CHAMBER OF DEPUTIES
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The Italian economy
Trends and prospects

Statement by the Governor of the Bank of Italy
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The international crisis that exploded in Asia in the middle of 1997 and spread last year first to Russia and later to Brazil and other South American countries is now producing its full effects on economic activity in Europe and Italy.

Economic growth in Europe was brisk in the first half of 1998, but weakened in the second half. In the euro area the annualized rate of growth in the first six months compared with the second half of 1997 was 2.9 per cent; in Germany GDP expanded by 3.3 per cent and in France by 3.1 per cent; in Italy the annualized rate was only 0.6 per cent. In the third quarter Germany and France continued to record a satisfactory growth rate and in Italy the increase was 2 per cent. The figures for the fourth quarter signal a marked slowdown in aggregate demand and economic activity in several countries.

World trade grew by nearly 10 per cent in 1997, despite the Asian crisis; in 1998 it grew by 3.3 per cent, with the growth slowing down during the year.

Businesses recorded a markedly falling trend in expected orders in all the industrial countries in the second half of 1998.

In the United States output continued to expand last year at a brisk pace and only slightly less fast than in the two previous years. The crisis revealed its full severity in Japan, where industrial output was 7 per cent lower than one year earlier.

Industrial output declined sharply in the last quarter of 1998 in Germany. The strong growth recorded up to July was followed first by a slowdown and then by a rapid contraction in subsequent months; the slowdown was less marked in France.

In Italy industrial output stagnated for most of 1998 and declined significantly in the last two months of the year. It picked up at the beginning of this year but the future is still uncertain.

The fallout from the difficulties faced by the international economy has been more intense in Italy; medium-technology sectors have been badly affected by their loss of competitiveness vis-à-vis the Asian countries.

In my testimony to this Committee on the Finance Bill last October, I warned that GDP growth in Italy would be lower than forecast. The official estimates will become available in a few days, but preliminary estimates prepared by the Research Department of the Bank of Italy indicate an increase in GDP of just under 1.5 per cent in real terms for 1998.

One positive aspect of the present economic situation is the increase in the number of persons with a job, which is largely linked to the development of more flexible forms of employment. The climate of household confidence appears to be reacting positively to the stability of prices; the low level of interest rates will have a favourable impact on the demand for consumer durables and investment in housing. Demand for non-durables should also continue to rise gradually.

Nonetheless, the trend in output, the modest growth in consumption, the still uncertain pattern of investment and the outlook for the international economy may lead, unless appropriate policies are implemented, to the Italian economy performing poorly again in 1999.

1. *Macroeconomic adjustment and the public finances*

Over the last six years, since 1993, budgetary consolidation, incomes policy and the firmness of monetary policy enabled the Italian economy to make significant progress on several fronts.

The budget deficit was brought back below 3 per cent of GDP. The accumulation of external current account surpluses in the last few years made it possible to reabsorb the net external debt, thereby laying the foundations for the return to a firm exchange rate. Both expected and actual inflation were brought down towards the levels prevailing in the rest of Europe. Market interest rates came down close to those of economies with more firmly established traditions of stability.

The adjustment of the public finances and the checking of inflation called for determined action. Structural reform measures for the key items of expenditure were introduced from 1992 onwards.

The average annual increase in GDP declined from about 3 per cent in the eighties to 1.3 per cent in the nineties. The rest of Europe also suffered from a slowdown, but it was less severe.

Between 1990 and 1997 general government net borrowing was brought down from 11.1 to 2.7 per cent of GDP; last year it remained close to the latter level, thanks to a further reduction in interest payments. The bulk of the consolidation was achieved in the three years from 1995 to 1997.

The primary balance swung from a deficit of 1.7 per cent of GDP in 1990 to a surplus of 6.8 per cent in 1997; last year the surplus fell to just over 5 per cent of GDP.

The progress on the inflation front and the formation of a substantial primary surplus made it possible for interest rates to decline; they reached low levels in all the principal markets in connection with the abundance of international liquidity. Italy's public finances benefited last year to the tune of 1.5 per cent of GDP; compared with the peak of 1993, interest payments fell by 4 percentage points.

