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The global economy and Italy

Address by the Governor of the Bank of Italy
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1. International liquidity

International liquidity has been abundant for some years now. The globalization of markets has led to the widespread adoption of liquid instruments that are not under the control of national monetary authorities. The large-scale use of derivatives has increased the ability to multiply financial transactions in relation to money.

Monetary policies in the major areas became highly expansionary in 1998 and the early months of 1999; they continue to be accommodating even after the increases in interest rates decided in the second half of last year.

Short-term nominal interest rates declined from the early nineties onwards and are at historically low levels.

Consumer price inflation has remained moderate everywhere, matching the values recorded in the sixties.

The expansion of international liquidity began to accelerate in 1995 with the marked easing of monetary conditions in Japan in the spring. Following the Mexican crisis, which had led in the first four months of that year to a sharp depreciation of the dollar (by 19 per cent against the yen and 13 per cent against the mark), currency re-equilibration was pursued not by raising dollar interest rates but by further reducing the yields on assets denominated in yen, which had already been very low for two years.

In the summer of 1995 the Japanese central bank intervened with massive purchases of dollars. In view of the weakness of domestic demand for credit, the abundant liquidity spilled over into international markets.

At the end of 1995 the yen had fallen against the dollar by 21 per cent compared with its peak in April. The dollar appreciated gradually.

The lira, which had depreciated by 18 per cent against the mark in the early months of 1995, also staged a recovery, triggered by aggressive exchange market interventions and reinforced by drastic monetary restriction and fiscal adjustment.

The growth in the monetary aggregates in the leading industrial economies remained basically in line with that in nominal income from the beginning during most of the nineties. Since the end of 1998 the ratio of money to income has increased, rising from 67 per cent to more than 70 per cent in the first three quarters of last year.

In the three years from 1995 to 1997 the flows of capital from the industrial countries to the emerging countries were very substantial. A large proportion of these funds were reallocated by offshore centres, in part with the intervention of highly-leveraged institutions.

These intermediaries raised funds where interest rates were lowest and then, using derivatives, made investments in all the main financial markets equal to a multiple of the funds they had borrowed. This fueled a rise in bond and share prices.

From the end of 1997 onwards the effects of the Asian crisis and, from August 1998 onwards, the difficulties encountered by other emerging market economies resulted in a reduction in international bank lending. The funds withdrawn from the economies in crisis flowed into the financial markets of the United States and to a lesser extent Europe, judged by investors to be safe havens, further contributing to the rise in bond and share prices.

Short-term real interest rates rose temporarily in 1997 and 1998; the slowdown in inflation produced by the fall in commodity prices was more pronounced than the decline in nominal interest rates. In 1999 real rates returned to very low levels of between 2 and 2.5 per cent, or roughly half the average values recorded in the eighties.

In 1999, with the easing of the crises, the flow of portfolio investment from the industrial to the emerging countries resumed. Access to international credit is more selective than before the crises.

The expansion of credit and money at the international level is reflected in, and part of, the more general process of rapid growth in global finance. In the ten leading industrial economies the stock of public and private bonds increased from 90 to 127 per cent of their combined GDP between 1985 and 1998 and the capitalization of their stock markets from 30 to 97 per cent. The spread of derivative financial instruments was faster still, especially in the nineties: between 1990 and 1997 the notional value of the derivatives traded on organized exchanges rose from 37 to 195 per cent of the combined GDP of the Group of Ten countries.

In a context marked by expansionary monetary conditions, inflation has been curbed by the sluggishness of effective demand for consumption and

investment everywhere except in the United States. Until the early months of 1999 raw material and energy prices declined. Contributions to holding inflation in check came from restrictive incomes and budgetary policies in Europe and from large improvements in productivity in the United States. In Japan, owing to the prevalence of pessimistic expectations among businessmen, there continued to be significant signs of deflation.

2. Structural problems of the leading economies

In the United States, the expansion that began in the spring of 1991 is now surpassing that of the sixties to become the longest ever in US economic history. In the last five years the rate of growth in economic activity has accelerated to an average of 3.5 per cent; these years have been distinguished not only by a notable increase in labour productivity, which has risen at an average rate of 2.1 per cent, compared with 1.5 per cent in the preceding ten years, but also by rapidly expanding investment, robust employment growth and low inflation.

The economy's strong performance, together with the structural adjustment measures adopted in 1993, has helped to correct the imbalance in the public finances, largely the legacy of the expansionary fiscal policy of the first half of the eighties. A federal budget deficit gave way to a surplus of $69 billion in 1998 and $123 billion in 1999. The ratio of public debt to GDP is declining rapidly and should fall below 50 per cent in the coming years.

