BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1991

THE GOVERNOR'S CONCLUDING REMARKS

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As in the past, the Annual Report presented to you today describes and interprets the events that have affected the economy in the last twelve months, provides an account of the Bank's activities on the intemational stage and in Italy, and records the steps taken in the fields of monetary policy, supervision and the payment system. It reveals the intensity of the changes that are taking piace in the financial system, and particularly in the credit sector. These concem the legislation and regulations applicatile to credit institutions, the organization and geographícal distribution of their activities, the composition of their accounts, the services they provide to customers and the ways in which they cooperate. Those who work in the banking system recognize that the economy and society require it to provide an improved operational capability and a wider range of more efficient services; in formulating and implementing their basic strategies and in performing their day-to-day activities, they are committed to supporting the effort Italy is making to meet the European challenge.

The banks and the centrai bank form a system for creating money and transferring it between producers, merchants and consumere. In recent years the Bank of Italy has planned a series of measures to transform the way in which it performs its functions, and most of these have already been implemented. The introduction of modern procedures for managing banks' compulsory reserves, the system of centralized accounts for the clearance and settlement of transactions in government securities and the reorganization of the Bank's supervisory activities are among the main accomplishments of last year. The secondary market for Government securities, the interbank deposit market and major projects regarding the payment system were developed in dose cooperation with the banking system and other operatore and institutions.

The changes in the Bank's *modus operandi* are reflected in the ways in which its human and technical resources are organized and managed in the central Departments and in the branches. A major project involving the comprehensive reform of branch operations is under way and the branches' data transmission and processing facilities are being modemized at the same time. Automation is also being carried further in the Central Administration and is stimulating other innovations. All of these activities require and are supported by an intensive training programme.

Both the conception and implementation of the strategy to which the Bank of Italy is committed are the work of a staff that is highly qualified,

aspires to achieve the best possible results and is conscious of the values the Bank represents. I wish to express my thanks to them, confident that their perseverance will enable the Bank to continue to perform its institutional tasks in a way that satisfies the requirements of a society that is advancing.

This meeting and the entire Bank will wish to join me in remembering Rinaldo Ossola, who died last December. He was Deputy Director General from 1969 to 1975 and Director General from 1975 to 1976, during which time he also played an extremely active diplomatic role in the fora devoted to multilateral economic cooperation. He was subsequently called upon to hold office in Government. We shall keep alive the memory of his dedication to the Bank for nearly forty years, the services he rendered to Italy, his competente and intelligence, and his ability to propose new solutions that contributed to the renewal of the international monetary system.

The world economy

Economic developments and prospects

The growth in the world economy was already showing signs of slowing down in the first half of 1990, following an expansion that had lasted for seven years. In August the crisis in the Gulf generated a wave of uncertainty, which caused households and firms to reduce their spending plans still further and spread to production. The difficulties of economic reform in the countries of Central and Eastern Europe and the Soviet Union became more pronounced.

In the face of events in the Gulf, the major industrial countries confirmed their commitment to economic policies oriented towards stability in order to prevent the rise in energy costs from inducing a permanent increase in inflation. With the markets prey to adverse expectations, their aim was to provide a more certain frame of reference, partly through the careful control of money creation. The acceleration in prices was short-lived: between July and November the rate of inflation in these countries rose by more than one point to 5.8 per cent, reflecting the increase in oil prices; it then fell back to 4.8 per cent in Aprii of this year.

World trade grew by 4.6 per cent in 1990, compared with 7.2 per cent in 1989. The growth in output in the industrial countries as a whole was 2.6 per cent, but in the second half of the year it barely exceeded an annual rate of 1 per cent. There were substantial cyclical divergences; the sharp

slowdown in activity during the year in the United States, Canada and the United Kingdom contrasted with rapid, albeit decelerating growth in Germany and Japan, while France and Italy found themselves mid-way between the two groups, with output increasing by around one point less than in 1989.

In the United States, cyclical developments and the banks' reduced willingness to lend in view of the deterioration in their assets encouraged an easing of monetary policy, leading to a reduction in official interest rates in December and again in February and Aprii of this year.

Unification led to rapid growth in the economy of the Western regions of Germany, while output and employment declined sharply in the Eastern part of the country. In view of the substantial transfer payments needed to finance the economic restructuring of the Eastern regions, the 1990 budget of the united Germany recorded a large deficit equivalent to almost 4 per cent of gross national product, whereas in 1989 the budget of the Federal Republic had been virtually in balance. The budget deficit is expected to increase by more than one point in 1991 despite the recent tax measures; monetary policy has been tightened to counter the pressure the deficit is exerting on resources. The monetary authorities in Japan also adopted a more restrictive stance to curb demand and contain the rise in real estate values and share prices.

The current account payments imbalances of the leading countries diminished, reflecting cyclical differences and changes in competitive positions. In Japan the surplus was equal to just over 1 per cent of gross product, compared with 2 per cent in 1989 and more than 4 per cent in 1986. The surplus of the united Germany decreased owing to the growth in domestic demand following unification; the main beneficiaries were the Community countries that trade most intensively with Germany, such as Italy, France, Belgium and the Netherlands. Although the United States' deficit has been declining since 1988, it remains at around $100 billion, equal to 1.8 per cent of gross national product; it is adding to a net external debtor position that now exceeds $700 billion.

The end of hostilities in the Gulf eliminated a source of uncertainty that threatened to turn the slowdown in economic activity finto a worldwide recession. Oil prices, which had touched peaks of $40 a barrel, fell to below $20; the danger that inflation would be accentuated by events in the Gulf receded. This was followed by a fall in market and official interest rates in a number of countries. Although subject to wide fluctuations, the exchange rate of the dollar recovered from the extremely depressed levels it had reached last year, as market perceptions reflected the improved prospects for the US economy.

In the countries where economic activity is weak, policies have been directed towards preventing the downturn from persisting and spreading. At their recent meetings in Washington, the Group of Seven countries emphasized the importante of action that was concerted but differentiated according to the situation in each country to promote growth in the world economy coupled with price stability. The declive in interest rates that has already begun in several countries can be reinforced by an appropriate combination of economic policies that ease the pressure of the public finances on the capitai markets.

Saving and investment in the world economy

The changes now occurring and those yet to come confirm that the shortage of savings is a problem facing the world economy as a whole, a conviction we expressed on this occasion two years ago. The evidente for such a shortage is to be found by comparing the level of saving with the substantial volume of funds required for investment. Heavy demand for resources is coming from the less developed economies, many of which are burdened with foreign debt, and from the regions that suffered most as a result of the Gulf conflict. The Central and Eastern European countries and the Soviet Union have immense investment requirements. In the industrial countries there is also an urgent need for improvements in infrastrutture, land management and environmental protection, and demographic trends are putting additional strain on social security and health systems.

Between the sixties and the eighties gross saving declined by around 3 percentage points as a proportion of national income in the OECD countries. The slowdown in growth, the aging of the population, the spread of social security systems and the development of financial instruments and intermediaries that gave households easier access to credit all contributed in this regard. The contraction in saving occurred primarily in the public sector; although the condition of the public finances has improved in some major countries in recent years, in others the state is still drawing on private saving to finance current expenditure.

Real interest rates, which were marginally positive in the sixties and dose to zero in the seventies, rose to historically high levels at the beginning of the last decade as a result of policies to combat inflation; they then stabilized at around 4 per cent. Whereas real interest rates had previously been well below the rate of growth in output, they have now exceeded that rate for more than ten years and are showing consideratile downward rigidity.

