UNIONE INDUSTRIALE TORINO

"Club Optime"

The global economy, the firm and human capital

Address by the Governor of the Bank of Italy

Antonio Fazio

Turin, 7 July 2000

Contents

Global finance

Guido Carli used to open his Concluding Remarks to the Annual General Meeting of the Bank of Italy with a broad review of the international economy, of which he had a thorough knowledge. This structure of the Bank's Annual Report is now customary.

In the sixties the cyclical situation and finances of each country were of interest in and of themselves, independently of their important implications for the world economy; they constituted a term of reference against which to read the data of our economy. The typically international problems had to do with the dollar, gold, liquidity, and from the institutional standpoint they were bound up with the working of the Bretton Woods system.

The intense, tumultuous growth of financial assets, outstripping that of the real economy, has assigned the capital markets a central role in the international equilibrium. Segmentation of financial systems has been superseded by strict interdependence, bestowing on the world economy the nature of a single entity.

Nowadays all the national economies are vitally immersed in the single market of currencies and finance, where the levels and movements of interest rates and exchange rates that affect the economies of the individual countries, inflation, production and employment are determined. The transmission of monetary and financial impulses therefore depends on the connection of national markets with the global market.

The development of finance in its current forms has made the worldwide allocation of savings more efficient. The workings of global finance and the global market result in more efficient specialization of economic activity worldwide, faster accumulation of wealth, a higher standard of economic welfare. However, disparities and imbalances can be aggravated; national economies and productive sectors unable to take advantage of the integration of markets can even be harmed.

Speculative impulses radiating from the global market can influence the operations and stability of national banking systems and financial markets. The performance of even fair-sized economies can be affected.

We have recently lived through several episodes of this kind. The financial crisis that erupted in Mexico in late 1994 and early 1995 involved the dollar and, with opposite sign, other currencies, most notably the yen, with extensive repercussions on many economies including Italy's; if timely action had not been taken to counter the most destabilizing repercussions, the impact on world finance and the international economy would have been even more severe. Since then we have experienced the spread of turbulence generated by the crises of Korea and South-East Asia and by those of Russia and several Latin American countries.

In the past, excesses and shortages of savings were offset within individual national economies. Today, the excess of savings in Japan and Europe finances investment in Latin America or Asia and, above all, the United States. The realm of competition has been extended to embrace national economic systems.

In the nineties investment gave rise to an exceptional increase in productivity in the United States. Savings flowing to that economy enjoyed high returns. The result was remarkable growth for the American economy, especially in its innovative sectors. Other economies supplied their more traditional products to American consumers and firms.

Globalization, especially financial globalization, is the outcome of the computer revolution.

The new possibilities for augmenting wealth with innovation and investment, the latter financed by lending and the transfer of savings on a worldwide scale, have opened a phase of expansion similar in some respects to that enjoyed by the national economies in the later nineteenth century.

In that historical setting the growth of banking allowed the formation of saving in some sectors of the economy to be fruitfully matched with the need for investment capital in others. Credit, above all bank lending, was a decisive factor in industrial development, but it also created totally unfamiliar problems of monetary and financial stability. These problems triggered major crises, which in some cases spread at the international level.

The crisis of 1929, which shook the banking system of various countries, can be traced to the restrictive stance of US monetary policy and the transmission of its effects via the gold exchange standard. The Great Depression of the thirties brought a collapse of production and spawned mass unemployment. Economic and social conditions of great hardship arose, the premise of the political upheavals that would lead to the Second World War.

The crisis of the market compelled government to enter important sectors of the economy; the role of budgetary policy and public spending came to the fore.

At the institutional level, the response to the Great Depression took two directions.

There was an accentuation of the tendency towards economic isolationism; trade remained possible, but subject to stringent controls.

In all the major economies, the presence of the “central bank” was strengthened.

It was recognized that banking, thanks to its power to multiply credit, could impart destabilizing impulses to prices and output. Towards the middle of the thirties all the major countries adopted laws subjecting the banking and financial systems to special rules and supervisory regimes. Italy had already taken important steps in this direction in the twenties; the Bank of Italy had been assigned supervisory tasks and had ceased transacting business with private parties. The 1936 Banking Law redesigned the institutional framework along these lines.

Similar developments occurred in the credit sector in other European countries and in the United States.