Inflation has steadily abated; in the three years from 1997 to 1999 consumer price inflation hovered around 2 per cent. Core inflation remained basically unchanged, again at close to 2 per cent. Unit labour costs rose at an average annual rate of 1.8 per cent, compared with 4.6 per cent in the eighties. In the manufacturing sector, they have fallen at an average rate of 1.5 per cent since 1994, reflecting large productivity gains and the moderate growth in nominal wages.

Underlying the prolonged expansion of the US economy is the widespread introduction of new technologies, particularly information technology.

These new technologies have progressively boosted individual companies' productivity in industry and services. Firms' activities have been reorganized, with resulting gains in efficiency in the utilization of labour and plant.

The possibility of using labour with a high degree of flexibility has been fundamental in this process.

The reorganization is presumably spreading to the system of intersectoral relationships. This improves the economy's efficiency and leads to higher output with the same input of productive factors.

The ratio of private gross investment to GDP, which had fallen by more than 2 percentage points in the eighties, rose by around 6 points between 1991 and 1999 to above 18 per cent, the highest figure since the end of the Second World War.

Spending on research and development, which is structurally higher than in other countries, rose from 2.4 per cent of gross domestic product in 1980 to 2.8 per cent in 1998.

According to national accounts data, calculated using a methodology which has now been replaced and which probably underestimated the scale of the phenomenon, private-sector investment rose in the nineties at an average rate of just under 6 per cent, more than twice that recorded in the preceding decade; investment in machinery and transport equipment grew by an average of 8 per cent. Spending on computer equipment, in particular, rose at an annual rate of almost 20 per cent and currently accounts for nearly 30 per cent of all private-sector investment, compared with 9 per cent in the early eighties, when the far-reaching restructuring of the US economy began.

Between 1991 and 1996 total factor productivity in the private sector rose at an average rate of 1.6 per cent, compared with 0.7 per cent in the eighties. The increase in the manufacturing sector was far higher, nearly 6 per cent, compared with 2 per cent in the eighties; it was concentrated in the machinery and transport equipment industries, where total factor productivity grew by more than 10 per cent.

This picture, highly positive as a whole for the productive system, is not without elements of fragility. The increase in domestic demand continues to outpace the economy's potential rate of growth. The consequent gap between investment and saving led in 1999 to an external current account deficit in excess of $300 billion, more than 3 per cent of GDP. The level of private-sector debt is rising.

In Japan, following the speculative bubble in the financial markets at the start of the nineties, the economy entered a prolonged period of stagnation that culminated in 1998 with the deepest recession since the end of the Second World War. In 1999 economic activity showed a modest recovery, primarily as a result of substantially higher public spending. The economy grew at an average rate of 1.6 per cent in the nineties, compared with 3.9 per cent in the eighties; the average improvement in labour productivity was also very small.

Numerous factors have contributed to the protracted weakness of the economy: the crisis in the banking and financial system that followed the collapse of equity and housing prices; the initial hesitancy with which macroeconomic policies, particularly fiscal policy, were used to support the economy; the appreciation of the yen in the first half of the decade; the difficulty of maintaining competitiveness through continuous productivity gains; and the growing competition from other Asian countries, especially in the Japanese economy's key sectors.

The unsatisfactory performance of investment followed the sharp acceleration recorded in the second half of the eighties, which had culminated in 1990 in investment rising to 32 per cent of GDP. Capital formation had been strongest in branches of the manufacturing sector, which plunged into crisis in the nineties.

Monetary policy adopted a more and more expansionary stance in the course of the nineties. In September 1995 the discount rate was lowered to 0.5 per cent; the central bank pumped in substantial liquidity, not least to help the banking system to recover. The scope for monetary policy action appears to have been virtually exhausted.

Since 1992 budgetary policy has been geared to supporting economic activity. In 1990 the general government budget recorded a sizable surplus, equal to around 3 per cent of GDP, partly as a result of the adjustment measures taken in the second half of the eighties; the surplus gradually gave way to a deficit of 8 per cent of GDP in 1999. Gross public debt rose from 61 to 107 per cent of GDP in the same period.

The measures to stimulate the economy, involving ever-larger amounts, have mainly centred on public investment in infrastructure. This enormous fiscal effort has still not succeeded in fostering a new phase of rising production sustained by domestic demand; the increase in the budget deficit on current account has been compensated in part by more private-sector saving; private investment is still in decline.

