BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY 2001

THE GOVERNOR'S CONCLUDING REMARKS

Ladies and Gentlemen,

Against the background of rapid economic and financial change, both in Italy and throughout the world, the Bank of Italy provides the organs of state, the country and the markets with a substantial contribution in terms of analysis and proposals. It systematically gives account of its activities in the appropriate fora.

The Bank is an active member of multilateral bodies for the international coordination of supervision and the examination of economic and monetary policies.

Within the European System of Central Banks we participate in setting the common monetary policy and are responsible for implementing it in our own market.

The programme for extending the functions performed by the Bank's branches has come into operation.

The network of branches plays a part in the supervision of banks and payment systems and the safeguarding of competition in local credit and financial markets. Increasingly, analysis of the Italian economy is being supplemented by studies of the regional structure of production and finance carried out by our local branches in collaboration with the Bank's Head Office.

Preparations for the changeover to the euro are continuing, beginning with the printing of the new banknotes, and the deadlines are being met. In conjunction with the Ministry of the Treasury and the Italian Bankers' Association, we are organizing the transition to the new currency in accordance with principles of functionality and security.

In order to increase operational efficiency, particular attention is being paid to the planning and verification of the Bank's decision-making and expenditure procedures.

We are working closely with other public bodies in the prevention and suppression of money laundering and in the fight against usury.

The projects for screen-based treasury operations are designed to integrate the public administration into the payment system and to enhance the exchange of information.

We are paying particular attention to utilizing and developing the professional skills of the staff. I wish to express my personal thanks, as well as those of the Directorate and the Board of Directors, to all our employees for their espousal of the values of the Bank and for the skill and dedication with which they perform their duties.

The world economy

The ratio between share prices and gross earnings, which stood at around 30 in the United States and Italy last May, has fallen back to 24 in the United States and 22 in Italy.

The decline in the ratio was caused by the fall in the value of technology stocks both in the United States and in Europe by about 50 per cent from the peaks of last spring, which were based on an assumption of extremely rapid earnings growth that proved unfounded. The prices of shares in traditional sectors, which account for the greater part of stock market capitalization, are still close to the peaks reached in 2000.

The long bull market began in the United States in 1995, after modest fluctuations in share prices in earlier years; the markets anticipated the exceptional rise in productivity and profits. The upward trend spread rapidly to share prices in Europe, where output grew more strongly in the second half of the nineties than in the first but did not exceed the rates achieved in the eighties.

The availability of ample liquid funds and the use of derivatives influenced valuations and helped spread the rise in share prices both within the US market and from there to other countries. The rise in equity markets went hand in hand with the reduction in interest rates everywhere; long-term bond yields fell sharply until 1998 and continued to decline in real terms in 1999 and 2000.

The abundance of liquidity in international markets encouraged corporate acquisitions and mergers in the service sector and in industry, both within the euro area and between companies in the area and firms based elsewhere.

In Italy, France and Spain there were more concentrations between financial intermediaries than in the early nineties and the amounts involved were larger. The operations were mainly between companies in the same country, but the international openness of banking and financial systems is increasing everywhere.

The euro area

The introduction of the single currency and the intensification of capital movements have made the effects of rigidities and structural shortcomings more obvious in many economies. It is necessary to remove them, in order to remain competitive in the new environment.

The aging of the population in Europe weighs on the prospects for long-term growth.

More rapid and lasting growth requires a prolonged expansion in domestic demand. At the same time, it presupposes reforms that limit public expenditure in relative terms, offer the prospect of a reduction in the tax burden and amend the rules governing the labour market and the regulation of corporate activities. Sensible immigration policies can mitigate the effects of the aging of the population.

In Germany and France programmes have been launched to reduce the tax burden on households, firms and the financial markets. In Italy moves towards a larger tax reduction conflict with the need to contain the budget deficit and reduce the ratio of public debt to GDP.

Increasingly, the social security systems of the majority of European countries are proving to be financially unsustainable. Expenditure on pensions reflects legislation passed in times of rapid economic growth and when the demographic structure was closer to the norm.

In the three years from 1998 to 2000 gross domestic product increased at average annual rates of 2.9 per cent in the euro area, 4.5 per cent in the United States and 4.1 per cent in the emerging economies.

Over the same period, GDP growth in Italy averaged 2.1 per cent, the lowest rate among the European countries.

In the euro area growth was fueled by exports, which increased by an annual average of almost 8 per cent over the three years, against the background of a depreciating currency. Household spending grew in line with output, while corporate investment rose almost twice as fast, at an annual rate of 4.9 per cent, aided by high profit margins and an abundant supply of credit.

Gross domestic product increased by 3.4 per cent in 2000. The rise in energy prices drained purchasing power away from households and firms and generated inflationary pressures.

The balance of payments on current account, which had shown a surplus of 31 billion euros in 1998, has steadily deteriorated. The deficit rose from 6 billion euros in 1999 to 34 billion in 2000, equal to 0.5 per cent of GDP.

The monetary authorities countered the growing inflationary pressures with a series of increases in official rates totaling 225 basis points between November 1999 and October 2000.

Forecasts for this year indicate a weakening of demand and output in the area. The slowdown in activity became more marked in the first quarter of this year. In the largest economy the increase in output in relation to the same period of the previous year was 2 per cent; in May the rise in consumer prices reached 3.5 per cent.

Consumer price inflation in the area averaged 2.3 per cent in 2000. In 2001 the annual rate will still be above 2 per cent; it should gradually decline over the coming months and fall below this threshold in 2002.

At the beginning of May we reduced official interest rates by 25 basis points, bringing the rate on main refinancing operations down to 4.5 per cent.

World economic developments

The prolonged expansion in domestic demand in the United States helped to sustain the rapid growth of the world economy in the second half of the nineties. The current account deficit reached $435 billion last year.

Part of the deficit is in relation to firms and economies for which the United States and the dollar are a point of reference. The breadth and depth of the financial markets, the earning prospects of investments and the stable institutional environment have continued to attract direct and portfolio investment from all over the world.

