UNIVERSITY OF PAVIA
Almo Collegio Borromeo

Money and the global economy

Lectio Magistralis by Antonio Fazio
Governor of the Bank of Italy

Pavia, 4 March 2000

CONTENTS

The monetary order established at Bretton Woods lasted for a quarter of a century, from 1946 to 1971, a long period of growth in the world economy.

The system did not become fully operational, however, until the leading European currencies had attained external convertibility in 1958. The strains that developed in the gold market in the early sixties were already portents of the crisis that was gradually to worsen, until the convertibility of the dollar was suspended in 1971.

The dollar reserves of the leading central banks had long exceeded the United States' gold reserves, valued at the official exchange rate of $35 an ounce; the link between the American currency and gold was severed on 15 August of that year.

The abandonment of the gold standard was followed by a loosening of monetary conditions in many of the industrial countries.

Commodity prices rose rapidly in the early seventies. Abundant liquidity triggered a resurgence of inflation worldwide; it was against this background that the oil crisis occurred at the end of 1973, which led to a quadrupling of the dollar price of crude oil.

In several industrial countries inflation spread to wages. In Germany and Japan the effects of the rise in oil prices were neutralized by means of rigorous monetary and wage policies. The Bundesbank prevented an excessive fall in the purchasing power of the mark, though at the cost of a sharp slowdown in industrial output.

In Italy, where the budget deficit was rising, the monetary authorities intervened repeatedly with drastic credit restrictions in 1974, 1977 and the early eighties to curb explosive wage increases and inflationary pressures and the depreciation of the lira. The measures were eased when the rise in prices approached single figures for fear of jeopardizing economic growth and the level of employment.

At the end of 1979 the US monetary authorities reverted to giving priority to control of the money supply; interest rates rose to unprecedented levels. Credit growth was curtailed, partly by administrative means.

In Italy we abandoned credit rationing in the early eighties and shifted the emphasis to controlling monetary base. This instrument had not been entirely ignored during the preceding decade, but it had to some extent been made subordinate to direct credit controls in order to limit the impact on interest rates.

In Europe the eighties were dominated by the creation of the European Monetary System, in which the lira participated with a fluctuation band that was wider than the standard one, namely 6 per cent above and below the central rate.

Italy's membership of the EMS provided an anchor for the progressive reduction of inflation, but in the absence of consistent policies for restoring sound public finances and restraining labour costs it could not prevent a series of exchange rate realignments, which continued until 1987.

During that decade the Italian economy suffered the effects of a steady real appreciation of the lira; the current account of the balance of payments, which had returned to surplus at the end of the seventies, once again moved into deficit. Strong domestic demand and the loss of competitiveness caused a rise in foreign debt, which reached 11 per cent of gross domestic product in 1992.

During the same decade the leading countries further liberalized capital movements, including flows of short-term capital. In Italy the process was completed in 1990 together with adoption of the narrow fluctuation band of the EMS.

Efforts to create a single monetary area in Europe were resumed in the early nineties. Progress was halted temporarily by the crisis in the exchange rate mechanism, which culminated in the depreciation of sterling and the lira in September 1992.

The financial crisis in the autumn of that year was averted in our market by raising 3-month Treasury bill rates to more than 18 per cent; yields on 10-year securities rose to 15 per cent. Restraints on credit growth, which were imposed by all the major banks at the request of the Bank of Italy, contributed to preventing a new wave of inflation. The labour costs agreement of July 1993, which was promoted by the Ciampi Government, helped curb the rise in prices.

In May of that year the lira was 20 per cent below its previous central rate; in real terms, competitiveness had recovered to the level of the early eighties.

Official interest rates were steadily reduced from the extremely high levels reached at the time of the exchange rate crisis.

The easing of monetary conditions in Europe after a new EMS crisis in August 1993 enabled Italy to continue to reduce interest rates, while maintaining a substantial differential in relation to Germany and France.