It would be an oversimplification to postulate a mechanical link between the shortage of saving and the behaviour of real interest rates. The high level of interest rates is a complex phenomenon, the causes of which and their relative importance are difficult to determine; they include not only the imbalance between the supply of savings and the demand for investment but also the increased profitability of capital, the overburdening of monetary policy and continued uncertainty.

Our economies are not doomed to endure real interest rates at their current level; rates can be reduced if the leading countries persevere with economic policies directed towards maintaining stability in both prices and expectations, easing the pressure of current account budget deficits on real and financial resources and encouraging saving in the private sector. Even in less developed areas, improvements in efficiency and higher rates of growth may generate additional resources. Lower real interest rates would foster a recovery in economic activity, ease the burden on heavily indebted countries and facilitate the investment needed by developing countries and for the transformation of the planned economies.

In the countries of Central and Eastern Europe, the problems of generating and mobilizing savings are inextricably bound up with the difficulties of marrying political and institutional reforms with the transition to a market economy. The quality of their production plant is proving inadequate to meet the needs of economies that have less and less protection; the process of regeneration, which of necessity will be far-reaching, first entails a period of falling output.

The recent report by the Group of Ten stressed the need for the Eastem European countries to implement structural reform as rapidly as possible in order to avoid the higher costs and risks inherent in a gradualist approach. The conditions attached to the financial support provided by international institutions should aim to stimulate reform, on which depend the flows of bilateral aid and direct investment that are essential during the period of transformation and take-off in order to complement domestic saving, introduce competitive technologies and mobilize the abundant and qualified human resources these countries possess.

In the Soviet Union economic and monetary disequilibria are becoming more pronounced. Output continues to fall. The inefficiencies of the transport and distribution system are affecting the supply of goods to consumer markets and the regularity of deliveries of raw materials and semi-finished products to industry. Hoarding is being exacerbated by the loss of confidence in the currency, and persistent excess liquidity is fueling inflation. The reform process must be continued to keep the period of declining activity as short as possible and to complete the transition.

Some of the developing countries, particularly those in Latin America, are carrying out adjustment programmes, as a result of which they are achieving more balanced growth and inflows of private capital have resumed. However, the majority of these countries are having difficulty implementing the necessary policies. Their problems were aggravated in 1990, not only by the Gulf crisis but also by the slower growth in their export markets in industrial countries, the fall in raw material prices and restrictions on intemational trade, the removal of which is being held up in the GATT negotiations. The overall rate of growth of the less developed regions was barely 1.5 per cent, half that of 1989 and less than the rate of population increase.

The difficulties of the poorest countries are giving rise to substantial migratory flows. In Europe, the phenomenon has become particularly marked in the Mediterranean basin and is also increasing between East and West. In the Mediterranean area, the propensity to emigrate reflects rapid population growth, especially in North Africa, and a greater awareness of income disparities; it is also encouraged by the demand for labour in sectors in which Europeans no longer wish to work. According to widely accepted projections, the population of working age in the countries on the Northem rim of the Mediterranean will increase by only a few million between now and the year 2020, but in countries on the Southem and Eastern shores it will expand by more than 100 million, predominantly in urban areas. The pressure from regions so dose at hand requires the industrial countries of Europe to adopt effective and uniform measures to regulate migratory flows, facilitate the integration of immigrants and provide adeguate resources to support the development of their countries of origin.

European Economic and Monetary Union

The development of the European Community accelerated last year: its originai objectives were supplemented by the search for a new continental equilibrium to take account of the end of bipolarity between East and West and the unification of Germany. Within this new context, the European Councils held in Dublin and Rome defined the methods and timetable for grafting Economic and Monetary Union onto the emerging single market and for a pian to advance towards Political Union. The two Intergovernmental Conferences that opened in Rome last December are drafting the necessary treaties. The difficulties the Community had in pursuing a coordinated policy during the Gulf crisis underlined the weakness of a half-finished structure and the need to complete it.

The implementation of the single market is proceeding apace. The process of passing the necessary Community legislation is at an advanced stage. In 1990 the percentage of such legislation that had been incorporated irto national regulations also rose rapidly, although not to the same degree in all member countries.

The Community's first line of approach is through the removal of the remaining non-tariff barriers, which affect a wide spectrum of sectors. The second is through competition policy, which is proving a potent force for structural change. The Commission, which has wide executive powers in this field, launched a Community policy on mergers last year and intensified its action with regard to national policies on the granting of aid to enterprises. The recent judgement by the European Court of Justice confirming the Commission's power to intervene in order to eliminate the public monopoly in telecommunications also opens up other sectors to competition policy, such as air transport, postal services, energy and rail transport.

These significant advances contrasted with difficulties on the tax harmonization front. Some important aspects, such as those regarding excise duties and VAT, appear dose to solution. Conversely, little progress has been made on the crucial question of the taxation of savings: the issue has been in suspense since the Council rejected the Commission's proposals almost two years ago, despite the undertakings given when the Directive on the liberalization of capital movements was approved.

The first phase of Economic and Monetary Union began in July. The United Kingdom's entry to the exchange rate mechanism means that for the first time in the history of the European Community the four major European countries are parties to an agreement limiting exchange rate fluctuations without any restrictions on capital movements. This requires monetary policy coordination within the Committee of Central Bank Govemors to be strengthened.

The work of the Intergovemmental Conference on Economic and Monetary Union has confirmed the consideratile degree of consensus on the objectives to be achieved, namely the creation of a single central bank with full autonomy, strict rules for national budgetary policies, convergence between the economies of member countries and the final transition to a single currency. When laws and common institutions are being established to set the seal on a union between systems and traditions rooted in the history of each individual country, there is bound to be intense debate both between countries and within them on the ways of effecting the transition.

The conclusions reached at the European Council meeting in Rome foresee that, on the basis of the new treaty and significant economic

convergence, the transitional phase will commence at the beginning of 1994 with the creation of the European central bank. There are some who argue that the new institution is unnecessary as long as national authorities retain ultimate responsibility for monetary policy. In our view, however, the central institution needs to be brought iato being at the start of the transitional phase to guarantee the commitment that has been assumed and as a means of attaining the objectives of the treaty; the Commission performed the same function in the creation of the single market, and continues to do so. To abandon this method would weaken the credibility of proceeding towards a single monetary policy and irrevocably fixed exchange rates, cause uncertainty as to the final structure of the system and adversely affect the markets.

It is no less essential to achieve greater economic convergence even before the beginning of the transitional phase. Countries with sound public finances and a statile currency will find it difficult to win the necessary public support for a monetary union with countries that do not fulfil these conditions. In the final stage of EMU the Community itself will exert discipline on member states with regard to public finances, but even today the procedures for multilateral surveillance provide that the broad thrust of member states' policies regarding convergence shall be agreed at Community level.

Italy is an essential part of the history and life of the European Community, with a positive exchange of ìdeas and initiatives over a period of more than forty years; the measures the country has to take are increasingly the same as those the building of the Community requires and are becoming more and more urgent.

The Italian economy and economic policy

The results for 1990

Last year was marked by a deceleration in economic activity, an intensification of domestic inflationary pressures and a widening of the deficit in the current account of the balance of payments. Under the impetus of the economie expansion of the eighties, employment grew by 300,000 persons, with most of the additional jobs being created in the private services sector. The public sector borrowing requirement amounted to 140 trillion lire, 7 trillion more than the target despite supplementary budget measures enacted in May.