The demand for dollars for both financial and direct investment was consistently greater than the supply generated by the current account deficit. Between 1995 and 2000 the dollar appreciated by 24 per cent in nominal terms and by 17 per cent in real terms.

Hourly labour productivity in the non-farm private sector rose by an average of 3 per cent per year in the second half of the nineties, compared with 1.4 per cent between 1974 and 1995. More than one percentage point of the acceleration was due to technological and organizational advances; the remainder can be ascribed to growth in the capital stock. The cyclical upturn made it possible to modify the structure of the economy.

Hourly labour productivity in manufacturing industry rose by an average of 4.4 per cent per year between 1996 and 1999. The electronics and communications sectors recorded annual increases in excess of 10 per cent in the nineties.

Abundant liquidity and the gradual fall in the cost of capital stimulated a sharp acceleration in the world economy during 1999 and the first half of last year.

After growing by 2.8 per cent in 1998 and by 3.5 per cent in 1999, output increased by 4.8 per cent in 2000.

World trade in goods and services, which had grown at an annual average rate of 6.5 per cent between 1995 and 1999, rose by 12.4 per cent in 2000.

In the emerging economies, exports to developed countries increased substantially and domestic demand in the form of consumption and investment rose.

The speed of the expansion in the world economy over the last two years generated widespread inflationary pressures. The price of crude oil increased threefold between the end of 1998 and November 2000, partly on account of the oligopolistic constraints on supply.

Consumer price pressures intensified last year. In the industrial economies inflation increased by one percentage point; in Europe the depreciation of the currency was a contributory factor.

The very factors that had fostered the recovery of the world economy were ultimately responsible for depressing growth via their effect on inflation.

In Italy the increase in energy prices reduced the disposable income of the private sector by an estimated 1.5 per cent.

The rise in energy prices also had a significant effect in the United States and Japan, countries where energy intensity per unit of output is high, and in numerous emerging economies that depend heavily on imported oil.

In the United States the slowdown in activity was abrupt; in the last quarter of 2000 investment fell for the first time in many years. Consumer demand continued to grow, but more slowly.

Financial factors also had an adverse effect. Credit conditions, which had been particularly favourable until last year, became tighter during 2000, partly on account of the repeated raising of official rates. An over-optimistic assessment of firms' prospects, which was reflected in the excesses of some segments of the stock markets, had been accompanied by abundant bank lending at relatively low interest rates, especially to firms in the new technology sectors.

In Japan the recovery recorded in the first half of last year was frustrated by the weakening of neighbouring economies. Exports slackened considerably and private consumption declined in the second half of the year. The quality of banks' assets is deteriorating as uncertainty about the recovery persists; it is being affected by fluctuations in share and property prices.

In Europe a gradual slowdown in economic activity until the third quarter of 2000 was followed by a recovery in the fourth in some countries, including Italy. The recovery proved to be short-lived, with growth declining sharply in the first quarter of this year.

The slowdown in activity spread to all regions of the globe.

The rate of growth in output in the newly industrialized countries, which stood at 8 per cent in 1999 and 2000, will fall to 4 per cent this year.

The appreciation of the dollar exacerbated the position of countries whose currencies are pegged to the US currency. In Argentina the authorities responded to the crisis by taking additional restrictive budgetary measures and obtaining financial support from the International Monetary Fund and the World Bank.

In Turkey the crisis arose because of a serious deterioration in the assets of public-sector banks. Here too, financial support from the international community was needed.

According to IMF estimates published in April, the world economy will grow by 3.2 per cent this year. In the United States the increase is put at 1.5 per cent.

The US economy should nonetheless regain momentum in the second half of the year owing to the expansionary effects of monetary policy and the budget measures already approved by Congress.

The Federal Reserve reduced interest rates aggressively from the beginning of January onwards. The first reduction of 50 basis points was followed by four further cuts of 50 basis points each in late January, March, April and May. The federal funds rate was brought down to 4 per cent and the discount rate to 3.5 per cent.

The rate cuts prevented a collapse in equity prices and improved investor confidence.

Available data point to a small increase in output in the first quarter. While a recovery in investment seems unlikely in the short term, especially in the sectors where capital spending was very high in the last decade, output in the automobile industry and investment in new homes are rising. The fall in employment and the decline in the value of financial assets are generating uncertainty about the prospects for consumption.

The fiscal package will produce an initial reduction in taxes of about $40 billion in the closing months of this year; the total for the years 2001 and 2002 will amount to about $110 billion. The measures extend over a period of ten years and will bring down the tax burden by a total of $1.35 trillion, equal to more than 1 per cent of GDP for the entire period. It will also have significant supply-side effects.

The growth potential of the US economy remains high. Bringing actual growth back closer into line with potential growth will be crucial for the equilibrium of the entire world economy.

Economic recovery in Japan depends on restoring the banking system to health and on implementing sweeping structural reforms that can restore household and business confidence, revive domestic demand and change the structure of the economy.

In the euro area efforts to stabilize the public finances must continue. Reforms to stimulate investment and increase supply-side flexibility must be implemented.

A new global equilibrium

Growth rates in China and India will remain high. In the rest of Asia economic expansion will be slower than in the last two years.

In Latin America the Mexican economy, with its greater vulnerability to the deceleration of demand in the United States, will undergo a pronounced slowdown. In Brazil economic activity should continue to expand, thanks to the flexible exchange rate regime and rising domestic demand.

In the economies in transition, the harm will be greatest where relations with the industrial countries are closest.

The downturn in the world economy is exacerbating the problems of the least developed countries. It is making it all the more urgent to achieve the poverty reduction targets set by the United Nations and endorsed by the World Bank and the International Monetary Fund.

In the nineties the free movement of capital and investment led to vigorous growth for the economies and industries best integrated into world trade.

The liberalization of trade in medium and high-technology industrial products created openings for business start-ups, often by major multinational corporations, in countries where labour costs and consumption are particularly low.

In a number of industries the products of the emerging economies now compete effectively with those of the traditional industrial countries.

However, the expansion in world economic activity during the last decade and the overall improvement in living standards have been accompanied by a deterioration in income distribution and a worsening of disparities both within the developing countries and between different parts of the world.

