire for the state sector and 16 trillion for general government.

The overall adjustment planned for 1997 is substantial: including the measures taken in June 1996, it is equal to 5 per cent of GDP. Increased revenues and temporary measures form the larger part of the correction; structural measures play only a limited role.

The credibility of efforts to adjust the public finances depends on their ability to bring about certain and long-lasting improvements. Households have discounted most of the impact of the measures needed to correct the rise in public spending and have revised their income expectations downwards.

On the revenue side, far-reaching reform is needed to redefine responsibilities for taxation at the various levels of government, simplify the structure and procedures of the tax system and take resolute action against tax evasion.

The Government has adopted a series of measures that provide an initial response to these needs.

Refining the standard parameters used to determine income, simplifying tax return requirements and amending the structure of personal income tax will help counter tax evasion.

The planned changes in the taxation of income from both business and financial investment and in the financing of local authority spending will reduce the allocative distortions in the tax system; they increase the neutrality of the system by reducing the discrimination against equity financing as opposed to borrowing.

The necessary containment of public spending on pensions and social programmes must be accompanied by a commitment to improving the efficiency, fairness and transparency of welfare policies and ensuring a minimum level of essential services for the public.

The satisfaction of certain social security needs and the adjustment of the public finances could benefit from the activity of non-profit-making organizations, which can mobilize and harness the energies of voluntary workers, raise private financing and tailor their action to actual needs. Limited and targeted government incentives could help such organizations become established and develop.

Faster growth in output can make a substantial contribution to reducing the deficit. Scaling down current public spending and easing the debt burden must form part of a broader economic policy aimed at increasing capital accumulation and boosting economic growth.

Banking and finance

In order to obtain the benefits of the global market and prevent the destabilizing forces it sometimes generates from harming the economy and output, national financial systems are adapting their operating structure, organization and institutions to the new international configuration of economic and monetary relationships.

Italy began to liberalize banking activities and modernize its money and financial markets in the early eighties with the aim of increasing their efficiency.

The opening-up of our financial and banking system took a decisive step forward at the beginning of the nineties, when the freedom of capital movements was extended to short-term flows.

The process was completed with the implementation of the Investment Services Directive, which allows EU intermediaries to do business in Italy without having to be established here.

The banking system

In the last fifteen years several industrial countries have suffered banking crises, some of them serious and extensive. The immediate causes varied, but in every case the crisis occurred during a period of transition from an economic environment of relatively stable interest and exchange rates to one in which banks were exposed to increased domestic competition and international openness.

Coping with these crises required action by supervisory agencies, governments and parliaments. The most common solution was for the distressed banks to be taken over by healthy ones. Where the size of the insolvencies led to fears that loss of confidence might jeopardize the stability of the entire system, the authorities intervened by shoring up deposit guarantee schemes, providing funds at subsidized rates and supplying capital to the banks in difficulty.

Public sector support was always contingent on the implementation of rigorous reorganization plans in which the accent was placed on the reduction of operating costs, often with a view to the banks' subsequent sale.

In the Nordic countries the crises of the early nineties were of a systemic nature, involving the major banks and whole categories of intermediary. The budgetary cost of restoring the stability and viability of the banking system amounted to 9 per cent of GDP in Finland, 4 per cent in Sweden and 2 per cent in Norway.

The losses incurred by banks in the United States in the eighties were met by the federal government at a total cost of around $160 billion, or nearly 3 per cent of GDP.

The problems of the Japanese economy in recent years, especially the fall in property values and share prices, have caused numerous failures among financial companies and credit cooperatives; the losses have been borne largely by shareholders and the banking system. Some of the leading banks are in difficulty. For the moment, official intervention has been limited.

State aid in France, which has been granted primarily to the largest banking group, is expected to be of the order of 1.5 per cent of GDP. Shareholders have suffered substantial losses as a result of the collapse of banks in the United Kingdom and Spain.

In Italy the greatest difficulties have arisen in leading southern banks with weak capital bases, organizational and operational deficiencies and high costs. The decrease in government transfers, the reduction in relief from social security contributions and the stagnation of the economy have depressed corporate profitability, thus causing a decline in bank revenues and an increase in bad debts.

In the last five years nearly all the banks with their head office in the South have been inspected. Last year inspections were made at 49 banks, most of which were small; in 30 cases the assessment was unfavourable. In the Centre and North 135 banks were examined, with unfavourable conclusions in 12 cases.