The corrective measures implemented in recent years relied primarily on increases in revenue; between 1990 and 1997 the ratio of tax and social security receipts to GDP rose from 39.6 to 44.3 per cent, almost one point above the European average and more than 12 points above the level in the United States. In 1998 the ratio fell by about one percentage point on account of the expiry of the provisional measures introduced in 1997, the decline in the withholding tax on interest income and the smaller-than-expected yield of the new regional tax on productive activities.

A high tax burden reduces international competitiveness and fosters the growth of a substantial underground economy. The high level of tax evasion pushes the tax burden of contributors who comply fully with their obligations above average levels.

The partial success of some budget measures and the frequent failure of economic activity to fulfill expectations necessitated supplementary action on several occasions. This consisted either of stop-gap measures, mainly on the revenue side and of a duration not easily quantifiable in advance, or of reductions in transfers to non-state public bodies. In the absence of a clear definition of these bodies' tasks, the effect of the reductions was primarily to penalize capital expenditure.

The adjustment to expenditure other than interest payments mainly concerned public investment, which declined in relation to GDP from 3.3 to 2.4 per cent between 1990 and 1997.

The curbing of public sector investment interrupted the process of making good the shortfall in Italian infrastructure compared with that of other European countries. The comparative disadvantage is most marked in the South, where in many respects public capital is inadequate.

2. Pensions

Since 1992 substantial reforms have been introduced in the pension system, whose structural foundations were laid in the fifties and sixties.

Spending on pensions and annuities was equal to 5 per cent of GDP in 1960. It rose to 7.4 per cent in 1970, 10.2 per cent in 1980 and 13.8 per cent in 1990. Until the early nineties the trend was one of unsustainable expansion.

The reform launched in 1992 has had a marked curbing effect on the expansionary tendency of expenditure. Almost one third of the discounted value of future spending commitments has been eliminated. Much of this saving has been achieved by indexing pensions to prices, rather than to wages and gradually basing new benefits on retirees’ entire working lives, rather than the years immediately preceding retirement.

The reforms of 1995 have forged a closer link between contributions and benefits, especially for the younger generations; they have cut back the redistributive effects of the system and fostered a longer working life. At the same time the legal framework has been put in place for the establishment of supplementary pension schemes alongside the public system and provision made for some severance pay allocations to be paid into such schemes.

Notwithstanding these measures the ratio of expenditure for pensions and annuities to GDP reached 16 per cent in 1997. According to official estimates, which take into account the additional measures introduced in the budget for 1998, the ratio is expected to rise further, albeit slowly, in the coming years.

The pension system these reforms are designed to shape has a number of positive aspects. Of particular merit is the two-tier arrangement comprising a basic scheme run by the state on a pay-as-you-go basis, with benefits proportional to the amount paid in, and a privately-run supplementary funded scheme.

The public scheme provides for workers with a long contribution record to receive a very large proportion of their final earnings, in some cases close to 100 per cent. This means that there is room for adjustments to future benefits with a view to curbing, in the medium and long term, the equilibrium contribution rate, which for employees would amount to around 40 per cent of gross earnings, even when the cost of welfare measures charged to general tax revenue is excluded. Such an adjustment would permit a more favourable indexation of pensions than the one currently envisaged, which is based exclusively on prices.

In order not to lower the standard of living of future pensioners, the measures to curb expenditure must not aim at reducing the size of per capita benefits. It is necessary to limit the rise in the ratio between the numbers of pensions and persons in employment.

The reform of 1995 will enable workers to retire between the ages of 57 and 65, with large differences in benefits in relation to the age of retirement. In 2001 the numbers of workers included in this age range will be small; a much longer period will be required before the new limits are fully phased in. The choice afforded workers is undoubtedly a positive factor. The retirement window nonetheless needs to be adapted to take into account the future age structure of the population resulting from increased longevity, the large rise in the ratio of the elderly to the young and, finally, the improvement in the working ability of older persons.

Any increase in the average age of retirement calls for a structure of earnings that rewards only effective working capabilities.