Because of extreme social backwardness and political instability, many economies have drawn only limited benefit from globalization, others none at all. Traditional industries in some of the less backward countries have suffered as a result of competition from cheaper products.

Recurrent financial crises have had severe repercussions on employment and the welfare of the population.

In the two most populous countries of Asia the benefits of macroeconomic progress have spread to large parts of the population; in the other developing economies of Asia, Latin America and Africa the number of people living in extreme poverty has increased.

In some countries civil war or international conflict has had serious repercussions on living standards.

Even in the seventies, and also during the decades that followed, the flow of public and private funds to economically backward countries was not put to fruitful use. Their mounting foreign debt and difficulty in servicing it drove these countries to the margins of world economic development.

All the international institutions are engaged in a profound rethinking of the impact of globalization on the stability of the emerging economies and the distribution of the benefits of economic transformation and changes in production methods.

The initiative to reduce the debt of the heavily indebted poor countries, which was launched by the Group of Seven countries at the Cologne summit in June 1999, began to be implemented last year. In accordance with the conditions laid down by the International Monetary Fund and the World Bank, agreements for the partial cancellation of the debts of 22 of the 41 poorest countries were concluded.

The current value of the debt was reduced by about half. The reduction in interest payments was more than 40 per cent; $375 million a year has been remitted by the World Bank. If bilateral debt relief measures are included, the debt reduction amounts to nearly two thirds.

The developed countries have been urged to cancel all or part of their official trade credits.

Italy has cancelled claims amounting to about $1.8 billion. A further reduction of up to $3.6 billion is scheduled to take place by the end of 2003.

Negotiations on the start of debt reduction are under way with the other 19 countries. The talks with nine of them are hindered by military conflict.

Strong calls for debt relief, which is being pursued by the Bretton Woods institutions, were made by the Roman Catholic Church in connection with the Jubilee Year and by other churches, non-Christian religious groups and non-governmental humanitarian organizations. Debt remission accords with the principles of human and civil solidarity. It reintegrates the poorest economies into world commerce, where they often face unfavourable terms of trade. It is the prerequisite for foreign investment that can trigger economic development.

New rules are needed for handling official aid to the least developed countries. A greater role must be given to international organizations and multilateral development banks, which assign higher priority than donor countries to the objective of reducing poverty.

The traditional agricultural and textile products that frequently typify the developing economies still run up against tariff barriers and, in the case of textiles, import quotas in the advanced countries.

The World Trade Organization must resume negotiations on the liberalization of trade, first and foremost in foodstuffs and textiles, while taking due account of the interests of the least developed countries and safeguarding the environment and local culture.

The European Union's decision to remove the barriers to imports of all products from the poorest countries, except for arms, will contribute in this regard.

Italy's "beyond debt relief" initiative, which was announced at the meeting of finance ministers and central bank governors in Palermo in February and will be on the agenda of the Genoa summit of the Heads of State and Government of the major industrial countries, aims in this direction.

Globalization and financial capitalism are powerful, fundamental factors in extending development to the least developed economies. They need to be supplemented by policies to amplify their positive effects and more effectively prevent the crises of the last few years from recurring.

Through the operation of the market, trade liberalization tends to concentrate products of higher quality and greater value added in the advanced economies, leaving the mass production of basic goods to the middle and low-income countries.

The industrial countries should encourage this tendency by adopting economic policies that foster technological innovation and scientific research and thus succeed in combining stronger domestic growth with the development of the emerging economies.

The outcome, in a framework of closer international cooperation, should be a widespread increase in welfare at the global level.

Economic development, the reduction of poverty, better social equilibrium and decent living standards for the people of the developing nations are closely interlinked. These objectives must be pursued with foresight and determination, thereby contributing to international détente and peace.

Banks

In the mid-nineties the Italian banking system was still fragmented. The return on capital was far lower than in the other leading countries.

The earning capacity of Italian banks was limited by the growing volume of non-performing loans, the narrow range of services provided to enterprises and households and high labour costs.

Staff costs absorbed 44 per cent of revenues, 7 percentage points more than the average for German, French, British and Spanish banks.

At the urging of the Bank of Italy, the banking system has achieved a substantial improvement in efficiency as a consequence of privatizations, consolidation and restructuring. The deregulation of operations, the entry into the market of leading foreign intermediaries and the expansion of supply networks have intensified competition. Innovative products and distribution channels have been developed, production processes reorganized and labour costs held down.

The contestability of ownership and the need to raise capital in the markets to finance concentrations have forced banks to set higher objectives for profitability. The number of banks listed on the stock exchange has doubled in the last ten years: on a consolidated basis, the 40 banks whose shares are traded on the main market account for 80 per cent of the banking system's total assets.

The efficiency gains achieved by the banking system and the reduction in the cost of intermediation benefit the entire economy, households and enterprises.

The consolidation of the Italian banking system has been particularly rapid in the last five years. Bank mergers and acquisitions accounted for nearly 40 per cent of all M&A activity by value; the only major country to record a higher proportion was Japan, where a large number of concentrations involved companies in serious difficulties. In the United States the proportion was 15 per cent, in France 16 per cent and in Germany 3 per cent.

Between 1996 and 2000 banks holding 37 per cent of the banking system's total assets were the target of mergers and acquisitions; in the preceding five years the figure had been 15 per cent.

Large banking groups have been created; the five biggest account for 54 per cent of total assets, compared with 36 per cent in 1995. The degree of concentration in the industry is similar to that in France and Spain and higher than in Germany and the United States.

The larger scale of production has allowed banks to achieve economies in the supply of services, especially in the field of managed savings, and to develop distribution channels based on new technologies. The number of customers using telecommunications links to obtain information, trade securities and carry out banking transactions is growing rapidly.

As a result of restructuring, the major banks in southern Italy have acquired stable ownership structures, improved their profitability, rebuilt their capital bases and are now again providing support for production and investment.

In response to strong urging by the supervisory authorities in 1997, banks have adopted measures, in agreement with the trade unions and with the blessing of the Government, to curb their unit labour costs and make better use of the professional skills of their staffs. At the same time they have expanded their activities with a higher value added.

