NOMURA SECURITIES

Seminar on Recent Developments
in the Italian Economy and Financial Markets

ASPECTS OF ECONOMIC GROWTH IN ITALY IN THE EIGHTIES

Takanawa International Center
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I. ASPECTS OF ECONOMIC GROWTH IN ITALY IN THE EIGHTIES

In the past decade, the industrial economies returned to the virtuous path of relatively non-inflationary growth. Although there remain large disequilibria in world financial markets and substantial international payments imbalances (not always tackled with sufficiently vigorous or coordinated economic policies), these are clouds on the horizon of a world economy with much more promising prospects than at the start of the eighties.

The Italian economy made notable advances in the decade. The changes were more extensive and rapid than in most other industrial countries, involved all the main sectors of the economy and enabled Italy to narrow some of the gaps existing at the start of the period vis-à-vis other countries.

GDP expanded throughout the period (Figure 1). In 1981-82 -- unlike some other countries -- Italy did not suffer a decline in output in the wake of the second oil shock, only a slowdown in growth. In the years that followed, a strong recovery in investment and then the 1986 oil countershock spurred the expansion of domestic demand, which began to outpace GDP. This generated a modest deficit on trade in goods and services. Between 1980 and 1988, Italian GDP grew by 2.2 per cent per year; in 1989 it rose by 3.3 per cent and it is expected to rise by a further 3 per cent in 1990.

For the decade as a whole investment in machinery and equipment rose at an average annual rate of 4.3 per cent (Figure 2). This component of fixed capital formation is particularly sensitive to cyclical variations, however, and the pattern was uneven. Expenditure on capital goods in 1988 amounted to more than 12 per cent of GDP.

Manufacturing industry reorganized on a very large scale during the eighties. The most striking result was the nearly 60 per cent rise in per capita productivity over the decade (Figure 3). This reflected both the fall in industrial employment, which started in 1981 and did not end until 1987, and technological innovation. At the same time employment in the services sector rose, partly owing to the transfer of some productive functions previously performed by industry. Value added in manufacturing followed a cyclical pattern: after expanding through mid-1980, it declined until 1983 and then entered a period of rapid growth that is still under way.

One key condition for the successful reorganization of industry was a change in the climate of industrial relations. In the early eighties, the energy crisis generated expectations of stagnation or recession; labour conflicts in manufacturing and the rest of the economy declined sharply. Clear evidence of this is to be found in the sharp fall in the number of man-hours lost due to strikes in manufacturing from 109,820 in 1979 to 8,623 in 1988 (Figure 4).

The structural changes in the manufacturing sector also shifted the distribution of income to the benefit of profits. As measured by gross operating profits, the share of the latter in value added rose rapidly and now stands at around 45 per cent (Figure 5).

The productive base only started to widen quite recently, however, and in the meantime employment failed to expand fast enough to keep pace with the growth in the supply of labour. As a result the unemployment rate rose until 1987 and then stabilized at 12 per cent during the next two years, despite the good output performance (Figure 6). In comparison with the other OECD countries, Italy's unemployment rate appears very high, but this is partly due to differences in statistical method. "Unemployed" persons are broadly defined in Italy to include all those who have actively sought work at some time in a period of up to two years. When Italian unemployment is recalculated using the definition of the US Bureau of Labor Statistics, which only counts job-seekers who have actively sought work in the latest month, the rate for 1988 was about 7 per cent; the underlying trend is virtually the same in both cases however.

One of the characteristic features of the Italian labour market is the dualism between the South and the Centre-North. Comparison of the unemployment rates in the two areas reveals a gap that has been widening since 1986 (Figure 7). While the rate of unemployment in the Centre-North is falling -- and in many parts there is full employment -- it is rising in the South. Unless corrective measures are taken, the gap is likely to widen still further in coming years as a result of demographic trends.

The damping of wage and salary increases made an important contribution to curbing inflation during the eighties. The slowdown in the rise of labour costs was more marked after 1983, reflecting government-sponsored agreements between management and labour on targets for nominal income growth. Industry thus reaped the benefits of the large gains in productivity and savings in labour and capital inputs (Figure 8). The rate of increase in unit labour costs consequently fell from over 20 per cent in 1981 to 3.6 per cent in 1988, though it rose somewhat in 1989.

Inflation peaked in 1980 in the wake of the second oil shock; in the years that followed the rate was significantly reduced and by 1987 it was down to 4.6 per cent (Figure 9). The differential with other industrialized countries started to narrow in 1984, and the collapse of international energy prices two years later made it possible to return to "single digit" inflation. The start of the slowdown followed the creation of the European Monetary System in 1979 and was sustained by a more restrictive monetary stance and an unaccommodating exchange rate policy. The small upturn in consumer price inflation in the last two years has been linked to the rise in demand and the recovery of raw material prices; it has been common to other industrialized countries and has therefore not resulted in any widening of Italy's inflation differential.

Italy's external accounts also improved in the eighties. The current account deficit averaged less than 0.5 per cent of GDP over the decade (Figure 10). The deficit rose in 1981-82 to over 2 per cent of GDP, partly owing to the buoyancy of domestic demand; this trend subsequently reversed as Italy benefited first from the appreciation of the dollar and then from the fall in oil prices in 1986. Despite the appreciation of the real exchange rate, there is no evidence of a structural deterioration in the merchandise trade balance; on the other hand, the balance of investment income has worsened considerably as a result of the large inflows of foreign capital and the steady erosion of the surplus on tourism.

Italian exchange rate policy after the inception of the EMS in 1979 was designed to maintain rates for the lira that would be consistent with the priority objective of curbing inflation. The roughly 25 percentage point fall since 1980 in the nominal effective exchange rate of the lira with reference to Italy's fourteen most important trade partners (just over 20 points with reference to the other EMS countries; Figure 11) did not fully offset the inflation differential. Consequently, the lira appreciated in real terms, especially against the other EMS currencies (Figure 12).

Over the last three years the exchange rate has benefited from capital inflows. Since 1986 Italy has gradually lifted its exchange controls on financial transactions and by 1 July 1990 all transactions will have been completely liberalized. This process has reduced the risk premium required by foreign investors and led to a growing inflow of foreign capital.

Italy now ranks as a "top quality borrower" on international capital markets. Most of Italy's foreign borrowing is done through "jumbo" issues, which set "benchmarks" in the various segments of the market. Such issues are frequently used to refinance earlier loans whose terms no longer reflect the country's improved credit standing.

At the end of 1989 the Treasury's outstanding foreign currency issues, including ecu securities issued in Italy but purchased by non-residents, amounted to about $27 billion or 3.3 per cent of Italy's total public debt. Foreign currency borrowing has for some time been mostly in ecus, as a mark of the Italian authorities' commitment to fostering this currency's use (Figure 13).

The Treasury's higher credit standing has also brought benefits to other leading Italian borrowers, whose access to the international market is coordinated by the monetary authorities with a queuing system. This system has been maintained on an informal basis since foreign borrowing by Italian residents was completely liberalized.

A market for Eurolira bond issues was started in October 1985 with the aim of promoting the internationalization of the Italian lira. Italy's currency has in fact been underrepresented in international financial transactions compared with the country's role in the world economy. The Eurolira market also provides Italian banks with an opportunity to increase their placing power abroad. The new market has developed extremely fast, with the volume of issues more than doubling every year (Figure 14). The organization of the market includes a queuing system for instruments and issuers that prevents an excessive supply of issues and ensures the market's regular and orderly development.

Investor interest in Italy stems not only from the country's good economic prospects and the new freedom of capital movements but also from Italy's relatively high interest rates. Although nominal interest rates declined rapidly in the period 1981-87, they did not fall by as much as inflation. In recent years real interest rates have fluctuated around 5 per cent (Figure 15 and 16), a level consistent with the restrictive stance of monetary policy made necessary by Italy's large and persistent budget deficits. The public debt has grown considerably in recent years as a result of these deficits (Figure 17). In relation to GDP the deficits are now decreasing, especially the non-interest part (Figure 18).

Net issues of government securities dropped from the equivalent of 9.5 per cent of GDP in 1988 to 8.6 per cent in 1989. Net domestic bond issues by the private sector (i.e. special credit institutions and corporations) also fell as a result of increased recourse to foreign borrowing and bank credit (Figure 19). Strong demand for short-term securities from the household sector prompted the authorities to increase the share of Treasury bills in new issues. To counter the resulting reduction in the average maturity of the public debt, the Treasury issued more five-year credit certificates and also new fixed rate three-year certificates carrying an option for a three-year extension.

In the last thirty years Italy and Japan have shared the record for the highest private sector propensity to save. After correcting for inflation, this propensity followed a rising trend during most of the eighties, and averaged about 22 per cent of GDP during the last 4 years (Figure 20). By contrast, the deterioration in the public finances caused a decline in the rate of total domestic saving, from 26 per cent in 1979 to just under 21 per cent in 1989.

On the stock market, 1989 was a year of consolidation after several years of rapidly rising trading volumes and share prices (Figure 21). The latter rose by 15 per cent during 1989 when many sectors performed strongly, with the notable exception of insurance. For the year as a whole, stock market activity increased in terms of both turnover (53.8 trillion lire, as against 41.3 trillion in 1988) and new issues (up from 5.1 to 7.5 trillion lire). The profitability of listed companies improved on average. Given the pattern set by income statements for the first half of the year, the net earnings of parent companies should rise by about 17 per cent in 1989, and the P/E ratio fall to 18, as against 23.8 on the basis of 1988 earnings.

II. PROSPECTS FOR THE PERIOD AHEAD

After this brief overview of the development of the main economic and financial variables, I should like to conclude with some remarks on the challenge that European integration poses to Italy's economy, public finances and banking system.

The completion of the European single market is scheduled for the end of 1992 and progress has been significantly accelerated by the Community Directive on the liberalizaton of capital movements, which comes into full effect on 1 July this year. Italy has made major strides towards exchange liberalization in the recent past. In practice, the only remaining restriction on residents is the ban on holding bank accounts abroad, while credit institutions are only subject to restrictions on forward market operations and the use of some innovative instruments, such as currency options. These restrictions will be lifted, probably before the 1 July deadline. Their removal nonetheless presupposes some prior harmonization of the taxation of income from financial assets, and, in particular, a reduction in Italy's taxation of bank deposit interest.

Despite the fears voiced in some quarters, there are two reasons why we do not expect massive outflows of capital after the removal of the remaining restrictions. First, liberalization of portfolio investments has already allowed Italian residents to diversify the currency composition of their assets over the last two years; and second, since the EMS was set up, Italian monetary policy has constantly maintained an interest rate differential sufficient to cover the inflation gap vis-à-vis our major trading partners. This policy will be continued with the aim of ensuring exchange rate and price stability. It was precisely in order to convince Italian and foreign operators of the firmness of our monetary policy stance that we advised the Government to adopt the narrow EMS fluctuation band for the lira in January this year, ahead of the complete removal of exchange controls.

A scenario based on a stable lira appears plausible and sustainable as Italy's international competitiveness has not been weakened by the appreciation of the real exchange rate. The balance of payments does not pose a serious threat; the inflow of capital is likely to continue to cover the current deficit, which is equivalent to only a small fraction of GDP and shows no significant tendency to expand. Moreover, the deficit can be attributed more to the domestic investment cycle and higher world energy prices than to any loss of price competitiveness. In 1989, Italian exports expanded by 9.5 per cent in volume, 2 percentage points faster than world trade. Moreover, after rising to 7 per cent in mid-1989, domestic inflation has come down to about 6.3 per cent and is expected to decline further during the year.

At present the key to the internal and external equilibrium of our economy is fiscal policy. If the Government pursues a consistent strategy of lowering the budget deficit, reducing public expenditure and enlarging the tax base, Italy can confidently look forward to non-inflationary growth and broad balance in the external accounts.

Some improvement in the public finances has been achieved in recent years. In 1990 the state sector deficit is expected to amount to 10.4 per cent of GDP, as against 14 per cent in 1983. Net of interest payments, the deficit should be little more than 1 per cent of GDP, as against 6.5 per cent in 1983. Moreover, the Government's medium-term financial plan projects a small budget surplus net of interest payments in 1992; this will speed up the reduction in the overall deficit and stabilize the public debt in relation to GDP.

Another important aspect of European integration is the creation of a single market in financial services. A major step in the construction of the EEC regulatory framework in this sphere was taken in December 1989 with the adoption of the Second Directive on Banking Coordination and the Directive on Solvency Ratios for Credit Institutions, the main pillars of what can be considered the European Community's banking law.

The mutual recognition of national regulations and supervisory control, which has been made possible by harmonization of their basic features, now allows European banks to establish branches and provide financial services throughout the Community on the strength of their home country banking licences. The directive on solvency ratios strengthens the Community framework by laying down risk-related standards for banks' own funds.