The economic slowdown mirrored the trend in the world economy but also stemmed from domestic demand factors. Signs of slower growth in investment and of the end of the prolonged rise in expenditure on consumer durables emerged as early as the spring. Confidence weakened in August with the onset of the crisis in the Gulf. Gross domestic product increased by 2 per cent in the year as a whole, with a perceptible slowdown in the second half. From the first quarter onwards employment grew very little overall and contracted in manufacturing industry.

Consumer prices increased by an annual average of 6.5 per cent. The twelve-month rate declined to 6 per cent in May but then increased again, to reach 6.6 per cent in December. Apart from fluctuations in the course of the year, the persistente of inflationary pressures cannot be ascribed to external factors. Indeed, the stability of the lira within the EMS, the weakness of the dollar and the decline in the prices of raw materials other than energy led to a reduction in the average unit value of merchandise imports expressed in lire, despite the rise in oil prices.

The GDP deflator, which better reflects the domestic component of inflation, rose by 7.5 per cent last year, one and a half points more than in 1989. Wages and salaries per unit of labour in the private sector increased by 7.4 per cent. In the main labour contracts signed last year, the need to maintain competitiveness conflicted with the desire to keep pace with large salary increases in the public sector, which exceeded 15 per cent, nine points more than the rise in the cost of living.

In view of the stability of the lira and the slackening of demand, industrial firms passed only part of the increase in costs onto prices; the resultant narrowing of profit margins helped defend export market shares. The trade account improved by 3.5 trillion lire, and by more than 5 trillion net of energy products, ending the year in balance. The expansion of demand in Germany had an appreciable effect: Italian exports to the German market increased by more than 18 per cent in value. The current account deficit nevertheless rose to 17.3 trillion lire, owing mainly to the deterioration in the deficit on investment incorre, which increased to 16 trillion lire.

Italy 's integration finto the international financial markets has accelerated appreciably in the last few years. As in other countries, capital transactions are now the predominant component in our balance of payments. This fundamental change requires markets and intermediaries to compete in the international financial arena; it also has implications for the conduct of monetary policy.

Monetary and exchange rate policy

In the conduct of monetary and exchange rate policy, the Bank of Italy sought to combine the disinflationary impact of adherence to the narrow EMS band and the achievement of the money supply targets with the need to contain interest rates so as not to jeopardize economic activity. Exchange rate stability and freedom of capital movements restrict the scope for central bank action to govern the domestic economy, but they do not eliminate it. The Bank made extensive use of the freedom of manoeuvre that is stili available, and which will remain until European integration has been completed. The credibility now attaching to the long-run stability of the lira made it possible to handle unexpected contingencies by making small adjustments in the exchange rate and allowing the money supply to deviate briefly from its targeted growth path.

Between January and July, investors' perceptions of reduced risk on lira investments made it possible to bring domestic interest rates down with respect to German rates, so that the differential on the interbank market narrowed from 4.6 to 3.2 percentage points. The average yield on govemment securities declined, with that on Treasury bills falling from 11.2 to 10.1 per cent net of withholding tax. The rise in capital movements produced net inflows, which consolidated the position of the lira. The extremely delicate phase that had begun with Italy 's adherence to the narrow fluctuation band and the liberalization of foreign exchange transactions was concluded without tension.

The monetary policy stance was not altered after the onset of the Gulf crisis, as evidenced by the underlying stability of real interest rates. Constancy in the basic stance does not imply automaticity in the conduct of monetary policy, however. At the beginning of September, when expectations were uncertain, market subscriptions of medium-term govemment securities covered only part of the volume reaching maturity, despite the Treasury having increased the base yield on bonds by half a percentage point. Taking advantage of the lira's strength, the Bank of Italy refrained from mopping up the additional liquidity for several days in order to curb an excessive rise in medium and long-term interest rates. The signal was perceived immediately, and operators purchased securities on the secondary market at yields lower than those offered on issues at the beginning of the month. At the mid-month auctions demand once again exceeded supply, and the rise in Italian interest rates carne back more closely into line with that observed elsewhere.

In November the Bundesbank raised its officiai interest rates, while the Italian Treasury's borrowing requirement greatly exceeded the forecast for

the month. Exchange market intervention and higher short-term interest rates were needed to maintain the lira's position within the EMS and contain the expansion of the money supply. From December to the beginning of March 1991 the average yield on Treasury bills was about 11.5 per cent, one and a half points higher than in September. Interbank rates rose even more sharply, so that the differential vis-a-vis German rates temporarily increased to almost the level observed in early 1990. 'This monetary and exchange rate response halted the deterioration in expectations. Towards the end of the year medium-term yields on the secondary market were less than half a point above their September level of 11.6 per cent. In February they began to fall, both in absolute terms and in relation to rates abroad. The downward pressure on the lira waned and gave way to an upward tendency in March.

The Treasury issued an exceptionally large volume of securities last year to replace maturing paper and finance the deficit: 755 trillion lire, equivalent to 58 per cent of GDP, compared with 598 trillion in 1989. The issue volume is a reflection both of the size of the public debt and of its short maturity.

As lending rates were not fully adjusted to the rise in money market rates in the last few months of the year, it became more attractive to use bank loans to finance purchases of short-term government paper. This contributed to an acceleration in lending, reversing the slowdown recorded during the early part of the year. Domestic finance to the non-state sector expanded by 15.5 per cent in 1990, three points less than in 1989 but three and a half more than forecast. The demand for credit was fueled by a decline in corporate self-financing and an increase in transactions in both real and financial assets.

Domestic financial assets increased by 11.9 per cent, but the most liquid components grew more moderately. While the growth in nominal GDP was higher than forecast, the increase in the money supply remained within the target range until December, when the twelve-month rate of expansion rose to 9.9 per cent, exceeding the 9 per cent ceiling, in part because of the events that occurred at the end of the year. The growth in the money supply slowed down in early 1991; between January and April it remained within the more restrictive target range set for this year.

A net inflow of foreign exchange reserves of 24 trillion lire until the summer was followed by an outflow of 9 trillion in the closing months of the year, so that the official reserves rose by 15 trillion lire in 1990 as a whole. This increase reflects the fact that our economy is part of a stable exchange rate area but must contend with higher current and expected inflation than its partners, a very large budget deficit and persistent difficulty in controlling incomes growth. The convergence of Italy's inflation rate with the European

average requires real interest rates to be no lower than those prevailing in the countries with more stable currencies. In fact, in real terms interest rates in Italy are comparable to those in the other leading industrial countries. In assessing the increase in official reserves and the year-end stock figure of around 73 trillion lire net of gold, one must take into account the intensification of capital inflows and outflows and the size of the country's net external debt. Total capital flows exceeded 800 trillion lire in 1990, while Italy's net debtor position stood at 125 trillion lire, excluding gold holdings of more than 30 trillion lire.

The persistence of inflation and the state of the economy

The performance of the economy last year and the account I have just given of the conduct of monetary and exchange rate policy corroborate the lesson of the last three years, namely that exchange rate discipline and financial integration alone can narrow but not close the gap between Italy and the more stable EMS countries. If inflation is to be tamed, a rigorous exchange rate policy must be accompanied by a change in the patterns of behaviour that determine domestic costs.

