BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 30 MAY, 1992

THE GOVERNOR'S CONCLUDING REMARKS

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As the deadlines for closer European integration rapidly approach, our economy is passing through a difficult period, faced with pressing problems that must be addressed in any case. The issues we have examined in this Meeting for many years must be resolved swiftly and decisively by acting now, in the next few weeks.

The Bank of Italy is fully conscious of the significance of the moment. It is committed to maintaining a stance consistent with this awareness, in monetary and exchange rate policy, in the supervision of the financial system, and in its internal administration.

The Bank of Italy was created as an institution at the service of the country; it was given a legal form that would permit it to pursue the public interest by operating in the market, and it is managed in accordance with criteria of efficiency. This is the enduring principle underlying its actions, a precious asset that has been confirmed down the generations for almost a century. Its autonomy is enshrined in law, and was recently reinforced by the will of the Government and Parliament; autonomy ensures the effectiveness of the action that the central bank takes in the economy and requires consistency between the performance of its institutional functions and its conduct as an enterprise.

The professionalism and commitment of the staff find concrete expression and further motivation primarily in the enhancement of the functional efficiency of the institution. Further important modifications in the Bank's departmental structure and organization were completed or begun last year; they are designed to assist the transformation taking place in the banking and financial system.

If in this year's internal wage negotiations the Bank of Italy had not decided to comply with the limits that Parliament had set for public employees and which all employers are called upon to respect, it would have been denying its awareness of the difficult times through which the country is passing and of its institutional role. We are confident that the staff understand how important it is, particularly in the situation described in this Report, that the manner, amount and timing of the recognition and remuneration of the ability of those working in the Bank should be in keeping with the performance of the economy as a whole.

I wish to express my sincere thanks to all members of the staff, whose excellence and dedication I have always been proud to acknowledge and with whom I have shared my entire working life.

Before beginning to examine the events in the domestic and international economy, I am certain that I am expressing the feeling of this Meeting in extending respectful greetings to the President of the Republic, who was elected by the Italian Parliament on 25 May.

The world economy

European Union

In signing the Treaty on European Union in Maastricht, the member states of the European Community took fundamental decisions of historic significance in the institutional, political and economic spheres. One of the principal functions of government, the conduct of monetary policy, is to be placed at the Community level, where it will be performed exclusively by a federally structured body, the European System of Central Banks, which will issue a single currency, the ecu. The System's independence is guaranteed. It will govern monetary policy in accordance with the provision of the Treaty that defines price stability as its primary objective, and it will be accountable for its actions.

The decisions made in Maastricht complement the plan to create a European internal market, the completion of which is now imminent. Together, the single market and monetary union constitute a system within which economic freedom is guided and sustained by institutions and regulations aimed at ensuring stability and growth.

The delicate stage of implementing the commitments that have been undertaken has now begun; first and foremost, this entails ratification of the Treaty, which national Parliaments are called upon to do before the end of the year.

The Council of the Community has been empowered both to set the date for the beginning of the final stage of economic and monetary union and to decide which countries will participate. The main criterion will be the degree of economic convergence. It is in the interests of all member countries that a decision of such importance be based on a rigorous and comprehensive assessment. The final stage could begin as soon as 1 January 1997, and in any case it will commence not later than 1 January 1999. The setting of a definite date for the completion of the Union strengthens the commitment to convergence and gives economic agents and the markets a fixed point of reference.

The period of transition will be used not only to achieve economic convergence, but also to prepare the instruments of monetary policy within the Union. This task has been assigned to the European Monetary Institute, which must complete its work in the three years from 1994 to 1996. The Institute must specify the regulatory, organizational and logistical framework that will permit the European System of Central Banks to perform its various functions, ranging from the procedures for the single monetary policy to the structure of the payment system, the collection and harmonization of monetary statistics and the preparation of ecu banknotes. The Institute will strengthen the coordination of monetary policies, monitor the functioning of the EMS and oversee the development of the ecu. The Committee of Governors has already begun work on the implementation of this programme.

Participation in the Union means profound changes and reforms for each country. For some, it imposes deadlines for the restoration of sound public finances and the elimination of structural disequilibria; for others, it entails amending the legislation on monetary policy in order to give their central bank full autonomy; for yet others, it means renouncing the prospect of hegemony for their own currency, which would have been a source of tension.

The changes that the Treaty entails might be seen as a loss of sovereignty, as a sacrifice, but this would be an error of judgement. They are steps in a process that transfers monetary sovereignty to the only level at which it can now be exercised, namely the Community level, a process that aims to lay continent-wide foundations for price stability, the prerequisite for lasting growth, and to exploit fully the potential offered by free and integrated capital markets.

Whereas the Treaty places the accent on Community strategies in the medium term, the imminent completion of the single market underlines the need to speed up negotiations on directives that are still under discussion and the incorporation of those that have already been approved into national law. The unification of the market is sweeping and irreversible, but there remain differences in the extent to which it has been implemented. The translation of Community legislation into national law is well advanced as regards the elimination of physical frontiers and barriers arising from differences in technical standards; it has begun in the case of public contracts, the freedom to provide services and the free movement of persons. Negotiations on other important matters, such as the dismantling of the remaining barriers in the financial markets, are proceeding slowly. The agreements reached last year regarding VAT and excise duties have not yet been translated into directives, and harmonization of the tax treatment of savings is at a standstill.

As well as completing the creation of the single market and establishing the European Central Bank, the Community must respond to the challenges posed by international political and economic events. The applications for membership from neighbouring countries, the recent agreements with EFTA for the creation of a European economic area and with some Central European countries for the reduction of trade barriers indicate the extent to which the Community is a magnet for the entire continent. This testifies to the merit of the ideal that inspired it, and underlines the need for the Community to make its large market even more open to the outside world.