The rise in unit labour costs in the four years from 1997 to 2000 was reduced to an annual average of 1.2 per cent in nominal terms. The payment of incentives totaling 2,600 billion lire encouraged the exodus of 21,900 employees. Employment declined by 3 per cent in the banking industry as a whole; at the largest banks it fell by 10 per cent, while at smaller banks it rose by 7 per cent.

Labour productivity increased at an annual average rate of 6 per cent; the figure for the largest banks was 8 per cent.

In 1999, the last year for which international comparisons can be made, the ratio of staff costs to revenues at Italian banks was close to the average for France, Germany and Spain. Average staff costs per employee are nonetheless still higher than the average for the other main euro-area countries.

The favourable trend in the profitability and financial structure of industrial firms and improvements in loan management have contributed to reducing credit risk. The ratio of the flow of new bad debts to total loans stood at around 2.5 per cent in the mid-nineties; it fell to 1 per cent in 2000.

The progress made by the banking system is confirmed by the results of on-site examinations. In the three years from 1998 to 2000, inspections were carried out at 516 banks with 32 per cent of the system's total assets. Highly positive assessments were issued for banks representing 19 per cent of the system, negative assessments for banks with a market share of 4 per cent. In the three preceding years, the corresponding figures for a sample representing 36 per cent of the banking system were 10 and 8 per cent respectively.

The efficiency gap between Italian banks and their main European competitors has been almost closed. The ratings awarded by international agencies have improved.

The increase in profitability has led to bank shares outperforming those of industrial companies and foreign banks over the last five years.

Results for the year 2000

The improvement in profitability was more pronounced in 2000 owing to the rise in credit demand, boosted by investment, and the further rapid growth in asset management services. Total revenues increased by 11 per cent.

Operating costs rose by 4.7 per cent, primarily as a result of investment to expand distribution channels and upgrade information systems.

In the course of the year employment increased by 4,400 in small banks and fell by a similar number in large ones.

The Solidarity Fund that recently came into operation provides the means for improving staff qualifications and making more efficient use of personnel.

Loan losses fell to their lowest level for ten years as a percentage of total lending.

Banks' return on equity averaged 11.3 per cent, the highest value since the middle of the eighties; for large banks the figure was 13 per cent.

Maintaining a high level of profitability requires careful management. The slowdown in economic activity and the fall in share prices are reducing income from services and having repercussions on the financial situation of corporate borrowers.

In Italy equities account for a small part of banks' securities portfolios. The commissions earned on placements and securities trading fell sharply in the first quarter of this year, as did those generated by asset management services. The net assets of investment funds contracted, partly as a result of net redemptions.

The rapid growth in bank lending, which outstripped that in fund-raising, was financed primarily by increased borrowing abroad and disposals of government securities. Dependence on wholesale funds, which are subject to sudden shifts in the terms on which they are supplied, and the reduction in the volume of liquid assets may cause the cost of banks' funding policies to rise if strains develop in the market.

A substantial proportion of new lending was to large enterprises; the decisions to grant credit were mostly made in the first half of the year, when the profitability of investment projects was judged to be especially promising. Very large loans were granted at below-average rates to groups in the telecommunications industry.

Since the summer of 2000 growing uncertainty in all markets about corporate profitability has caused share prices to fall in several sectors and the risk premiums demanded for placing bonds to rise.

Lending decisions, especially where innovative sectors are concerned, must be based on a careful assessment of the quality of investment projects, their profitability over time and the firms' exposure to adverse cyclical developments. At a time of wide fluctuations in economic activity and in the prices of securities and property, the price of credit must be based on an assessment of lending risk that goes beyond the short term.

Prospects and outstanding problems

The need to compete in international markets requires further increases in the profitability and efficiency of Italian banks. The range of services provided to enterprises must be broadened and the quality of those supplied to households improved; banks' capital bases must be strengthened.

The groups that have recently been formed must complete the integration of their production and control functions.

More than three quarters of banks' fee income comes from services provided to households, especially asset management; the supply of services to enterprises is still limited.

In Italy, as in other European countries, the demand for services is growing strongly, in connection with the rapid development of share and bond markets, syndicated loans, takeovers and corporate restructuring. In Europe fees from services provided to enterprises in the last two years are estimated to have been on the order of 25 billion euros, three times the figure for 1997 and 1998.

For the major Italian banking groups, the capture of a significant share of these markets will be the key to expanding their businesses and increasing and stabilizing their profitability.

Innovations and the growing complexity of financial products make it harder for savers to be fully aware of the risks when choosing investments. Transparency and fairness in dealings with customers strengthen confidence in the financial system, enhance intermediaries' reputations, and are a means of competing successfully.

We have specified the information that Community and Italian law requires banks to make available to customers and the method of disclosure. More stringent rules have been issued for structured notes combining features of derivative instruments and bonds.

Via our network of branches, we have begun a systematic survey of bank branches in their local markets to verify observance of the rules on disclosure and investigate any anti-competitive behaviour that comes to light.

We trust that banks will take steps on their own initiative to ensure scrupulous compliance with proper professional conduct, simplify their contracts, and make it easier to understand the obligations of the parties and compare the terms and conditions applied by different institutions.

There is a need for a substantial improvement in relations between banks and their customers.

The rapid growth in lending in the last few years has reduced the banking system's capital adequacy, for which the minimum standard is 8 per cent of risk-weighted assets. Despite very large increases in share capital and the high level of self-financing, the solvency ratio fell to 10.3 per cent in 2000, compared with 11.3 per cent in 1998.

The solvency ratio in Italy is lower than in the other Group of Ten countries; at the end of 1999 the average for internationally active banks was 12 per cent.

The new capital Accord being drafted within the Basel Committee requires banks to develop more accurate methods for assessing their capital adequacy and to follow operational policies that ensure its maintenance over time. It recommends that banks have own funds in excess of the minimum standard and broadens the range of information to be disclosed concerning the risk-management techniques used.

The Bank of Italy has contributed to devising a balanced solution for the new regime. Banks are left ample freedom to determine their capital requirements on the basis of appropriate internal procedures for measuring the probability of customer default as an alternative to the assessments of rating agencies, which small firms do not normally use.