But the impulse imparted to the economic cycle by public spending has averted a downward spiral of the economy, which would have had destabilizing consequences for the financial system and the world economy.

The weakening of Japan’s position in outlet markets and the gradual decline in the return on capital have forced firms to embark on far-reaching restructuring with a view to reducing excess capacity and restoring profitability. Although this process inevitably carries high social costs in the short term, it should lay the foundation for greater economic growth in the years ahead.

In the euro area, output grew in the nineties at an average rate of 1.6 per cent, albeit with significant differences between the main countries. Italy recorded the lowest growth rate, just above 1 per cent; Spain achieved a rate of 2.4 per cent; Germany and France held an intermediate position.

Despite the sharp disparity in the area's rate of economic growth vis-à-vis most of the other industrial countries and the emerging countries, the surplus on the current account of the balance of payments is running at less than 1 per cent of GDP. This highlights a problem of competitiveness for the European economy.

The large fall in long-term real interest rates abetted by fiscal consolidation, the stability of the currency and wage moderation have not yet succeeded in boosting capital accumulation. The ratio of investment to GDP in the euro area fell significantly in the first half of the nineties and has only showed signs of recovering since 1997; in 1999 it was just above 21 per cent. In Germany the ratio declined gradually between 1991 and 1998. Among the major countries, only Spain has seen investment grow significantly faster than GDP since 1994.

Private-sector investment grew at an average rate of less than 1 per cent in the nineties, compared with 2.2 per cent in the eighties; the variation was slightly negative in France and virtually nil in Italy. The increase in investment in machinery, equipment and transport equipment in the euro area as a whole amounted to only 1 per cent, compared with 4 per cent in the eighties. Capital spending was weak in all productive sectors, most notably the construction industry and some branches of manufacturing. Despite the gradual shift in the composition of the capital stock to the benefit of services, capital formation in the three main countries of the euro area is still concentrated in industry.

The fiscal consolidation carried out in order to comply with the convergence requirements of the Maastricht Treaty was achieved in part by increasing the tax burden, which now stands at levels well above those of the

United States and Japan. Constraints of various kinds are an obstacle to the flexible utilization of the factors of production.

In addition to the firmness of monetary policies, a contribution to the fall in inflation has come from the extreme moderation of incomes policies, which partly reflects the steady and significant rise in unemployment.

3. Financial instability and exchange rates

The integration of capital markets worldwide has eased the constraints on growth imposed by the availability of funds. These constraints were especially tight for developing countries.

In the absence of complete information on the final use of funds and efficient financial structures, the globalization of markets increases the risk of instability. The abundance of international liquidity in recent years has fostered sometimes indiscriminate financing of investments.

The perception of an imbalance between the expected return on capital and the cost of borrowing can give rise to doubts about borrowers' ability to repay their debts, leading to pressure on exchange rates, a sudden cutting off of financing and a fall in productive activity and employment. The crisis can become acute if residents' foreign debt is largely at short term and denominated in foreign currency.

To a certain extent systemic risk is inherent in global finance. Given its implications, the possibility of the rapid spread of financial turbulence among

countries in the same region or even beyond represents a challenge for the international community.

A first factor in the propagation of crises is the reduction of demand in the countries directly affected.

Financial disturbances can also be transmitted through portfolio adjustment by international investors, especially highly-leveraged institutions.

A currency crisis in one country can lead investors to modify their assessment of conditions in other economies, thus triggering a reallocation of portfolios. Increases in interest rates and capital flight may ensue, possibly causing the external value of the currency to fall.

In the short run the exchange rate in the leading economies is influenced mainly by short-term interest rate differentials.

The orientation and credibility of monetary, budgetary and incomes policies are crucial to the stability of the exchange rate. In the case of the dollar, factors tied to its predominant role as international reserve currency are also relevant.

In the long run, the external value of a currency reflects the economy's fundamentals: productivity gains, the ability to compete in international markets, potential output growth.

The relationship between economic growth and the credibility of policies on the one hand and the external strength of the currency on the other is basically borne out by the experience of recent decades; however, this link may be less certain at times for some currencies.

The weakness of the dollar in the seventies was especially pronounced after convertibility was suspended. In the following decade, the abrupt swings of the US currency, first appreciating then depreciating, appear to have been determined largely by the economic policy mix.