Economic developments and prospects for the world economy

With recession in the United States lasting longer than expected and expansion in Germany and Japan coming to a halt during the year, the growth of output in the industrialized nations fell from 2.5 per cent in 1990 to 0.9 per cent in 1991. Their average inflation rate declined from 5.7 to 3.6 per cent between December 1990 and December 1991, despite an acceleration in Germany.

The growth in world trade declined only slightly, falling from 4.1 per cent in 1990 to 3.2 per cent. The slowdown in activity in the industrial countries contrasted with an acceleration in Asia and Latin America. Conditions worsened still further in Africa, where population growth continues to outstrip the increase in output.

Central and Eastern Europe, especially the republics of the former Soviet Union, are proving a source of new and serious concern. Output in this area has fallen further, by an estimated 17 per cent. The rise in prices, which is rapid throughout the region, has turned to hyperinflation in some countries. The disintegration of the economic and monetary system based on the rouble is jeopardizing trade among the new republics and exacerbating the fall in production and the rise in prices. Despite immense difficulties, Central and Eastern European countries have made some progress in the transition to a market economy; the process has begun in Russia, and is still at an embryonic stage in the other republics. Aid from the industrial countries has not been lacking: substantial sums were promised in 1991, mostly in the form of export credit. The net flow of official financing amounted to $13 billion for the former Soviet republics and more than $6 billion for the other countries of Central and Eastern Europe; a substantial volume of Poland's debt was cancelled and the former Soviet Union was granted a moratorium on debt servicing. The admission of Russia and the other former Soviet republics to the Bretton Woods institutions, which was approved during the recent meetings in Washington, will give these states access to additional technical and financial support. A rouble stabilization fund financed by the leading industrial countries will be set up as soon as economic and foreign exchange conditions permit.

In general, the present recession in the industrial countries has been mild; it was not synchronized among the various areas, and its development was influenced by the Gulf crisis, which caused not only a weakening of demand but also an increase in prices that made it inadvisable to relax monetary policies. Inflation was brought swiftly under control in the first few months of 1991.

The fragile financial condition of some countries helps to explain why an initially modest slowdown in production evolved into prolonged stagnation. In the United States and the United Kingdom the expansionary phase from 1983 to 1989 had been accompanied by a sharp increase in household and corporate debt that was sustainable only as long as profits, share prices and property values continued to rise. The slowdown in economic activity and the high level of interest rates prompted operators to curb spending and led to bankruptcies. In Japan the growth in the economy had been sustained by a boom in stock market and property prices, fueling higher overall investment and foreign lending. When share prices fell back to more realistic levels, spending plans were cut.

Banks in the United States, Japan and the United Kingdom were caught between the depreciation of their assets and the need to improve their capital bases; they therefore reined in both lending and deposit-taking and retrenched abroad. This led to a contraction in the international banking markets and an appreciable slowdown in the growth of domestic monetary and credit aggregates.

The disequilibria in the public finances prevented the use of budgetary policy for countercyclical purposes. The task of economic stabilization thus fell mainly to monetary policy: in the United States, Canada and the United Kingdom it was used to sustain demand, and in Germany to counter inflation fueled by transfers to the Eastern Lander and by labour costs. In Japan, monetary conditions were eased from the autumn onwards on account of overriding concern about the performance of the economy and fears of a further decline in property values and share prices.

Notwithstanding the wide interest rate differential in favour of assets in Deutschemarks and yen, the dollar appreciated by an average of 8 per cent against the other leading currencies between the end of the Gulf conflict and July, buoyed up by expectations of a recovery in the US economy. When this failed to materialize and inflation fell to around 3 per cent, US monetary policy was made decidedly expansionary in the second half of 1991, helping to bring the dollar back to the levels recorded at the beginning of the year. Coordinated intervention in the foreign exchange markets in the early months of last year and again in July signaled the central banks' intention to limit fluctuations in the dollar exchange rate.

The US trade deficit has declined gradually since 1987, but it was still in excess of $70 billion last year. The Japanese trade surplus, which had contracted between 1987 and 1990 as a result of the real appreciation of the yen and the strong growth in domestic demand, expanded again to more than $100 billion. Japan's strong competitive position reflects rapid productivity gains concentrated in a few sectors. Measured on the basis of purchasing power parity, output per worker and wages in the economy as a whole and in manufacturing industry itself are still lower in Japan than in the United States, where the trade balance remains in deficit principally on account of the far higher propensity to consume.

The persistence of substantial trade imbalances among countries and major groups of countries has exacerbated trade disputes and led to attempts to reach bilateral solutions. It is essential, in the interests of the industrial countries and even more so in those of less developed nations, to reject these regressive tendencies and complete the Uruguay Round of negotiations. Relations between different economic regions and the processes of integration that are taking shape in some of them must evolve in ways that will encourage rather than jeopardize progress towards a worldwide system of freer trade.

In the first few months of 1992 there was a moderate recovery in production in the United States and in some European countries, while in Japan economic activity remained weak.

At their recent meeting, the Group of Seven countries noted the factors that may encourage a more generalized and vigorous recovery, namely the reduction of interest rates in the United States, Japan and some European countries, the improvement that began in corporate balance sheets in the United States in 1991, and the maintenance of generally low levels of inflation. Nonetheless, growth in the industrial countries as a whole is once again expected to be well below potential. Hence the need for measures to sustain economic activity, where circumstances permit. The call for Japan to adopt temporary measures of fiscal stimulus, partly to strengthen the yen and to curb the current account surplus, is consistent with this objective. In the United States, Italy and Canada, where budget deficits remain large, priority should be given to implementing fiscal policies that will make it possible to reduce real long-term interest rates and encourage a recovery in investment. The same applies to Germany, where unification has raised complex problems that are reflected in the budget and in industrial relations;

a more suitable combination of economic policies will enable other European countries better to reconcile the objectives of price and exchange rate stability on the one hand with an expansion in output on the other.