In the second half of 1994 domestic political instability and developments in international markets created fresh tensions in our financial system. Inflationary pressure began to build up. A new period of credit restriction began; in August we raised the discount rate and the rate on central-bank advances.

In the spring of 1995 the fall in value of the dollar and major European currencies, including the lira, had its counterpart in an appreciation of the mark and the French franc and a sharp rise in the value of the Japanese yen.

In Italy the measures taken by the Dini Government to curb the budget deficit checked the outflows of capital, but the depreciation of the lira threatened to fuel inflation. We tightened monetary conditions even further; official interest rates were raised again in February and May. Inflation expectations, which had steadily worsened since the summer of 1994, were turned round for the first time in June 1995.

At the meeting of the Group of Seven countries in Washington that April a further increase in dollar interest rates had appeared inadvisable, in order to avoid aggravating the crisis that had erupted in Mexico and prevent it from spreading to other Latin American countries. It was decided, although not explicitly announced, that steps would be taken to correct the imbalance between weak and strong currencies, primarily the dollar and the yen respectively, by generating further monetary expansion in Japan. The measures, which were complemented by massive intervention in the foreign exchange market, proved effective in initiating a move towards more balanced exchange rates among the leading currencies.

Thanks to the drastic curbs on monetary growth, which cut the expansion in the money supply in Italy to almost nil for two years, the lira also began to appreciate again.

A period of abundant liquidity creation began in the international market. This did not rekindle inflation, given the continued weakness of world demand and the associated decline in commodity prices; however, it began to affect long-term interest rates and share prices.

1. Money and global finance in the nineties

During the nineties, in a context of freedom of capital movements, technological progress in the field of telecommunications and financial innovation lent impetus to the creation of a global market for money and finance.

The global market makes it possible to channel savings to countries offering the best investment opportunities, leading to efficient allocation of available resources and giving a boost to productive capital accumulation, with beneficial effects on growth. However, global finance can become a source of instability, contributing to the spread of turbulence; the separation of the centres in which savings are formed from those in which they are used increases the difficulty of evaluating investment projects.

In the ten largest industrial economies the stock of public and private sector bonds rose from 90 to 130 per cent of GDP between 1985 and 1998, and stock market capitalization increased from 30 to 120 per cent of GDP between 1985 and 1999. Over the last decade the spread of derivative instruments has been much more rapid, driven by the expansion in world trade, the diversification of financial portfolios and the high volatility of securities prices and exchange rates. Between 1990 and 1997 the notional value of exchange-traded derivatives rose from 35 to 200 per cent of GDP.

The deeper integration of national markets is reflected in the more synchronous movements in nominal long-term interest rates: over the last thirty years the correlation of yields in the Group of Seven countries has become progressively closer, albeit fluctuating in the short term. Real long-term yields, calculated by deflating nominal yields by the rise in consumer prices, have also tended to become more uniform among the major economies.

Inflation in the industrial countries had come down to 6 per cent in the eighties, compared with rates on the order of 8 per cent in the seventies. It declined further in the nineties, to 3 per cent.

The ratio between the money stock and nominal GDP remained virtually constant for much of the last decade. It began to rise again in 1998; although part of the increase was attributable to a reduction in the opportunity cost of money, this trend is an indication of abundant liquidity.

In Japan the monetary expansion that had been initiated in 1995 was intensified from 1997 onwards; rather than stimulating domestic demand, however, it translated mainly into capital outflows. The abundant supply of liquid funds, a good part of which poured into the emerging countries, delayed the correction of the disequilibria which would later lead to the Asian crisis. As a consequence of the crisis, the United States recorded huge inflows of funds, attracted by the profitability of investments and the efficiency of the stock markets; this gave a further boost to share prices.

Real short-term interest rates fell from more than 4 per cent in the early nineties to around 3 per cent in the middle of the decade. They have come down further since the end of last year and now stand at around 2 per cent.