Between 1987, the date of the last effective realignment within the EMS, and 1990 the lira depreciated by 2.6 per cent in nominal terms vis-a-vis the narrow band currencies and by 2.8 per cent vis-a-vis the Deutschemark, on the basis of average annual figures. It remained virtually unchanged against the currencies of the wider group comprising Italy's competitors. This performance curbed imported inflation and moderated the rise in domestic costs, but not sufficiently to match the rate recorded by our competitors. The lira prices of imports rose on average by 3.6 per cent a year, with the result that consumer price inflation was about one percentage point a year lower than the annual rise in the GDP deflator, a significant difference.

Inflation, which had come down from over 20 per cent in 1980 to 4.7 per cent in 1987, averaged 5.9 per cent between 1987 and 1990. We have not succeeded in reducing the inflation differential vis-a-vis the other countries adhering to the narrow fluctuation band; it remains at more than three percentage points. Indirect taxation has contributed to consumer price inflation, adding nearly half a point a year over the three years.

Short-run fluctuations apart, between 1987 and 1990 Italy suffered a cumulative loss of 4.2 per cent in the price competitiveness of industrial products, ascribable partly to the depreciation of the dollar and the yen. The loss in relation to the economies belonging to the narrow fluctuation band

amounted to 3.6 per cent. At the very least, this loss of price competitiveness must be halted by reducing inflation to the level experienced by our competitors. However, the current account deficit that Italy has been running for a decade cannot be remedied without an increase in domestic saving, in particular by the public sector. Compliance with the balance-of-payments constraint therefore goes hand in hand with the restoration of sound public finances. In the past, negative saving by the public sector has translated into insufficient saving by the country as a whole, as reflected in the cuffent account deficit. Italy's net external debt and the public debt fuel rising interest payments: it is imperative that this double spiral be broken.

Industrial output, which decreased by 2.5 per cent in the last quarter of 1990, has steadied at a slightly higher level in these initial months of the new year; industrial employment is falling and recourse to the Wage Supplementation Fund increasing. Economic surveys taken after the termination of hostilities in the Gulf show a revival of confidence among households and improved demand expectations among firms, indicating that economic activity may begin to pick up later in the year. Faster growth will depend on the state of the world economy, which is still uncertain, and on a recovery in investment.

The twelve-month rate of increase in the cost of living rose to 6.8 per cent in May, half a point more than in December. In most other industrial countries the downward trend has already resumed.

In this cyclical situation, and with the price of oil at its current level, inflation is likely to decelerate in Italy as well in the second half of the year, and all the more sharply the more costs are curbed. Even if the twelve-month rate falls to less than 6 per cent by the end of the year, which is possible, the differential with respect to France and Germany will not narrow significantly. Cost pressures are tending to cause a further erosion of competitiveness. The rise in labour costs per employee in the private sector is some two or three percentage points faster than in France and Germany. This is hampering the reduction in the current account deficit that might result from the improvement in the terms of trade. In the first four months of this year the trade deficit declined to 8.8 trillion lire, including insurance and freight costs for imports, compared with 10 trillion in the same period of 1990.

Having established that the state sector borrowing requirement would be 14 trillion lire above the target of 132 trillion set for 1991, on 11 May the Government introduced measures to bring it back within the ceiling and promised to take further action should this prove necessary.

With the easing of the tensions provoked by the conflict in the Gulf, the average rate on Treasury bills has come down by more than one percentage point since mid-March to 10.2 per cent and that on longer-term securities by half a point. The lira has strengthened, in conjunction with the appreciation of the dollar and the depreciation of the Deutschemark. The demand for medium and long-term securities has enabled the Treasury to limit issues of bills to the volume required to replace those maturing, and to offer the market a regular supply of longer-term securities with maturities of up to ten years.

Official interest rates have been reduced from 12.5 to 11.5 per cent, and the reserve requirement on banks' deposit liabilities has been eased. These measures were taken on 12 May at a time of stagnating industrial output and slack demand for investment goods; they are consistent with the guidelines that emerged from the recent meetings in Washington and contribute to the coordinated management of exchange rates within the EMS.

The target range for the growth in the money supply in 1991 remains 5-8 per cent, as announced last September. The Committee of EEC Central Bank Governors has judged these limits to be consistent with less inflationary growth in the Italian economy and with the necessary convergence of economic conditions among member countries.

The contradiction in Italy's situation

The contradiction in Italy's situation is becoming increasingly evident. In the eighties Italy made significant progress in strengthening the economy and reducing inflation, but its structures and economic policies continue to reflect the difficulties it is having in raising the overall quality of the system to the level required by the commitment to Europe. 'The elimination of all internal barriers within the Community makes areas of backwardness that have long been identified even more conspicuous and worrying. Firms that are capable of operating successfully in the world market coexist with the inefficiencies of the administrative machinery and of the sectors less exposed to competition at home and abroad.

We need to adopt incisive policies and rigorous standards of conduct, irrespective of membership of the Economic and Monetary Union. The decision to participate in EMU adds a compelling spur to action; its aim is to ensure that the opportunity for economic and social progress Europe offers us will not be wasted. Monetary stability and budgetary adjustment are the conditions for being a part of EMU from its very inception. Our ability to reap all the potential benefits of membership depends on the competitiveness of the whole economy.

Three issues are central: the public finances, labour relations and the efficiency of services. They are important not only in their own right and for their direct effects on industry, but also because they impinge on every aspect of Italian society, beginning with the regional imbalance between the South and the rest of the country. These interconnected questions, with their implications for monetary stability, have already been examined in various fora; there is consensus on the nature and urgency of the measures to be taken.

The public finances. — By moving towards the setting of limits on the budget deficits and public debt of states that aspire to be part of EMU, Europe itself enjoins us to restore sound public finances. The Government's recent Economic and Financial Planning Document confirmed that we must accomplish the first, decisive step of stabilizing the ratio of public debt to GDP within two years, and then reduce it. Given the present high level of international interest rates, it is unlikely that the average cost of the public debt will fall below the rate of growth of the economy in the next few years. Reducing the ratio of debt to GDP will therefore require, at one and the same time, sustained growth in output and a fiscal policy capable of producing a substantial budget surplus net of interest payments. If the budget is once more to become an instrument that can be fully deployed for governing the business cycle, it will then be necessary to eliminate the budget deficit on current account, a target the Planning Document sets for 1996.

Over the next three years it will be necessary to raise the incidence of taxation further and, above all, to stabilize the sources of revenue. These objectives must be achieved in ways that comply with the norms that are being set, either de jure or de facto, by the European Community. Even without formal tax harmonization, Italy must not diverge from the general levels of indirect taxation and taxes on investment, corporate and personal earned income obtaining in the Community. Otherwise, it will be impossible to prevent not only a narrowing of the tax base, but also a weakening of the productive sector, a flight of domestic savings and the relocation of financial intermediation and trading activities in other countries. In the radical overhaul, indeed reform, of the tax and social security contribution system that needs to be carried out, revenue must be increased by broadening the tax base where it has been eroded and especially by collecting taxes that have been evaded on income from real estate, self-employment and small businesses, and, more generally, by reviewing the specific concessions granted to particular sectors, categories and areas.

Together with rigorous action to combat tax evasion, the primary task of fiscal policy remains that of curbing public expenditure and increasing its efficiency. The basic problem is the upward slope of expenditure. The

situation in the health service and, above all, in the pension system is already serious and expected to worsen; the Government has undertaken to draft legislation for the reform of the pension system by mid-June.