The supervisory authorities will check compliance with the standards set at international level and the use of such procedures in evaluating creditworthiness and setting interest rates.

Under this new regulatory regime banks' capital is more closely related to the risk inherent in their assets; they will have to seek higher returns on capital by reducing their costs rather than by increasing the volume of loans with higher yields and greater risks.

Mergers and acquisitions have permitted the rapid creation of sizable banking groups operating in many markets and able to take advantage of the contribution that banks with long traditions and solid relationships with their local customers can make.

The priorities are to integrate different corporate cultures, to overcome the complex problems that arise in defining strategies by bringing different entities under unified management, and to coordinate the use of distribution channels and operating techniques. Only in this way is it possible to increase efficiency and productivity and ensure better combinations of risk and return on the assets side.

Banking foundations played an important role in the privatization programme; they are members of the stable groups of shareholders they helped to form when the share sales were carried out. They may not be involved in the management of banks; the members of their governing bodies may not hold positions in the banks in which they have an interest; the rules on incompatibilities between appointments must be observed. It is not in the spirit of the law for foundations to reinvest privatization proceeds in the banking sector; the acquisition of very small holdings of bank shares as financial investments must be part of a portfolio diversification policy.

The financial markets and the allocation of savings

Banks figure prominently in the intermediation of savings in all countries, including those where the role of stock markets is pre-eminent. In the investment fund sector, banks' market share is large in Italy, in line with that in France and Germany and larger than in the United Kingdom, where it is close to 50 per cent. In the placement of bonds, their role is of comparable importance in the major European countries.

Leading countries have amended their legislation in order to allow banks to operate in sectors formerly reserved for other intermediaries. In the United States, the repeal of the Glass-Steagall Act in 1999 encouraged links between banking, finance and insurance.

The growth of the share and bond markets, the wide range of competing intermediaries, transparency and the action of the supervisory authorities counter the risk of conflicts of interest in the provision of services to customers.

Italian households' propensity to save declined considerably in the nineties, primarily because of the scant growth in disposable income. The ratio of households' saving to income fell to 11.3 per cent in 2000, compared with 17.2 per cent in 1993. The ratio is higher in France and Japan, where it is equal to 15.6 and 12.8 per cent respectively; it is lower in Germany and the United Kingdom, standing at 10.1 and 3.9 per cent; it has fallen to nil in the United States.

The decline in inflation has led to changes in the composition of households' wealth. Savers are turning to long-term financial assets, and particularly to shares, entrusting a high proportion of their portfolios to institutional investors. Demographic trends and the prospects of pension-system reform are reinforcing this tendency.

As the Italian financial system moves towards more efficient, internationally open arrangements, banks are capitalizing on their links with customers, turning the knowledge they derive from their experience of working with firms to the advantage of savers, and thereby lowering the information barriers to smaller firms' access to the capital market.

A wide array of services and the development of the securities markets will facilitate the financing of innovative projects characterized by high risks and returns and deferred profitability, leaving it to the market to select the most efficient ownership and operational arrangements.

It is necessary to reduce the tax-related competitive disadvantages that are causing important Italian intermediaries to move their operations to financial centres elsewhere in the euro area. The loss of professional skills and the relocation of massive investments tend to diminish the growth potential of the entire financial system.

The privatization of market organizations has been completed; the high degree of fragmentation that once characterized the sector has largely been remedied; the services provided for market participants have increased.

The development of a major financial centre in Italy is beneficial first and foremost for an efficient allocation of domestic savings. It contributes to strengthening the European market.

The Strategic Planning Committee composed of the Treasury, market participants, Consob and the Bank of Italy is working towards this objective.

Forty-five companies were admitted to stock exchange listing in 2000, a large proportion of them on the Nuovo Mercato. This was the highest number in the last ten years.

Because the private capital market is still small, a substantial part of the demand for diversification of households’ portfolios of financial instruments tends to be directed abroad.

Households are assisted in this by institutional investors, which achieve large economies of scale in collecting and producing information on foreign firms and markets. At the end of 2000 foreign assets accounted for 53 per cent of Italian investment funds’ net assets; for equities the proportion was 75 per cent.

The balance on portfolio investment has deteriorated steadily since 1995. In 2000 there was a net outflow of 51 trillion lire. Inward portfolio investment fell to 116 trillion lire last year, compared with 190 trillion in 1999.

Direct investment flows, which depend more directly on developments in productive activity, were virtually in balance. Inflows and outflows were equal to 1 per cent of GDP last year. They are small in relation to the level of development of Italy’s industrial and service sectors.

The smallness of the flows testifies to the insufficient internationalization of Italian firms, due partly to their small average size. It reveals the difficulty of attracting finance from abroad. These are attributable to regulatory and administrative inefficiencies, obstacles to the establishment of businesses, inadequate infrastructure and the heavy burden of tax and social security contributions.

It is necessary to offer better opportunities for the investment of domestic savings, to attract a significant proportion of international capital for the development of innovative sectors, and in this way to improve our economy’s growth prospects.

The Italian economy

The Italian economy grew by 2.9 per cent in 2000, a considerably higher rate than in previous years.

In the period from 1996 to 1999 the average annual increase in GDP had been 1.6 per cent.

Domestic demand did not fail to contribute in those four years, growing at an average annual rate of 2.4 per cent. Capital spending expanded rapidly. A substantial part of the increase in demand translated into imports rather than domestic output.

Italy's world market share fell considerably, from 4.6 per cent in 1995 to 4.1 per cent in 1999. The stabilization of the currency was not accompanied by a compatible trend in production costs.

The lower competitiveness of Italian products in both the international and the domestic market was reflected in the modest growth in industrial production. Between 1995 and the fourth quarter of last year production increased by 9 per cent in Italy, compared with 20 per cent in the euro area; in France and Germany it expanded by 17 and 19 per cent respectively.

The loss of competitiveness is attributable not only to adverse cost and price trends, but also to the type and quality of Italian products and, more generally, to the mismatch between supply and the composition of demand.