In southern Italy 25 banks have had to be placed under special administration since 1992 because they were badly or improperly managed and had excessively high costs; 16 banks have been put into liquidation. All the crisis measures were adopted by the Minister of the Treasury acting on a proposal from the Bank of Italy. The difficulties of another 89 banks in the South were resolved by merging them with other banks, of which one in three was from the Centre or the North.

The effects of the reorganization plans undertaken at five leading southern banks at the request of the Supervision Department are beginning to appear. The plans are based on a reduction in staff costs, the rationalization of domestic and foreign branch networks and the disposal of non-strategic and unprofitable equity interests and buildings.

The operating costs of these banks, which account for 5.5 per cent of the total assets of the banking system, stopped rising in 1996; the number of employees was cut by 6 per cent and agreements with the unions have created the conditions for a substantial reduction in labour costs, beginning this year.

Reorganization must be continued with determination. The resolution of crises and the restructuring of banks in difficulty must lead to a more stable and efficient banking system, one that is competitive and better able to meet the needs of saving and production in that part of the country.

A deterioration in the quality of credit and a fall in bank profitability have been common to several continental European countries in recent years.

The net profits of the Italian banking system are lower than elsewhere owing to the slowness with which it has reduced costs in response to the narrowing of margins induced by competition. The relatively large proportion of banks' capital invested in low-yielding assets has also been a factor.

In the three years from 1993 to 1995 profits averaged 1.6 per cent of capital and reserves. In the United Kingdom and the United States they were 17.1 and 14.9 per cent respectively, in Germany and Spain 6.4 and 5 per cent. Only in France was the average return on bank capital lower than in Italy, reflecting the difficulties of some large banks.

Low profitability is a widespread problem among Italian banks. Of the 268 banks that make up the sample we use for statistical analyses only 61, with 12 per cent of the banking system's total assets, earned a return on capital of more than 7.5 per cent, whereas in France, Germany and Spain about half the banks achieved this figure.

The net profits of Italian banks rose to 2.7 per cent of capital and reserves in 1996. The increase can be attributed to the rise in the prices of securities in the domestic market. Banks with their head office in the North-East of Italy achieved a return of 6.7 per cent; the figure for the Centre and North as a whole was 4.4 per cent. In the South only small banks made satisfactory profits.

The weakness of economic activity end investment and the high level of corporate self-financing limited the growth in bank lending. Bad debts rose over the year from 110 to 123 trillion lire; net of value adjustments, they remained basically unchanged in relation to supervisory capital, at around 40 per cent. Losses on loans declined from 16 trillion lire in 1995 to 11.5 trillion last year.

The average rate on lira loans fell from 12.9 to 10.8 per cent in the course of the year. The spread between average lending and deposit rates narrowed by nearly half a percentage point.

Competition is already intense and will become even fiercer as a result of the increased presence of foreign banks; with the integration and unification of money markets, it will spread to deposit-taking, the supply of services to prime customers and the financing of smaller firms.

A year ago I stressed that the new domestic and international environment required Italian banks to review their organizational structures, develop new products, make better use of human resources and take vigorous action to reduce costs.

Staff training has been intensified and branch networks further rationalized. Significant results have been achieved in expanding services in the field of managed savings. The response to competition from the highly professional major foreign banks will have to be based not only on keeping down the costs charged to customers but also on broadening the range of products supplied and improving their quality.

Relationships with firms can be put on a new and more stable footing.

Italian banks play a minor role in the international placement of domestic firms' bond and share issues and in the organization of syndicated loans.

New services have to be developed to meet the needs of small and medium-sized firms, of which there are a great many in Italy; on average they are highly profitable and their growth is sometimes impeded by lack of adequate financial assistance. The opportunities offered by the Banking Law as regards equity investments and the underwriting and placement of new debt instruments have been exploited only to a limited extent so far.

Italian banks' staff costs rose by 5.9 per cent in 1996 to reach 39 trillion lire. The cost per employee rose by 6.8 per cent as a result of the renewal of the wage agreement for the sector. The number of staff declined by 1.9 per cent over the year, with nearly all the reduction occurring in some large banks.

Last year the cost per employee was 30 per cent above the average of the other leading European countries, partly owing to the high level of social security contributions.

It will be necessary to continue the action aimed at reducing staff costs and improving productivity, with the objective of reaching the desired results during the four years of the next labour contract.

The reduction in costs that we are urging the banking system to achieve will also require changes in the contractual mechanisms that produce automatic increases in expenditure, reduce mobility and hinder the flexible use of staff.

The negotiations between the sector and the trade unions, to which the Government has pledged its full support, must identify the appropriate means and procedures for attaining these ends.