The necessary condition for curbing budget expenditure and deficits while at the same time improving the quality of services continues to be compliance with the Constitutional principle that legislation entailing additional expenditure indicate the means whereby it will be financed. The Government and Parliament are called upon to make this principle fully operational by making changes to ensure that the unity and financial consistency of the budget are not undermined by sectoral provisions or devices to circumvent the financing rule. Responsibility for a larger proportion of revenue, expenditure and decisions can be decentralized, provided that stringent limits are set, including restrictions on bon-owing, so that administrators are forced to decide their priorities.

In the supply of public goods, in the provision of services such as education and above all health, in the social security system and in public employment, the principle of squaring the accounts can and must be accompanied by production methods, organizational procedures and rules that enhance efficiency. Greater efficiency at both the central and local levels must be sought not only through compliance with the financing requirement but also by ensuring that services rendered are commensurate with remuneration, by fostering competition within the public sector itself and with private sector firms, by adopting entrepreneurial management procedures and, not least, by transferring activities to the private sector.

The nature and size of the public sector 's presence in the economy need to be changed drastically. The sale of public assets, especially shareholdings, is not simply a means of resolving the problem of debt and debt servicing. Carried out in accordance with rules and procedures that are both functional and strict, disposals must relieve the state of the burden of activities that are not its proper concern.

The labour market. — Economic policymakers and the two sides of industry must rapidly make incomes growth consistent with inflation at the lowest levels in Europe. The Economic and Financial Planning Document sets sharply diminishing inflation targets: 4.5 per cent in 1992, 4 per cent in 1993 and 3.5 per cent in 1994. These targets imply action to curb the factors that perpetuate inflation. They have to be achieved if the plan to rehabilitate the public finances is to succeed.

Changes in the methods and levels of collective bargaining and in indexation provisions need to be coordinated with the action being taken by

the Government to orient expectations and behaviour to price stability through incisive policy measures and guidelines that take account of developments in all forms of income. To slow down the growth of nominal wages and salaries in both the public and private sectors, an economic policy that is credible in every respect must assure employees in each sector of the economy that a wage-price spiral in other sectors will not erode the real value of their wage settlements. A sound monetary yardstick reinforces the independence of the two sides of industry in wage negotiations, restoring their power to reach agreement within individual firms and at other levels on the distribution of income between profits and wages, on relative wages and on company incentives.

In the present system of industrial relations, the *scala mobile* tones down conflict by partly protecting the value of incomes. As it is now configured, however, it tends to compress wage differentials, prolongs the impact of rises in production costs and commodity prices, and even gives increases in indirect taxation an inflationary echo.

The credibility of the inflation target and the protection of the real value of wage settlements hinge primarily on exchange rate stability. The pressure of foreign competition on employment in the non-sheltered sectors, particularly manufacturing industry, is greater than in the past. In closely integrated economies with exchange rates that are on the way to becoming irrevocably fixed, wage behaviour must be dictated by the more moderate trend prevailing in the Community if employment is to be safeguarded. To avert shifts in relative incomes that are not justified by productivity differentials, public sector wage settlements must not diverge from those in the sectors exposed to competition. As regards immediate steps to reduce inflation rapidly to European levels, the Economic and Financial Planning Document lays down that in the new configuration of public sector employment, which must be in place before the next contracts can be drawn up, the growth of per capita earnings in the public sector must not exceed the target rate of inflation. Subject to that condition, incomes policy will have to tackle and resolve the specific problems of the civil service, and will make monetary stability and the competitiveness of the economy the paramount considerations for determining wage increases in other parts of the public and private sectors not directly exposed to foreign competition.

Social security contributions and personal income tax drive a wedge between companies' labour costs and their employees ' net earnings. Higher tax and contribution levels than in the major European countries would be justified only if they were matched by public services whose quality and cost offset the burden placed on the competitiveness of domestic producers.

We must also move towards European standards of labour market legislation in the fields of recruitment, vocational training and retraining, and unemployment benefits.

There is a growing need to innovate in the use of technology and personnel and to increase labour flexibility. In the South the elimination of rigidities, including those in the wage structure, is essential if the development gap is to be bridged.

Services.— The performance of market services as a whole compared unfavourably with that of industry in the eighties; the average annual growth in labour productivity was more than four percentage points lower, wage increases one point lower and the rise in the value-added deflator three points higher, preserving relative profit margins in the face of the rapid increase in the sector's unit labour costs. During the past decade the consumer prices of services rose faster than those of goods by an average of two points a year, despite the fact that the prices of goods include distribution costs. The differential was roughly twice as large as in France or Germany.

Under the discipline exerted by the exchange rate, industry is tending to align its prices and costs with those prevailing in the world market. No signs of a comparable development can be seen in vast areas of the private and public services sector, which now accounts for around two thirds of GDP. This difference in behaviour has been observed in other countries, and within certain limits it is perfectly normal, but in Italy it is hardening into a structural dualism, leading to internal conflict on both sides of industry.

The single European market will see the elimination of protection not only for banking and financial services, which we shall discuss in a moment, but also for various other categories of services. This must be accompanied by a wide-ranging, affirmative competition policy commensurate with the specific features of each branch of the tertiary sector. Bathers to entry, cartel agreements and public monopolies are obstacles to economies of scale, turnover among companies and innovation.

The law adopted last October for the protection of competition provides instruments for vigorous intervention, in services as well as elsewhere. The new Authority is responsible for preventing collusive agreements and the abuse of dominant positions, and for proposing changes to administrative rules or provisions that impede competition.

The adequacy of policies and conduct in both the private sector and general government will be gauged by their capacity to produce a surplus on trade in goods and services, to set against the deficit on investment income

and other current account transactions. Industry bears the brunt of this burden; it is in the front lime in international competition. By easing the external constraint on the growth of income and employment, industry and the most efficient segments of the tertiary sector can determine the performance attainable by the economy as a whole.

In the eighties a long period of investment in the modernization of plant and production methods enabled industrial companies to regain competitiveness and profitability. The strengthening of the productive base was accompanied by the restoration of sound corporate finances. International competition is now more acute, however, and new players have entered the arena, such as the newly industrialized countries of Asia. To face this challenge, companies must focus on product innovation, improvements in quality and the realization of the full potential of human resources.

European integration, the exchange rate constraint, the removal of non-tariff barriers and the diminished independence of national industrial policy reduce the scope for compensating for the remaining weaknesses, and demand that they be addressed and overcome.

Italian industry must exploit the opportunities offered by a rate of productivity growth that can surpass that of other European countries. The economy is diverse, with a wealth of small and medium-sized firms that are one of our country's specific strengths and which ensured the continuity of economic growth in the seventies.

The public imterests that justify state participation in enterprises need to be reassessed. In the companies that will remain in the public sphere, stringent standards of economic efficiency must be the hallmark of a renewed commitment to entrepreneurial values. In the fields of transport, telecommunications, service networks and infrastructure, public companies can and must have a long-term vision.

Industry must be strengthened, its productivity improved and its costs curbed, but to meet the challenge of competition, both private and public services must make even greater progress in enhancing quality in relation to cost. Services account for more than 40 per cent of industry's current inputs, excluding labour and resources supplied by industry itself. If the deficiencies in private and public services continue to raise manufacturers' costs and to impede their investment decisions, Italy's productive base is bound to contract.