Under the influence of a centuries-old culture, people continued to refer to the link between legal tender and gold. In the decades following the Second World War that link was severed first *de facto* and then *de jure*. In 1971 the convertibility of the dollar was suspended. There ensued a long period of instability and high inflation worldwide, the backdrop for the oil crisis of 1974 and its sequel at the end of the seventies. In all the industrial countries the upshot was a surge in inflation and lost economic growth, investment and employment.

The situation of the global monetary and financial system today is to some extent comparable to that of the national monetary systems before currency issue was entrusted to a single institution in each country.

Each monetary system is linked with the others by floating exchange rates; loanable funds and currencies circulate freely from one system to another.

There is no cogent rule limiting the quantity of money created worldwide. The free circulation of capital is encouraged, but the national systems are vulnerable to destabilizing speculative impulses.

Immediately after the Mexican financial crisis the leading countries, beginning with the Group of Seven, inaugurated a new phase of closer cooperation with a view to mitigating the repercussions of the crisis and establishing rules and procedures for the supervision, solvency and stability of banks. This collaboration has extended to the Group of Ten at the Bank for International Settlements in Basle. All the industrial countries have been invited to contribute, and an effort is being made to involve the emerging countries as well in the programmes of oversight and supervision.

A central role is reserved to the International Monetary Fund, especially in surveillance of the national economies' performance and links with the global market.

The world economy

In the early months of 1995 the Mexican crisis struck the dollar, which depreciated by 10 per cent in a matter of weeks; the yen appreciated by 20 per cent and the German mark and French franc also strengthened. Currencies that the markets deemed vulnerable, including the lira, depreciated along with the dollar but more sharply. Massive transfers of funds between countries altered exchange rates and threatened the stability of the financial systems.

Alongside the launch of programmes of international cooperation on supervisory matters, Japan reacted with an expansionary monetary policy. Interest rates were progressively lowered to near zero and the supply of yen on the international markets was increased. Intervention in the foreign exchange market was carried out on a substantial scale, with sales of yen for dollars.

Within just a few months the exchange rates of the main currencies returned to more balanced values. The general decline in interest rates was accompanied by a steady increase in the quantity of money worldwide. The greater supply of yen and other strong currencies, such as the mark, depressed their exchange rates, with gains for the dollar. The total quantity of liquidity available to participants in the international markets began to expand rapidly.

The intermediation of hedge funds and other global financial players and the activity of pension funds, which play an important role in the US market, fueled an enormous volume of investment in government and corporate bonds, which led to a progressive reduction in long-term interest rates. In parallel, mounting purchases of equities first in the United States and then in Europe pushed share prices steadily up across the board.

The reduction of budget deficits in Europe and the United States, the stability of labour costs, the increase in competition and the weakness of the economic cycle contained inflation.

Price/earnings ratios in the United States and Europe, which in 1995 were still in line with the long-term average level of around 15, began to rise. They expressed a gross return on equity investment of between 6 and 7 per cent. This was comparable to the real yield on what are considered safe bonds, increased by the risk premium normally demanded by investors and net of the expected rate of growth in earnings.

At the end of 1999 the price/earnings ratio of listed companies was close to 30. This means a rate of return of just over 3 per cent.

This value can be justified only if investors perceive the risk of equity investment as very low, far below that historically recorded in all the markets, or else if the rate at which listed companies' earnings are expected to grow is very high, close to 10 per cent a year.

Individual and institutional investors need to analyze the prospective yields of securities with great care. A more generous valuation of securities than in the past may reflect the market's increased depth, its greater liquidity, which reduces the risk of investments. In addition, individual securities can be part of broader portfolios whose risk they reduce by means of negative covariance.

Securities of companies operating in the high-tech sectors, information technology and communications, may have specific prospects. Companies in these sectors are characterized by initially modest earnings but great expectations.

However, higher growth always means higher risk. The prices of these securities are subject to large fluctuations, which sometimes reflect pronounced uncertainty about the companies' performance.

The expansion of liquidity on world markets favoured the exceptionally strong growth of the US economy, where employment also increased very rapidly in conditions of price stability. The intensive and widespread use of new technologies resulted in a step-up in productivity growth. The rise in share prices in traditional sectors and especially those of firms engaged in information technology was thus founded, in the United States, in developments in the real economy.

The markets apparently foresaw this phase of exceptionally rapid growth before economists and policy-makers.

It is questionable whether the market prices of shares have not gone beyond what would be justified on the basis of rational calculation. However, every cycle in history has had its own distinctive characteristics. It is difficult to reach a clearcut conclusion. The exceptional nature of the present values calls for constant monitoring.

