ACRI

Association of Italian Savings Banks

1999 World Savings Day

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After slowing down significantly in 1998, the world economy has resumed expansion at a quicker pace. The International Monetary Fund has raised its estimates for output growth in 1999 to 3 per cent.

The expansionary stance of economic policies in most of the world and the substantial support provided by the international community to crisis-stricken countries succeeded in overcoming the tensions in financial markets and helped to foster the upturn in economic activity.

Asia has emerged from the severe recession triggered by the crisis of 1997. In Japan the prolonged contraction in output has come to an end, owing mainly to massive public investment. In Russia, the collapse of the economy was averted. In Brazil, the decline in economic activity proved less sharp than originally expected.

A fundamental contribution to these successes came from the easing of monetary conditions by the Federal Reserve in the autumn of 1998. The expected slowdown in the growth of the US economy has not materialized.

Private capital flows to the emerging economies of Asia have resumed. The rise in oil prices has brought a sharp improvement in the oil exporting countries’ terms of trade.

In the United States, the expansion of domestic demand in the first half of this year remained well in excess of the economy’s growth potential; the balance-of-payments deficit on current account rose to $300 billion on an annual basis, or 3.5 per cent of GDP. At the end of June the Federal Reserve tightened monetary conditions.

International financial markets remain very volatile. Long-term interest rates have risen in all the main industrial countries. The upward trend has spread from the United States to Europe.

The world economic situation is not without risks. Uncertainty over the sustainability of the Japanese recovery persists; Latin America’s balance-of-payments deficit on current account remains large; from the summer onwards exchange rates have come under renewed pressure in several countries, and the conditions of access to international financial markets have deteriorated again.

Within the euro area the slowdown in economic activity in the first half of this year was modest. Demand was bolstered by the reductions in short-term interest rates made by national central banks at the end of 1998 and by the Eurosystem in April. Consumer confidence improved over the summer months; production rose appreciably.

The Italian economy

In Italy, industrial production had already begun to weaken slightly in the first half of 1998; the decline became more pronounced in the second half of the year and continued until May 1999. During the summer the index of industrial production rose significantly.

The September business survey conducted by the branches of the Bank of Italy suggests that the expansion will continue in the fourth quarter. Firms are optimistic about the outlook for domestic and export demand; the growth expected nonetheless appears modest.

In the first six months of the year economic activity was stimulated by fixed investment, public works and the renovation of residential buildings. Purchases of equipment, machinery, transport equipment and intangible goods continued to expand. The growth of consumption remained limited.

As in the two previous years, the effect of net exports in the first half of 1999 was to slow Italian growth by about one percentage point. GDP grew by 0.2 per cent.

Exports are now showing signs of an upturn in response to the acceleration of world demand and the appreciation of Asian currencies.

Employment has increased for seven consecutive quarters. In July the number of persons in work was up by 250,000 or 1.2 per cent on a year earlier, the gain coming in services and construction. The number of permanent full-time employees rose by about 1 per cent, while that of workers on fixed-term or part-time contracts increased by about 10 per cent.

The increased elasticity of the demand for labour with respect to output stems from firms' greater use of more flexible employment contracts. In industry, little scope was left for further lengthening of effective working hours, in addition to what past corporate restructurings had required. Employment now tends to increase more than output, partly owing to the expansion of the service sector, where average productivity is lower than in industry.

The unemployment rate fell to 11.1 per cent in July. The gap between the South and the Centre and North, widened to over 16 percentage points.

In the first ten months of 1999 the state sector borrowing requirement was 61.7 trillion lire, some 15.5 trillion less than in the same period of 1998. The result for the broader general government sector was less satisfactory owing to the high level of local authority borrowing.

Caution is called for in evaluating the results for 1999 as a whole, in view of the uncertainty regarding developments in the last part of the year and the relationship between the state sector borrowing requirement and general government net borrowing. The latter may nonetheless turn out to be just under 2.4 per cent of GDP, the level indicated in the Quarterly Report on the Borrowing Requirement published in March.

Inflation in Italy has gradually accelerated over the year. Commodity prices have been rising since the spring, energy costs have surged and the euro has depreciated in the first ten months of 1999 by 10.3 per cent with respect to the dollar and by 9.9 per cent on a trade-weighted basis.

In October the twelve-month rate of increase in consumer prices was 2 per cent; since July the seasonally-adjusted annualized rate has been about 3 per cent. The underlying rate of increase in producer prices has remained just under 1 per cent.

The inflation differential with respect to the euro area has narrowed but remains significant. Italian unit labour costs continue to rise appreciably faster, owing to smaller productivity gains.