Monetary policy: the institutional framework and operational instruments

The integration of the European Community is creating new conditions and prospects for monetary policy; all the member states are required to

make their legal systems, market structures and operating procedures consistent with the design for Europe.

In Italy monetary policy benefited in the eighties from the clarification of the institutional relationship between the Treasury and the central bank, the creation of new markets, the enhanced efficiency of existing ones and improvements in intervention techniques. At the operational level, despite the progress that has been achieved, monetary policy continues to be affected by the pressure the public finances exert on monetary conditions. At the institutional level, apart from changes that would be desirable in the powers regarding official interest rates, the condition for moving to the second phase of EMU is the elimination of direct monetary financing of the budget deficit.

The Treasury's current account with the Bank of Italy, which was regulated by a law adopted at the end of 1947 to confine borrowing from the central bank to the financing of temporary imbalances between receipts and payments, has degenerated into a regular and copious source of monetary financing as the result of a provision approved in 1948 that linked the overdraft limit to the total amount of public expenditure.

Reform of this facility is also a prerequisite for a major change in the compulsory reserves. In most countries these have proved an effective instrument for exercising monetary control; in Italy they have also served to absorb the liquidity created via the Treasury's current account, especially in the early eighties. Monetary and financial integration make it necessary to eliminate the differences between the reserve systems in force in individual member states. The competitiveness of the Italian banking system is diminished by the fact that the cost of reserves is well above the Community average, despite their higher remuneration.

The link that exists between compulsory reserves and the Treasury's current account means that the two systems need to be modified simultaneously, in the short time left before the advent of the single market and the second phase of EMU. The new arrangements for Treasury access to central bank credit will have to conform with the guidelines agreed in the Community and prevent the account from being a source of finance; the flexibility of the Treasury's cash management will have to be assured in ways that comply with this limitation. It will then be possible to reduce the compulsory reserve ratio substantially, notably for bank deposit flows, and bring it into line with those of the other major European countries. The outstanding amounts could be dealt with by converting the current account overdraft into long-term government securities and releasing the reserves in excess of the new requirement gradually, to avoid overburdening the public finances and upsetting the monetary and financial equilibria.

The measures adopted on 12 May of this year modified the reserve system and brought a first reduction in its cost. The requirement in respect of repurchase agreements was abolished and the ratio applicable to net foreign currency fund-raising was reduced to zero. Subjecting residents' gross foreign currency deposits to the same reserve ratio as their lira deposits is consistent with the liberalization of the use of foreign exchange.

The secondary market for government securities, which was set up three years ago, demonstrated its usefulness in a year in which it was necessary to renew a large volume of maturing government paper in addition to financing the borrowing requirement. The new market and the related trading and settlement procedures ensure transparent, multilateral and efficient trading, based on an operating system that is superior in many respects to those in other countries. Daily turnover in the first four months of this year exceeded 3.5 trillion lire, more than four times the figure for the same period of 1990. The fastest growth was in securities with residual maturities of more than five years, which currently account for about two thirds of the total turnover. Issues of long-term securities are made easier by the depth of the secondary market; we are moving towards a situation in which the volume of transactions on the secondary market will exceed that on the primary market and will determine its equilibrium conditions at the margin. Secondary market prices are a more reliable guide for the Treasury and for investors and are replacing the base rate as a benchmark for new issues.

The introduction of seven and ten-year Treasury bonds, of which 39 trillion lire have been issued in the space of a year, was an important step forward. The key to maintaining this trend towards longer maturities, which simplifies the management of the public debt, lies in restoring sound public finances; it is strengthened by a monetary policy oriented towards internal and external stability and will benefit from an increase in the role of institutional investors. The creation of official futures and options markets in government securities, which could be brought into operation relatively quickly, would be a step towards completing the structure of the financial market and encourage foreign investors to play a stable role in Italy.

The launch of the new procedure for the clearing and settlement of interbank transactions, the creation of the market for interbank deposits and the mobilization of compulsory reserves resulted in an integrated system, based on telematic techniques and providing a more efficient and transparent environment for the growing volume of transactions. The partial mobilization of compulsory reserves has enabled banks to improve their treasury management and made very-short-term rates more meaningful. The

positive impact on the new interbank deposit market rapidly became apparent: daily turnover, which had been running at around 6 trillion lire before mobilization, rose to nearly 9 trillion lire in April of this year. The combined effect of the changes has been to make the intra-day markets for monetary base an integral part of a market spanning the monthly period for which the average reserve requirement is calculated. There has been a pronounced reduction in the variability of interbank rates, which now provide a better indicator for both the monetary authorities and operators.

The changed configuration of the money market since it became possible to mobilize reserves has also modified the role of the traditional instruments for the refinancing of banks. Ordinary advances are no longer the only immediately available source of funds to satisfy their monetary base requirements; a revision of these credit lines is now possible and desirable. The recent amendment to the regulations on fixed-term advances enables the Bank of Italy to set the penalty surcharge up to a maximum of 1.75 percentage points. It will therefore be possible to link the cost of refinancing more closely to market conditions.

Money market rates are the reference variable for the central bank's operations in almost all countries. Within the EMS, active management of short-term rates is also indispensable to maintain orderly exchange market conditions. In Italy, the link between interbank rates and the exchange rate grew stronger last year following the lira's adhesion to the narrow band and the removal of the last restrictions on capital mobility. The interest rate differential vis-a-vis foreign currencies fluctuated widely in parallel with exchange rate developments, but tended to narrow. The upward and downward movements of the lira last year confirm that Italian interest rates can be reduced permanently with respect to those abroad only insofar as an effective and credible programme is implemented to restore sound public finances and reduce inflation. In the meanwhile, it is left entirely to monetary policy to counter the deterioration in expectations in order to prevent a decline in the propensity of savers to invest in financial assets.

Monetary policy is already conducted within the framework of European integration as regards the setting of intermediate objectives. The Committee of EEC Central Bank Governors has indicated that the coordination among central banks in the first phase of EMU is to focus on monetary aggregates, the targets for which must be set in accordance with a policy stance defined for the area as a whole. As the integration of the financial market proceeds, each country's control of its monetary aggregates, an indispensable component of a stability-oriented policy, will be increasingly influenced by exchange rate considerations. Any attempt to evade this constraint would have only short-lived success, create tensions in

the markets and give rise to imbalances that would be unsustainable in the long run. The objectives agreed for each country at Community level should refer exclusively to the domestic component of money creation; the set of objectives defined in this way will be the expression of the monetary policy of the whole Community. As in a system of communicating vessels, the area's overall liquidity situation will make itself felt in each country through flows of foreign exchange.

Financial institutions and markets

The three new laws: towards a financial services code

The laws approved last year — on securities markets and intermediation, banking groups and publicly owned banks, competition and company ownership — complement Italy's banking law. The incorporation of the relevant Community Directives into Italian law will complete the foundations of the legal framework for finance with which Italy will participate in the European market. The unitary nature of the provisions governing the financial sector has been enhanced and oriented to the development of the capital markets.

The new legislation on securities business provides for a composite system in which banks and other specialized intermediaries will operate together. When they engage in the same activities, they will be subject to the same rules on transparency and proper conduct under the control of the Consob. Capital requirements designed to safeguard stability will be laid down for securities investment firms as well. The securities industry will be strengthened not only by the regulation of intermediaries but also by the reorganization of the stock exchange and the creation of new markets.