Real long-term yields have declined less markedly, falling from 4 per cent at the beginning of the decade to an average of just over 3 per cent in the last two years. The decline was checked by a number of factors, including the high profitability of productive investment in the United States and, until 1997, in the emerging countries as well, and the increasing riskiness of financial investment in the new macroeconomic environment.

In the second half of the nineties the steady rise in share prices led to a generalized reduction in the cost of capital in the leading economies.

The pre-eminence of financial factors over real economic factors gives the growth in international liquidity a kind of “autoreferentiality”: the expansion is taking place without any close link to the real economy.

The availability of abundant financial resources is fueling the growth in lending; given the less than prudent conduct of intermediaries and inadequate controls, this may not only cause a deterioration in loan quality but also lead to the formation of speculative positions.

The events of these years demonstrate the inherent risk of instability due to the configuration of the financial system; it underlines yet again the need for some form of governance of global finance.

2. Monetary policy and the prices of financial assets

In recent years the expansion of international liquidity has not been accompanied in the leading countries by a pickup in consumer price inflation but by a rapid and prolonged rise in the prices of financial assets and, albeit to a lesser extent, of property. This result reflects favourable conditions in the supply of goods and services in the United States and the restrictive stance of budgetary and incomes policies in Europe.

The developments under way suggest the need to reflect on the effectiveness and objectives of monetary policy in the new global context, with special reference to the importance that central banks should attribute to the price dynamics of financial and real assets, especially when these are not firmly rooted in the evolution of macroeconomic variables.

The most appropriate measure of inflation for monetary policy purposes is under debate.

A given real or financial asset allows the holder to receive future payments or services; its price corresponds to the present value of the future consumption it permits. Some have argued that the measure of inflation for monetary policy purposes should include the increases in the prices of financial and real assets in addition to those in the prices of goods for current consumption. According to this view, central banks' objective should be a weighted average of the prices of goods for current and future consumption.

Monetary policy can stabilize the value of the numéraire but it cannot influence the relative price of current consumption with respect to that in the future. The use of a basket that included financial assets might make it possible to control the latter's prices, but at the cost of undesired fluctuations in consumer prices and economic activity.

A monetary strategy based on a broad index, aimed at stabilizing the purchasing power of money in the long run, would be difficult to put into effect, not least on practical grounds.

In the first place, action to stabilize an index that included future consumption would be effective in the hypothetical case in which consumers were able to determine their present and future demand for goods accurately.

Stock market price movements are influenced in the short and medium term by erratic factors. It is extremely difficult to assess even prices correctly, not least owing to the difficulty of determining the actual profitability of shares. Investors may be remunerated by the issuing company buying back its own shares instead of distributing dividends. Accounting standards allow purchases of intangible technologies to be included in operating costs. Estimates of the premium investors demand in order to hold equity are highly uncertain.

The prices of real and financial assets can provide indications on the future course of key variables for the conduct of monetary policy: above all inflation, but also consumption.

Analyses focusing on some leading industrial countries suggest that the prices of real and financial assets can anticipate the future course of inflation to a degree; however, the link is uncertain and variable, both over time and across countries.

The absence of solid empirical evidence on the relationship between share prices and future inflation has also been demonstrated for Italy in a study carried out in the Research Department of the Bank of Italy with reference to the eighties and nineties.

Recent experience provides important examples of the price dynamics of real and financial assets significantly influencing demand for consumer goods. In the second half of the eighties and the second half of the nineties some countries, including the United Kingdom, Sweden and Finland, experienced rapid rises in share and property prices accompanied by a surge in household expenditure and borrowing; when asset prices fell, the sharp contraction in consumption was coupled with a significant slowdown in economic activity.

The growth in securities markets, which has been extremely rapid even in economies where banks traditionally played a major role, the spread of share ownership associated with the rise of institutional investors and the gradual shift in many countries towards funded pension systems could considerably increase the impact of changes in stock market prices on expenditure.