The overall flexibility of the system needs to be enhanced; the implicit reward for those who put off their retirement should be increased; and workers should have greater freedom of choice, with matching penalties and rewards.

The necessary measures, to be taken over an appropriate span of time, will have to avoid disappointing the expectations and rights of workers nearing retirement. The key factor is not so much the amount saved in the next few years as the present value of more distant future payments. In other words, the curve of the ratio of pension outlays to GDP should cease to rise from the middle of the next decade and then show a clear downward trend.

The curbing of public pension benefits must be accompanied by rapid growth in the supplementary pension schemes for which the regulatory framework has already been created.

3 The use of saving and competitiveness

In Italy unemployment and the sluggishness of investment reflect the inadequacy of domestic demand and, indirectly, deficient competitiveness.

Saving is the basic ingredient of investment and growth. Its amount is large in relation to income in our country; not all of it is invested at home.

It is necessary to create conditions of labour costs and competitiveness in the economy such that a larger share of saving is translated into investment, to the benefit of growth and employment.

The surplus on the external current account amounted to 42 trillion lire in 1998, one third less than in 1996 and 1997. A considerable part of the excess of receipts over payments is systematically reinvested abroad, without passing through Italy’s financial accounts.

The “errors and omissions” item of the balance of payments absorbed around half of the current account surplus in 1996 and 1997. In 1998 receipts that were not officially repatriated or not recorded in the financial accounts are estimated to have been on the order of 45 trillion lire and to have annulled the overall surplus on current account.

Moreover, an examination of the officially recorded capital inflows and outflows shows the surplus on portfolio investment contracting and being replaced by a growing deficit in 1998.

Foreign investment in Italian bonds and shares totaled 61.5 trillion lire in 1995. In 1996 the inflow grew to 125 trillion, primarily in connection with the increase in liquidity in the international market. It remained at much the same level in 1997 and then rose to 170 trillion last year.

Outward portfolio investment has risen more rapidly in the past few years. The outflow was far smaller than the inflow in 1995 and again in 1996. With the reduction in official and market interest rates in Italy, outward portfolio investment increased; the less attractive outlook for gains tended to slow down the growth in the inflow. In 1997 there was still a surplus of 7 trillion lire; last year the balance turned negative to the tune of 10 trillion.

The proportion of foreign securities in savers' portfolios is still smaller in Italy than in other leading countries; it is destined to grow as diversification continues.

In addition to the reduction in the attractiveness of the Italian market owing to the disappearance of the interest rate differential on bonds and government securities, there are the problems connected with the still relatively underdeveloped state of the Italian share market, in both qualitative and quantitative terms.

The presence of many foreign intermediaries in Italy is highly positive for the role they perform to the benefit of savers and firms, as a stimulus for the modernization of the market and greater competition. However, in the absence of profitable domestic investment opportunities, they also make it easier for domestic saving to be invested abroad. The process of increasing the potential of the Italian banking system, in terms of the scale and scope of operations, must be carried forward. To this end, we have encouraged the privatization of the banks in the public sector and consolidation among the major institutions. The projects under way must be completed without delay.

The direction of the flows of saving at the global level ultimately depends on the expansion, growth prospects, efficiency and competitiveness of the productive system.

Direct investment of foreign capital in Italy amounted to 5.5 trillion lire in 1996 and 6.3 trillion in 1997; in 1998 it was equal to 5.3 trillion. Direct investment abroad by Italian firms amounted to 10 trillion lire in 1996 and rose to 18 trillion in 1997; in 1998 it reached 30 trillion. The Italian economy attracts much less direct investment than France, Spain and the United Kingdom. Only Germany is in a situation comparable to Italy's.

The exporting of capital by firms for direct investment is normal in a developed economy.

Around 10 per cent of the jobs created by Italian industry during the nineties are located beyond the nation's borders.

Together with weak investment, the situation regarding the external accounts, and especially the balance on direct investment, indicates the need to raise the competitiveness of the Italian economy in the global and, particularly, the European setting.

There are still large areas in Italy that are underdeveloped and with high unemployment. They do not attract sufficient investment from firms located in the more developed regions and abroad.