It is essential for the industrial countries as a whole to increase both public and private sector saving in the medium term, as a necessary, though not sufficient condition for investment and growth in productivity, as the foundation for financial stability throughout the economy, and as a response to the enormous demand for resources from the world's less advanced economies and from Central and Eastern Europe.

The Italian economy

Current trends

Deficiencies in economic policy, an excessive rise in labour costs and the slowness of firms to react, combined with the effects of the international recession, meant that Italy failed to achieve the necessary progress in economic adjustment in 1991. The early months of 1992 have already passed without any improvement. The effort of will needed to rectify the imbalances in the Italian economy can be postponed no longer. These imbalances are threatening to get out of hand; they may prevent Italy from embarking on the path marked out in Maastricht and are even undermining the economy's long-term potential. They have to be tackled immediately through coordinated action that must be pursued resolutely over many years. The seriousness of the imbalances and the scale of the required effort call for a detailed exposition here, but this in no way diminishes our sense of urgency.

Last year the fall in the volume of exports and the rise in that of imports had the direct effect of reducing the growth in output by one percentage point. The increase of 1.4 per cent in gross domestic product was concentrated in the services sector, while industrial output declined by 2.1 per cent. Investment stagnated, discouraged by the fall in profitability and the uncertain outlook. Most of the growth in domestic demand occurred in private consumption. The unemployment rate declined by a further half point, but this was only due to the lag with which employment reflects developments in production.

Consumer prices continued to rise at an annual average rate of 6.4 per cent, about twice the rate in the other countries whose currencies are in the narrow EMS band. The cost of imported goods fell, thanks to the stability of the lira and the low prices of raw materials and energy products. The inflationary pressures were entirely domestic in origin.

Per capita earnings in the private sector increased more rapidly than in 1990, rising by 9 per cent. Owing in part to the slowdown in economic activity, productivity gains did little to offset the effects of this increase on unit labour costs. Caught between the exchange rate constraint and the stagnation of demand, industrial firms saw their profit margins shrink for the third successive year; firms supplying services, which operate in markets where there is little competition, passed the added costs on to their customers.

The containment of the prices of industrial goods and the strength of German demand were not sufficient to prevent a further decline in the volume of Italian exports as a proportion of total world trade. The slowdown in production affected the volume of imports less strongly than in the past. Only the improvement in the terms of trade, which were the most favourable since 1973, kept the trade account nearly in balance. The current account deficit rose to 26 trillion lire, equal to 1.8 per cent of GDP, its highest level since the second oil crisis, when it reached 2.2 per cent. The deficit on investment income amounted to 20 trillion lire. Italy's net external debt, excluding gold reserves of 29 trillion lire, grew to 150 trillion at the end of the year. The banking system's net external debtor position was of a similar size and had its counterpart mainly in loans to the private sector.

The state sector borrowing requirement amounted to 152 trillion lire, 20 trillion more than the target. The ratio of the borrowing requirement to GDP remained at 10.7 per cent, marking a halt in the downward trend that had been under way since 1986. The deficit net of interest payments continued to fall in relation to GDP, declining from 1.1 per cent in 1990 to 0.5 per cent last year; it amounted to 7.3 trillion lire, whereas a surplus of 8.1 trillion had been forecast. By the end of the year the public debt had risen to 1,484 trillion lire, equal to 104 per cent of GDP.

The budgetary programme set out in the Finance Law for 1991 and the supplementary measures adopted in May and September achieved a correction equal to 3.2 per cent of GDP, but were nonetheless insufficient to keep the borrowing requirement within the limits. In addition to generating effects that were largely temporary, they continued to focus on the revenue side. Between 1986 and 1991 the incidence of taxation rose by 4.5 points to 40 per cent of GDP. Over the same five years public sector expenditure net of interest payments rose by one point in relation to GDP, instead of falling. Including interest payments, it amounted to 54 per cent of GDP last year. The reforms that have been under discussion for some time, which are now more necessary than ever in order to curb the growth in public spending and restore its efficiency, were not carried out.

The inadequacy of action intended to improve the trend in production costs and the public finances prevented the whole economy from reaping the full benefits of the policy pursued with regard to the foreign exchange and financial markets; indeed, it raised the cost of maintaining exchange rate stability.

The lira remained solidly within the narrow EMS band. Moments of tension in the foreign exchange and money markets were overcome by combining Bank of Italy intervention with short-term movements in exchange rates and interest rates.

The reduction in interest rates that began at the end of the conflict in the Gulf was followed by a period of relative stability. Rates showed signs of hardening at the end of June, when the difficulty of achieving the public finance objectives became evident and expectations of a rate rise in Germany spread, culminating in an increase in German official rates in mid-August. The first positive signs on the inflation front, after the rise in the cost of living had peaked at 6.9 per cent in June, and the fact that money supply growth remained within the target range created the preconditions for a limited reduction in interest rates between September and October, against the background of continued weakness in economic activity.

Towards the end of the year the lira was affected by strains in the foreign exchange markets caused by the divergence of monetary conditions in Germany and the United States. On 26 November the Bank of Italy raised the cost of fixed-term advances by half a point. In the second half of December the rise in the official rates in Germany and the reduction in those in the United States led nearly all the European countries to increase their discount rates. Italy also found it necessary to increase its discount rate by half a point to 12 per cent on 22 December.