Keeping down costs and achieving adequate profit margins are an integral part of the concept of sound and prudent management of banking businesses.

The ratio of staff costs to operating income will need to move towards the values prevailing in the other European countries, with which we shall increasingly have to compete in the coming years.

Banks have a crucial and irreplaceable role to play in saving and investment. Restoring competitiveness is indispensable for the stability of the system and for its functioning in the interests of the economy; it will improve the outlook for employment in the sector.

Reducing costs will make it possible to take on well-qualified young people and to raise the level of professional competence.

Higher profitability will facilitate the process of privatization, in which the banking foundations can and must play an important role. As we had hoped, there is a tendency for a core group of large shareholders with responsibility for defining strategy to be flanked by a host of small shareholders. It will be necessary to strengthen the capital base of the banks to be privatized, by means of private placements or by turning to the stock market.

The earning capacity and international competitiveness of the large banks could be enhanced by their combining with other large Italian or foreign banks. The achievement of critical mass will make it possible to sustain the development of technologically advanced services satisfying the quality and cost requirements of households and enterprises.

The process of consolidation is entrusted to those responsible for running the banks. It is up to the owners to decide between officially approved alternative merger proposals, taking account of the price offered. The success of each project depends not only on its intrinsic merits but also on the ability of the banks involved to manage its implementation.

The Bank of Italy seeks to stimulate and facilitate the process. The objective is to strengthen the banking system, by creating larger institutions where necessary and by removing the causes of weakness in comparison with other countries.

In assessing each project, the Bank of Italy ensures that it does not restrict competition.

Financial markets

Greater involvement by the Italian banking system in the more innovative sectors of finance requires a quantitative and qualitative enhancement of the capital market, which is still inadequate in relation to the needs of the economy.

The activities of banks and the stock exchange must develop in tandem.

The emergence of new institutional investors and the hopefully imminent launch of pension funds make it necessary to strengthen the rules providing for the full and detailed disclosure of information on companies' operations, intragroup relationships and shareholder agreements.

Italian firms are little involved in the international transfer of capital. Foreign direct investment in Italy and Italian investment in foreign firms are both very small in relation to the size of the economy. The limited ability to attract inward investment is due not only to the tax regime but also to inefficiencies and diseconomies in large parts of the country and the underdevelopment of the financial markets. An increase in the volume of capital investment flows would foster the exchange of advanced technologies and the adoption of new methods of organizing production.

The drive to reorganize the financial markets has made it possible to counter the pressure to transfer business abroad, especially in the share market. Competition from the leading foreign financial centres remains intense.

The legislation adopted in implementation of the Investment Services Directive provides for Italy's securities markets to change from public to private status and entrusts the creation of new markets to entrepreneurial initiative.

For the Italian financial system to be competitive, it will be necessary to ensure high-quality services at low cost by adapting financial techniques and structures to keep pace with rapid innovation. In the new privatized system this will be the responsibility of the markets themselves.

With the prospect of permanently low inflation, the reduction in real interest rates to a level close to the growth rate of the economy and the return to a yield curve with a normal slope will foster longer-term investment.

The untapped potential of Italy's capital market is considerable in view of the country's resources, above all savings, which must be safeguarded and properly managed, and channeled into expanding the country's productive capacity to a greater extent than in the past.

If an economy is to seize the growth opportunities offered by the world market in goods, factors of production and finance, its fundamental variables must be healthy.

Italy has made considerable progress in overcoming long-standing disequilibria in the last few years, although not without moments of hesitation and difficulty.

The country's net external debtor position has been almost eliminated and is giving way to a net creditor position; this demonstrates an abundance of saving, guarantees exchange rate stability and provides the basis for price stability.

The growth in the public debt has been brought to a halt.

Interest rates have come down; a lasting and significant reduction requires firm expectations that the task of restoring sound public finances will be concluded and confidence that inflation has been permanently defeated.

The temporary fiscal measures that have been taken must be transformed into structural reforms that remedy the tendency for public expenditure to rise.

In accordance with the intentions expressed by the Government and the two sides of industry, the overhaul of the social security system, which is the pride of our generation, the source of relief from poverty and need for many sections of the working population and the less well-off, must be aimed at conserving the benefits while eliminating the causes of distortion and inefficiency and curbing the costs.

A general and significant increase in productivity in the public sector is both necessary and possible. The rationalization initiated recently must permeate all branches of the Administration.

The concomitant of the high level of public spending is an equally high tax burden, which is concentrated on a narrow base, partly because of evasion.