There are regional differences in the situation described above, which have been analyzed with the help of our branches.

The contraction in industrial production in the early months of 1999 was most pronounced in the North-West and the South. By sector, the sharpest falls in output occurred in the textile, clothing and footwear industries.

The signs of recovery observed during the summer were widespread. Some 38 per cent of the firms covered by the Bank's survey reported production increases since June. In many regions the growth appears set to continue in the last part of the year, albeit at a subdued pace.

In the first nine months of 1999 some 420,000 applications were made for tax relief in connection with the renovation of residential buildings; the demand was concentrated in the Centre and North, where the ratio of applications to buildings was more than three times as high as in the South.

The schemes for cooperation between firms, unions and local government to foster development in the southern regions are making slow progress. Local authorities' ability to develop projects continues to be limited and entrepreneurial capabilities are in short supply.

In many cases, businessmen are aware of the need for renewed efforts to curb costs, increase efficiency and flexibility, and improve product quality. Traditional sectors with mature technology are more exposed to competition from the newly industrialized countries. In some regions, including those of the North-West, firms are embarking on plans to strengthen their presence in sectors with a higher value added and internationalize production. In other areas, especially those where small firms account for the bulk of industry, there appears to be less scope for applying technological innovations.

Lending and interest rates

The signs of recovery in economic activity that emerged during the year were promptly reflected in the financial markets. The downward trend of interest rates has reversed, first at the long end of the market and more recently at the short end.

For longer maturities, euro yields began to rise in May. The upward movement first appeared in the United States at the end of 1998; it spread to the euro area in response to the signs of an upturn in economic activity and fear that the increase in commodity prices, especially that of oil, and the depreciation of the euro might rekindle inflation.

From the low values reached in April, the interest rate on ten-year BTPs has risen by 1.4 percentage points to 5.4 per cent, returning to its level at the end of 1997. The yield differential with respect to equivalent German securities has remained stable in a range of 20-30 basis points; since April the yield differential between 10-year bonds denominated in dollars and euros has narrowed from 1.2 to 0.7 percentage points.

The recovery in economic activity has contributed in recent months to interest rates rising at the short end of the market as well. The rate on three-month interbank deposits is currently about 3.5 per cent, some 0.9 points above the low reached in the spring; in part this reflects expectations of a temporary rise in connection with the Year 2000 problem.

The rapid expansion in bank lending, which has been common to the whole of Italy, owes much to the 23 per cent growth in home mortgage, spurred by low interest rates and the tax incentives for the renovation of residential buildings. Signs of recovery in the real-estate market have emerged as a consequence. Lending to Italian firms by foreign intermediaries has also risen sharply.

The cost of medium and long-term credit began to rise again in August in the wake of the increase in the preceding months in the yields on securities; bank rates have nonetheless risen much less and, as regards lending to households, less than in the other countries of the euro area.

The banking system

Banks' accounts showed an improvement in profitability in the first six months of 1999. The fall in net interest income and profits from securities and foreign exchange trading was offset by the increase in income from services. Operating costs were broadly unchanged. Staff costs declined by 1.7 per cent compared with the first half of 1998 as a result of an equal reduction in the number of employees.

Profitability benefited from the smaller volume of loan losses. The return on equity was 10 per cent on an annualized basis, compared with 8 per cent in the first half of 1998. The performance in the second half of the year could be less satisfactory owing to the decline in the value of banks' securities portfolios.

Intermediaries from other areas had already begun to enter local markets in the eighties. There has been a major redistribution of market shares in the different geographic and product segments; the leaders in markets for mature banking products have been joined by other intermediaries in the supply of innovative services.

Competition is intensifying in lines of business where transaction volumes are growing rapidly. New channels of supply are spreading, based on telematic systems, the telephone and the Internet; they enable customers to compare and choose among the products offered by a wide range of intermediaries.

Supply is especially abundant and diversified in the field of asset management. In September there were 58 management companies of open-end investment funds operating in Italy. Customers can choose from among nearly 800 Italian investment funds; about 1,000 foreign funds are marketed in Italy under distribution agreements with domestic intermediaries.

The presence of foreign banks has expanded, especially in areas such as corporate finance, lending to households and wholesale securities trading. By introducing products and techniques typical of more advanced financial systems, these banks have stimulated innovation and efforts to increase operating efficiency in the banking system as a whole.

Foreign banks have also entered the market by acquiring large interests in Italian banks. They now hold more than 10 per cent of the capital of each of the five largest domestic banking groups, which is more than comparable foreign holdings in the other leading countries.