The credibility of the commitment to exchange rate stability and the depth attained by the country's financial markets limited the economic cost of the periodic tightening of monetary conditions necessitated by international or domestic developments. Increases in short-term rates were transmitted to the long end of the market to a much smaller degree than in the past. The average net yield on Treasury bills rose from 10.4 to 11.6 per cent between October and December, but Treasury bond yields remained stable. Even the rise of around one point in Treasury bill yields between February and May of this year was accompanied by only a negligible increase in the yields on long-term government paper. The underlying tendency for Italian yields to come down towards European levels since the lira's adherence to the narrow band has not been reversed; net yields on long-term government securities have fallen by more than a point since January 1990.

The market took up sufficient securities at issue to meet the Treasury's requirements, which were larger than forecast. As in 1990, it was thus possible to avoid direct monetary financing of the Treasury. Monetary base grew by 9.7 per cent, half a point less than in 1990. In the last two years central bank credit to the banking system in the form of temporary open market operations and refinancing has become the main instrument of monetary base control.

The growth of the M2 money supply remained below the 8 per cent upper limit of the target range for much of 1991, despite the fact that total financial assets increased by more than 11 per cent. In the final month of the year the growth of the money supply overshot the upper limit by one percentage point. The acceleration was partly due to the banks' increased need for deposits, which was matched by the public's demand for money in the face of uncertainty about the future course of the economy. Many banks again indulged in the inappropriate practice of window dressing at the end of the year. The overshooting of the target for the budget deficit inflated the demand for money in the short term and also prevented a significant curbing of the expansion of total domestic credit.

The performance of the economy denoted a deterioration in the early months of 1992 and confirmed the urgent need for remedial action.

The trough of the industrial cycle may have been passed, but the recovery is even more hesitant than abroad. Employment is declining, with more jobs being lost in industry and agriculture than are being created in services. Despite the fact that oil prices remain low, the deficit on the current account of the balance of payments is worsening, as is the deficit on non-bank capital movements; both deficits are being offset in part by a further increase in the Italian banking system's foreign indebtedness. The Treasury's borrowing requirement from January to April amounted to 63.9 trillion lire; this was some 10 trillion more than in the first four months of 1991, even after adjusting for the tax revenue brought forward to last December.

Progress has been slow on the inflation front. It is proving difficult to reduce the rise in the cost of living to below the rates obtaining before the Gulf crisis; today the rate of increase is 5.8 per cent. The differential in relation to the other countries in the narrow EMS band has declined by around half a point since the end of 1991, chiefly as a result of the rise in prices in Germany and the Netherlands, and now stands at around two percentage points. Net interest rates on long-term government securities are at their lowest levels for four years, but are still 2-3 points higher than in France and Germany.

The action the economy needs

Italy's slowness in bringing about the conditions for participation in monetary union has been noted with growing concern by the European Community. Within our economy, recurrent strains are superimposed on fundamental weaknesses that are becoming increasingly manifest. Economic policy must tackle the causes with measures that have an immediate but enduring effect. Action is needed in four main fields: the money supply and the exchange rate, competition, nominal incomes, and the public finances.

The money supply and the exchange rate. — A stable lira within the narrow EMS fluctuation band remains the fundamental precondition for bringing inflation down to the levels of the Community members where it is lowest. Monetary policy will continue to be geared towards this exchange rate objective, the sheet anchor of all economic policy action. If inflationary expectations are to be eradicated, this fundamental approach must be maintained, even in the face of unexpected events, whether domestic or external.

As long as inflation is high, convergence will require a more restrictive monetary policy than in other countries. The exchange rate, which has remained stable despite more rapidly rising prices, is itself an instrument of discipline. Its credibility will strengthen as inflation diminishes and as economic adjustment proceeds; in turn, it will favour a reduction in interest rates, fostered in part by capital inflows. The overall effect on economic activity will become expansionary.

In this context of a firm lira and closer linkage between domestic and international interest rates, quantitative money supply targets continue to shape expectations and contribute to disinflation; at the Community level they are an instrument for the coordination of monetary policies and a yardstick for measuring convergence.

To facilitate comparison and coordination with the other Community members, the definition of Italy's target M2 aggregate has been modified and the method of calculation revised to refer to quarterly averages. Measured according to the new method, the money supply expanded by 8.3 per cent in 1991. The target for 1992 remains a range from 5 to 7 per cent, as announced last September. This objective is an ambitious one. It was framed with reference to a macroeconomic scenario predicating a much smaller government deficit than is implied by present trends. Average money supply growth in the three months ending in April, although slower than previously, was three tenths of a percentage point above the upper limit of the annual target range owing to large-scale Treasury expenditure. The banks must moderate the growth in lending and give priority to supporting productive activity. If this occurs, the expansion in deposits and the money supply will not preclude a reduction in nominal interest rates as inflation abates.

Fostering competition. — In a market economy, competition must be able to operate as widely as possible. This fundamental precept, which is enshrined in the Constitution, has been made fully effective by the recent competition law. Competition is not *laissez-faire,* nature; it is governed by regulations and institutions, in ways that vary from sector to sector. A robust competition policy gives the Italian economy untapped potential to raise productivity and curb inflation.

The effects of the single European market must unfold, and restraints on competition must be curbed by using the instruments established by the new law on competition; however, positive action is also required to revise and refocus the rules and regulations governing economic activity.

On a number of occasions we have called attention to the unsatisfactory performance of productivity and prices in the services sector and suggested remedies. The lack of international competition can and must be offset by promoting competition in the national market and at local level. Restrictions on freedom of enterprise and barriers to market access must be removed wherever possible, notably in distribution, transportation, tourism and the professions. Competitive stimuli should also be introduced in public services. Even in the markets for industrial and agricultural goods, there remain barriers to trade within the Community, but especially with respect to imports from Asia and Eastern Europe.