With the tightening of monetary policy at the end of the seventies, in conjunction with a highly expansionary fiscal policy, the rise in interest rates made it easy to finance a growing current account deficit; it caused the dollar to rise strongly until early 1985.

The situation was not sustainable. The US authorities emphasized the need to reduce the external value of the dollar. A sharp reversal of trend was achieved, facilitated by changes induced in expectations and concerted intervention in the foreign exchange market. Over the medium term, the objective was pursued by altering the policy mix: monetary conditions were made less restrictive and budget deficits reduced.

The early nineties were characterized by limited fluctuations of the dollar. After weakening in 1995 in connection with the Mexican crisis, it began to strengthen again. The subsequent appreciation has been associated with the vigorous economic growth of the United States, which has far outpaced the other leading industrial countries. The rise in the value of the dollar has been consolidated as the economy's growth has shown itself to be of a structural nature.

The large current account deficit has continued to be easily financed by substantial capital inflows, attracted by the favourable prospects for investment; the inflows increased further during the crises in the emerging economies.

Between 1996 and the third quarter of 1999, the United States recorded net capital inflows of about $1 trillion. Three quarters of this amount was portfolio investment, much of it channeled through the London financial market. In 1998 and 1999, inward direct investment exceeded $160 billion, more than half of it originated by euro-area residents.

The yen has tended to appreciate in the long term.

The main factors underlying the strength of the Japanese currency in the seventies and eighties were undoubtedly low inflation and rapid output growth, which were attributable to large improvements in productivity. The high saving rate fueled substantial large domestic flows of productive investment together with massive net purchases of real and financial assets abroad.

In 1999 Japan’s net external assets were equal to just under 30 per cent of gross domestic product.

In 1995 monetary expansion pushed the yen into a period of depreciation that lasted until 1998. The decline can be attributed to the problems associated with the Japanese model of development. Since 1992 Japanese exports have sustained large losses of market share. The recent recovery of the yen is the

result of progress in reviving the economy and the new prospects for growth opened up by the restructuring of the productive system.

The rise in the effective exchange rate of the mark in the seventies and eighties reflected the ability of the German economy to absorb the effects of the oil shocks. Thanks to rigorous monetary and budgetary policies, the inflationary impact of the increases in the price of oil was less severe than in other countries; Germany's competitiveness benefited, and its external current account recorded substantial surpluses.

The mix of economic policies was changed in order to cope with the costs of reunification and the related risk of inflation. Budgetary policy became expansionary, while monetary policy was made even more restrictive, with a consequent rise in interest rates and substantial appreciation of the mark.

The policy mix was modified again in the mid-nineties: budgetary policy was tightened in order to meet the requirements laid down in the Maastricht Treaty, while monetary policy was made expansionary in order to counter the slowdown in economic activity. From 1995 onwards the mark tended to weaken.

It was essentially this policy mix that the new European currency inherited.

From the end of 1998 onwards the expansionary stance of monetary policy in Europe was accentuated by the convergence of interest rates towards the low levels prevailing in the countries with the longest record of stability.

The euro weakened against the dollar up to July, recovered in August, began to lose ground again in November and is currently close to parity with the US currency.

Until last summer the euro's depreciation was partly a reflection of the gradual widening of the differential between short-term dollar and euro interest rates. The link between the exchange rate and the monetary policy stances in Europe and the United States subsequently weakened.

The key factor in the euro's weakness against the dollar is markets' awareness of the greater strength of the US economy. Although the European economy is recovering, it appears to be held back by structural deficiencies that limit its rate of growth and restrict the demand for euros in the international markets.

Proof of this lies in the substantial net outflow of private capital in the form of direct and portfolio investment, which amounted to more than €300 billion in 1998 and 1999.

Recent improvements notwithstanding, unemployment remains high, at more than double the rate in the United States. There are shortcomings in markets' configurations and manner of operation. Rigidities in the labour market are still hindering the expansion of employment.

Government budgets remain large and the level of taxation high.

4. Share prices

Since 1995 share prices in the major countries have registered an exceptional increase. From a base level of 100 in January of that year, by the end of 1999 they had risen to 307 in the United States, 305 in France, 258 in Germany and Italy, 210 in the United Kingdom and 111 in Japan.

There was a sharp dip in prices, ranging from 12 per cent in the US to 27 per cent in Germany, in connection with the financial crisis in the summer of 1998. In the autumn the upswing resumed even more powerfully, taking stock market indices to all-time highs by the end of 1999.