Once the Community's recommendations on large exposures and deposit protection schemes are converted into directives and the proposed directives regarding supervision on a consolidated basis and securities investment firms are approved, the harmonization of the single market in financial services will be complete.

The Italian supervisory authorities have been preparing for the changes the EEC directives will bring and have sometimes anticipated the enforcement of internationally-agreed decisions, as in the case of capital adequacy standards, which were introduced in Italy two years before their approval by the Community. The application of the Second Directive will thus involve adaptation rather than radical change in Italian banking regulations.

In two key areas -- bank specialization and separation between banking and commerce -- the Second Directive recognizes the right of Member States to subject their national credit institutions to stricter regulations. The scope for exercising this right is limited, however, by the need not to place national credit institutions at a competitive disadvantage vis-à-vis those of other countries.

The Second Directive does not recognize the principle of bank specialization by function: the list of "typical" banking activities recognized by the Directive includes virtually all "securities powers". In Italy, where no restrictions on securities business (such as those of the Glass-Steagall Act) have ever applied to banks, this provision will not pose any significant problems.

The Second Directive also lays down guidelines for regulating both interests in non-financial undertakings and the ownership of banks, thereby providing a framework for national legislation on the separation of banking and commerce.

Italian regulations in this field are likely to be stricter than the Community rules. The present ban on banks owning interests in non-financial undertakings may be replaced by a system of authorizations compatible with the provisions of the Second Directive. With regard to bank ownership, the view of the Italian supervisory authorities is that control of a bank by an industrial undertaking always involves a risk for its independence in granting credit. Thus, quantitative restrictions will be applied to such participations, as already foreseen in the proposed antitrust legislation currently before Parliament.

Another important issue addressed by the Second Directive concerns the conditions for the establishment of banks and their international branches.

For banks, the Directive sets a comparatively small minimum initial capital requirement of ECU 5 million, which is less than the requirement currently in force in Italy (25 billion lira, or about ECU 17 million). Although this amount is likely to be reduced in the future, Italy does not share the view that a higher initial capital requirement is an entry barrier to banking or prejudicial to competition.

Italy's position on the endowment capital of branches of foreign banks is naturally different, since it conforms with the principle of home country control. We have already complied with the Directive by halving the requirement for the branches of all foreign banks, whether established in the Community or in third countries.

On the question of foreign banks' establishments the Second Directive's approach should not be a cause for concern among non-Community countries, since it is now based on the criterion of national treatment and comparable competitive opportunities. The Italian supervisory authorities have always viewed reciprocity in these terms and have never had serious problems with third countries. Thus, we see no reason why this should not also be the case under the Second Directive.

In addition to the measures implementing the Second Directive, other initiatives are being studied to strengthen the Italian banking system in preparation for the competition it will face in the single market. A bill is before Parliament that will enable Italian public sector banks -- which are mostly established as non-profit-making institutions or foundations --

to become limited companies. This will not only facilitate mergers and takeovers but also increase the role of private capital in banks. The bill also contains favourable provisions for the creation of banking groups offering a complete range of banking services, including both short and long-term finance and merchant banking. This should enable Italian banks to compete effectively with other countries' "universal banks". Parliament is also examining a bill to regulate securities business, which is designed to strengthen the capital bases and operational structures of non-bank securities intermediaries.

The foregoing measures will supplement those adopted in the last few years regarding the rationalization of trading and settlement procedures in the primary and secondary markets for government securities.

It is too early to say whether or not these initiatives will be sufficient for the Italian economy and its financial sector to meet the challenges of the single market. Nonetheless, without going into further detail, it is worth stressing a general point: the scope and contents of the strategy being pursued by the Italian authorities show their awareness of the need to act rapidly to correct the imbalances in Italy's public finances and modernize its banking and financial structures.

In addition to the efforts that Italy and the other Member States are making to prepare for 1993, the Community will also have to make rapid progress in coordinating economic and monetary policies. It will hardly be possible for a market of some 320 million people with no barriers to the free movement of persons, goods and capital to operate on the basis of twelve macroeconomic policies that are formulated and implemented independently. Lack of coordination would only result in greater instability of interest and exchange rates, since these are the variables most directly affected by mutually inconsistent economic and monetary policies.

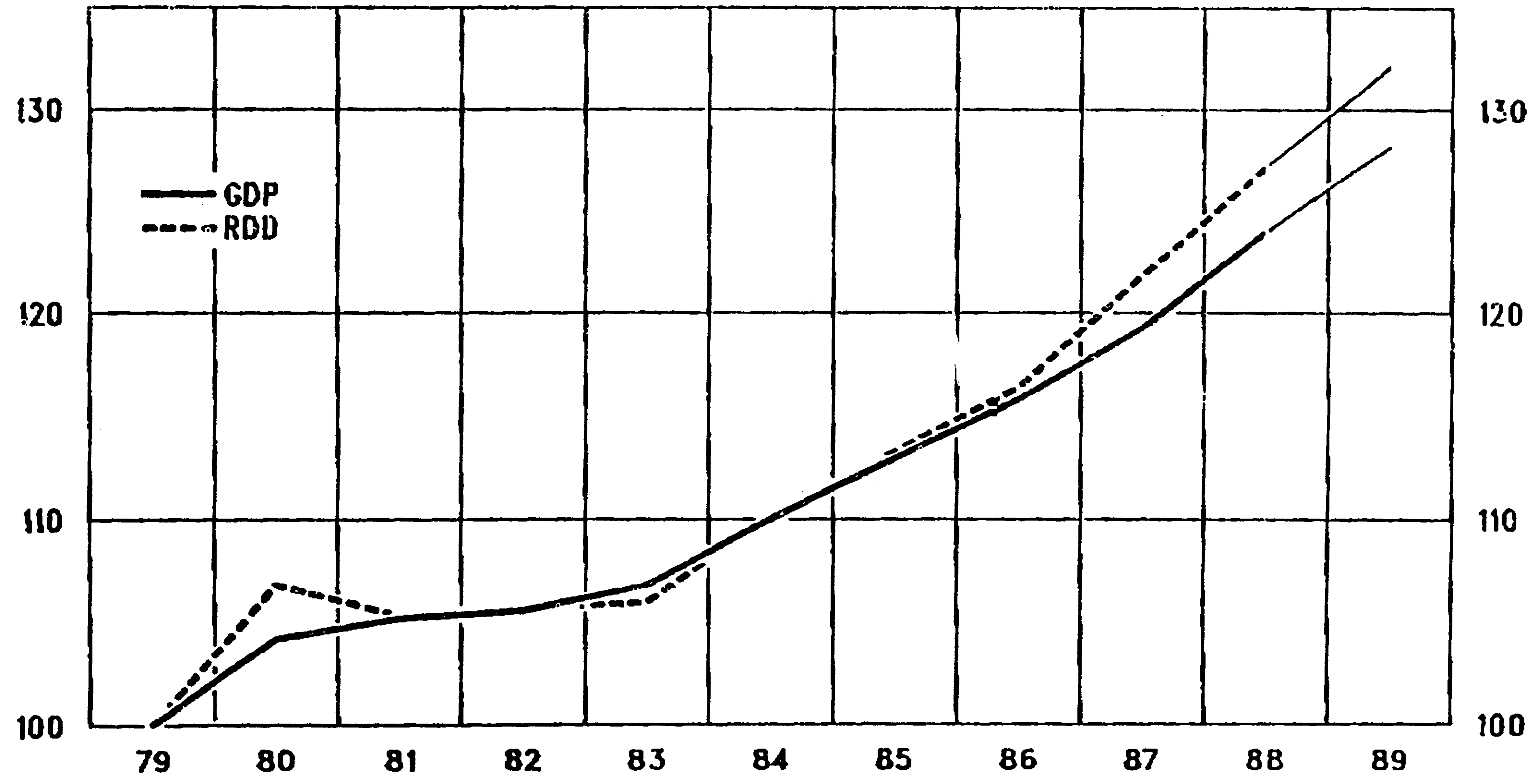
This is why the Bank of Italy has played an active role in the formulation of the project for economic and monetary union in Europe and is committed to promoting the creation of a European system of central banks. Towards the end of this year the European Council, with Italy presiding, will inaugurate the Intergovernmental Conference entrusted with the task of negotiating the new treaty providing for economic and monetary union. Pending the outcome of this complex process, it will nonetheless be possible to achieve effective ex ante coordination of Member States' monetary policies in the Committee of EEC central bank Governors. The Bank of Italy has been pressing for an autonomous body to be set up to conduct economic and monetary analysis in support of the Committee's coordination activities.

Both domestically and in the European sphere Italy is thus playing its part in creating the conditions for balanced growth and the maintenance of monetary stability.

Fig. 1

REAL GROSS DOMESTIC PRODUCT AND REAL DOMESTIC DEMAND (1)

(1979 = 100)

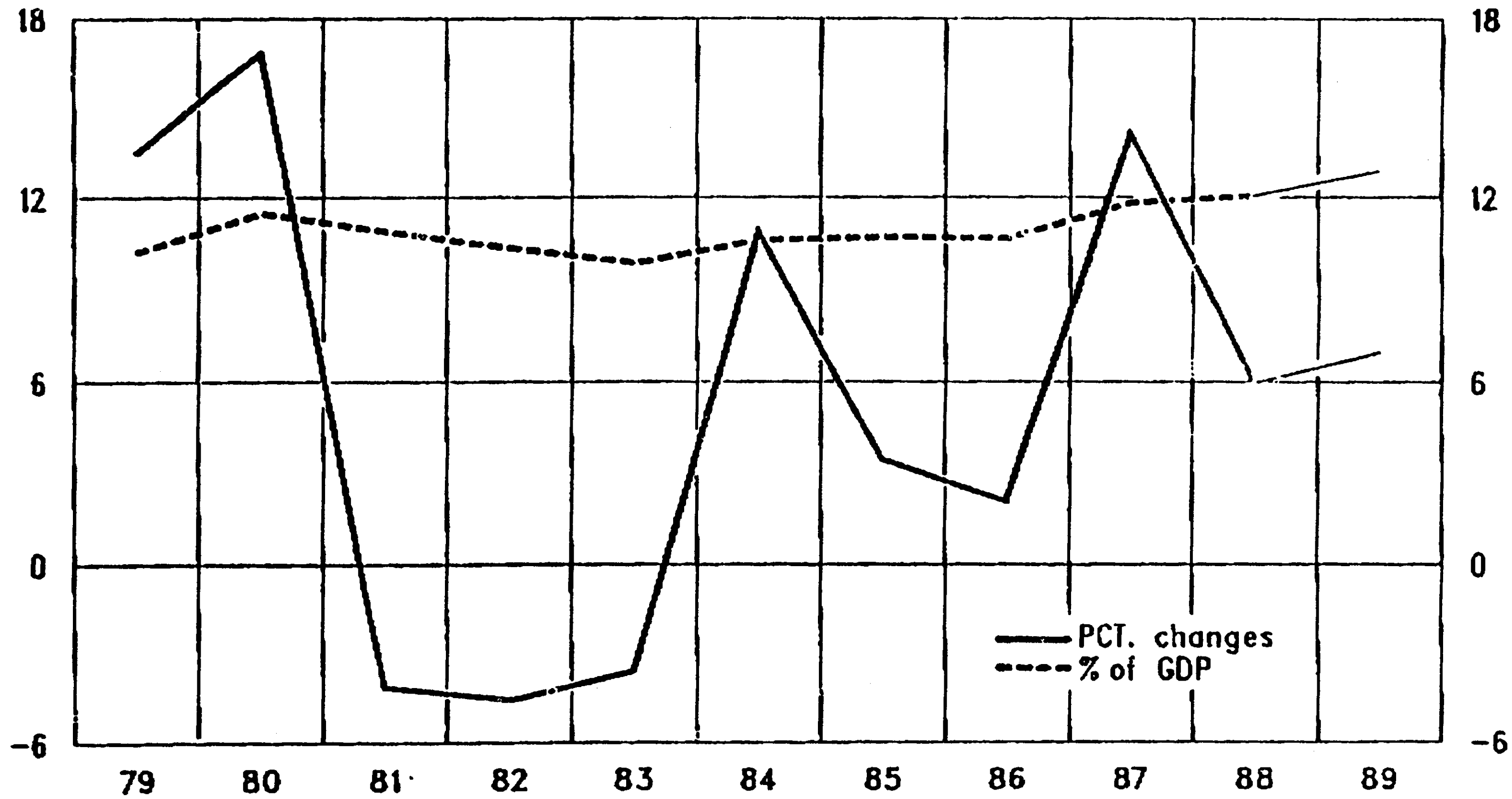


(1) GDP at factor costs at 1980 prices. Domestic demand at 1980 prices.
Figures for 1989 are estimated