One factor is the limited production of high-technology goods in Italy. World demand for such goods is growing twice as fast as that for other products. In the last ten years their share of total exports of manufactures remained static in Italy at 8 per cent, while it rose from 13 to 19 per cent in the European Union and from 26 to 29 per cent in the United States.

In 2000 exports of goods and services grew by 10.2 per cent, compared with an increase of 12.4 per cent in world trade. Exports to euro-area countries rose by 5.4 per cent, while those to the rest of the world increased by 13.3 per cent, boosted by the depreciation of the currency.

In response to robust demand, imports expanded rapidly, but by less than exports.

Consumption increased by 2.9 per cent. Investment excluding construction grew by 7.8 per cent, that in construction by 3.6 per cent.

As in the other European countries, economic growth gradually slowed down in the course of the year.

Signs of a reversal of trend became apparent in the summer. Foreign and domestic orders began to decline as early as mid-year; business confidence deteriorated.

Domestic demand showed signs of weakening in the second half of the year, reflecting the erosion of purchasing power due to the increase in the prices of oil products. Exports slowed down sharply in the autumn; the deterioration in the terms of trade led to a deficit on the current account of the balance of payments after seven years of surpluses.

The acceleration in inflation due to the rise in energy prices depressed the propensity to save. Only part of its effects became apparent in 2000; they will be reflected in consumption and the other components of demand this year.

Employment

Labour market reforms enabled Italy to be among the countries to benefit from the world economic upturn in terms of higher income and employment.

Unemployment fell from 11.2 per cent of the labour force in the fourth quarter of 1999 to 10 per cent in the corresponding period of 2000. The employment rate among the population between the ages of 15 and 64 rose to 53.5 per cent last year; the average for the euro area is above 60 per cent.

According to the national accounts, the number of persons employed rose by 1.7 per cent in 2000 to an annual average of 22.6 million.

In the other ten countries of the euro area, employment expanded by 2.1 per cent. In Spain and France the increase amounted to 3.3 and 2.3 per cent respectively; in Germany it was 1.6 per cent.

According to the labour force survey, in 2000 the number of persons in work rose by 1.9 per cent, or 388,000, comprising 80,000 self-employed workers, 203,000 part-time or fixed-term employees and 105,000 full-time permanent employees.

During the three preceding years, employment had increased by only 567,000 persons owing to the slowness of economic growth; almost all of the new jobs were part-time or fixed-term positions.

The number of persons in permanent payroll employment began growing again in the second half of 2000; between last October and January of this year the increase amounted to 160,000 workers, of whom 97,000 were in the South.

The Finance Law for 2001 introduced a tax credit of 800,000 lire a month, valid until December 2003, for each additional employee hired on a permanent basis; the incentive is increased by 50 per cent in the southern regions. The reduction in labour costs for each new employee averages 16 per cent in the Centre and North and 31 per cent in the South. The measure is also an effective means of bringing undeclared employment into the open.

At the end of last year employment surpassed the peak recorded at the beginning of 1992, thus making good the loss of more than one million jobs suffered between then and 1995.

The composition of employment changed during the recovery. The number of full-time employees and self-employed workers increased by 226,000; that of workers with fixed-term, part-time or temporary contracts rose by 828,000. One third of the part-time and fixed-term workers accepted such employment because they were unable to find a steady job.

The demand for skilled labour is tending to grow: the number of persons employed in professional or specialized work requiring a high-school or university education is rising, while the number of blue-collar workers, artisans and clerical workers employed in tasks requiring the least skills is declining.

A higher level of education increases the probability of employment; it is generally associated with higher pay.

The proportion of the population between the ages of 25 and 59 with at least a high-school diploma rose from 38 to 48 per cent between 1995 and 2000. Italy still lags significantly behind the other countries of the European Union, where the average is 69 per cent.

The improvement in the quality of job vacancies did not fully match that in the average level of schooling; the correlation between level of education and positions offered by firms weakened. The possibility of developing human capital in the workplace is decreasing.

The proportion of workers on relatively low pay has increased; in the ten years from 1989 to 1998 it rose from 6 to 12 per cent among full-time workers, including those with a high level of education.

The composition of employment reflects the insufficient adjustment of the structure of production: activity remains fragmented among a multitude of small firms; industrial production and exports are not responding adequately to quantitative and qualitative changes in demand; high-productivity services are underdeveloped.

The rise in total factor productivity is small.

Capital spending was increased substantially in the last five years, with the aim of reorganizing production and replacing unskilled labour. However, changes in the structure of the economy and productivity gains were impeded by the hesitant growth in output.

The innovations in labour contracts have made a sizable contribution to the growth in employment. Further benefits can come from a widening of the range to provide a bridge from temporary jobs to more stable employment.

More widespread and effective use of wage flexibility that provides workers and their families with a dignified standard of living and is also consistent with profitability and the needs of production will further raise the overall employment rate, contribute to the economy’s competitiveness and increase firms’ propensity to invest.

The public sector

The general government borrowing requirement net of settlements of past debts and privatization proceeds, which had been equal to 9.5 per cent of gross domestic product in 1994, was reduced to 3 per cent in 1998 and 2.2 per cent in 1999.

The improvement in the public finances came to a halt in 2000.

The borrowing requirement rose from 47.5 trillion lire in 1999 to 72.7 trillion in 2000, or 3.2 per cent of GDP.

General government net borrowing diminished from 1.8 per cent of GDP in 1999 to 1.5 per cent in 2000. The difference between the borrowing requirement and net borrowing increased to 38.3 trillion lire.

While nominal GDP rose by 5.2 per cent, public expenditure net of interest payments increased by 3 per cent; revenue grew by 3.2 per cent. Despite the modest rise in interest rates, interest expenditure diminished further in proportion to GDP.

Personnel costs were affected by delays in renewing most of the collective wage agreements for public employees. Pension spending benefited from the raising of the retirement age by one year and from the adjustment of pensions on the basis of the inflation rate for 1999, which was lower than that for 2000.

Health costs continue to rise rapidly.