No more than seven years ago, at the end of 1992, some 68 per cent of total bank assets were held by public-sector banks. Today, the share is 17 per cent, one of the smallest in continental Europe; with the sale of Mediocredito Centrale, it will fall to 15 per cent.

In recent years the increase in competition has accentuated the fall in bank interest rates. The spread between average lending and deposit rates has narrowed to its lowest value since the early sixties.

Banks must continue to improve their organization and management structures.

The operating efficiency of the banking system must be raised by rationalizing the use of human resources and consolidating the benefits of technological innovation and changes in distribution networks. The greater flexibility envisaged in the labour contract signed in July will contribute to this by increasing the scope for productivity gains. Banks must persevere in their efforts to reduce operating costs to the levels prevailing in the main foreign banking systems.

Achieving more rapid growth in high-value-added services requires very large-scale production. This can be accomplished through mergers and acquisitions and collaborative alliances with banks that have extensive local networks.

In a situation where banks’ branch networks are widely diversified and markets are fully open to new entrants, mergers do not reduce competition. When they do lead to dominant positions, the Bank of Italy takes measures to foster competition, such as ordering the disposal of branches or prohibiting the opening of new outlets for a specified period.

When it was first opened to international competition, the Italian banking system was highly fragmented.

Between 1990 and 1997 some 265 banks were involved in mergers; another 90 were taken over. The banks merged or acquired in the period held 22 per cent of the banking system's total assets.

At first, the process of consolidation mainly involved small banks, some of them in trouble; more recently it has spread to major institutions. Last year's operations involved 54 intermediaries, accounting for 11 per cent of the banking system; this year's have involved 49 banks, with assets equal to 10 per cent of the system total.

The spread of competition to regional markets has spurred medium-sized banks into adopting expansionary policies too. In the last four years 9 such intermediaries have acquired 67 mostly local banks and raised their share of total assets from 6 to 11 per cent.

In the two years 1997 and 1998 banks involved in mergers and acquisitions recorded an increase of 54 per cent in non-interest income and a reduction of one per cent in operating costs. Their operating profits rose by 40 per cent; those in the rest of the system fell by 8 per cent.

Mergers and acquisitions have benefited from the favourable conditions of the stock market, in view of the growing demand for forms of investment other than government securities. After raising 4.5 trillion lire of equity capital on average in each of the years between 1994 and 1996, banks completed capital increases amounting to 5.1 trillion in 1997 and 14.2 trillion in 1998; in the first half of this year they raised a total of 2.7 trillion lire.

The plans for reorganizing the credit system have been well received by investors; in the last three years bank shares have risen more than industrial shares.

Restructuring has been accompanied by a considerable improvement in the system's capital strength: at the end of last year the shortfalls in relation to the 8 per cent minimum solvency ratio had fallen to 250 billion lire, while the surpluses had risen to 61.5 trillion.

The concentrations between major insurance companies launched in the last few weeks may alter the situation as regards the control of some banks, further consolidating the ownership structure of the leading banking groups.

The planning of mergers, their accomplishment by the most suitable means and the process of integration are left to the discretion of banks' managements.

The Banking Law, which implements the EU's Second Banking Directive, requires these operations to be authorized by the Bank of Italy in order to ensure that they do not conflict with the sound and prudent management of banks.

The successful outcome of a merger depends on a high degree of cohesion among the various components of the new structure and the proper functioning of the system of corporate governance, on the rationalization of the use of productive factors and on the development of internal control systems able to ensure that the whole company complies at all times with the risk/return criteria established.

The Bank's supervisory instructions were recently amended to bring them closer into line with the markets' information and operational needs. The Bank of Italy must be informed of proposed concentrations when the outline plan is ready to be submitted to the board of directors and at least seven days before the board meets to approve the plan.

Where such operations involve an irrevocable undertaking to purchase a significant shareholding, the time limit for authorization has been reduced from 60 to 30 days.

In Europe, the organization of supervision at the national level corresponds to a design for regulatory harmonization intended to ensure timely and effective control.

The legislative approach adopted consists in harmonizing the aspects that are deemed essential, necessary and sufficient, and leaving the remaining aspects to mutual recognition of the supervisory systems of individual member states, where banking is governed by provisions of public and private law that differ from one country to another.

The framework agreed at the European level is consistent with the need to recognize the links between supervisory authorities and other institutions whose legal bases are of an exclusively national nature and far from uniform.