Source : National accounts

Fig. 2

REAL GROSS FIXED CAPITAL ACCUMULATION IN MACHINERY AND EQUIPMENT (1)

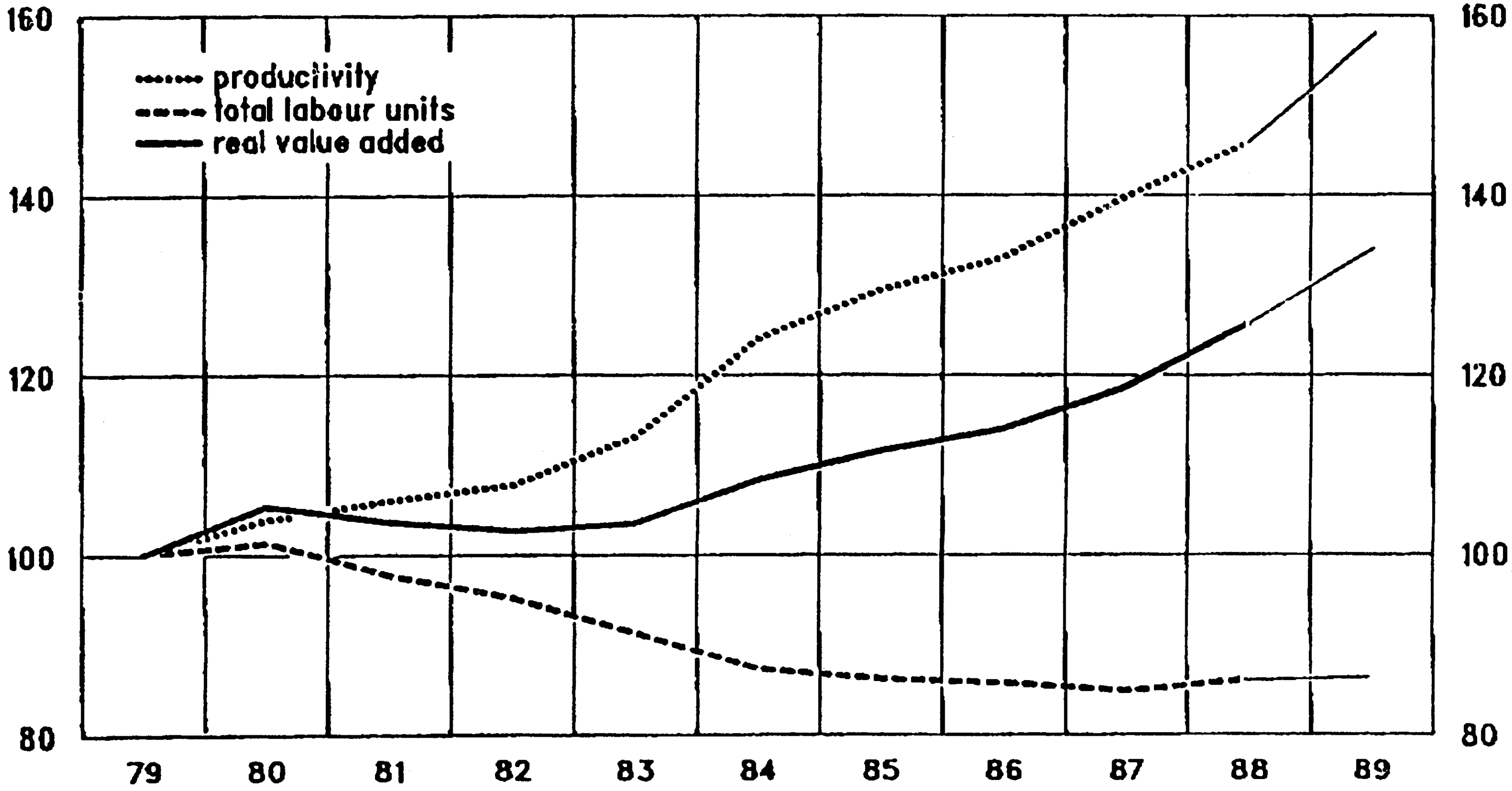


(1) Capital accumulation at 1980 prices.
Figures for 1989 are estimated.

Source : National accounts.

Fig. 3

VALUE ADDED,LABOUR UNITS AND PRODUCTIVITY IN THE MANUFACTURING SECTOR (1)
(1979 = 100)

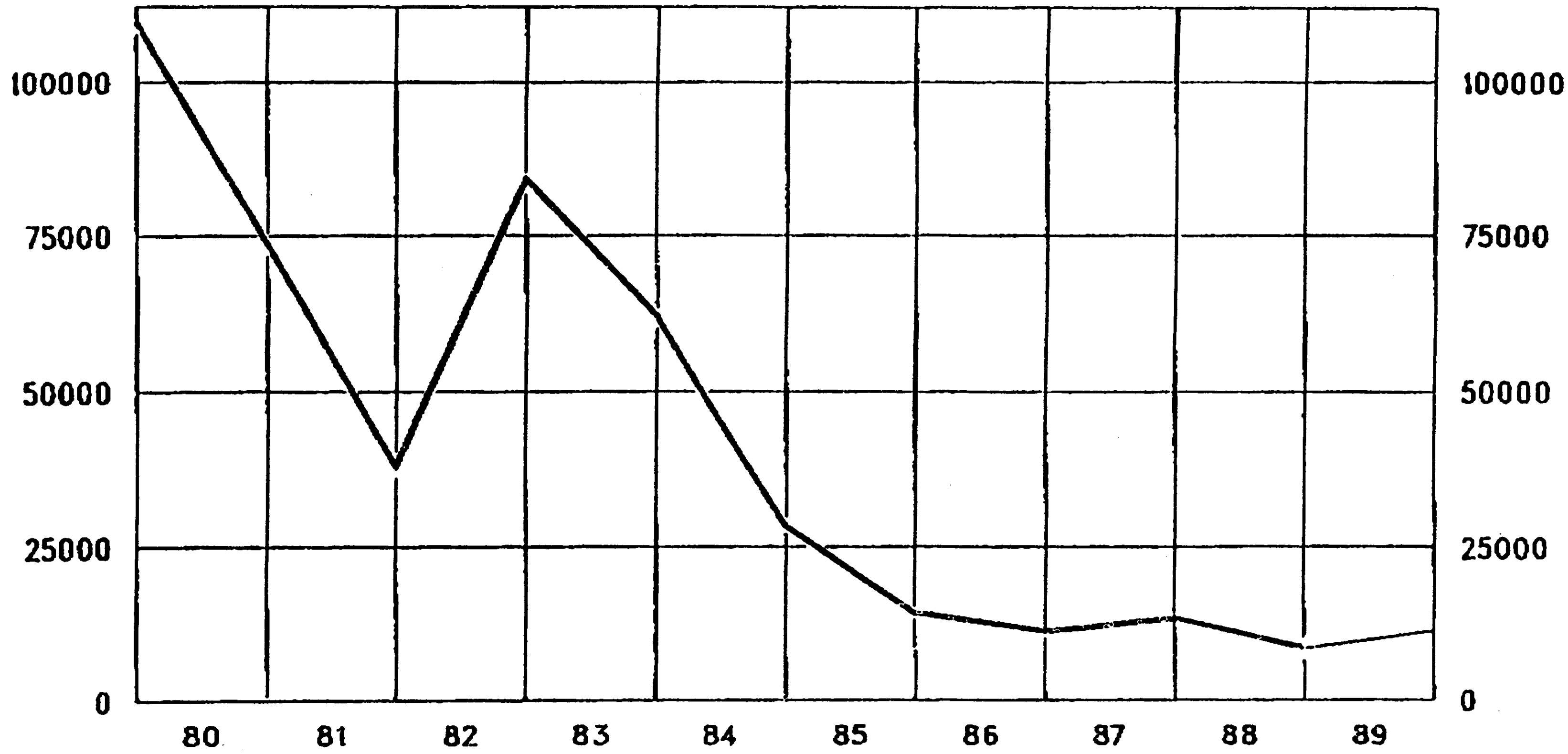


(1) Value added in the manufacturing sector at factor costs at 1980 prices.Productivity is the ratio between value added and total labour units.
Figures for 1989 are estimated.

Source : National accounts.

Fig. 4

HOURS OF STRIKE IN THE MANUFACTURING SECTOR (1)
(thousands)

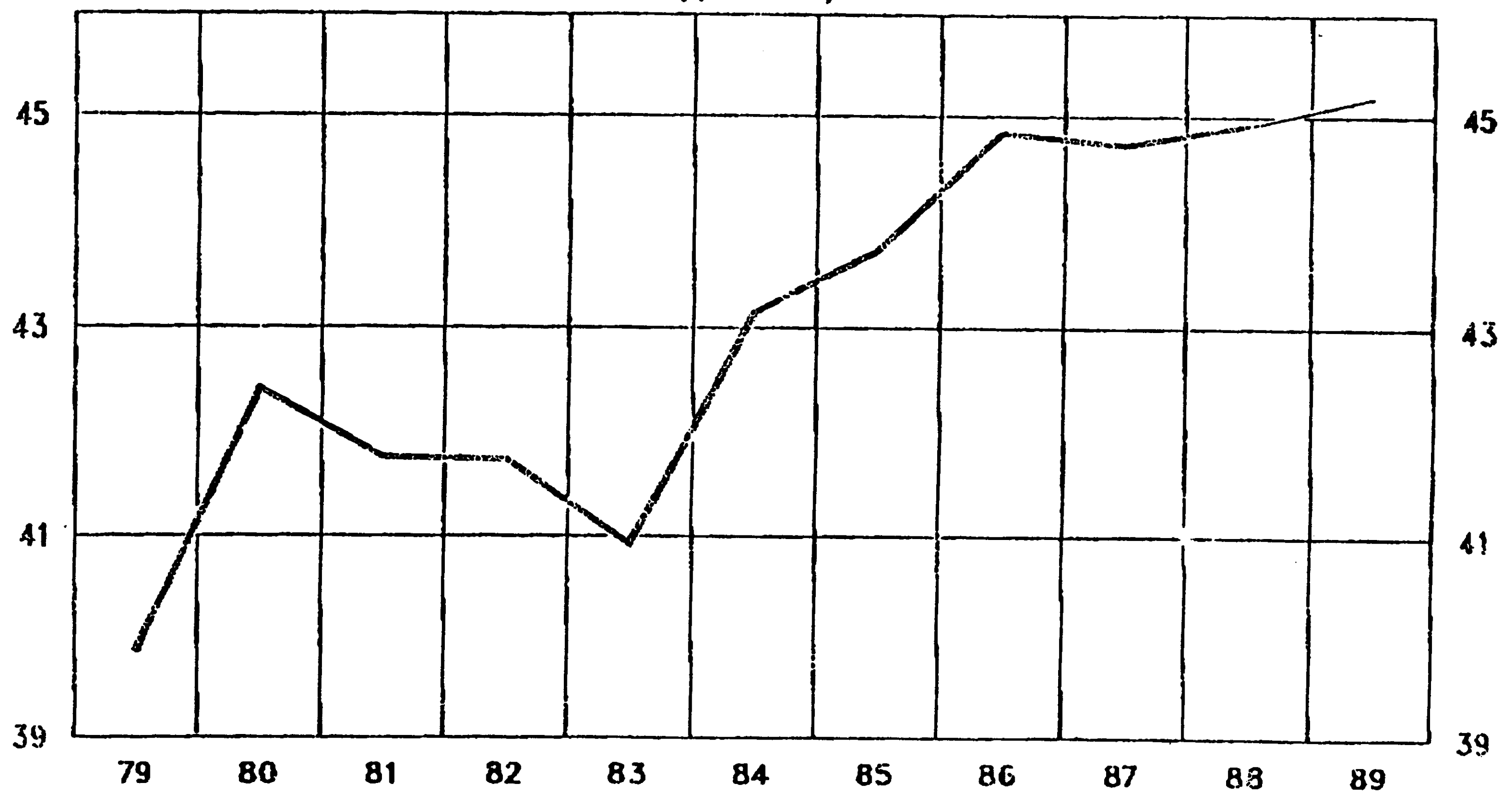


(1) Figures refer to the end of year.
The figure for 1989 is estimated.

Source : National accounts.