In the labour market, the working of competition needs to be matched even more closely by the actions taken by institutions. By European standards, the Italian system allows comparatively little flexibility in the utilization of labour, while the protection given to workers is more costly and less comprehensive. The linkage between the modernization of the capital stock and the enhancement of human resources once again raises the issues of education, vocational guidance and career-long training. Efficient retraining arrangements and incentives are essential when the distribution of the work force by firm, sector and skill alters rapidly as technology and markets change. Hiring procedures and the operation of the state employment service have been suitably revised, but rules are still needed to facilitate the exchange of information between workers and firms, which would make for a more efficient matching of labour demand and supply.

In a competitive market, freedom of access means that entrepreneurs must be free not only to establish new productive capacity but also to transfer existing activities. Well developed capital markets, a certain and impartial body of law, a network of intermediaries to disseminate information about available opportunities, and the possibility for firms to move from the public to the private sector are necessary conditions if the allocation of ownership and control of enterprises is to help increase the efficiency of the economy.

The determination of nominal incomes. — If inflation is to be defeated rapidly, the mechanisms for the determination of nominal incomes in the various parts of the economy must be mutually consistent and orientated towards price stability.

The discipline imposed by exchange rate stability has a sharper and more immediate impact on prices and costs in sectors facing international competition; here, agreements are needed to define wage bargaining procedures and permit more flexible labour relations. In market services, where competition is weaker at present, such agreements must be supplemented by transparency and self-regulation by professional associations, employers' organizations and all those involved in the process of production. Government can and must give guidance for wage negotiations in the private sector by setting targets within a general macroeconomic framework, and it must monitor incomes and prices in each branch. In the public sector, where job security is guaranteed, conduct must be strictly compatible with the anti-inflation objectives. In the effort to achieve such consistency, the fight against inflation links up with the reduction of the budget deficit.

If nominal income trends in the public and private sectors do not accord with exchange rate stability, disinflation will be slower, competitiveness will deteriorate, market shares will be lost at home and abroad, output growth will be depressed, and investment and employment will contract. Until now, income growth in the private sector has been insufficiently compatible with the exchange rate constraint, and the situation in the public sector has been even less satisfactory.

There is no substitute for collective bargaining as the means of determining wages and working conditions. However, purchasing power should be safeguarded not so much by demanding increases in nominal incomes to compensate for past inflation, as by taking steps to prevent inflation in the future. In the final instance, the stability of the exchange rate and the constraint of competition can ensure that nominal wage moderation remains credible and translates quickly into a slowdown in inflation, to the benefit of real wages.

The Finance Law enacted in December limits wage increases for public employees to 4.5 per cent in 1992 and 4 per cent in 1993. In the same month, trade unions and employers' associations agreed on the need to curb the rise in nominal wages. These intentions must now be translated into resolute action. Compliance with the guidelines will permit an appreciable reduction in inflation, even in the short run. In the longer term, wage determination in both the private and public sectors must take account of European economic integration: in 1991, nominal wage increases in the Community countries with the lowest inflation were on the order of 4 per cent.

The public finances. — The serious budgetary situation is documented in the Report on the borrowing requirement submitted to Parliament at the end of March by the Minister of the Treasury. The programme for European monetary union fixes the scale and timing of the adjustment to be made.

In order to illustrate the macroeconomic impact of the correction required, the body of the Report I am presenting today contains a description of the main assumptions and results of an econometric simulation covering the period 1992-96. The simulation sets out from the guidelines and objectives established in the Government document published in May 1991 and subsequently approved by the European Community. As exogenous variables, it uses the main projections formulated by leading international organizations, in particular the forecast that growth in the major industrial countries will resume in the second half of this year.

The econometric exercise assumes that the limits imposed by the Government and Parliament on public sector pay increases will be observed and will serve as a benchmark, in conformity with the planned rate of inflation, for the growth in private sector nominal incomes, pensions, and regulated prices and public service charges; it also assumes that the repeatedly announced reforms of the social security and health systems and local finances will be implemented shortly.

Action on these two fronts is indispensable to halt the unsustainable expansion of public expenditure inherent in current trends; it will reduce uncertainty, slow inflation and permit a reduction in interest rates. The combined effect of such action on the borrowing requirement will increase over the years, but it will not be sufficient to ensure that the adjustment timetable is respected, partly owing to the delay in implementing the main reforms. In order to achieve the objectives for the budget deficit in 1992 and 1993, further substantial measures that produce prompt and lasting results will have to be adopted to curb expenditure and, inevitably, to increase revenue.

The simulation also indicates that in order to reverse the increase in the public debt in relation to GDP by 1994, the measures will need to produce a permanent reduction in the growth of the borrowing requirement equivalent to 2 per cent of GDP in the second half of 1992, or 4 per cent on an annual basis. Since it will also be necessary to replace earlier temporary measures, an additional adjustment equivalent to another 2 per cent of GDP will be required in 1993. Further measures to improve the trends will be needed in subsequent years, but they will not have to be so large. As a result of such a series of measures, public expenditure net of interest payments would be 4 percentage points lower in relation to GDP in 1996 than it was in 1991, with taxation and social security contributions rising by around 2 points and interest payments declining by 1.5 points.

In a virtuous circle consistent with exchange rate stability, inflation and interest rates would come down towards the levels that can be expected in the more stable Community economies. The curbing of private and public consumption, the halting of the loss of competitiveness and lower interest rates would help to bring the external current account back into balance.

The reduction in the budget deficit would not imply a real fall in per capita GDP, which at present is about 3 per cent above the Community average. The measures to be adopted should impinge on the components of demand that least influence employment and productivity, on domestic demand more than production, on consumption more than investment. If the Italian economy is put in a position to benefit from world recovery, the boost from exports and investment should enable it to maintain a moderate rate of growth in 1992-93 and from 1994 onwards gradually to return to the growth path consistent with its productive potential.