In the United States the large fall in the propensity to save has been set in relation to the tendency to include both realized and unrealized capital gains among households' sources of income. Recent research has shown that every dollar increase in equity wealth has an impact effect of between 3 and 4 cents on consumer spending; the long-term effect is much larger.

The information derived from the price dynamics of real and financial assets and the effect these dynamics can have on output need to be assessed in the light of macroeconomic conditions, the phase of the business cycle and the general stance of economic policy.

The experience of many countries has shown that fluctuations in the prices of financial assets and property can affect the solidity of intermediaries, especially banks, to the point of undermining the stability of the financial system as a whole.

The close link between fluctuations in asset values and the solidity of the banking system emerged clearly in the recent difficulties faced by banks in Korea and South-East Asia and, in the eighties, in the crisis of America's savings and loan associations.

The most important example is undoubtedly that of Japan. Between the end of 1985 and the beginning of 1987 the Bank of Japan reduced the discount rate by half, to 2.5 per cent, and then held it unchanged for two years in a period of rapid economic growth. Over these four years the ratio of the stock market's capitalization to GDP nearly tripled to 130 per cent; property prices nearly tripled as well. In the spring of 1989, faced with these developments and rapid growth in GDP, the central bank began to tighten monetary conditions and in little more than one year raised the discount rate by 3.5 percentage points to 6 per cent.

The monetary squeeze caused the speculative bubble to burst, with severe repercussions on banks' assets: the prices of Japanese shares fell by 36 per cent between the middle of 1989 and the end of 1991; the fall in property prices was equally large, although more gradual. The average rate of return on bank capital in 1988 was 10 per cent; in 1997 it was -20 per cent.

Financial stability is indispensable for macroeconomic stability. It requires an efficient and profitable banking system with a capital base that can absorb the effects of fluctuations in economic activity.

Supervisory controls aimed at avoiding excessive risk concentration and ensuring compliance with the rules on sound and prudent management and the separation between banking and commerce remain of fundamental importance.

3. Share prices

Since the second half of the nineties share prices have been rising in all the leading European and US stock markets.

Putting stock price indexes equal to 100 at the beginning of 1995, the S&P 500 stood at 268 at the end of 1998 and 320 at the end of 1999; on the same basis the Italian stock exchange index, which stood at 166 in 1997, rose to 233 in 1998 and 285 at the end of 1999.

In France and Germany the rise in share prices through 1997 was between that in the United States and that in Italy; by the end of 1999 the French index had risen to 317 and the German index to 277.

The steady and sustained rise in share prices was fueled by the long period of low inflation, the decline in real long-term interest rates and the particularly strong performance of the US economy.

Economic growth in Europe was more hesitant and affected by the Asian crisis in 1997 and the Russian crisis in 1998. Profit margins were nonetheless high throughout the period and in the last twelve months businessmen's output forecasts improved steadily.

Share price trends can be analyzed better by considering companies' market value in relation to their profits, the price-earnings ratio.

In the first half of the nineties, after wide fluctuations and cycles lasting from four to five years, the price-earnings ratio in all the leading markets except Japan was only slightly higher than in the mid-seventies. In other words share prices had risen only a little faster than profits.

In the second half of the nineties the ratio rose exponentially; there continued to be fluctuations, which were pronounced in the United States and in Italy.

At the end of 1994 the ratio was 18 in Germany, 13 in France and 19 in Italy. In the United States it was around 17, just above its long-term average value; two years later, at the end of 1996, it had risen to around 21.

In 1997, partly as a consequence of the inflows of capital from the crisis-stricken areas, the price-earnings ratio continued to increase in the United States and began to rise in Europe as well.

The rise in the ratio accelerated everywhere in 1998; the substantial decline recorded in the autumn in connection with the Russian crisis was made good in the last part of the year.