The increase in revenue in 2000 was sustained not only by the growth in economic activity but also by the rise in share prices in 1999, which was reflected in the yield of the withholding tax on managed savings. VAT revenue increased, in part owing to the rise in the prices of oil products.

The tax reductions enacted in the Finance Law for 2000 and the further reduction of 13.1 trillion lire provided for in the budget measures for 2001 worked in the opposite direction.

The deterioration in the public finances has continued into the current year.

In the first four months of 2001 the Treasury borrowing requirement came to 54.8 trillion lire, 20.3 trillion more than in the same period of 2000 and practically equal to the forecast for the entire year.

Expenditure on public sector wages and salaries will accelerate in the course of the year as a consequence of collective wage agreements. Spending on health care will continue to fuel the growth in public expenditure.

Revenue will be affected by the cyclical slowdown in growth and last year’s stagnation in equity prices.

The reduction in the tax burden planned for 2001 and subsequent years is not matched by the trend in expenditure as a proportion of GDP.

Measures to curb the growth of current expenditure in the medium term are essential in order to ease the tax burden significantly, to finance increased public investment and to achieve a balanced budget.

By international standards, Italian health care expenditure is not disproportionate to the size of the economy, but fundamental problems in connection with the efficiency of health services and the aging of the population remain unresolved. In the absence of effective means to regulate access to health services, the weakest social groups will suffer from rationing.

The rise in health expenditure was slowed by the reforms of 1992, but from 1996 onwards spending again increased more rapidly than GDP. The trend has been accentuated in the last two years, with substantial overshooting of the sector’s budget allocations.

There are marked disparities in the quality and cost of health care between regions, and between different facilities in the same region. Such inequalities demonstrate the wide scope that exists for reducing expenditure and improving efficiency.

It is necessary to rethink the provision of health care services, beginning with a systematic examination of the costs and activities of individual institutions and proceeding to a review of the overall organization of the system. Eligibility must be redefined. Greater recourse to private health insurance could permit a more efficient mix of public and private provision.

Over the medium and long term, the pension system exhibits disequilibria, the fundamental nature of which has been clearly identified and which are similar to those found in most continental European countries and other large industrial economies.

The disequilibria stem from the slowdown in economic growth and the aging of the population.

Over the last decade Italy has initiated major reforms that have significantly curbed expenditure on pensions. Such spending nevertheless remains high and is tending to rise. It is not compatible with lasting budget balance and the objective of reducing the tax burden.

Prompt action is needed to attain a gradual but significant rise in the average age of retirement. Wide freedom of choice in this regard must be guaranteed, with appropriately calibrated costs and rewards. This will make it possible to reconcile the curbing of pension expenditure with the guarantee of reasonable living standards for future retirees. Efforts must continue to be made to augment the role of funded private pension schemes.

In the nineties the reform of local government finances strengthened the autonomy of regional and local government. The curbing of transfer payments from central government contributed to the adjustment of the public finances.

A domestic Stability Pact was introduced in 1999 to ensure that the decentralization of public finances would be consistent with the targets for the public sector budget as a whole. Substantial legislative and regulatory measures to implement the pact are still required.

Funding responsibility must be more closely correlated with spending powers at each level of government. Budget constraints must be made binding. The financing of investment must be ensured.

Fiscal decentralization will become increasingly important in the light of the foreseeable reform of state institutions. The positive aspects of federalism must be harnessed to derive the benefits it can offer in terms of resource allocation and the ability to match public services more closely to the needs and preferences of the local community. The transfer of adequate resources from the more highly developed to the less well endowed parts of the country will ensure the provision of basic services to all citizens.

There remains the problem of the efficiency and effectiveness of government action.

Progress has been made in recent years, especially in the simplification of administrative procedures, but Italy is still one of the countries in which the public sector contributes least to the competitiveness of the economy.

Cost reductions throughout general government, organizational and technological innovation and an improvement in services to the community can bring substantial benefits in terms of growth in gross domestic product, given the comparatively large size of the public sector and its low level of efficiency.

Investment

The growth in investment reveals the expectations for the development of an economy and defines its features.

Between 1995 and 2000 total investment increased at an annual rate of 4.1 per cent; in the first half of the nineties it had contracted, sapping the economy's ability to respond to the expansion of demand and reducing the growth in potential output.

In the last five years investment in machinery and equipment, transport equipment and intangible goods has increased at an average annual rate of 6.1 per cent. Expenditure on intangibles has been especially strong, growing at nearly 10 per cent per year.

High profits, tax incentives for their reinvestment and the availability of abundant finance at low cost have encouraged firms to invest heavily.

Construction activity has also been recovering since 1999, thanks to lower interest rates and tax incentives for renovation work.

Rather than in industry, productive investment has been concentrated in services, in line with the long-standing tendency in the advanced economies for the formation of value added to shift to the tertiary sector.

In industry the proportion of investment allocated to the rationalization of production processes rose to 40 per cent in the last three years. Expenditure on information and communications technology was the fastest-growing component of investment in all sectors of the economy between 1995 and 2000.

The positive effects of the new economy in terms of productivity growth emerge only after a long period of capital accumulation. Investment must be combined with corporate reorganization, which may sometimes be quite radical. Innovation in employment arrangements and appropriate skills are required. It is essential that aggregate demand for goods and services continue to expand rapidly. The weakness of growth in the second half of the nineties was one of the reasons for the slow pace of productivity gains.

The acceleration of economic growth in 2000 boosted employment and productivity. Investment grew at an annual rate of nearly 10 per cent in the second half of 1999, in the initial stages of the cyclical upturn, and continued at that pace in the first six months of 2000 before decelerating in the second half of the year.

The cyclical slowdown in investment that is liable to occur this year threatens to affect the prospects for long-term growth.

The Bank of Italy's annual survey of the intentions of industrial companies confirms the tendency to cut back capital spending.

Effective, structural economic policy measures for the public finances and the labour market will make it possible to avoid curtailing the modernization of the Italian economy and to revive expectations of growth.

It is up to firms to respond innovatively in order to exploit the opportunities offered by advanced technology, regain world market share and increase the output of products able to keep pace with changes in demand. The high level of profits gives them the means to do so.