The simulation I have briefly described indicates the order of magnitude of the adjustment that will have to be achieved through the measures outlined above and reveals the macroeconomic consequences they would have. It cannot specify which measures should be chosen or their relative importance in the overall package, nor does it seek to do so; the choice is exclusively political and will have to be set out in a Government programme. Succint though they be, the summary simulation figures reveal the severity of the policies and conduct required.

The main problems in the field of public expenditure — relating to social security, health care and local finances — have been thoroughly analyzed in the last few years; an extensive debate has taken place, leading to a broad consensus of opinion, and specific projects have been put forward. Other important aspects, including the scrutiny of government departments' budget appropriations, the overhaul of procedures for public procurement and the production and supply of public services, have also been examined and proposals made for reducing expenditure. Decisions must now be taken.

On the revenue side it will be necessary to consolidate the ratio of tax to GDP by replacing temporary levies with permanent taxes, seek additional receipts through a reduction in tax avoidance and evasion by providing incentives for taxpayers to comply with tax laws, and pursue a systematic policy aimed at reorganizing and simplifying the tax system. The perception of fairer taxation will be necessary to persuade citizens to participate with greater conviction in the rehabilitation of the public finances and in incomes policy.

The procedures for multi-year financial planning and for the preparation and implementation of the annual budget and the Finance Law need to be radically revised to ensure greater rapidity and compliance with the substance of the provision of the Constitution requiring the source of funds to finance new budget expenditure to be specified.

A potential for growth

The Italian economy has the ability to achieve greater productivity gains over the long run than its main European competitors, thereby reversing the adverse tendency of recent years. Our confidence in this regard is based on the trends in industry over the last twenty years as a whole and consideration of the weaknesses that can be overcome and the strengths that should be exploited.

Productivity in Italian manufacturing industry rose at an average annual rate of 4.4 per cent between 1971 and 1990. This average was the result of widely differing performances and factors during the various cyclical phases and periods of restructuring through which industry passed. The average annual growth in productivity over the twenty years was 2 percentage points higher than in Germany and 1.5 points higher than in France.

Looking to the future, the introduction of new forms of corporate and group organization is becoming an important factor in sustaining productivity growth. Advances should be made not only in the way in which production factors are combined but also in the entire cycle of production and distribution. Better coordinated but flexible links between firms, suppliers and distributors, simpler hierarchical structures, greater consultation with the workforce and staff motivation provide scope for substantial productivity gains. Policies of this kind have begun to be adopted in Italy's manufacturing sector, but are not yet sufficiently widespread.

Italian industry is poorly represented in technologically advanced fields; it invests less in research and development than the other leading countries. Full integration in the European economy, wage growth kept permanently in line with the lower rates prevailing elsewhere in Europe, and the new competitive regime established by the recent legislation in this regard may provide the critical momentum that will induce firms to innovate both in specialized production and in international trade.

Interdependence between the various sectors would prevent industry from being successful if productivity did not increase throughout the economy; this requires an agricultural sector that better exploits its qualitative potential, more efficient market services, and public services that foster economic progress. Services account for a high and rising proportion of industry's total inputs. The services sector has even greater scope than the others to curb costs and improve the quality of its output. Public measures, based on updated principles and instruments, should generate the externalities that will encourage this process and should focus particularly on the weaker areas of the country in order to overcome local diseconomies.

The South is at one and the same time a source of economic problems and one of the keys to the growth potential of the entire country. Integration in the Community makes the contrast between opportunities and achievements all the more striking. It is vital that a solid productive base be created in this area; one fundamental prerequisite is to guarantee legality and efficient public institutions, without which there can be no genuine progress. The underutilization of the South's human resources is the most serious manifestation of the imbalances in the Italian economy. Greater flexibility in labour costs, so that they correspond better to disparities in productivity and the cost of living between the different areas of the country, would help overcome this problem.

A sustained flow of saving into investment is the foundation on which to build improvements in productivity. If erosion by inflation is taken into account, the private sector's average propensity to save has declined by four percentage points over the last two decades in Italy. The decline has been attributable to the slowdown in growth, the changes in the structure and organization of households, the aging of the population, the configuration of the pension system and easier access to credit. Some of these factors, particularly those of a demographic and financial nature, will continue to have an effect. The private propensity to save in Italy nevertheless remains at around 20 per cent of gross national income, higher than in the other leading European countries. The effect of the forces tending to depress the national saving rate can be counteracted by a resumption in growth, but also by restoring sound public finances. If the saving propensity of the economy as a whole remains high by international standards, the resources will be available to finance greater investment, and hence foster greater productivity gains. Diversification of the sources of corporate finance, combined with the contribution being made by a financial system that is growing stronger, offers Italian firms greater opportunities than were available only a few years ago.

Since 1987, the year of the last realignment within the EMS, the price competitiveness of Italian industrial goods has declined by about four percentage points; the disparity in terms of unit labour costs is 11.5 points. Failure to eliminate the constraint that is again being imposed by the current account of the balance of payments will ultimately affect the rise in the standard of living. More rapid productivity gains and a reduction in the rate of wage growth towards the European average should be used primarily to restore price competitiveness. This will ensure the necessary consistency between exchange rate stability and balance-of-payments equilibrium in an economy enjoying renewed, sustained growth beginning in output and spreading to employment.

The monetary constitution

Monetary stability is an objective that lies at the heart of central banking. A sound currency is a cornerstone of a just democracy, a precondition for economic development and an orderly society. Debasement of the monetary yardstick generates uncertainty and distrust; it erodes economic relationships and the very fabric of society. Only confidence in the value of money allows the country, enterprises and households to plan well into the future.