Fig. 5

GROSS PROFIT SHARE IN VALUE ADDED IN THE MANUFACTURING SECTOR (1)
(per cent)



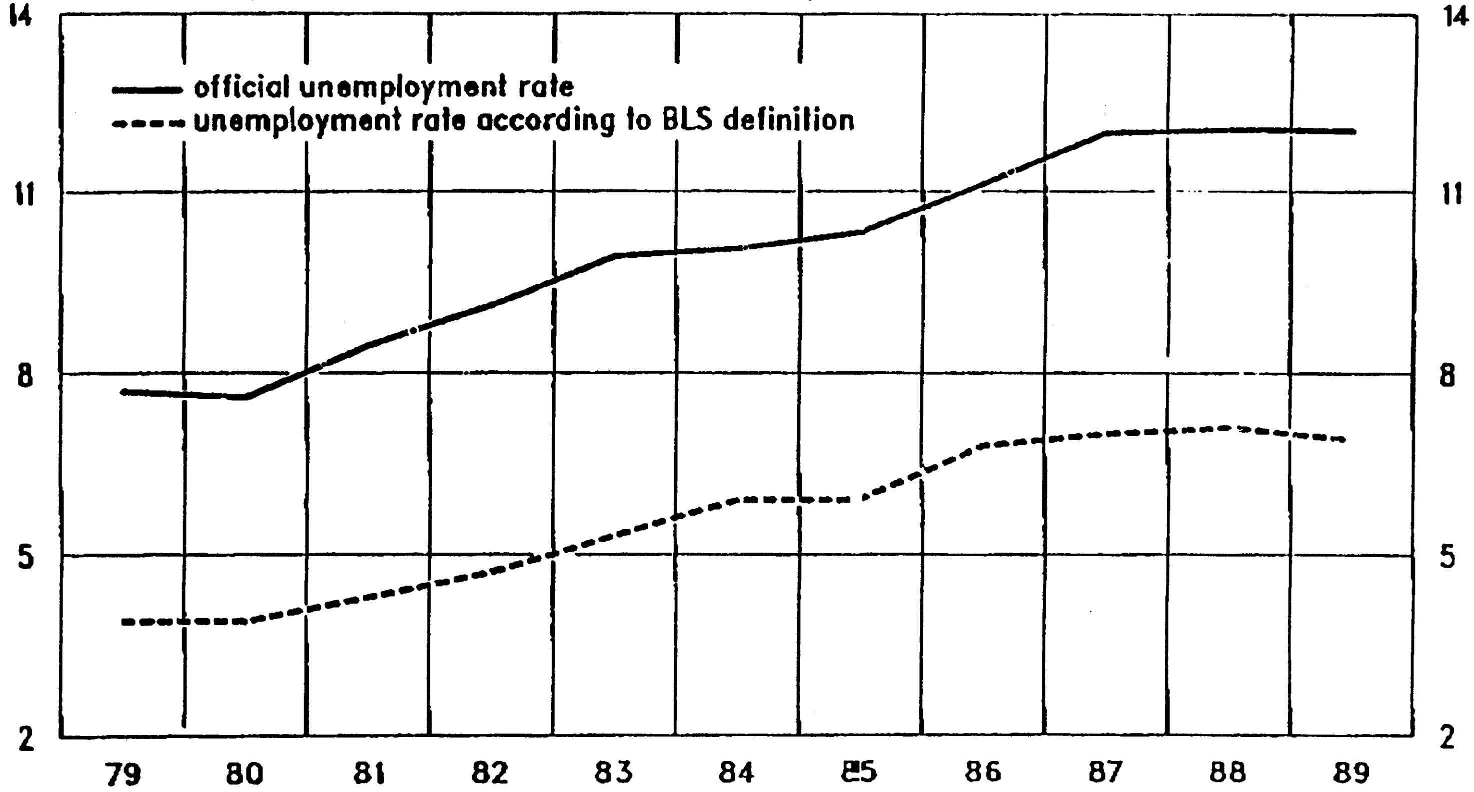
(1) Gross profits include incomes of the self-employed.
The figure for 1989 is estimated.

Source : National accounts.

Fig. 6

UNEMPLOYMENT RATE (1)

(per cent)



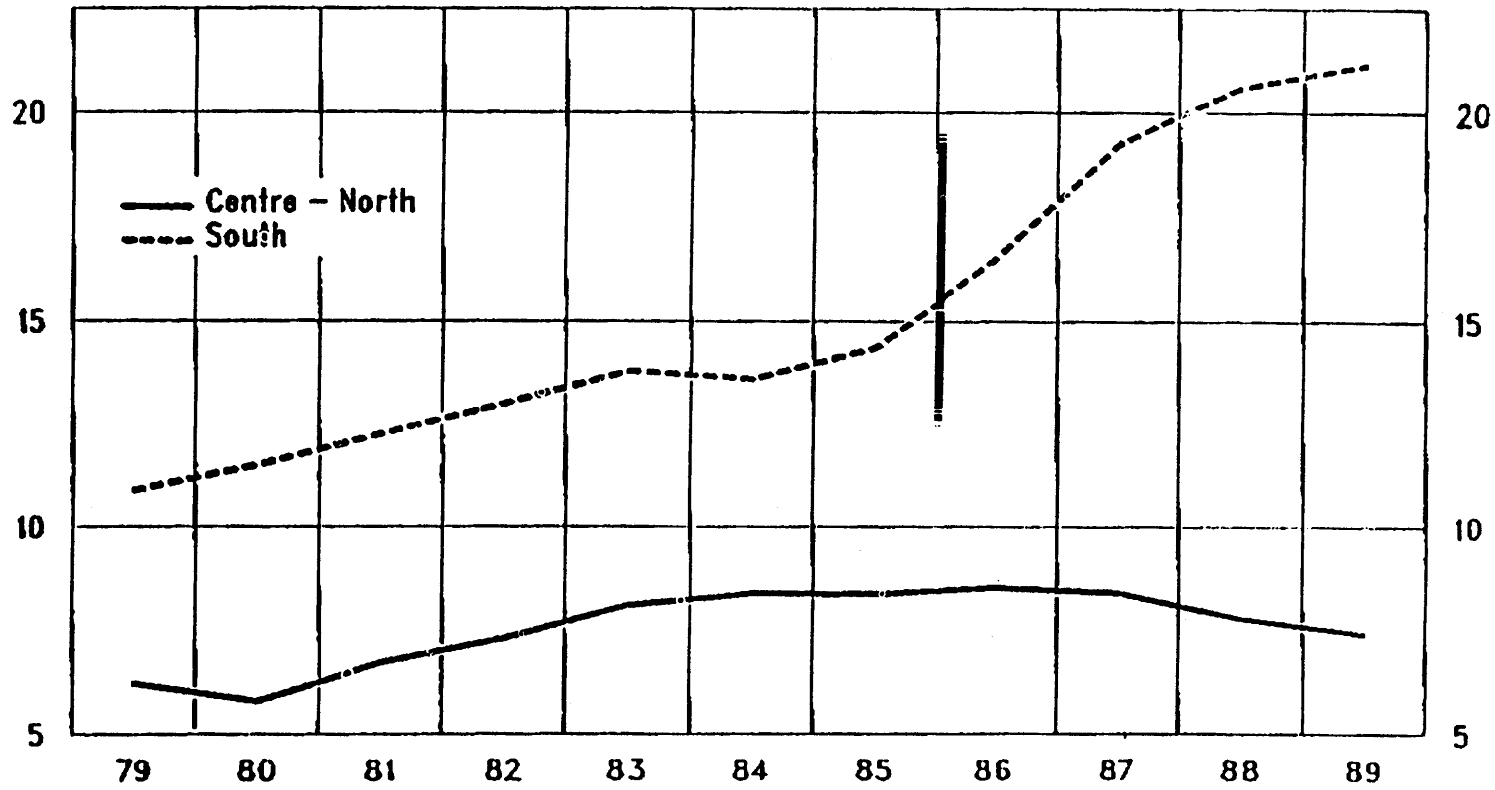
(1) The Bureau of Labor Statistics definition refers to those who have been seeking job in the last month

Source : Istat,Bank of Italy.

Fig. 7

OFFICIAL UNEMPLOYMENT RATE BY AREA

(per cent)

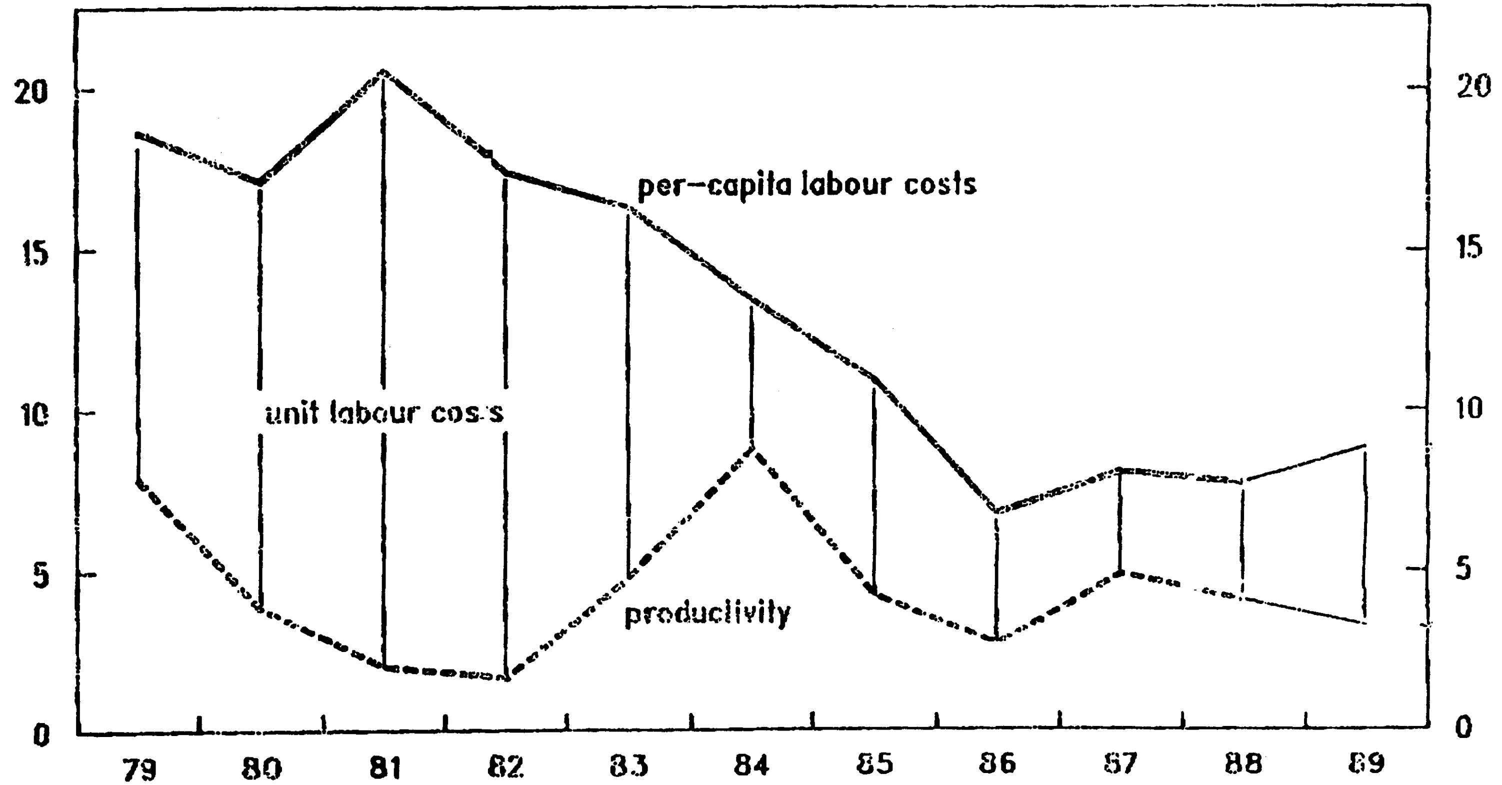


Source : Istat.