Last year the rise spread to Asian markets, owing to the improvement in economic conditions and the decline in interest rates. Share prices in South Korea, Indonesia and Thailand surpassed their pre-crisis levels. They also rose considerably in Latin America, except in Argentina, where the market was dampened by recession and the significant loss of competitiveness since the beginning of last year.

The performance of share and bond prices is partly a consequence of the wordlwide abundance of liquidity. In the industrial countries as a whole this has resulted in a fall in the prices of consumer goods relative to those of real and financial assets.

What appears to be occurring is an illustration at the global level of a well-known theory concerning the mechanism of monetary policy transmission: namely, that an expansion of the money supply and a decline in short-term

interest rates are initially accompanied by an increase in the prices of financial assets and capital goods.

The lower cost of capital thus favours the expansion of effective demand, in the first place for investment goods.

The most striking consequence of the low cost of capital has been the wave of mergers and acquisitions under way for some time, involving banks, insurance companies and industrial and service firms.

In 1993 the corporate mergers and acquisitions carried out in the financial sector amounted to $60 billion; five years later they had increased tenfold.

The lower cost of financing helped foster the world economic recovery that got under way last year.

The crucial question for economic policymakers, and for monetary authorities in particular, is how far the rise in share prices is consistent with the economic fundamentals.

Analyses based on economies' potential growth rates, long-term real interest rates and risk premia suggest that at their current prices shares are overvalued. However, the indicators of corporate profitability used in these estimates could be lower than the actual levels for at least two reasons: the practice of US corporations of rewarding capital by buying back shares rather than distributing dividends and the accounting practice of treating purchases of intangible technologies as current expenditure. The current level of share

prices may also be partly explained by a diminution in the risk premium demanded by investors.

The US economy has entered a new phase of expansion powered by firms in the most advanced sectors, whose share prices have soared. The economy's potential growth rate has been revised upwards.

In Europe and Japan, structural reforms to remove the factors that hamper growth are urgently needed. In many European countries it is essential to make a start on reducing the overall tax burden, which prevents the achievement of the full productive potential of the economy.

Since such action must necessarily be gradual, credible government announcements of measures to achieve this goal are required. At the same time a start must be made on reforming public expenditure to preclude the resurgence of budget deficits.

Economic policy in the main countries must prevent the opening up of too large a gap between share prices and their equilibrium levels. Inflationary tensions of international origin still have not had significant repercussions on the cost of domestic factors. Action is necessary to overcome the structural problems and improve the efficiency of production.

Time is running out.

The need for resolute intervention on the structure of the European and Japanese economies is demonstrated by wide-ranging and thorough analyses; there is a broad consensus on this matter.

Action must be taken to capitalize on today's favourable conditions, to prevent the opportunity represented by a new phase of growth from evaporating in a resurgence of global inflation.

5. The outlook for the global economy and Italy's situation

The world economy is marked at present by an expansion of the financial aggregates that has outstripped the growth in GDP at current prices.

The yield curve has a slightly positive slope in the United States; it points to a rate of growth in nominal GDP not dissimilar to today's. In Japan the curve has a similar shape, but nominal rates are much lower.

In the euro area the slope of the curve is steeper. The three-month interest rate, which is currently around 3.3 per cent, is expected to rise to 5.4 per cent in two years' time; the yield on ten-year securities, equal to 4 per cent at the end of 1998, now stands at 5.9 per cent.

GDP growth in the euro area is accelerating sharply.

In the eleven countries, net capital exports in the form of both direct and portfolio investment exceeded the current account surplus in 1999. The euro depreciated over thirteen months by 15 per cent against the dollar and by 22 per cent against the yen.

So far the decline in the exchange rate has not had serious inflationary consequences; it has been of limited benefit for cyclical recovery in a largely self-contained trade area.

Variations in the exchange rate affect the relative value of financial wealth. The 40 per cent rise in share prices in Europe in 1999 becomes smaller when it is converted into dollars.

In a period of robust growth in mergers and acquisitions, European firms are at a disadvantage in terms of valuations and more easily taken over.

In December 1999 the Italian and German stock exchanges stood 158 per cent higher than five years earlier; the French stock exchange was up by 207 per cent; in the United States the share index rose by 205 per cent. In the same five years the dollar appreciated by 19 per cent against the lira, 26 per cent against the mark and 23 per cent against the French franc.

At times of crisis, America has confirmed that it is a safe haven for international investors. The increases in productivity and production have attracted large financial flows from abroad that have reduced the cost of capital. The US economy has been an engine for global growth; US demand for imports has sustained production in the rest of the world.