The design of the monetary constitution outlined in the Maastricht Treaty is based on the principle that price stability must be the primary objective of the central bank. It recognizes that a central bank alone, even one with binding objectives and guaranteed independence, cannot protect the value of money in every circumstance if the other branches of economic policy fail to lend their support.

The Treaty lays down precise rules for fiscal policy: it prohibits direct financing of the public sector by central banks, which may purchase government securities only in the secondary market for the purpose of controlling liquidity; it precludes any assumption of liability by the Community or member states for the financial commitments of a member; and it requires member states to avoid excessive government deficits. By imposing restrictions on deficits rather than on the size of budgets, the Treaty allows individual countries to decide the scale of the public sector within the economy; its aim is to prevent the danger that fiscal imbalances will transmit instability to the monetary sphere.

In this same forum eleven years ago, I said that a new monetary constitution was needed to restore the stability of our currency. I indicated the three fundamental elements it should comprise: first, that the body with the power to create money should be completely independent from those responsible for deciding expenditure; secondly, that budgetary rules — requiring, for example, that current revenue and expenditure be in balance — should be defined in order to implement the principle enunciated in Article 81 of the Constitution; and thirdly, that procedures should be identified to ensure that agreements on wages and working conditions are compatible with economic policy.

The greater autonomy that monetary policy has acquired since then has been reflected in the firmness of the lira's exchange rate and the functional separation between monetary and fiscal policy. The creation of the secondary market in government securities, the organization of the screen-based interbank market, the reform of the clearing system and the abolition of restrictions on Treasury bill yields at auction have enhanced the effectiveness of monetary action. Important institutional changes have come into effect in the last few months. Parliament has given the Bank of Italy full powers to vary the discount rate and all the interest rates on refinancing, and the Government has approved a bill to reform the Treasury's current account with the Bank of Italy. The attribution of full responsibility for setting official rates both confirms the autonomy that has been a traditional hallmark of the Bank's operations and reinforces it on the institutional level.

Since May 1991 the premium applied to the base rate on fixed-term advances has been uniform, instead of being linked to the frequency of recourse by the individual bank, and can be varied by the Bank of Italy in accordance with the needs of liquidity control. Charging more than market rates for advances has helped to limit the demand for refinancing, thereby reducing the need for quantitative limits, and has created more transparent supply conditions. The mobilization of banks' compulsory reserves, the ceiling for which was raised from 3 to 5 per cent of their total reserves in October, has increased the flexibility of the interbank payment system and given depth and stability to the money market. This new facility has taken over a large part of the function previously performed by ordinary advances.

This series of innovations has increased the effectiveness of monetary policy. It has been possible to reduce direct central bank financing of the Treasury to zero; in these conditions banks normally obtain liquidity direct from the central bank.

The bill by which the Government proposes to amend the rules governing the Treasury's current account with the Bank of Italy is designed to preclude any possibility of automatic monetary financing of the state sector borrowing requirement. It provides for the overdraft on the present current account to be converted into government securities and for collections and payments to be made on an interest-bearing account that the Treasury will open at the Bank of Italy with its own resources. The balance on the account will have to be kept sufficiently high to preclude the risk of overdrawing. As in the former system, the ultimate consequence of an unresolved mismatch between expenditure and the resources to finance it would inevitably be that the Bank of Italy suspended payments on behalf of the Treasury. The depth that the market in government securities has attained in recent years means that a suspension of payments is less likely today than it was in 1983, when such action was averted only by a law sanctioning an extraordinary advance to the Treasury. Nonetheless, the bill proposes even stronger safeguards against this possibility; in particular, if the balance on the account falls below a predetermined threshold, the Minister of the Treasury must adopt corrective measures promptly and inform Parliament before the imbalance leads to its ultimate consequence, rather than afterwards.

Enactment of the bill will bring Italian legislation into line with Community requirements. As the commitments undertaken in Maastricht oblige member countries to comply by the start of the second stage of monetary union at the latest, the bill needs to complete its passage through Parliament by the end of this year, given the lengthy timetable for its implementation.

Reform of the Treasury's current account will remove the main obstacle to a comprehensive revision of the regulations on banks' compulsory reserves. The Bank of Italy intends to reduce the implicit cost of compulsory reserves to levels close to those prevailing in the other leading European countries. The first steps in this direction will be taken as soon as economic and financial conditions permit.

Banking and finance

The legal framework

The reforming drive of the last few years has brought three fundamental changes in the legislation on credit and finance that was designed in the thirties: the transition from a system revolving around banks to one based on both banks and markets; the extension of prudential supervision to all forms of financial intermediation; and enhanced protection for savers and the users of financial services. Last year and the early part of this year saw further significant progress in the laws and regulations governing both banks and markets.

There are now two tasks to perform in the banking sector: to incorporate the Second Banking Directive into Italian law and to codify the current banking legislation. The transposition of the Directive will bring our legal framework into line with those of the other Community countries: the distinction between banks and special credit institutions will give way to the single concept of "credit institutions"; regulations will differentiate according to the activities performed; the restrictions on the use and raising of funds will be eased further; banking enterprises will be free to choose their own operational and maturity specialization and to adopt the company and group organization they prefer. The codified banking law will collate the provisions that have been enacted over a period of more than fifty years and establish the limits of secondary legislation.

The legal framework for the capital markets has been largely completed, with the issue of regulations last year by Consob and the Bank of Italy to implement the provisions of the law on securities business and the approval of the laws on insider trading and takeover bids. Significant progress has been made by laying down precise requirements for the disclosure of information to the public, regulating conflicts of interests, making the transfer of the ownership of listed companies transparent, protecting the interests of minority shareholders when control changes hands, and providing for the creation of new markets. Further amendments may be made in the light of experience.