The weak growth of the Italian economy in the second half of the nineties and the unsatisfactory gains in productivity and competitiveness were due in part to the contraction in public investment.

Public investment fell from 3.7 per cent of GDP in 1985 to 3.3 per cent in 1990 and then to a low of 2.1 per cent in 1995. In more recent years it has recovered slightly; by 2000 it had risen to 2.4 per cent.

In the North-West of Italy the stock of public capital is slightly above the European average, but in many parts of the North-East, the Centre and especially the South it is distinctly below that level.

The deficiencies are evident in the road and rail networks, the production and distribution of energy, the supply of drinking water, and airports.

Inadequate infrastructure, together with the limited effectiveness of many public services, puts a brake on economic growth and employment.

It is necessary to carry out major public works programmes that can increase the productivity of the entire economy, possibly with the involvement of private capital and European financial institutions. The inadequacy of project planning capabilities at local level needs to be overcome, if necessary with assistance from central government.

In the realization of major investment projects, Italy's rich cultural and environmental heritage must be safeguarded.

Investment in the environment or designed to capitalize on the cultural heritage may itself be a source of growth and jobs. It can enhance tourist services, and it can go hand in hand with agricultural methods that lay the emphasis on quality.

Measures to improve services and the quality of life in large conurbations are a significant factor in sustainable development.

The cutback in public works and the termination of special development assistance in the first half of the nineties had severe repercussions on the economy of southern Italy.

The lack of basic infrastructure is a source of external diseconomies for companies operating in the South. The region's growth prospects are clouded by the consequences of social decay, undeclared activities and widespread illegality.

By the early eighties per capita output in the South of Italy had reached 60 per cent of that in the Centre and North; the ratio then declined, and at the end of the nineties it stood at 56 per cent.

Encouraging signs have emerged in recent years. The South's share of total Italian exports rose from 9 per cent in 1996 to 12 per cent at the end of 2000. Capital formation has resumed. Employment is growing again.

There is an abundant labour supply in the South of Italy, especially among young people.

The optimal use of environmental assets, appropriate labour and wage policies, and public investment can trigger a new phase of economic growth in the South and boost output in advanced sectors.

A state of comparative backwardness can be turned into an opportunity for development.

Ladies and Gentlemen,

Economic recovery in the United States is crucial to surmounting the crisis in the world economy. In response to the substantial reduction in interest rates and measures to lighten the tax burden, the recovery will manifest itself in the second half of this year and gain momentum in 2002.

In Europe the data point to a slowdown in activity in the early part of this year. An intensive round of reforms can raise the forecasts for economic growth in the European Union. Over the medium term, the entry of new member countries can open up the prospect of an expansion of internal demand and supply.

The problems of the Japanese economy can be overcome only by restoring the health of the banking system and radically restructuring the economy.

Equilibrium in the financial markets and the contribution they make to the financing of investment and to the improved international allocation of savings will be underpinned by recovery in the more advanced economies.

In Italy, as in the rest of Europe, output stagnated in the first four months of 2001.

Consumer price inflation rose to a seasonally adjusted annualized rate of over 3 per cent in the first five months of the year. An appreciable slowdown in inflation in the next few months may bring the average annual increase down to about 2.8 per cent this year and around 2 per cent in 2002.

Household consumption will increase by 2 per cent. The rate of export growth will decline by a half.

The growth in investment and national income is tending to slow down.

It is necessary to create the conditions for an acceleration in economic growth as early as the second half of this year.

There must be no interruption in the expansion and transformation of productive capacity and the growth in employment.

Economic developments and uncertainty about the trend in expenditure and some forms of revenue are raising doubts about the achievement of the budgetary targets.

The state sector borrowing requirement for the first five months of 2001, net of 4 trillion lire in tax refunds that have already been made, amounts to 74 trillion lire, compared with 50.6 trillion in the corresponding period of 2000.

Assuming adjustment items are on the same scale as last year, general government net borrowing will significantly overshoot the target of 1 per cent of gross domestic product.

The adverse effects this may have on inflation, investment and growth must be countered promptly.

In the very short term, the borrowing overshoot can be offset partly by restricting cash disbursements.

Given the limits to such action, the budget must be brought back into balance over a period of several years as part of a programme of reforms involving the pension system, the health service, the control of local government budgets and the overall efficiency of the public sector.

In order to reduce the structural budget deficit it was necessary to increase the ratio of tax and social security contributions to GDP by 6 percentage points between the second half of the eighties and the second half of the nineties.

Curbing expenditure in relation to the growth in gross domestic product should make it possible to reduce the ratio of tax and social security contributions by one percentage point a year for the five years beginning in 2002.

A fundamental contribution to reducing the tax burden and the ratio of expenditure to GDP must come from faster economic growth.

The announcement and launch of a programme to reform public expenditure and reduce the tax burden have a positive effect on growth expectations and investment decisions.

Specific measures are needed to eliminate the large pockets of undeclared employment and underground activities.

New forms of labour contract, to be defined by agreement between employers and trade unions, will contribute to the growth of the economy and employment.

In an economy with a large number of small enterprises, the new information technologies can make a decisive contribution to raising productivity, by fostering the development of more efficient relations between firms and between sectors of the economy.

The reform of company law must be completed and that of bankruptcy procedures begun. The organization of the system of civil justice must be reviewed and improved. A reduction in the length of legal proceedings will enhance the smooth operation of the market and its ability to allocate resources.

The resumption of public works projects and infrastructure investment, the privatization of public services and the measures to restore legality and security will, in the short term, boost aggregate demand and, in the longer term, revive the backward areas in the South, to the benefit of the Italian economy as a whole.

In the decades immediately after the Second World War there was a coherent vision of economic policy in which the commitment of workers and their organizations, businessmen and politicians enabled Italy to transform itself from a backward agrarian country into a modern industrial economy, to join with five other countries in initiating the process of European integration and to open its markets fully to trade from every part of the world within a context of political and institutional stability.

Today, in a more difficult international environment but one that is also rich in opportunities, we must find renewed dynamism, with all sections of society contributing. The post-war economic miracle can be repeated.

We can and must achieve it.