In common with the other legislation, the provisions regarding publicly owned banks aim to create equal competitive conditions in the credit industry. They attenuate the distinctions between the various categories of bank, remove the requirement for special credit institutions to operate in only one sector and allow intermediaries considerable discretion in deciding the group structure to adopt. Operational specialization becomes an entrepreneurial choice rather than a legal requirement. The transformation of publicly owned banks into limited companies promotes the objective of increasing the size of banks and groups and allows a new balance between the public and private ownership of banking companies.

The law on competition marks a significant change in public intervention in the economy. Banks and other enterprises are prohibited from engaging in practices considered by the Treaty of Rome to restrict competition. In the credit sector the application of the law on competition is entrusted to the Bank of Italy, in consultation with the Competition Authority, in view of the need for the protection of competition and prudential supervision to make a coordinated contribution to the efficient working of the financial system. Other provisions of the law defend the independence of credit institutions in their allocation of resources through restrictions on shareholdings, protocols of autonomy and limitations on connected lending. The new legislation does not impose a model of widely dispersed share ownership; it permits a significant role even for non-financial entrepreneurs, within prescribed limits that preclude their exercising control.

The Second Banldng Directive opens the Italian market to banks from the other member states and the European market to Italian banks, defines the division of supervisory responsibility and develops the principle of cooperation between the authorities of home and host countries. In order to eliminate uncertainty regarding the framework in which banks will be required to operate, the Directive should be implemented promptly by including the necessary provisions in the Community enabling legislation under discussion in Parliament.

The legal framework that is emerging will make it possible to resolve problems that arise at present from the differences between the regulation of banks and special credit institutions; it will also be possible to make a clearer distinction between the various forms of fund-raising, specifying the methods and limits for direct fund-raising by firms and allowing only credit institutions to receive deposits and other repayable funds from the public on a continuous basis. The decree law relating to the vast and heterogeneous sector of fmancial companies, which is currently under discussion in Parliament, fills a gap in the legislation; it lays down rules that in the ensuing law should be differentiated according to the activity actually performed.

Proceeding in stages, Parliament has strengthened and extended a body of financial legislation that continues to be based on general principles. They are worth recalling. The unitary nature of the financial sector is of cardinal importance. A balanced complementary relationship between institutions and markets increases the efficiency with which savings are intermediated. The entrepreneurial nature of banking and financial institutions, the full responsibility of managers and their operational autonomy are indispensable to the correct allocation of resources. Independence from interests extraneous to banking enterprises is protected in various ways by the law, but in the conduct of business it is the responsibility of the governing organs

to defend this independence with their technical competence and professional ethics. The uncertainty inherent in banking and financial activities is countered with rules that relate balance sheet aggregates to measures of risk and require organizational efficiency and effective internal controls. 'The transparency and fairness of customer relations are also a condition of efficiency.

In view of the diversity of aims, intermediaries in the financial sector will be supervised by different authorities, cooperating in ways that will not blur their separate responsibilities. The formula successfully used in the credit sector, namely a technical authority endowed with decision-making autonomy and discretion in applying guidelines laid down by law, has also been adopted for the securities and insurance industries and in the field of competition policy. For groups, the unitary basis of the controls is ensured by the principle of consolidation.

Once the Second Banking Directive has been incorporated into Italian law, it will be possible to begin drafting a code that will enhance the systematic nature of the legislation regarding credit and establish the necessary links with the laws on other aspects of finance.

Recent legislation based on measures coordinated in international fora requires that in their dealings with customers intermediaries make a greater and more continuous effort to help identify funds originating in illegal activities. There is a duty to cooperate in the fight against forms of organized crime that are attacking the very foundations of civilized society; such cooperation also promotes the stability of the credit system and defends its reputation; it must not alter the institutional aims or functional characteristics of credit institutions or the supervisory authority.

Banking

One of the features of the eighties in the industrial countries was the transformation of banking and finance, driven by the interacting processes of international integration, innovation in technology and financial instruments, and regulatory reform. Efficiency was pursued by reviewing and in many instances removing operational limitations; this was accompanied by more vigorous measures to induce credit institutions to strengthen their capital bases.

The restrictions on the operation of Italy's banking system were also attenuated and refocused. The credit institutions' response to greater

freedom was not uniform. Rankings changed more rapidly than in the past, even among the large banks, reflecting differences in market positions, corporate organization and the strategic and operational skills of their managers.

The rise in the share of assets in the traditional and more profitable form of loans enabled Italian banks to remain highly profitable throughout the decade, despite increasing competition. This possibility is receding for a growing number of banks as their securities portfolios decline.

The profits they have earned have enabled banks significantly to strengthen their capital bases, which are now on a par with those of other European banks and will be made more visible by the asset revaluations permitted by legislation approved last year. This facilitates the application of more stringent standards for own funds in conformity with the recent Community Directive that is being incorporated into Italian law.

Competition has spurred the various categories of bank to expand their business outside their traditional market segments. Savings and cooperative banks, which together hold some 45 per cent of total bank deposits, increased their share of the flow of bank lending to large firms from 18 to 28 per cent between 1982 and 1989. Banks of national interest and public-law banks have maintained and in some cases strengthened their role in fmancing small businesses and households. The pattern of risks has changed. The strategy of geographical expansion has sometimes involved banks in extending credit to marginal borrowers. The banking system has also committed more resources to sectors where higher profitability is associated with greater risk, such as consumer credit, the issue and management of credit cards and the financing of securities and real estate transactions.

Now that the key regulatory reforms have been completed and the capital base of the banking system strengthened, it is up to credit institutions to prepare themselves for the new challenges of the single market. Important early applications confirm that the law on publicly owned banks provides effective instruments for reorganizing and merging banking enterprises. The drive to achieve increases in size must not entail sacrificing the local roots of an important component of the banking system, which supports a similarly localized part of the productive system. The liberalization of branch networks led to the opening of some 1,500 new branches in its first year, and work is under way on nearly as many more.

The faster the system changes, the more difficult it is for each bank to decide on the extent and means of expansion. The greater freedom they now have permits but does not guarantee improved efficiency; it is management action that determines earnings and the adequacy of customer services.

There is widespread, but in part still latent, demand for intermediation, payment and advisory services; increasing efforts are being made to ensure that the financial assistance provided satisfies the requirements of the economy in terms of quality, cost and transparency.

Banking is taxed more heavily in Italy than in the rest of the Community. The taxation of interest income on interbank deposits, the restrictive criteria for loan loss provisioning and the shortcomings of legislation on the taxation of groups are competitive handicaps that need to be corrected before the advent of the single market.

Recent events in major banking systems, notably the savings and loan crisis in the United States, have again raised the question of how far and in what way the solvency of individual credit institutions should be protected and of how broad the safety net should be in the event of bank failures. Inespective of specific institutional arrangements, which are susceptible to change, certain principles need to be safeguarded.

The first and most important defence of the stability of credit institutions is their ability to generate profits by virtue of enterprising and discerning management. Equity capital must act as a stimulus to this end; it provides flexibility and constitutes a guarantee for depositors. It must be stressed that supervisory authorities are required to safeguard the stability of the system: the supervision of individual institutions is intended to forestall crises, but it cannot eliminate the possibility of their occurring, much less be responsible for overseeing single transactions. Lending of last resort must be allowed to be discretional, flexible and prompt, especially in the sometimes brief period available when a bank is close to the borderline between illiquidity and insolvency. On other occasions we have drawn attention to the narrow limits current legislation imposes on the use of this instrument.