Fig. 8

PER-CAPITA LABOUR COSTS AND PRODUCTIVITY IN MANUFACTURING (1)

(percentage changes)



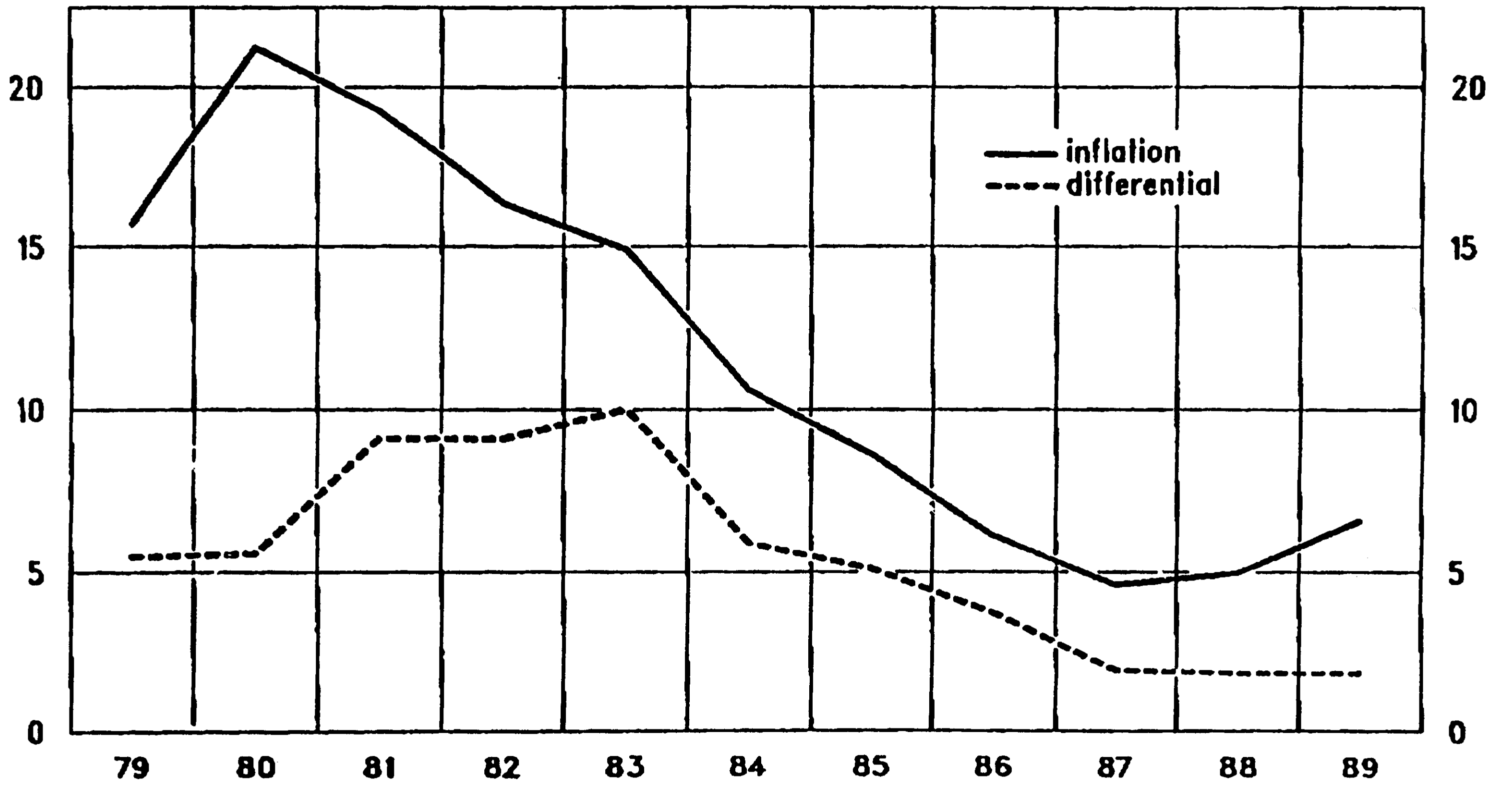
(1) The vertical distance between the two lines measures the change in unit labour costs. Figures for 1989 are estimated.

Source : National accounts.

Fig. 9

INFLATION RATE AND DIFFERENTIAL VS. OECD AREA (1)

(per cent)



(1) Consumer price Index.

Source : Istat,OECD.

Fig. 10

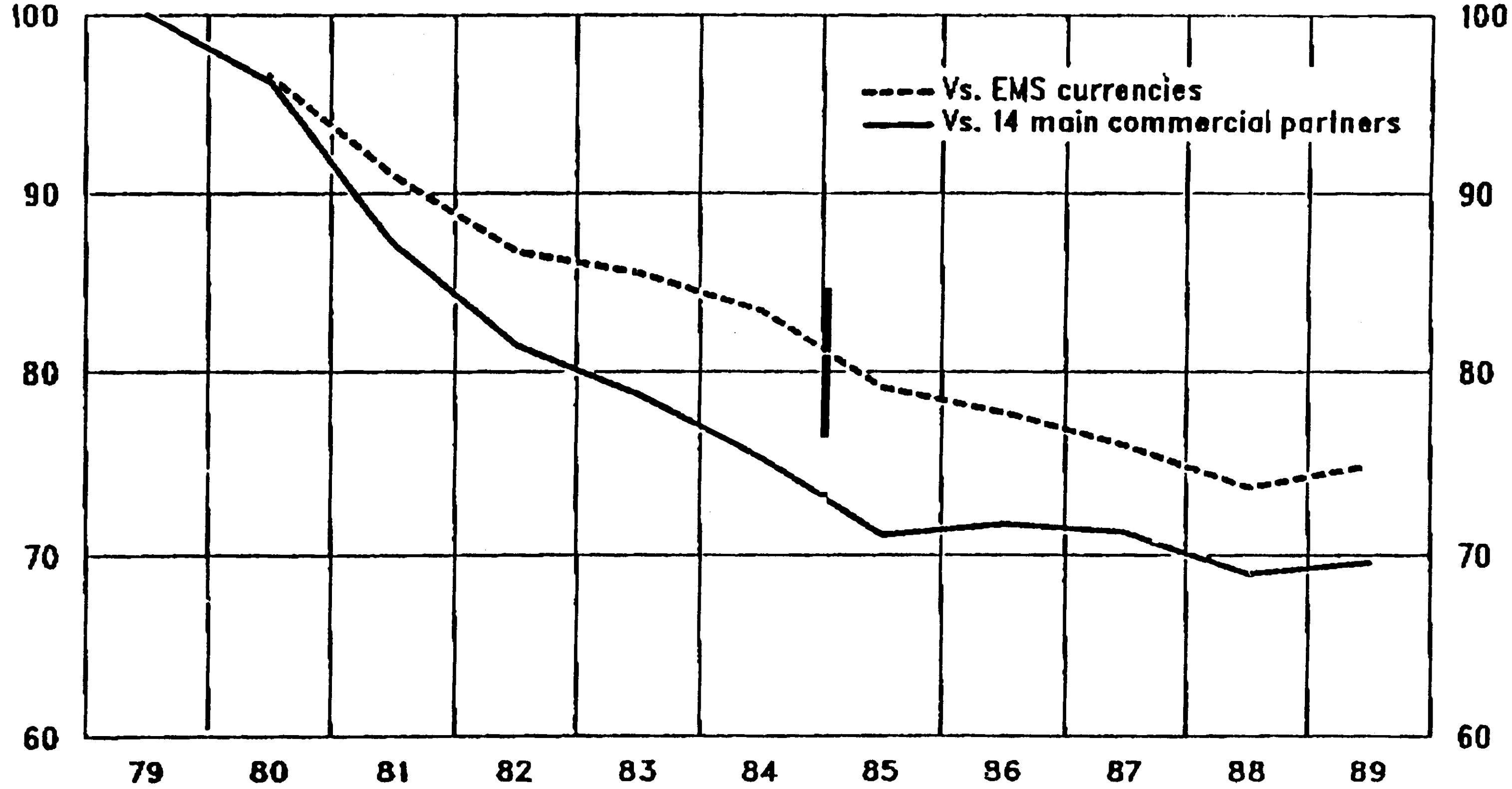
CURRENT ACCOUNT BALANCE (1)
(% of GDP)

(1) The figure for 1989 is estimated.

Source : Bank of Italy.

Fig. 11

NOMINAL EFFECTIVE EXCHANGE RATE OF THE LIRA
(1979 = 10C)

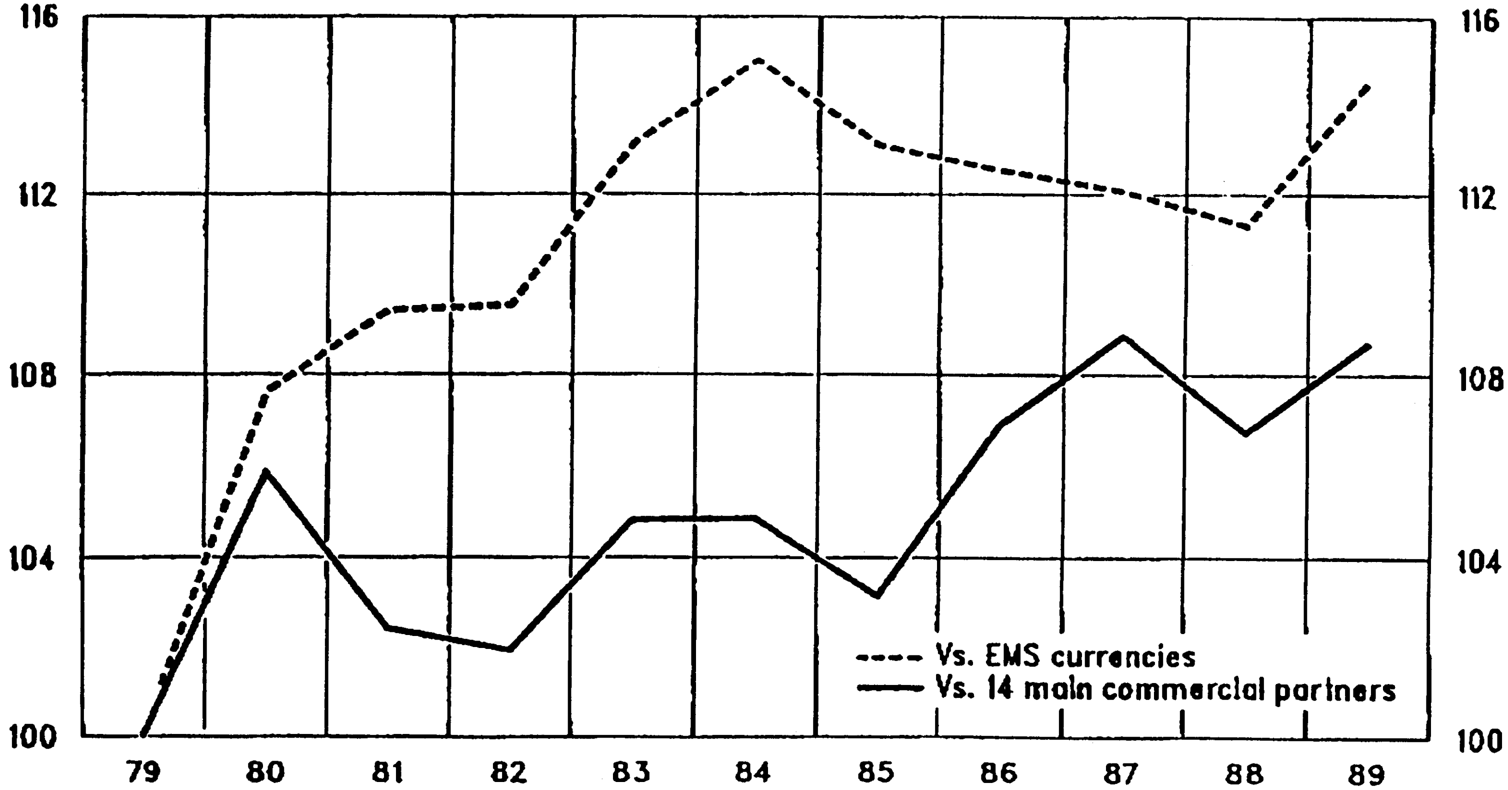


Source : Bank of Italy.