Analysis of the possible developments in global finance reveals significant risks for exchange rates and interest rates. An abrupt interruption in the monetary expansion in Japan is unlikely. Faster growth in Europe will contribute to the equilibrium of the world economy.

It is necessary to strengthen the role of the international financial institutions, first and foremost the International Monetary Fund. The ability to foresee crises must be improved, focusing on macroeconomic imbalances and financial systems in the countries at risk.

The Financial Stability Forum is developing studies of the activity of highly-leveraged institutions; their assets and the credit granted to them by banks must be monitored constantly. Together with global institutional investors, they manage funds totaling about $30 trillion. Shifts of this enormous mass can have a profound influence on the financial systems of even medium-sized economies.

The single currency of eleven European countries has contributed to the stability of the international financial system; it has protected their economies from market turbulence.

The rise in competition resulting from the opening and globalization of markets makes it more urgent to strive for enhanced competitiveness at the level of each country and of the area as a whole.

We had long warned that participation in monetary union would have exposed the weaknesses in the Italian economy. Imbalances that were previously expressed in higher interest rates and, in extreme cases, exchange rate difficulties are now directly reflected in investment, production and employment.

In the new context, the comparative advantage of abundant savings loses much of its value. What counts is the ability to create propitious economic conditions for higher returns on investment.

In Italy gross investment rose by 3.5 per cent in 1998 and 3.8 per cent in 1999, outpacing GDP, which grew by 1.3 per cent in both years. The positive difference could be larger this year.

But saving continues to exceed investment, and a considerable part of it is employed abroad. The unemployment rate remains high, even by European standards. The labour-force participation rate is low among men, even lower among women. The unemployment rate in the South averages around 22 per cent; among young people aged between 15 and 24 it stands at 57 per cent. The figure reflects a squandering of human and economic resources.

The weak points of our economy have been identified for some time now.

Abnormal pockets of off-the-books work reveal the inconsistency between labour costs and economic viability. The very high number of self-employed workers and small firms gives the system elasticity, but does not permit the creation of initiatives of a scale able to ensure the stability of employment and growth.

The flexibility introduced in labour contracts in the last few years has promptly produced the hoped-for results. There has been an increase in employment, albeit mainly where it was already highest. It is necessary to continue in this direction with appropriate measures.

Resolute action must be taken to reduce the tax burden in the medium term as well, in order to raise the propensity to invest.

The structural adjustment of the public finances has been achieved to a greater extent than in other European economies by increasing the overall tax

burden, which rose from 39.5 per cent in 1990 to 42.2 in 1995 and 43.2 in 1998. In 1999 revenues increased more than GDP. The Finance Law for 2000 provides for appropriate reductions.

The tax burden is no higher in Italy than in Italy's leading trading partners: 48.2 per cent in France and 42.5 per cent in Germany. In these countries the average quality of public services delivered in return for taxes is higher. Governments have made solemn commitments to reduce the burden of taxation on households and firms substantially over the next three to five years.

Competition in Europe will become fiercer on this front.

Italy will benefit from the programmes undertaken for enhanced effectiveness and efficiency in the public sector. The public administration can be transformed from a brake into an engine of growth. It is necessary to overcome, at local level, the deficiencies of project-development ability that impede full utilization of the structural funds made available by the European Union and more extensive recourse to international credit.

New and courageous entrepreneurial initiatives can already be found in many regions of the South. They must be protected and encouraged through the provision of adequate infrastructure and guaranteed conditions of law and order.

At the start of the nineties the Italian banking system was still highly fragmented and inefficient. Under the prompting of the Bank of Italy and the stimulus of international competition, a reorganization is in progress that is strengthening the system from the point of view of banks' size.

The banking industry will have to act resolutely to improve efficiency and reduce unit labour costs along the lines we have been urging for some time. The Bank of Italy will step up its efforts to foster competition right through to local markets.

But there cannot be sound credit without a sound economy. The only premise, in macroeconomic terms, for a return on investment is vigorous economic expansion.

It is up to policymakers and the social partners to promote the most favourable conditions for the nation’s economic and social development. The emphasis must be on the content of governmental action.

It is incumbent on businessmen to consider the enormous opportunities offered by innovation and an increasingly pervasive application of information technology.

It is necessary to enact structural reforms that will curb inflation and foster expansion in order to turn the recovery that is under way into the start of a new era of growth.

We must create the conditions that will transform potential into reality.

By acting today we will lay the foundations for the welfare of the generations to come.