It would be a mistake to try to correct the remaining disequilibria by substantially increasing taxes, particularly those that affect the level of prices and costs. This would lead to an erosion of competitiveness by diverting a further share of national resources from productive uses.

The efforts to adjust the public finances that have been under way for several years have reduced the rate of growth of the economy. The slowdown must be temporary and must lay the foundations for steady expansion in the years to come.

The fall in industrial output and the decline in GDP came to a halt in the spring of this year. Increasingly clear signs of a turnround and a slow resumption of growth are now emerging.

On the basis of current trends, it can be estimated that gross domestic product will increase by around 1 per cent in 1997; with conditions favourable to public and private investment, the expansion will gain momentum as the year proceeds.

The composition of public expenditure must be modified; current expenditure must be reduced to make room for new investment.

Labour costs must increase strictly in line with the growth in productivity and must facilitate the entry of new workers into employment. More flexible labour contracts and working practices are needed to reduce rigidity and defeat unemployment.

There is complete and fundamental identity between the objectives of firms and those of workers. The wealth produced and the level of employment are not independent of the level of labour costs and prices. There must be greater correlation between wages and corporate performance in industry, services and banking.

Responding to the competition coming from the emerging countries requires appropriate investment, flexibility in the organization of production and the containment of costs. The growth in exports to rapidly developing regions already offers new opportunities for industry, including firms using medium-grade technology, and will continue to do so for the next decade.

Now that the disinflationary phase has been successfully concluded, we aim in 1998 for a rise in consumer prices of 2 per cent or less and broadly stable producer prices, in line with developments in the leading industrial countries.

The regulation of money and credit and the gradual easing of monetary stringency will be consistent with this objective; this will show confidence in the non-inflationary recovery of the economy and will foster it. We assume that the adjustment of public expenditure will continue, with clarity of intent, and that inflationary stimuli will not be injected into the economy.

If events take an unfavourable turn, we shall not hesitate to halt our policy of reflation, and in extreme circumstances to change course.

We endorse the policy indicated in the Economic and Financial Planning Document and the prudent hypotheses adopted for some financial variables. We trust that the Government and Parliament will rapidly enact and fully exploit the instruments needed to ensure that the objectives are consistent and that they are achieved.

Assuming that the essential requirements of stable labour costs and a budget deficit within the 3 per cent limit are met, macroeconomic estimates for the next three years indicate inadequate economic growth, poor employment prospects and a growing surplus on the current account of the balance of payments.

There is a danger that the weakness of investment, which is a clear indicator of uncertainty about future developments, will persist. We have the resources and saving capacity for a higher level of investment. The shortage of public capital is severe in the South, but even in more prosperous regions of the country there is a striking contrast between the vigour of private initiative and the deficiencies of public infrastructure.

Greater planning capacity and more effective action is required on the part of local as well as central government. There is considerable scope for involving both domestic and foreign private investors in creating infrastructure to serve the community and industry.

The reform of corporate taxation in accordance with the powers granted to the Government will lower the cost of capital by reducing the levy on the proceeds from investment financed with equity capital. This will foster investment. The stimulus, which will also have a positive impact on the financial structure of companies, will not be sufficient, however, to ensure that the savings available in the economy are fully exploited.

The restoration of sound public finances, the curbing of labour costs and the provision of business incentives must be accompanied by an increase in corporate confidence and a higher propensity to invest, an undertaking in which the banks have a contribution to make.

Our economy is capable of returning to an annual rate of growth of the order of 3 per cent; this will require an additional permanent increase in investment in machinery and equipment equal to at least 1 per cent of GDP.

If rapid growth is achieved, it will be possible to eliminate the deficit on the current account of the budget by 1999 and to balance the budget as a whole by the middle of the next decade; accordingly, the public debt will decline to less than 100 per cent of GDP.

This result can be attained by reducing the GDP ratio of current expenditure, excluding interest payments, by two percentage points over the next five years. A substantial reduction in tax evasion will make it possible to alleviate the tax burden on those taxpayers who fulfil their obligations.

The record of the Italian economy during its years of fastest development and the recent experience of certain European economies show that growth, a balanced budget and price stability form an indivisible triad.

Money plays a part in all economic relationships, and reveals whether they are consistent with underlying principles of stability and prosperity.

We are convinced that we perform our task of monetary management in the general interest: for the good of Italy, the international community and Europe, into which we shall be ever more closely integrated.

In continuing to perform this task, we shall take account of the needs of the real economy, managing with determination, and if necessary severity, the primary public good consisting of the country's money, in order to protect the fundamental wealth represented by the savings of the public.