Fig. 12

REAL EFFECTIVE EXCHANGE RATE OF THE LIRA (1)

(1979 = 100)

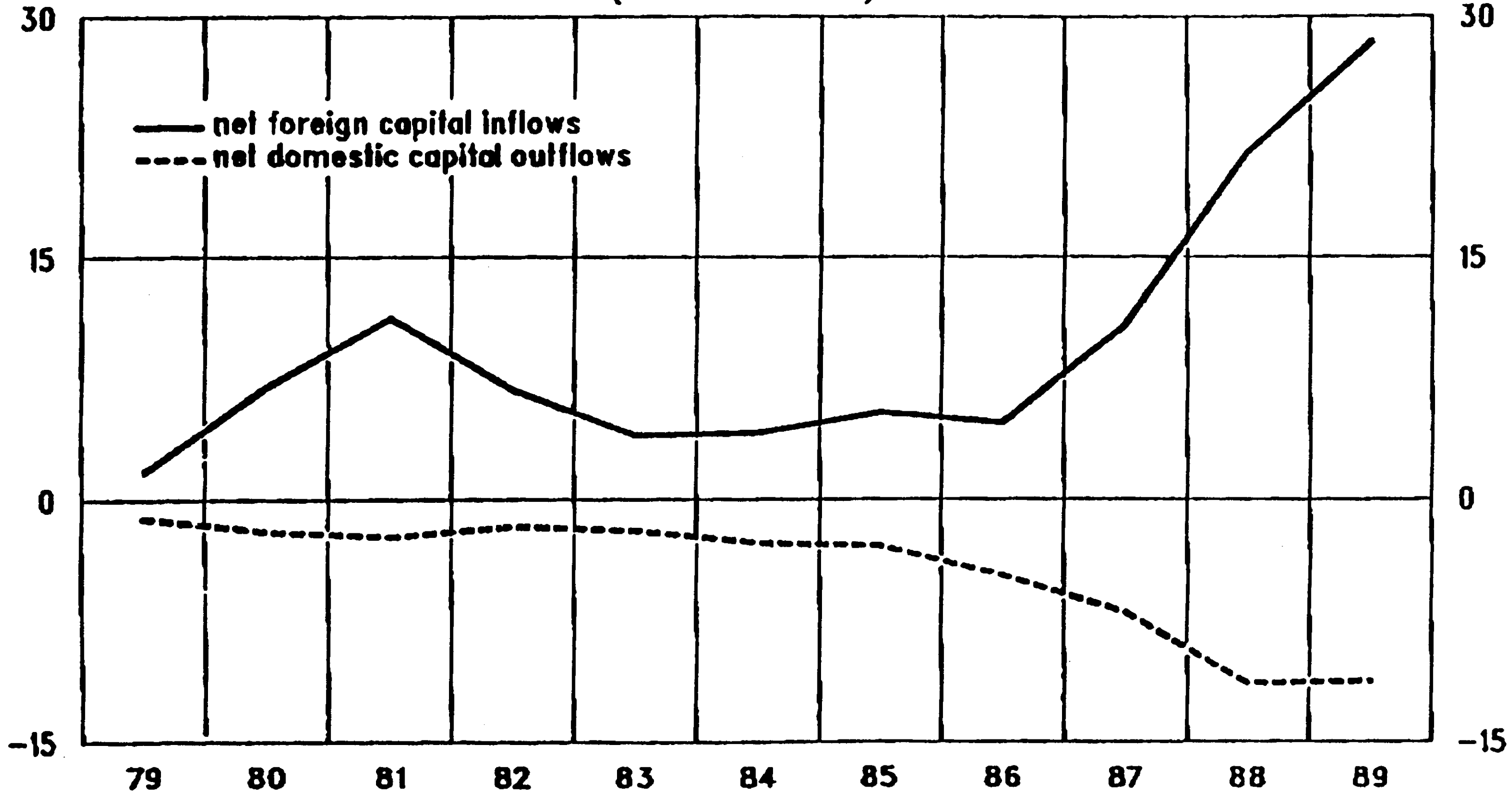


(1) Computed as the ratio of manufactures' producer prices.
Figures for 1989 are based upon preliminary data.

Source : Bank of Italy.

Fig. 13

DOMESTIC AND FOREIGN CAPITAL FLOWS (1)
(billions of dollars)

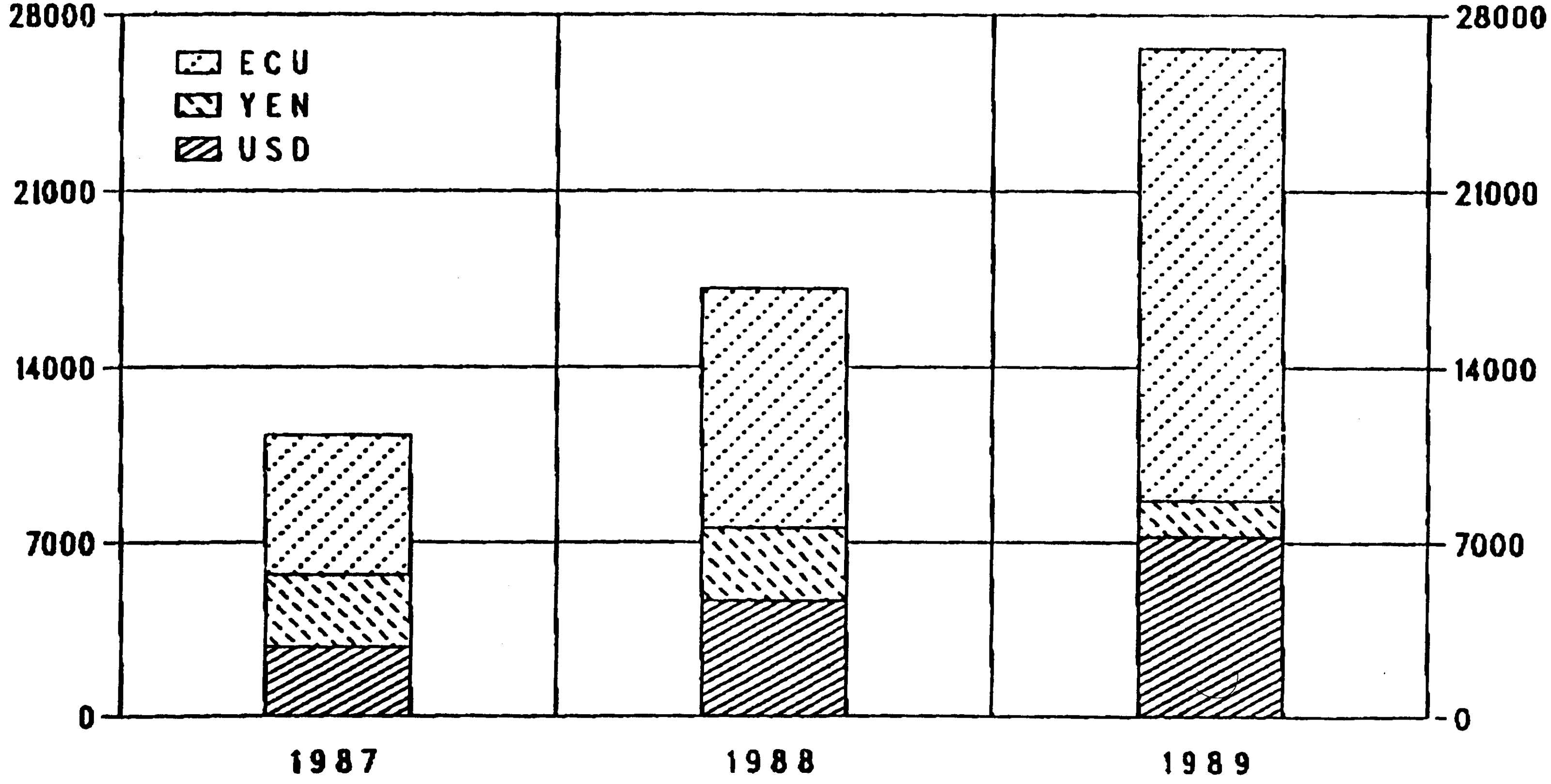


(1) Figures for 1989 are based upon preliminary data.

Source : Bank of Italy.

Fig. 14

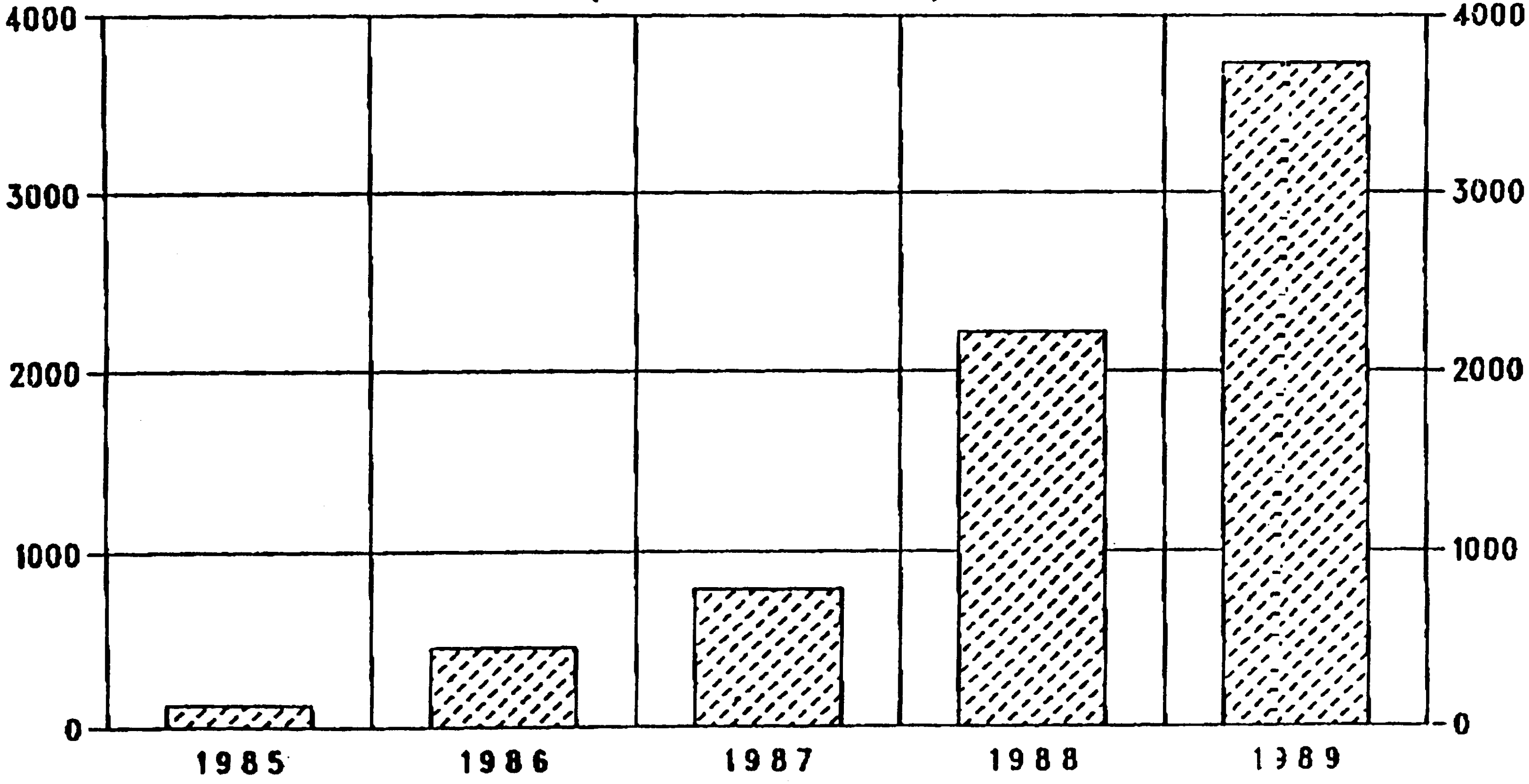
'REPUBLIC OF ITALY' EXTERNAL DEBT, BY CURRENCY
(amounts outstanding in millions of US dollars)



Source : Bank of Italy.

Fig. 15

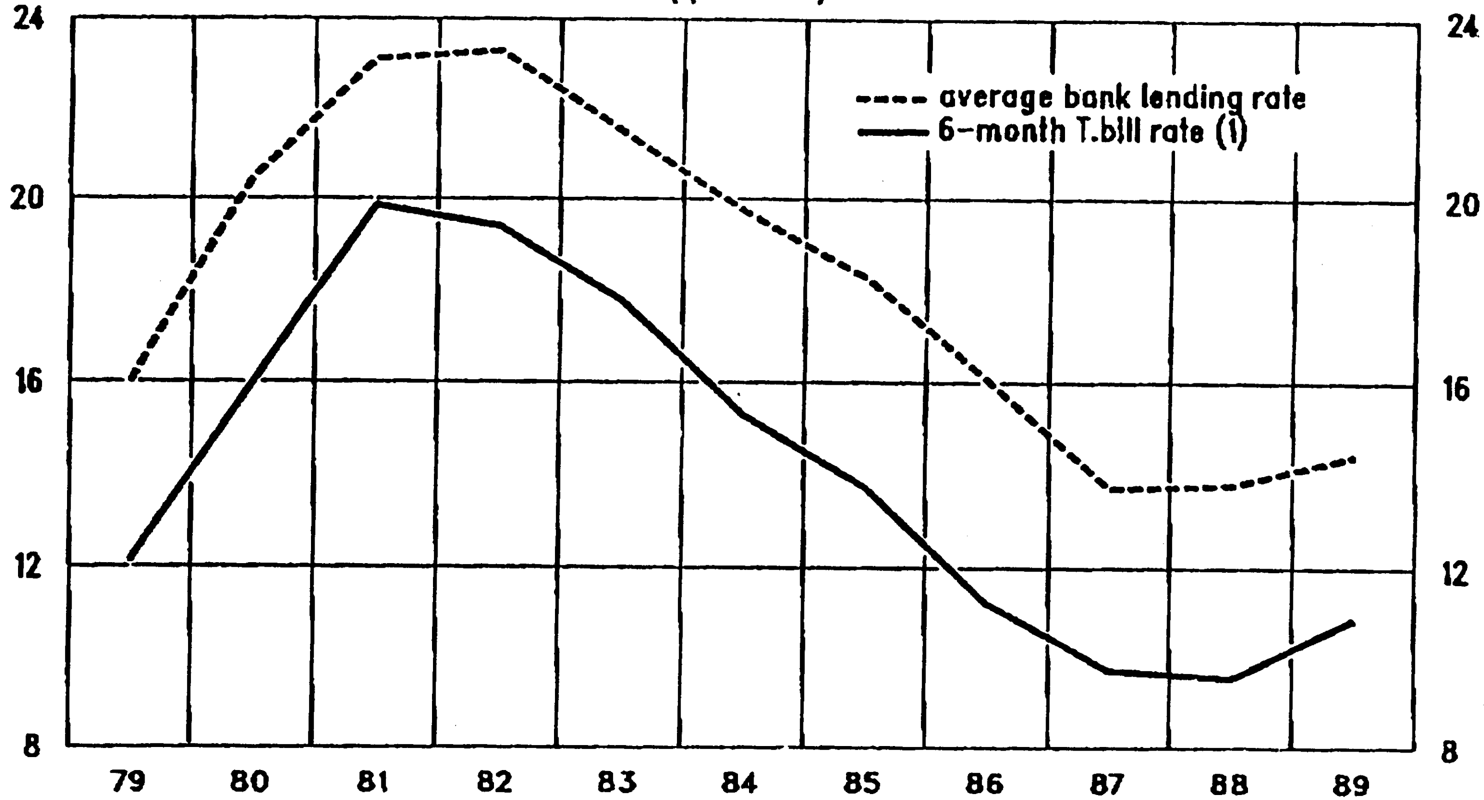
EUROLIRA BOND ISSUES
(millions of US dollars)



Source : Bank of Italy.