In 1999, after rising hesitantly in the first nine months, the ratio surged in France, Germany and Italy; in January 2000 it stood at around 27 in Germany and 24 in France; in Italy it was around 29, as in the United States.

These values correspond to a real rate of return on equity investments of between 3 and 4 per cent, which is close to that on bonds. In earlier decades there was a wide gap between the returns on the two forms of investment.

In Japan, reflecting the peculiarities of the economy, the price-earnings ratio was around 56 in the second half of the eighties; it dropped to around 49 in the first half of the nineties as a consequence of the difficulties described above and then rose, with wide fluctuations, to around 67 at the end of 1994 and reached 80 in the early months of this year.

The movement in share prices can be assessed by referring to the relationship between the value of a capital asset and its yield over time:

$$p = \frac{D}{r + s - g}$$

where:
- p is the price of the capital asset;
- D is the dividend to which the owner of the asset is entitled;
- r is the real long-term interest rate;
- s is the risk premium expressed as an increase in the real interest rate;
- g is the expected long-run rate of growth in real dividends.

The dividend-price ratio should therefore be equal to the real interest rate plus the risk premium, less the expected growth in real dividends.

In the five years from 1995 to 1999 the dividend-price ratio declined markedly in all the leading markets except Japan and Italy. In the United States the ratio fell from 2.9 per cent at the beginning of 1995 to 1.2 per cent at the end of 1999; in France it went from 3.1 to 1.8 per cent.

In Italy the movements in the ratio were irregular, with a sharp decrease at the end of 1999 and during the current year.

Expected real long-term bond yields in Italy, France, Germany, the United Kingdom and the United States now range between 2.9 and 3.7 per cent. Looking ahead over a sufficient number of years, we can assume as a first approximation that the rate of increase in dividends for the market as a whole is equal to the rate of GDP growth expected by analysts for these countries; the latter fluctuates between 2.2 and 2.7 per cent over the next ten years.

On the basis of these values, and assuming that the real interest rate plus the risk premium is always greater than the expected increase in real dividends, the current level of share price indexes is consistent with a risk premium of between 0 and 1.5 percentage points, a far lower level than in the past.

Over many decades, the premium demanded for investment in equities by comparison with an investment in riskless securities has been on the order of 5-6 percentage points in the leading markets.

On the basis of current dividends and with the risk factor set to 6 percentage points, in line with the historical average for the equity markets as a whole, the level of the Standard & Poor’s index is consistent with annual real dividend growth on the order of 8 per cent in the long run. The average annual growth in nominal dividends recorded in the United States over the last fifty years is 5.2 per cent.

The rise in share prices has been especially rapid in the case of securities representing investments in high technology sectors. For the Nasdaq 100 index, which contains a high proportion of such securities, the current prices would be consistent with real dividend growth of just under 10 per cent a year. For the Dow Jones Euro Stoxx index, the price level is consistent with real dividend growth of between 8 and 9 per cent a year.

According to analysts’ forecasts, in the five years between 1999 and 2003 the earnings of companies included in the Standard and Poor’s index will grow at an average rate of 18 per cent a year in nominal terms. Companies included in the Nasdaq index are expected to record average annual earnings growth of 31 per cent.

It must be stressed, however, that besides being expressed in nominal rather than real terms, these forecasts refer to a relatively limited period of time and are characterized by considerable dispersion among the companies considered.

For securities in the high-tech sectors included in the Euro Stoxx index, expected earnings growth is on the order of 20 per cent a year; here too, the forecasts vary widely.

The abundance of liquidity in the world economy in an environment marked by stable inflation has led to an increase in the percentage of equities held in portfolios.

The figures I have just mentioned suggest a decrease in market participants' perception of risk compared with the past. The increase in the liquidity of equity markets and the growing activity of institutional investors may have contributed to reducing risk.

For stock markets as a whole, the level of prices can be partly explained by investors' expectations that corporate profits will increase much more rapidly than GDP, taking into account the specific situations of companies involved in corporate reorganization or major investment and expansion plans. At a time of high dynamism in the economy and finance, the incidence of these companies may become substantial.