The stock market rise in the United States spread to Europe. The explanation may lie in the good prospects for the European economy opened up by the cyclical upswing under way and expectations of the spread of the new technologies.

The bull market continued into the first few months of this year.

Subsequently, among other things owing to the progressive tightening of monetary conditions in the United States and Europe, there began a period of uncertainty. In a number of cases share prices declined.

The ratio of the financial wealth represented by the bonds and shares listed on the leading stock exchanges to the GDP of the main industrial countries rose from 1.2 in 1995 to 2.8 in 1999. This rise underscores the abundance of liquidity worldwide, which has lent powerful impetus to economic growth in the industrial countries, but which also entails the risk of financial instability and inflationary pressures.

The strengthening of the expansion in economic activity in Europe and Japan underpins expectations of higher profits and dividends, makes the value of financial wealth more consistent with that of output.

The buoyant US growth has helped, through imports, to sustain the Latin American and European economies. The Asian crisis appears to be past. South Korea, Thailand, Malaysia and other minor countries in the region have returned to economic growth. After tracing an uncertain path in 1999, the Japanese economy also appears to be recovering.

The expansion of economic activity in Europe has been under way since the middle of last year, driven by the rapid acceleration of world trade.

It is necessary for the European economies, and above all the Italian economy, to take part in this movement and carry out the structural reforms needed to ensure the continuation of growth with stability.

The Italian economy

The Italian economy and those of other countries such as France, Germany and Japan grew vigorously in the two decades following the Second World War by concentrating primarily on the growth in demand for the products of large-scale manufacturing industries and the expansion of construction and public works.

The growth of industrial employment increased households' purchasing power. New patterns of consumption and new lifestyles spread. A young and still expanding population, eager to improve its standard of living, was the premise for the taking up of the additional products.

In the fifties and sixties Italy's national income grew at an average annual rate of 6 per cent in real terms.

While the opening of the European economies through the Common Market further accelerated the growth of output, inflationary pressures, emerging as early as the start of the sixties, were accentuated. That model of economic development broke down at the end of the decade. In the meantime, the unemployment rate had been sharply reduced.

Wage and price tensions were accentuated by the increasing power of labour unions.

Following the suspension of the dollar's convertibility into gold, the inflationary pressures in international markets culminated in the first oil crisis.

The higher cost of energy further reinforced inflationary pressures in the industrial countries. The cost of labour soared.

In the first half of 1974 inflation was running at a monthly rate of about 2 per cent; the annual rate was 25 per cent.

In the mid-seventies, first in 1974 and again at the end of 1976 and in 1977, it was necessary to make drastic cuts in the budget and impose quantitative restrictions on credit. These measures curbed the depreciation of the lira and slowed the rise in prices. The balance of payments, which had gone heavily into deficit, was righted.

In 1975, after more than 25 years of rapid and continuous expansion in economic activity, GDP growth slowed abruptly.

The second half of the seventies was marked by alternation between inflation and deflation, and by currency devaluations. The budget adjustment of 1977 was equal to 5 per cent of GDP. The system of wage indexation was modified. The devaluation of the lira nevertheless encouraged exports; the activity of small and medium-sized enterprises, with their labour-intensive processes and low technology content, permitted prompt adjustment to changes in relative prices.

The annual growth rate for the decade declined to 3.6 per cent.

After the second oil crisis, in 1979, the annual inflation rate again exceeded 20 per cent. A long period of monetary tightening began, pivoting on Italian participation in the European Exchange Rate Mechanism.

Major energy-intensive industries suffered a severe crisis.

The number of persons employed in industry had risen steadily from the late forties to the mid-seventies.

In the early eighties the labour unions recognized that it was impossible to keep on demanding wage increases, which only translated into more inflation with adverse effects on jobs. Sweeping industrial restructuring began, reducing the number of workers in the largest firms. Many smaller firms were created, supplying goods and services to the large ones. In response to technological progress there emerged new skills and positions, new types of worker with new needs for representation. Employment growth came to be concentrated in the service sector.

As in the rest of the industrial world, Italian economic growth slowed still further. The annual growth rate for the decade was 2.4 per cent. Budget deficits began to increase significantly in the mid-seventies, and grew still faster in the early eighties. The public debt mounted rapidly.

Together with employment in services, self-employment, which was already very substantial in Italy, expanded even further. There was an increase in the proportion of labour employed in the irregular economy, with inferior health and pension coverage, wages and job security compared with the standards of workers in the regular economy.