The high cost of labour relative to productivity in some areas, together with the heavy tax burden, holds back investment and employment; it contributes to the rise in unreported work, which harms the public finances and the efficiency of the productive system, distorts competition and is detrimental to the orderly life of the community.

It is estimated that 9 per cent of the workers in Italy in industry excluding construction are employed in conditions contravening tax, social security and workplace safety rules. In construction the proportion rises to 34 per cent. The phenomenon is much more widespread in the South, where its incidence reaches 50 per cent in some sectors.

An insufficient differentiation of labour costs between areas and firms that differ widely in terms of productivity is at the root of the grey economy; it also gives rise to the evasion of taxes and social security contributions. Through unreported work, the market tends to achieve a closer *de facto* alignment between labour costs and productivity.

Increased competitiveness must be pursued through a gradual reduction in the tax burden and an incomes policy defined by the social partners within the framework of the Pact for Growth and Employment; the policy must aim at closer correlation between labour costs and productivity at the regional, sectoral and company levels.

Enhancing the efficiency of government bodies will yield gains in competitiveness. In many cases the limited project-development capability of local authorities and the lack of coordination with central government departments contribute significantly to the slowdown in public investment spending and the failure to utilize available funds and resources.

It is important to proceed in fully implementing the legislation that has already been passed and to complete the reform process, *inter alia* with a view to federalist decentralization.

4. Employment and prospects

The sluggish economic growth from 1992 to 1995 was accompanied by the loss of about one million jobs in Italy. Sweeping restructuring was carried out, not only in industry, continuing the process initiated in the eighties, but also in services. Heightened international competition and the weakness of domestic demand made it indispensable to preserve and improve the competitiveness of Italian production, finance and distribution.

In 1996 and 1997 employment remained essentially unchanged; in 1998, as I mentioned earlier, it staged a recovery.

Average employment increased last year by 0.5 per cent, or around 110,000 persons. The largest increases came in non-farm employment, among women, and in part-time jobs. In industry the demand for labour was met through fixed-term hiring, especially short-term contracts, with the greater flexibility it offers.

The growth in employment brought a pronounced increase in the labour force participation rate, especially in the southern regions, thereby causing a rise in the unemployment rate, which reached 23.2 per cent in the South in October. The gap between the South and the rest of Italy widened further to more than 15 percentage points. Nationwide, the unemployment rate rose to 12.6 per cent, compared with 12.4 per cent in October 1997.

In the other large European countries the faster economic growth in the nineties led to an increase in employment. In France, Spain and the United Kingdom the number of persons in work rose between 1993 and 1998 by respectively 700,000, 1.4 million and 1.6 million. Germany followed a similar path to Italy, owing in part to the difficulties inherent in the country's unification. In 1998 employment grew significantly in all the European countries except Germany.

As I recalled earlier, the information now available indicates that Italian GDP grew by slightly less than 1.5 per cent in 1998.

The expansion was fueled by steady if not buoyant growth in consumption, estimated at around 1.7 per cent, and an increase of 2.6 per cent in investment, although the pace slowed during the year. Investment in construction diminished slightly. Effective demand was sustained by a high level of stockbuilding, which came on top of the substantial buildup recorded in 1997.

A significant proportion of the domestic demand for investment, consumption and stockbuilding was met by imports, which grew by 8 per cent in comparison with 1997, owing in part to lower prices for commodities and the products of the newly industrialized economies.

Italian exports increased by 3.6 per cent in real terms, compared with 6.3 per cent in 1997; exports to non-EU countries have been contracting since the summer.

General government net borrowing remained basically unchanged last year in relation to GDP.

Containing the budget deficit was made easier by a one-off reduction of some 6 trillion lire in expenditure by INPS as a result of the transition from two-monthly to monthly payments of pensions. The consequent decrease in net expenditure on pensions partially offset the loss of revenue caused by slower-than-expected economic growth and the rise in expenditure, which was faster than expected in some sectors.

Overall, temporary budget deficit-reduction measures amounted to 0.6 per cent of GDP.