Fig. 16

NOMINAL INTEREST RATES
(per cent)

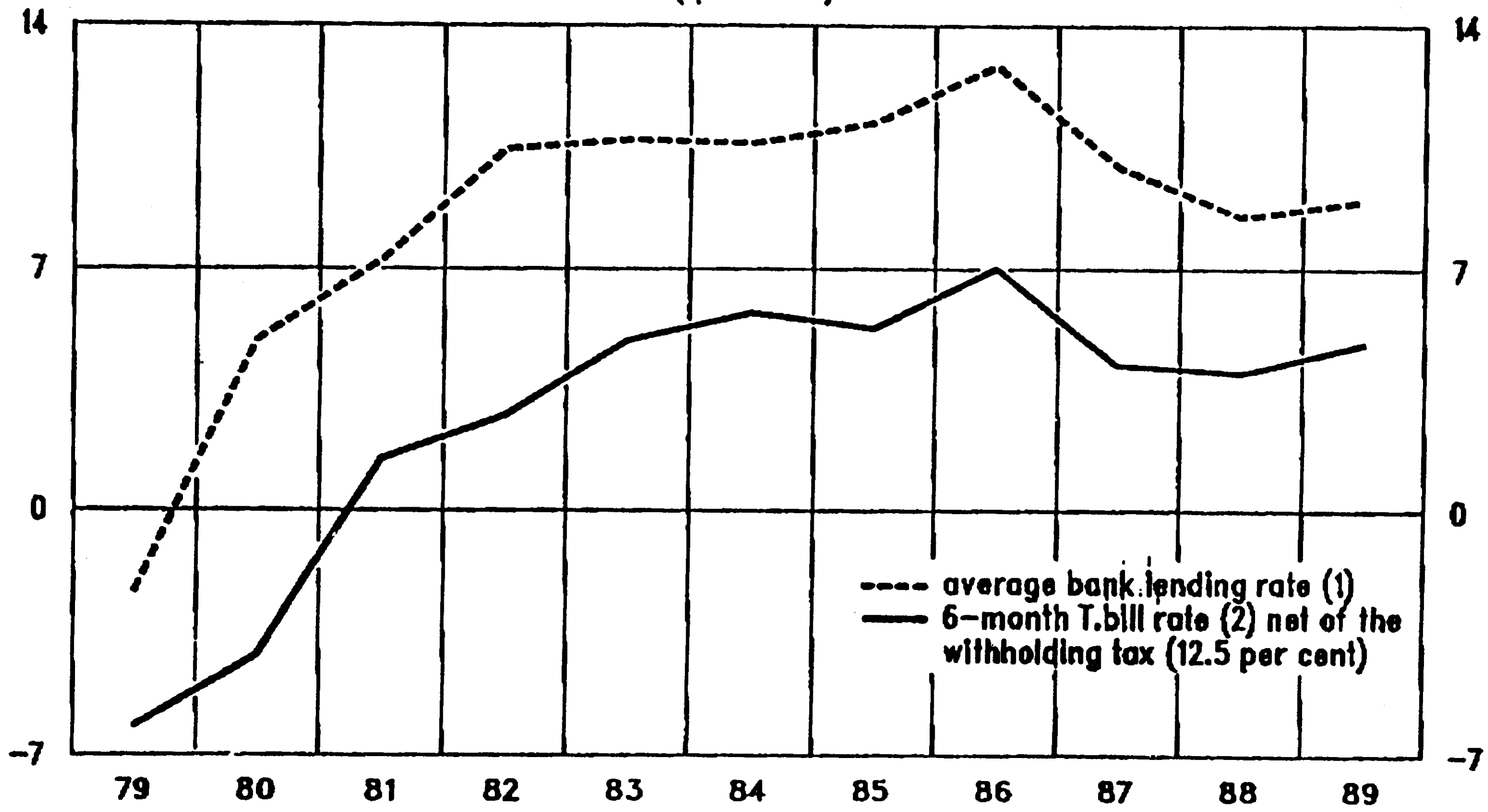


(1) Net of the withholding tax (12.5 per cent).

Source : Bank of Italy.

Fig.17

REAL INTEREST RATES
(per cent)

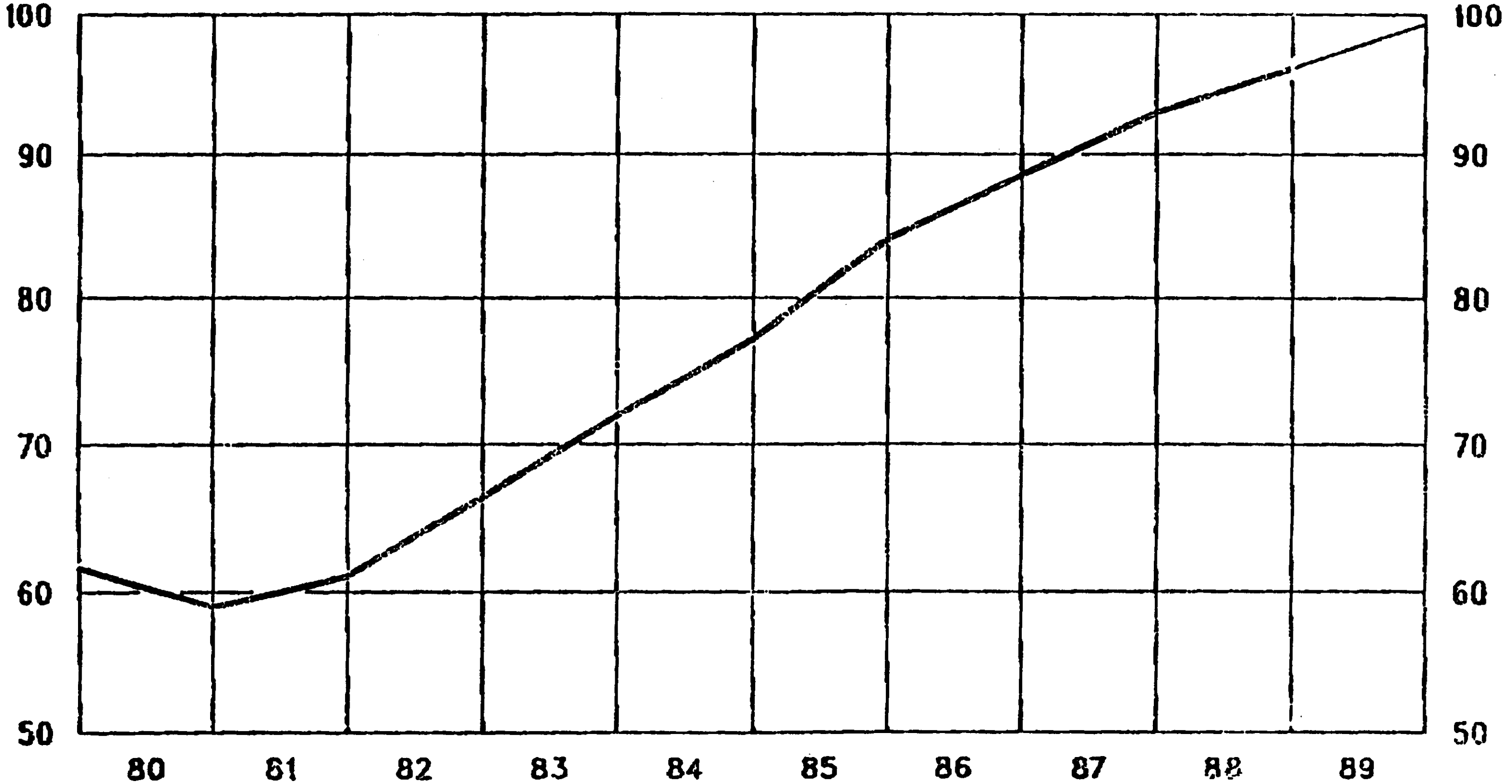


(1) Deflated by the manufactures' producer price index.
(2) Deflated by the consumer price index.

Source : Bank of Italy,Istat.

Fig. 18

PUBLIC DEBT (1)
(% of GDP)



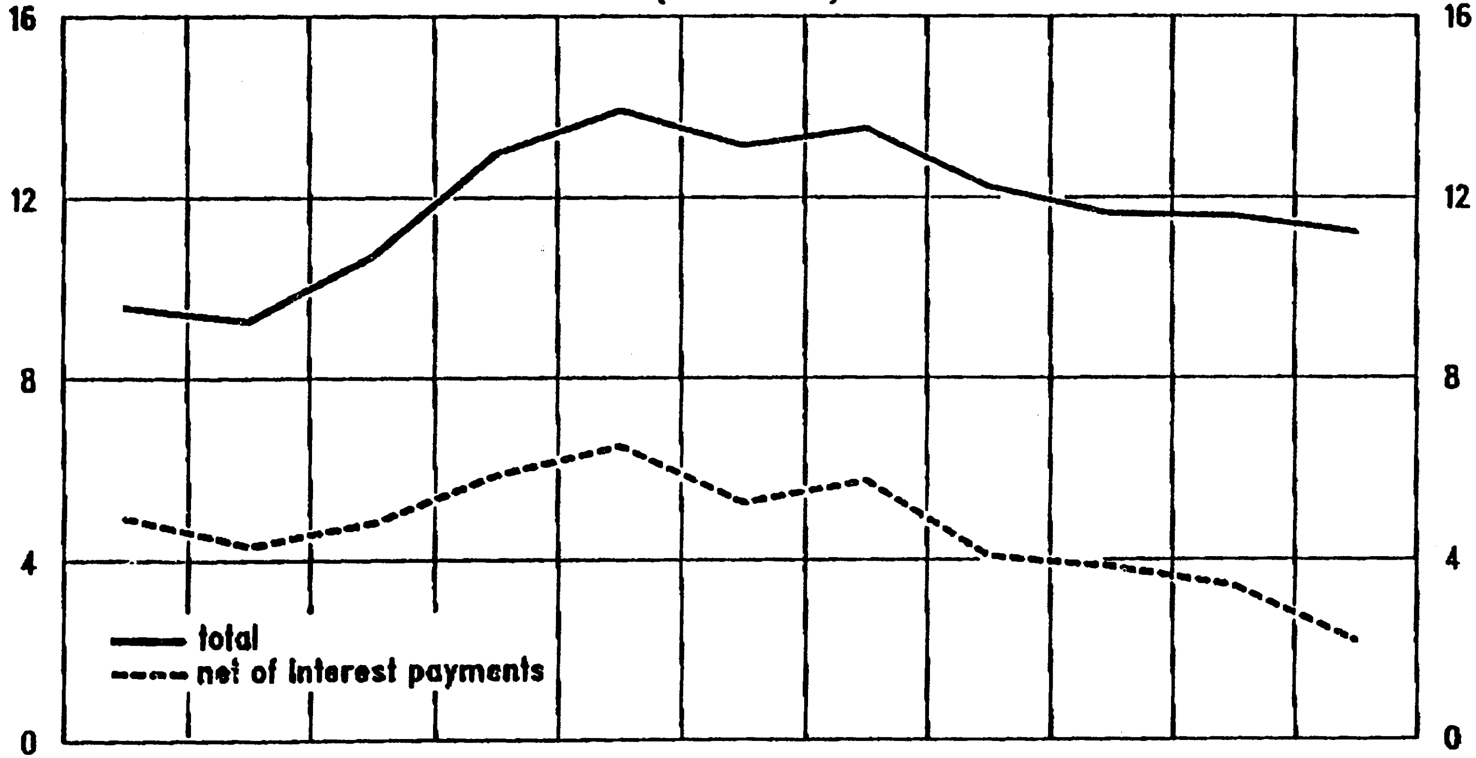
(1) Inclusive of the debt of the central government, local authorities and social security institutions.
Figures refer to the end of year.
The figure for 1989 is estimated.