By their very existence, deposit protection schemes forestall crises of confidence among depositors and mitigate the losses savers incur as a result of specific failures. In exceptional circumstances, such schemes may be supplemented by special government measures. The question whether schemes providing very extensive coverage may increase moral hazard among both banks and depositors has been raised in the United States and Europe; the need to protect small depositors, who have less easy access to information, is not in question. The interbank deposit protection scheme that has operated in Italy since 1987 appears to strike a reasonable balance between the various needs. Experience and the studies being conducted at Community level on guidelines for a future directive on deposit protection may suggest changes in the present system.

The development of the Italian stock market

In Italy credit institutions traditionally played a much larger role than capital markets. This changed in the eighties, primarily owing to the rapid growth of the market in government securities and the emergence of new forms of intermediation. The share market recorded some progress: between 1980 and 1990 the number of companies listed on the Milan Stock Exchange rose from 133 to 223 and market capitalization from 6 to 13 per cent of GDP. Gross share issues rose from an average of 4 per cent of firms ' external finance in the seventies to 11 per cent in the eighties.

Nonetheless, the gap between Italy and other major industrial countries has not narrowed. Share turnover in Italy last year was equivalent to 4 per cent of GDP, compared with 10 per cent in France, 15 per cent in the United Kingdom, 20 per cent in the United States, 33 per cent in Germany and 41 per cent in Japan. Listed shares account for less than one quarter of the total equity of Italy's public limited companies. The securities actually traded are still only a tiny fraction of the total. In 1990 more than 60 per cent of trades involved securities of the country's four largest corporate groups.

The banking system and the stock market are complementary allocative mechanisms; both are essential if the investment of households ' savings, firms ' capital spending and the ownership structures of companies are to be adequately supported. The legislation now in force, including the recent law on insider trading, makes it possible to undertake the urgent task of further developing the Italian securities market, and especially the share market.

The Consob and the Bank of Italy are jointly drawing up the regulations implementing the law on securities business. They will be issued at the beginning ofJuly. The rules governing activities other than those that the law expressly reserves to securities investment firms are being made as uniform as possible and, in particular, neutral with respect to banks' choice whether to trade directly or through an investment firm.

There are still obstacles to the full development of the capital markets. The taxation of financial instruments penalizes share issues by comparison with borrowing. Italy still levies a sizable tax on stock exchange transactions, whereas it has been abolished elsewhere. There is a need for the range of institutional investors to be broadened so as to guarantee large and continuous inflows of funds and portfolio management criteria oriented to the longer term. A significant step forward can be taken by setting up pension funds, which are now virtually non-existent. Their development, which will switch a part of Italy's retirement provisions over to the funded system, will help to ease the burden on the public finances in the long run, encourage the

participation of working people in the management of collective savings and create a broad base for share ownership. The transformation of public sector entities and firms into limited companies and the disposal of some state assets will help to enlarge the market on the supply side.

The development of the stock market requires a considerable commitment on the part of the credit system. By expanding their portfolio management services and creating investment funds, banks have fostered the transition to more sophisticated methods of investing households' savings while maintaining their relationship with these customers. Banks' relations with business customers can and must evolve in a similar fashion, by guiding medium-sized firms in their search for a better balance between their sources of finance, which may also entail changes in their ownership structure. The largest public and private sector groups will have to be encouraged and helped to issue shares and bonds. This will reduce the scale of firms' borrowings from banks and industrial credit institutions, which now often exceed the limits envisaged in Community legislation on large exposures. For the Italian banking system, the alternative to promoting the development of the capital market cannot be for the institutions to attempt to safeguard their traditional relations with corporate customers, as business would migrate to other intermediaries and other financial centres.

As you listened to my remarks, you may have perceived a state of mind marked by both serenity and concern.

The unifying factor and inspiration for the Bank of Italy in performing the functions with which it is entrusted is the commitment to Europe made by the Government and Parliament, interpreting the will of the country. Clear indications as to the approach, the methods and the timing of action in the pursuit of internal and external stability and an efficient fmancial system flow from that commitment. Hence the serenity, which stems from the conviction that the Bank's operational stance is consistent both with its specific institutional aims and with the European objective.

We are nonetheless conscious that the attainment of these goals requires the full cooperation of a wide range of participants: institutions, the employers and the unions, private and public entities. The analysis we have presented to you confirms that the results fall short of expectations. Inconsistent, discordant patterns of behaviour are clearly at the root of the failure to achieve the price and budgetary objectives, which have been

changed and revised too many times, and it is equally evident that this discordance reverberates through the economy and the groups of which it is composed. Hence the concern.

The decisions to join the EMS, to remove all restrictions on the movement of goods, services and capital, to adopt the narrow fluctuation band for the lira, and to participate actively in the design and implementation of Economic and Monetary Union have all contributed to Italy's economic and social advancement and enhanced its prestige.

We are still some way from the fmal step of irrevocably fixing the parities of the EMS currencies. And yet, as a result of those political and technical decisions, the exchange rate of the lira is no longer being used to restore lost equilibria at a lower level and through sacrifices by all sections of society, but has become the sextant indicating the position for the key economic variables, the constraint forcing Italy to converge.

The interaction of the forces generated by the integration of the Community impinges fully on enterprises and workers in the part of the economy most bound by the rules of the market, most directly subject to the discipline of the exchange rate. It is less keenly perceived in the other sectors. The behaviour of manufacturers exposed to international competition and that of protected sectors also differed in the past. When the difference persisted, its immediate effects were neutralized by devaluation and inflation.

Today, competition in the European Community is between entire economic and institutional systems, and no longer simply between firms and products. By definition, integration is all-embracing. It is incompatible with membership of an integrated area to have some parts of the economy producing inferior goods and services and to have abnormal growth in incomes, whether from employment or from capital. The national economy would be progressively emarginated in the integrated area: its most vigorous productive core would tend to contract, squeezed by the cost of the inefficiencies of the other sectors, which at a later stage would also suffer the consequences of that emargination and slower growth.

The whole country must react, with the state taking the lead by making the budget constraint the linchpin for its own operations and those of every central and local government body and by establishing guidelines for industrial relations and applying them where it is the employer. This is the way to moderate and ultimately reconcile sectoral interests that conflict in the short term and to encourage people to behave in ways consistent with the goals that they themselves have set, in their collective capacity.

These principles are at the heart of the Economic and Financial Planning Document for 1992-94 that the Government adopted a few days

ago. The objectives it sets for the adjustment of the public fmances and the macroeconomic results it postulates and implies will have to be achieved if there is to be convergence: they are difficult, but not impossible.

The timetable of European integration lays down precise deadlines that are now close at hand. The countdown for completion of the first phase of Economic and Monetary Union and the start of the second has begun. Time is now short. There is an urgent need for results that will give substance to the solemn undertakings to defeat inflation and to restore sound public finances, that will give credibility and weight to our presence in the markets and our participation in international fora. There is a real risk that hard-won successes will be nullified.

If the analysis and interpretation of the conditions and prospects of the Italian economy set out in these Concluding Remarks are endorsed, if the country has confidence in its ability to keep faith with the choices made, this Report, which is the product of the work of the whole Bank, can provide useful operational pointers. It seeks in any case to provide further testimony to the motives, the convictions and the economic and social values that induce the Bank of Italy to persist resolutely in the line of conduct it has pursued hitherto.