For companies operating in advanced technology sectors, the forecast annual increase in dividends, which is particularly high, may correspond to favourable prospects of growth. However, investors themselves remain very uncertain as to what future profits will be in these sectors owing to the innovative nature of the activities involved.

4. The world economic recovery and Italy

The global monetary expansion in the second half of the nineties began with a sharp cut in interest rates in Japan in the spring of 1995, which was aimed at stemming the fall in the value of the dollar and other currencies and the excessive appreciation of the yen in the wake of the Mexican crisis.

As the abundant liquidity in Japan could not be absorbed in the domestic economy, it spilled out into the international markets; it pushed up the exchange rate of the dollar, notwithstanding the increase in the supply of dollar-denominated instruments as a result of the US balance-of-payments deficit. The massive build-up of Japan's foreign assets sustained investor confidence, limiting the depreciation of the yen.

Monetary policy in the euro area in both 1998 and 1999 was characterized by an ample supply of liquidity, some of which flowed out to the rest of the world in the form of financial investment.

In the last few years in particular, the expansion of international liquidity has coincided with relatively weak growth in the world economy as a whole, restrictive budgetary policies in Europe and the United States, and wage moderation in the industrial countries. These factors have prevented the rise in liquidity from affecting current output prices; by contrast, securities prices have increased substantially.

The synchronous movements in securities prices in the main markets reflect worldwide portfolio optimization. The funds managed by global intermediaries, excluding banks, amount to approximately $30 trillion.

An analytical framework postulated by Tobin at the end of sixties with reference to a closed economy, consistent with the view he had already developed regarding the role of money and credit in a system of general equilibrium, examines the effects of the supply of monetary base and money first and foremost on securities and the prices of capital goods.

A rise in the market value of physical goods creates a gap with respect to the cost of producing them, prompting an increase in their supply. A reduction in the cost of capital with respect to its marginal efficiency increases investment.

Investment in the United States, which was already expanding rapidly, has been fueled by the large inflow of capital to that market. It has been concentrated in the high-technology sectors; the widespread gains in productivity have contained costs, curbed inflation and contributed to the rise in share prices.

The increase in financial wealth has further boosted consumer spending and reinforced the growth of the economy and employment.

In Europe, the recovery was stimulated in 1999 by a surge in demand from Asian countries following a pause in 1998. Capital spending is also rising at a sustained pace.

The decidedly expansionary stance of monetary and budgetary policy has averted a deflationary spiral in Japan, which would have jeopardized the growth of the entire world economy.

The economic outlook for important countries in Latin America remains uncertain.

The global recovery that began in the middle of 1999 has been partly due to the abundance and low cost of finance. However, it has affected the prices of raw materials and oil. This has led to inflationary pressure, especially in Europe, where productivity growth is limited.

The Eurosystem’s decision to raise official rates by 25 basis points in February was intended to prevent consumer price increases exceeding the ceiling of 2 per cent a year over the medium term.

In Europe yields on 10-year government bonds reached levels of between 5.5 and 5.8 per cent last year. The yield curve still has a steep upward slope.

Italy’s GDP grew by 1.4 per cent last year. Industrial output declined until May, but from June onwards it displayed a rapid increase typical of the initial stages of a cyclical recovery.

Consumer price inflation, to which we called attention in October, has risen since the second half of last year. The average rate of increase in consumer prices in 1999 was 1.7 per cent, an acceleration that largely reflects the rise in the dollar prices of oil and the weakness of the euro. If the expected fall in oil prices leads to a slowdown in monthly rates of increase in the second half of the year, consumer price inflation in 2000 will stand at 2.2 per cent.

There is still a wide differential vis-à-vis France and Germany, which account for about 40 per cent of Italy’s foreign trade.