Source : Bank of Italy.

Fig.19

STATE SECTOR BORROWING REQUIREMENT (1)

(% of GDP)



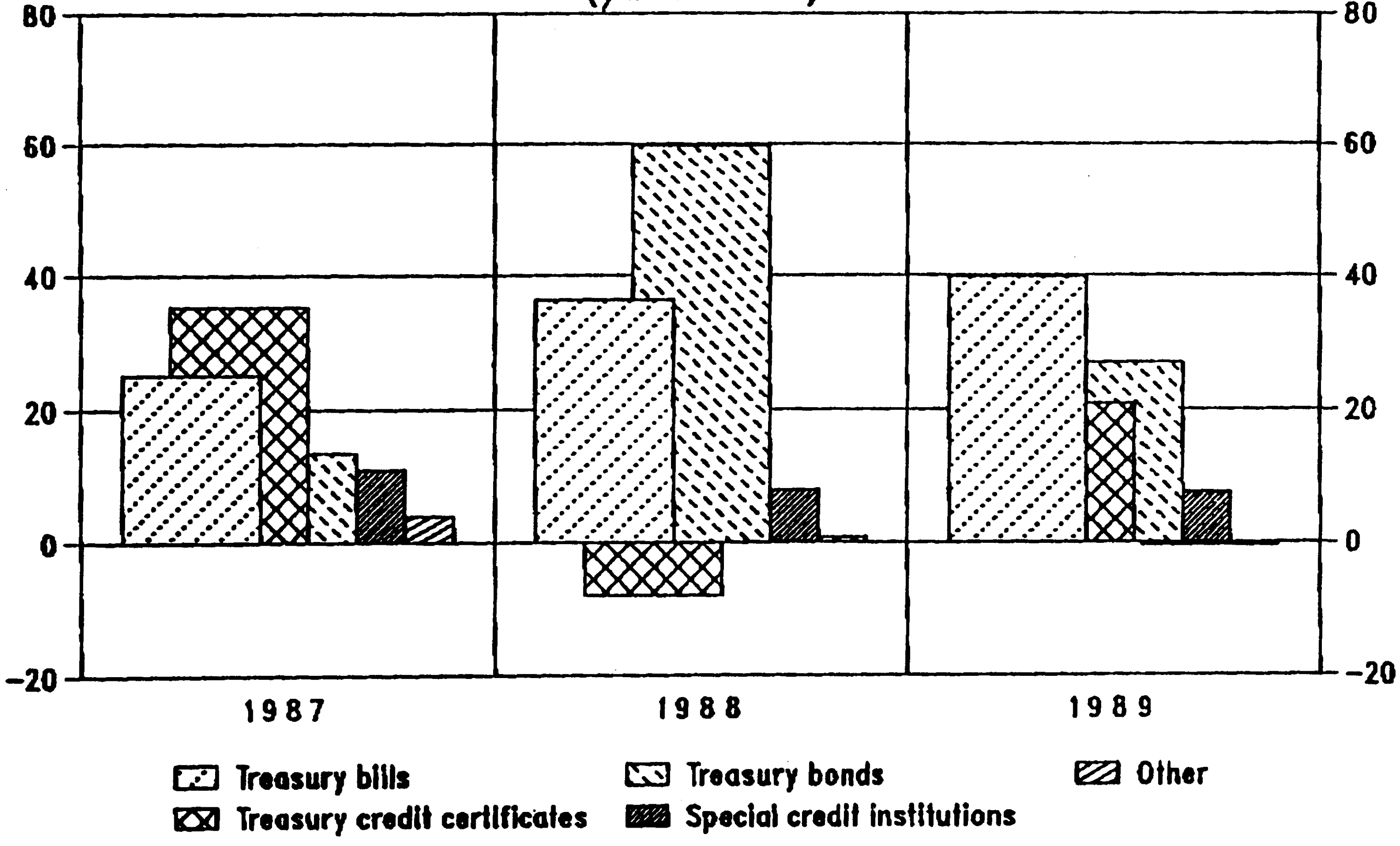
(1) Net of settlements of past debts.

Source : Bank of Italy.

Fig.20

NET ISSUES OF GOVERNMENT SECURITIES AND OTHER BONDS

(billions of lire)

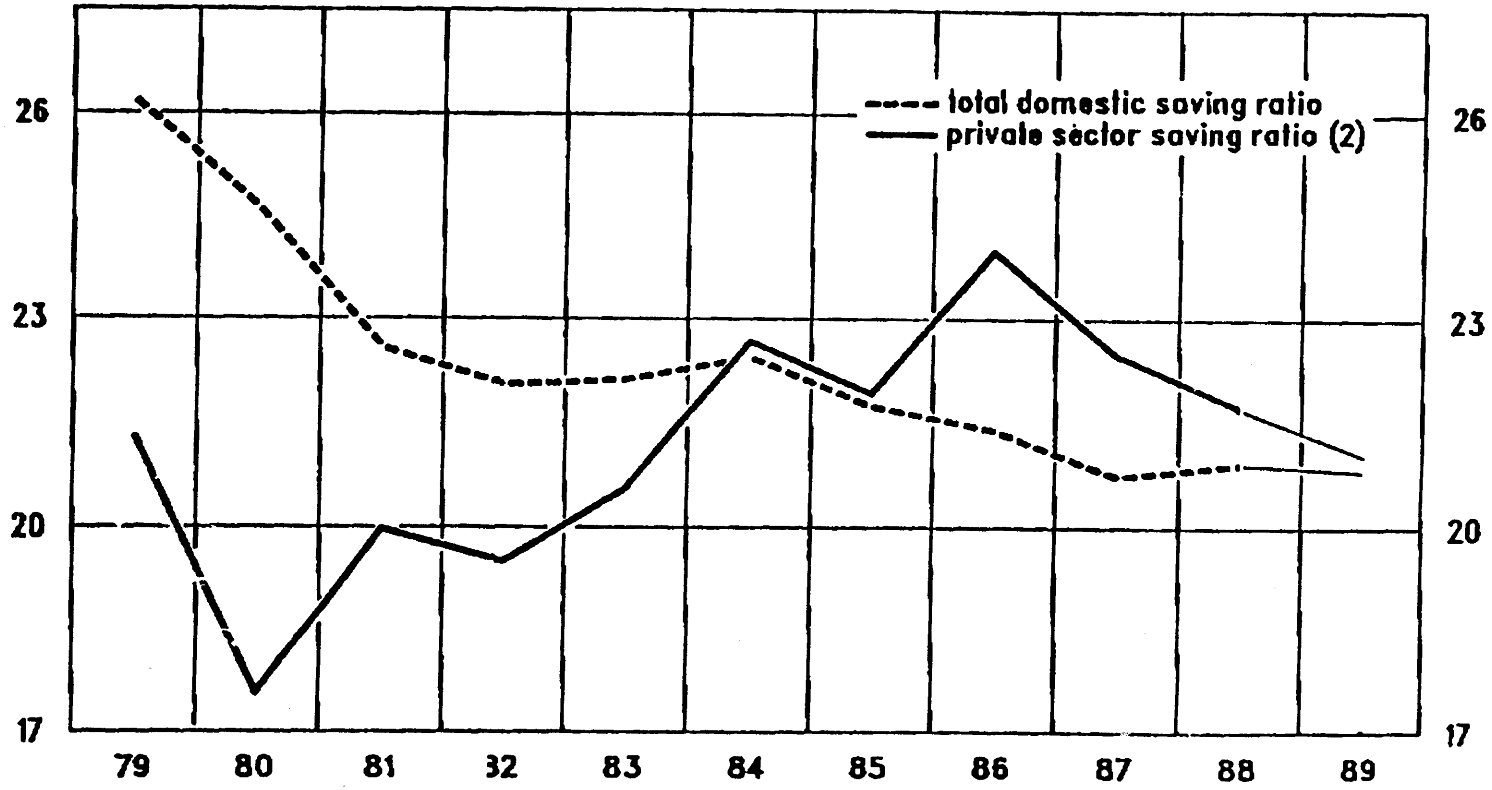


Source : Bank of Italy.

Fig. 21

DOMESTIC AND PRIVATE SECTOR'S PROPENSITY TO SAVE (1)

(percentage of GDP)

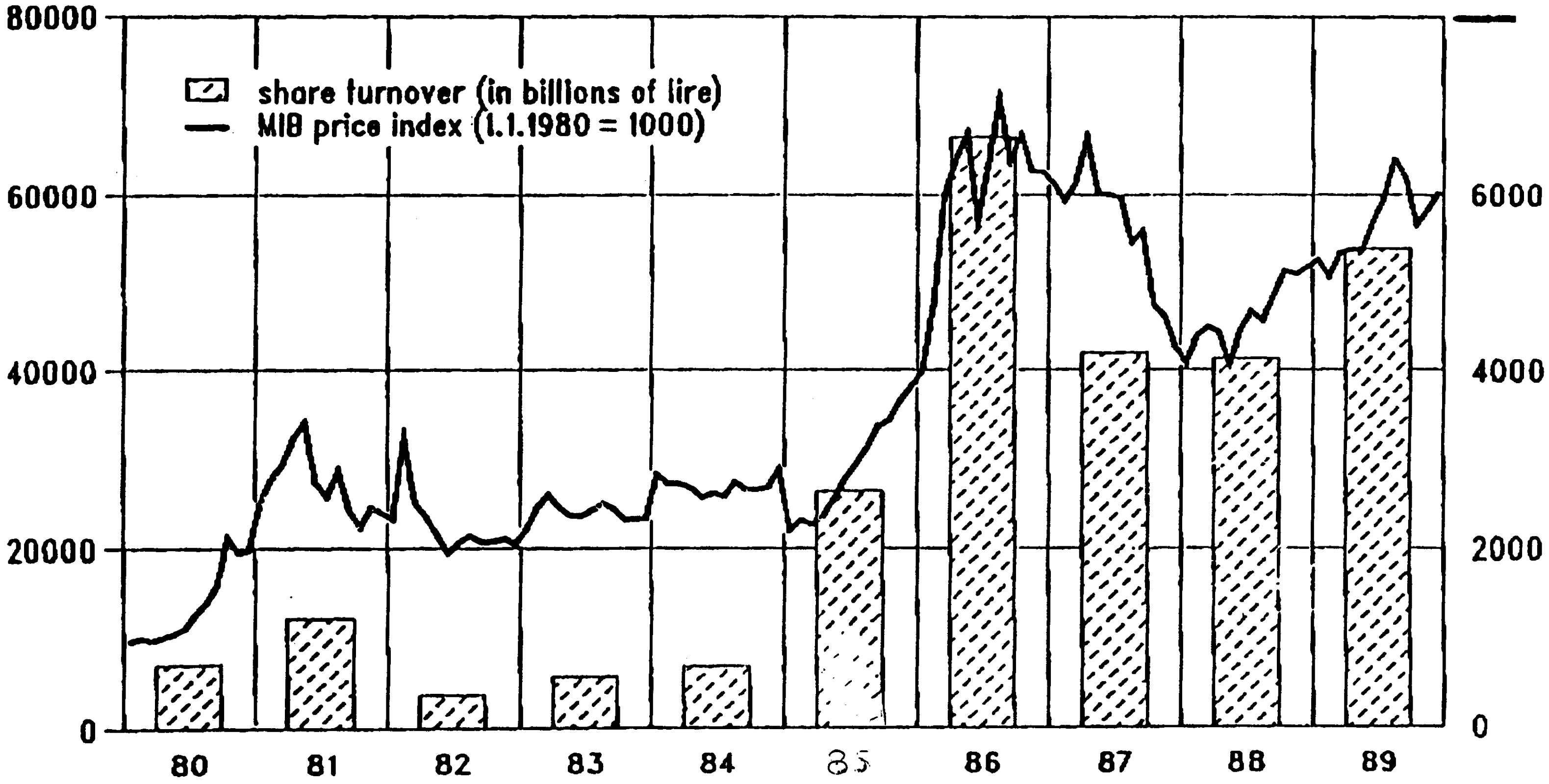


(1) Figures for 1989 are estimcted.
(2) Adjusted for Inflation.

Source : Istat.

Fig. 22

SHARE TURNOVER AND MIB PRICE INDEX AT THE MILAN STOCK EXCHANGE



Source : Based on Milan Stock Exchange