Extraordinary measures to safeguard the system’s stability are charged to national budgets; the European Central Bank takes them into account merely for liquidity management purposes.

The institutional framework for banking and financial supervision is fully specified, as is recognized in the Treaty on Monetary Union.

The coordination of supervisory authorities has proved fruitful and is worth strengthening further; it should be extended beyond the European Union to embrace the rest of the industrial world and emerging countries as well.

The Committee on Banking Supervision and the Financial Stability Forum at the Bank for International Settlements have been chosen as the most suitable bodies for this coordination. The Group of Seven, supplemented by other financially important countries, will provide an important linkage in this respect.

The risk of instability that is ever present and increasing in international markets can only be properly addressed by stronger cooperation at the global level.

The outlook

In the first six months of this year the seasonally adjusted and annualized monthly increase in consumer prices averaged just over 1.5 per cent. In the four months from July to October the average monthly increase exceeded 3 per cent on an annual basis. A contribution to curbing inflation can come from the Government's decision to reduce the taxation of oil products.

With the level of consumer demand remaining low, the rise in inflation is due to the lagged, and still not fully exhausted, effect of the rise in oil and other commodity prices and the depreciation of the euro, and hence the lira, against the dollar; it also reflects the increases in the prices of some services.

The prices of industrial products have stopped declining and are now rising significantly again.

After stagnating in the first five months of this year and recovering strongly between June and August, industrial output appears to have stalled in September and October.

GDP growth in 1999 will not be much more than 1 per cent.

Average annual inflation should be around 1.7 per cent.

Italy’s economic performance can be compared with Germany’s, where GDP is expected to grow by around 1.5 per cent and inflation to be around 0.6 per cent. In France the growth in output will be 2.5 per cent and inflation 0.6 per cent.

In the euro area there is relatively high inflation in Spain and the Netherlands, where GDP is growing by around 3.5 and 3 per cent, respectively.

Inflation in Italy continues to be higher than the average for the euro area, notwithstanding the weakness in demand and persistent uncertainty about future growth.

The limited growth in domestic demand will not prevent the external current account surplus from contracting to 1.3 per cent of GDP, from 1.7 per cent in 1998. The loss in trade competitiveness has immediate repercussions on industrial output and employment.

The structural difficulties afflicting the Italian economy prevent it from achieving its full growth potential. The same difficulties tend to impinge on prices.

The slow growth recorded in the nineties will continue next year. GDP will expand by just over 2 per cent, less than in Germany and France. Inflation is forecast to subside from its current levels, but it will remain higher than in these two countries and above the average for the euro area.

The persistence of a heavy burden of taxation and social security contributions in order to finance expenditure has contributed to the unsatisfactory rate of growth.

The Government's decision to initiate a significant reduction in the fiscal burden is the best and fastest way to regain competitiveness, to end the spiral of low growth and rising costs.

It appears increasingly necessary for a start to be made as early as 2000 on structural reforms that will allow the fiscal burden to be reduced steadily and substantially over the following years. More scope must be created for the growth already under way in public investment.

A recovery in growth will help to keep the public finances in balance.

Further effort along the lines of action already taken to increase the efficiency of the public administration and the labour market will create a more favourable environment for private investment.

Actual and forecast inflation is closely monitored by the Eurosystem. It is necessary to avoid a deterioration in price expectations, to consolidate confidence in the European currency and, ultimately, to curb the rise in medium and long-term market interest rates. Productive investment is influenced by the level of those rates and how they move. However, the propensity to invest depends above all on conditions in the real economy.

Apart from an improvement in the public sector’s ability to develop projects and an increase in the infrastructure serving business and society, investment depends crucially on expectations of stable growth in a secure and orderly social environment that is perceived as favourable to economic activity.

It is necessary that firms should grasp the opportunities offered by profitability conditions that are much better than in the past.

In an economy like Italy’s, characterized by a sizable outflow of savings for investment abroad, only an increase in private investment can bring a lasting increase in the economy’s rate of growth, reduce unemployment among young people, and shrink the large pockets of irregular work and related evasion of tax and social security contributions.

The reorganization under way in the banking system has resulted in the five largest groups holding 49 per cent of the total volume of assets, compared with 35 per cent only three years ago. It will provide the core of the financial infrastructure needed for the fruitful employment of domestic savings, by transforming them into investment, and ensure the efficient use of savings that flow in from abroad.

Examples close to us demonstrate that, in a context providing the necessary institutional stability, resolute and consistent economic policies are a valid instrument for turning missed opportunities to account, for putting idle resources to use, to the benefit of the entire national community, above all of young job-seekers.