In the nineties the need to reform public spending, reduce the budget deficit and the public debt and curb inflation brought a further slowdown in economic expansion. The annual growth rate for the decade fell to 1.4 per cent.

The after-tax incomes of wage and salary earners fell by 5 per cent in real terms over the decade. Macroeconomic adjustment proceeded. Monetary policy rooted out inflation. The budget deficit was sharply reduced in the second half of the decade. Despite its difficulties, Italy succeeded in participating in the single European currency from the outset in 1999.

Total employment, which had expanded until the beginning of the nineties, contracted drastically beginning late in 1992. It recovered in the second half of the decade, but the upturn was chiefly in the form of part-time and above all fixed-term jobs.

The challenges ahead

In the second half of the nineties the Italian economy became less competitive. Exports failed to keep pace with the growth of world demand; domestic demand was increasingly directed to imports from other countries in Europe and the rest of the world.

Industrial production grew much more slowly in Italy than in the rest of Europe.

Italy is the European economy with the lowest growth rate and the lowest employment rate. The disparity between the advanced northern regions and the South widened in the course of the last decade. The international economic expansion that got under way in mid-1999 has mainly benefited economic activity in the North of Italy. The South, albeit with exceptions, is following these positive developments only haltingly. The serious problems of high taxes, shortcomings in infrastructure and the excessive fragmentation of output among tiny firms persist.

The economic upswing is still robust this year, thanks to the exceptional performance of the world economy.

The forms of flexibility introduced into the labour market are producing positive results in terms of jobs.

The context in which economic activity is performed has changed profoundly. Much more than in the past, the financial and the industrial economy are open to outside competition and external shocks.

In the fifties and sixties output expanded continuously and rapidly. Employment grew. The purchasing power of wages increased. In the decades that followed, these conditions gradually ceased to exist.

Large firms have reduced their manning levels. They are exposed to intensifying competition from abroad and to fluctuating levels of demand for their products. They have to cope with competition by upgrading the quality of their output and increasing cost competitiveness and supply elasticity.

Around the large companies there have arisen myriad enterprises that provide them with goods and services for the domestic and export markets.

It is indispensable to respond adequately to fluctuations in demand and always to produce at competitive costs.

The conditions that can transform the current expansion into a new period of economic growth and make it less dependent on the performance of the world economy must be brought into being.

In the first place the measures needed concern government expenditure and revenue. As has been repeatedly recalled, it is necessary to curb the rate of increase in spending on health care and pensions, increase the efficiency of the public sector, drastically reduce bureaucratic requirements, simplify and streamline the entire administrative system, and progressively ease the tax burden on the economy. Especially in the economically backward areas, public investment must be expanded.

The legal system governing the economy must be revised to encourage the creation and growth of firms. Bankruptcy law must better reconcile the objective of preserving the firm as a going concern with the rights of creditors and facilitate market solutions to company crises.

A positive contribution to growth can certainly come from the application of information technology. Economic policies are needed that, in addition to removing structural impediments, foster the efficient use and the spread of the new technologies throughout the economy.

Human capital proves to be indispensable. We need to study the methods of applying the new technologies and IT in the most advanced economies, first of all the United States, and adapt them to our own industrial system. The closest possible cooperation between the universities and the productive economy is required.

Product quality and labour

The rise of the so-called new economy, made possible primarily by the application of information technology, brings opportunities to reorganize production, placing the emphasis on the quality of the product, prompt adjustment to demand and the ability to foresee and adapt to cyclical fluctuations.

This new scenario calls for a change in the structure of the supply of labour.

Each and every enterprise must have adequate profit margins if it is to survive and grow.

Profit margins are the difference between revenue and expense, both of which are large aggregates.

Given that, in a very open economy, revenue may fluctuate widely, labour costs cannot be rigid.

There must be room to adapt total wages to production needs and proceeds. Overall costs should fall during negative phases of the cycle; if unit wages are rigid, the number of jobs will necessarily have to fluctuate. In these conditions businesses tend to hold employment at sub-optimum levels.

When output is expanding, on the other hand, wages can be adjusted to share in some of the firm's increased revenue.

One way to give elasticity to the wage bill is to vary the number of hours worked by each employee and the related costs in tune with cyclical fluctuations: alternatively, wages can be adjusted. In practical terms a variable component can be added to the fixed portion of wages according to the phase of the cycle and the firm's prosperity; this component should account for a much larger share of wages than is currently the case.