This year the world economy will continue to be affected by the persistence of crises in important emerging countries and more generally of slow growth in world trade. The OECD has revised its 1999 growth forecast for the industrial countries down to 1.7 per cent; the IMF has also revised its forecast downwards to 1.7 per cent, compared with 2.4 per cent last May. For the countries participating in the Monetary Union, growth is currently estimated at about 2 per cent.

World trade is now expected to grow by 4.4 per cent; this forecast may still be overly optimistic. In the worst scenario considered so far, where a worsening of the Brazilian crisis and the contagion of the other emerging economies is associated with falls in the leading stock markets, the growth rate for the industrial economies as a whole is seen as declining in 1999 to well below the level of 2.2 per cent recorded last year.

In Italy, investment continues to be held back by the poor outlook for demand.

In the absence of profound changes in firms' operating environment and competitiveness, productive investment will continue to expand slowly.

A temporary stimulus to investment growth will be provided in 1999 and 2000 by the recent measures granting tax relief for reinvested profits amounting to around 2 trillion lire a year.

The construction industry should receive a boost, albeit delayed and less powerful than originally expected, from the tax incentives for residential building work and the recovery of public works that began in 1998. The reduction in interest rates will encourage households’ investment in housing and purchases of durable goods.

Households’ confidence is improving. Disposable income appears to be rising. There is evidence suggesting that the growth in consumer spending could accelerate to just over 2.5 per cent.

Given current trends and assuming constant interest rates and exchange rates, it is possible to forecast that GDP will grow by between 1.5 and 2 per cent in 1999.

In subsequent years, taking into account the economic policy measures already announced, the rate of growth in GDP could rise to 2.5 per cent.

Budget revenue will be affected not only by a lower starting level but also by the slower-than-expected growth in economic activity in 1998 and the foreseeable shortfall in 1999 compared with the original forecasts.

The budgetary position has benefited from the substantial savings on interest expenditure brought by the fall in interest rates, which, from the second half of 1998 onwards, has been much larger than had been assumed at the time the estimates were made. For future years the magnitude of such savings appears less certain; once the world economy overcomes its present difficulties and returns to growth, market rates may tend to rise again.

All things considered, the factors making for an increase in the budget deficit may prevail over those working for a reduction. The borrowing requirement needs to be carefully and regularly monitored this year and in the years to come.

According to Bank of Italy estimates, the expansion of employment, though modest at first, should be quite appreciable in the medium term. Taking into account the results achieved last year, nearly 400,000 new jobs could be created in the private sector in the four years from 1998 to 2001; total employment would grow markedly less, however, primarily owing to continued labour shedding in agriculture.

If more jobs are to be created, the economy must be made to grow faster.

The conditions for achieving this exist: abundant saving, some of which flows abroad in the absence of profitable domestic investment opportunities; the availability of labour resources; and considerable technical and occupational skills. Moreover, large parts of the population and the country still have significant needs to be satisfied.

A major effort is being made to foster the recovery of public investment in the South by coordinating the action of central government and local authorities.

Achieving faster growth will require determined action to reform the public finances, revise the structure of employment relationships and implement the economic policy measures already planned.

Faster growth in economic activity further increases the formation and availability of saving.

Lightening the tax burden, albeit in a medium-run perspective, creating basic infrastructure and making the most of human capital, above all in the most disadvantaged regions of the South, will enhance the productivity and competitiveness of the economy, thereby laying the basis for a period of renewed growth.

The Social Pact must be given substance.

The search for greater flexibility in the use of productive factors, by streamlining the rules governing economic activity and the labour market, can make a major contribution to achieving the objective of faster growth.

The extensive pockets of social malaise must be eliminated, Italian and foreign investors and firms offered attractive prospects, and the expansion of economic activity strengthened.

Italy has the saving, the labour resources and the necessary entrepreneurial skills to achieve faster growth.

We must build confidence in the future of the Italian economy and in the determination of the country’s political forces to take appropriate action. Confidence, in a framework of stability, is the indispensable foundation for increasing the propensity to invest, creating employment and ensuring proper jobs and a better future for our young people.