Our economy is hampered by structural shortcomings in terms of productive efficiency and labour market flexibility.

GDP should grow by about 2.5 per cent this year, well above last year’s figure but about half a point less than the rate for the euro area. Employment in the private sector should rise by more than 1 per cent; the increase will probably continue to be concentrated in the more prosperous regions and to involve mainly fixed-term and short-term contracts. Unemployment is forecast to settle at around 10.5 per cent and the labour force participation rate will remain low.

The recovery in output is closely bound up with the strong growth in exports, while imports are expected to record moderate growth.

Investment demand is accelerating in the sectors of plant, equipment and transport equipment, where it is stimulated by the recovery in industrial output and tax incentives, and in the construction sector, where it is due to the gradual build-up of the effects of tax relief for renovation work.

Consumer demand is held back by the modest rise in disposable income and uncertainty about future income growth. An improvement in the public finances calls for continued efforts towards budget adjustment and structural reforms.

Econometric estimates for the years after 2000 show that if the current recovery is to lead to a new and protracted period of growth, the propensity to invest will have to increase faster than at present.

The economic environment needs to be conducive to the growth of productive activity. An overhaul of company law could help in this regard. To eliminate precariousness in the labour market, the average duration of fixed-term contracts must be lengthened and supply adapted to the economic situations of firms, especially in those regions where the bane of unregulated employment is most widespread.

The streamlining of administrative procedures must be fully implemented; the constraints that hamper small and medium-sized firms must be eased and the efficiency of government bodies must be improved, especially in the regions.

There is an urgent need for a resumption of planning and investment in infrastructure, both in the depressed areas of the South and in the more developed regions; this can be financed both by recourse to European funds and by tapping the domestic and international capital markets.

An increase in domestic demand, and in investment in particular, is compatible with the volume of available savings.

° ° °

The protracted bull market in the United States has caused European stock markets to rise as well, providing the funds necessary for extensive restructuring in some sectors, including banking.

Compared with the end of last year Standard & Poor’s index has fallen by 6 per cent. The Euro Stoxx index has risen by 10 per cent, with the increase being concentrated in the services and telecommunications sectors. In Italy the stock market index has risen by a further 17 per cent.

Process innovation, restructuring and an expansion in size can justify substantial rises in expected profits, even in traditional manufacturing sectors. For advanced technology sectors a very large increase in sales, productivity and profits is plausible.

In the United States the rise in share prices in recent years has been underpinned by the sustained growth of the economy. Total factor productivity has shown exceptional average annual growth of more than 10 per cent in the machinery and transport equipment sector, thanks above all to the large increase in investment, the spread of information technology and corporate reorganization.

Higher profits have fueled the rise in share prices. It is increasingly evident that savers are becoming ever more selective in their choice of investments.

In Europe the availability of ample funds and the low cost of capital should translate into investment, particularly in high technology sectors that can generate increases in productivity and output that will spread to the whole economy.

Together with a careful selection of investments and business projects, Italy also needs economic and sectoral policies that will make it possible to harness the opportunities opened up by the cyclical upturn.

In this way it will be possible to prolong today's faster growth for several years, bringing benefits for employment in the more disadvantaged areas especially for young people.

An economy such as Italy's, where production is fragmented, can be revitalized by the so-called new economy primarily via a reorganization of firms and intersectoral relations induced by market forces and information technology. Swift adaptation to the new scenario will be essential.

The basic resources are available in plenty, particularly saving. The banking system has made considerable advances of late in terms of size, organizational structure and products, with beneficial effects on credit allocation. There is still a plentiful supply of labour and youthful skills, the ultimate factor for any economic and civic progress.

The future, what we become and what legacy we leave is written in the events of today, in the choices we make now.

The commitment of our institutions, firms, employers and workers will enable us to exploit the favourable conditions offered by the economic cycle, the global economy and finance in order to transform potential into reality, overcome uncertainties and difficulties and build a more just and caring society.