I am referring to the so-called share economy in which the labour factor participates in a firm's vicissitudes through variations in earnings and costs. This approach produces a form of strategic cooperation between employer and employee, while maintaining the distinction between their roles. It gives employees a greater interest in the firm's performance; the firm's cyclical and even structural difficulties are eased, dismissals decline and hirings may increase.

In advanced economic democracies employees can also participate in a firm's destiny through ownership of a portion of its capital, thereby broadening the horizons of shared interest.

The priority requirement in the new international economic scenario is for better quality goods. In Europe exports of high-tech products account for about 16 per cent of the total; in Japan and the United States the figure is close to 30 per cent; in Italy it is less than 10.

Italy finds itself competing by offering traditional products with slow demand growth against increasingly keen competition from emerging economies with low labour costs.

The demand for high-tech goods is rising much faster than that for traditional products. Italy's meagre showing in these segments of international trade is reflected in the growth rate of our economy.

In some ways the role of these products is akin to that of the mass consumer goods turned out by big industry in the fifties and sixties.

In those days Italian firms offered innovative production and organizational models and launched one of the most far-reaching and rapid phases of transformation of the Italian economic and social system.

The new technologies are accessible to all. The major firms that operate in this region can make an important contribution to restoring productivity and competitiveness, if need be through international agreements.

Large firms play a central role in transforming production methods and are actively involved in the processes of globalization and international investment. They encapsulate part of the drive to innovate products and processes; they are, above all, the hub from which new organizational and technological ideas radiate to other firms operating with them in the production chain.

The larger organizations have often given a timely and positive contribution in the fields of industrial relations and new forms of employment.

Small firms need to arrange their organization and labour relations to exploit the cost-cutting advantages offered by the new technologies and the rise of telecommunications networks. In this the financial sector will have a decisive role, particularly segments specializing in providing capital for innovative investments.

A survey conducted by the Bank of Italy found that about 90 per cent of firms are already connected to the Internet, which they use mainly for advertising and home banking services. There is a copious exchange of information with other firms regarding orders and deliveries: almost two thirds of firms are involved in this type of electronic quasi-trade. Small firms are studying new forms of cooperation, even including the joint planning of products and productive processes.

Relations with employees should facilitate the technological leap. Just as the whole structure of labour relations was overhauled in the fifties and sixties, so the changes we are experiencing today call for new rules and contractual formats. Flexible models of labour relations can both accelerate experimentation with new organizational arrangements and the adoption of new technologies and make them work profitably. The role of the social partners is pivotal to this process of redefinition. Agreements that spread flexible working hours over the whole working year are a first tentative step in this direction.

The use of technology to renew processes and products requires considerable skills in the fields of mathematics, science and information technology.

These must be supplemented with a classical education in the humanities for a rich well-rounded background.

The process of innovation should be pioneered by top-quality groups able to grasp exogenous changes promptly and seize the opportunities thrown up by scientific developments.

The average level of education in Italy is lower than in the other leading industrial countries. The supply of technically qualified persons is poor. Total spending on research and development by both public institutions and firms is less than in other industrial economies.

There is a pressing need for decisive, forward-looking and appropriate measures to strengthen both public and private sector initiatives, each in its respective sphere of competence.

Universities and research institutes must train an increasing number of young people with the ability and will to learn and progress.

Technologies developed in the research centres of more advanced nations are available to Italian firms: new organizational models can and must be adapted to the Italian productive framework.

In this process, the contribution of large firms is irreplaceable: they, and the training they give their employees, are the chief link between the organizational approaches developed in more advanced economies and those found in Italy.

However, no benefits will be forthcoming unless this type of progress extends to all firms.

Failure to take timely advantage of the opportunities available might well be tantamount to retrogression.

We should look to the next few years with confidence: they could bring a new surge of innovation and productive evolution. International financial conditions are favourable and Italy's credit supply structure has already improved considerably.

Economic policy must seize the opportunities that the new era in world economic development offers.

Economists have always known that development, economic growth and the enhancement and spread of well-being ultimately depend on the labour factor, on people and their ability to work, plan and innovate. This role is not about to be downgraded: on the contrary, the new *status quo* will give it fresh prominence.

Our generation cannot make itself the measure of all things. Everyone — public authorities, industrialists, businessmen and the social partners — must move resolutely forward towards new goals.

Today's young people want to have faith in the future; we cannot disappoint them; they are our most precious asset. We must count on them.

Today's actions acquire meaning and significance when viewed in a future perspective.