The scope of savings protection was enlarged by the law Parliament approved last year making it obligatory for all forms of financial activity involving the public to be performed by incorporated companies satisfying predetermined capital requirements. Larger companies, those with a higher gearing ratio and those offering payment, collection and funds transfer services will have to satisfy prudential requirements, in accordance with criteria that will be set out in the implementing decree.

The recent legislation to prevent money laundering via the financial system and to allow derogations from banking secrecy vis-à-vis the tax authorities provides new instruments and powers, which are required to combat criminal activities that threaten the country, to protect the public interest in the integrity of the banking system and to strengthen the fight against tax evasion. If the battle against organized crime and illicit behaviour is to be fully effective and competitive disparities are to be avoided, it is essential that similar measures be adopted in other countries, first and foremost the other members of the European Community and the Group of Ten.

The Bank of Italy participates actively in the action of the state against a form of organized crime that corrodes the social fabric, as I have reported at several previous Meetings and on other occasions. I feel it is my duty today to commemorate the five public officials who were the victims a few days ago of a ferocious attack that was an offence to the entire nation. The defence against the ruthless violation of basic human and civil rights lies in the strength of the country's institutions and individuals' sense of being part of a cohesive community.

The markets for government securities, money and stocks

Developments in the last few years testify to the ability of the Italian financial system to create markets that can compete with the most advanced in the world,

Daily turnover on the secondary market for government securities, which was created four years ago, is on the order of 10 trillion lire. The number of dealers has risen to 340. The market guarantees the transparency of transactions, makes it easy to liquidate securities and is deep enough to absorb new issues without undue price fluctuations. Futures trading, which is to commence shortly, will widen the scope of the market and encourage more stable participation by foreign investors.

The market for government securities is flanked by an equally deep and efficient market for interbank deposits. Since it opened in 1990, the daily volume of trading has risen from 4 to 15 trillion lire and spreads have narrowed considerably.

Taken together, these two markets bring direct advantages to bank treasurers and indirect benefits to millions of savers, as well as facilitating the conduct of monetary policy and the management of the public debt.

The next important step is to broaden and deepen the official market for private sector securities. At present it is inadequate for the size and diversity of the Italian economy; the number of companies listed on the stock exchange is tiny, market capitalization low and the volume of trading small, even though, in relation to GDP, the total equity capital of Italian enterprises is comparable with that of firms in other major countries. The shortcomings in the regulatory framework have been rectified. The organization of the stock exchange is being modernized, with the start of continuous screen-based trading as a first step. Once the Clearing and Guarantee House has been setup and settlement has switched to a daily basis, which is planned to take place next year, the organization of the Italian stock market will be on a par with that of leading foreign markets. A revision of dealing taxes would increase turnover; some Community countries recently decided to move in this direction, exempting certain types of transaction completely.

The remaining obstacles mainly concern the participants in the market: enterprises, institutional investors and intermediaries.

Finns must overcome their long-standing mistrust and recognize the advantage of raising funds regularly on the stock exchange by offering securities whose value and characteristics create lasting links with investors. The reluctance to seek listing and to raise funds on the stock exchange often reflects the unwillingness to accept more open management, exposed to scrutiny by all those with an interest in knowing the worth of a company. A. more extensive share list and a larger volume of trading would intensify the stimulus to improve the efficiency of production and make it easier for firms to expand beyond their family origins, enter new markets, possibly by way of mergers, and contribute to the internationalization of the Italian economy. The privatization of publicly-owned enterprises, along the lines followed by many other countries, would help the market to develop and would spread share ownership more widely among savers and institutional investors.

The demand for shares does not yet receive significant support from funded supplementary pension schemes. Pension funds, which are coming to play an increasingly important role in nearly all industrial countries, have stable and predictable resources and can thus make savings available for medium and long-term investments. In Italy the necessary reform of the public pension system is linked to the development and regulation of private supplementary schemes.

In Italy the great majority of financial assets are intermediated directly or indirectly by banks. The contribution the latter should make to strengthening the share market consists in giving greater weight to increased capitalization when assessing loan applications, and in assisting firms, especially small and medium-sized businesses, by providing merchant banking services. When the Second Banking Directive is incorporated into Italian law, it will be possible to increase the scope for banks to provide finance by allowing them to acquire interests in non-financial firms within predetermined quantitative and qualitative limits. The development of Italy's securities firms will depend to a considerable extent on the banks.

The transformation of the credit system

In the course of the eighties the Italian credit system underwent a far-reaching transformation, which was reflected first in the composition of bank balance sheets and then in organizational arrangements, the formation of banking groups and the structure of the entire sector.

Thanks to the prolonged economic expansion and the removal of credit ceilings, intermediaries were well able to meet the demand for credit. Lending increased more rapidly than gross domestic product; in the last five years, the growth differential was nearly seven percentage points for banks and five for special credit institutions. Bank lending in lire rose from the equivalent of 45 per cent of deposits in 1979 to 68 per cent in 1991. Over the same period deposits declined from 66 to 29 per cent of the total financial assets of the non-state sector, net of shares and equity holdings. Including portfolio management services and bank-controlled investment funds, banks still administer some 90 per cent of all financial assets.

Market shares have changed. Between 1986 and 1991, those banks whose positions improved increased their share of the loan market by 11 percentage points. Concentration and selection have intensified; over the past ten years some 180 banks, mostly small ones, have been absorbed by other institutions, often as part of rescue operations.

The relative importance of the various components of banks' profit and loss accounts has also altered. Circumstances that are unlikely to be repeated, such as the shift in asset composition towards lending and the development of securities trading in a period of rising security prices, enabled the banks to improve their net income despite high operating expenses.

The banks have drawn primarily on profits to strengthen their capital bases, which tripled as a ratio to total customer deposits between 1979 and 1991. The capitalization of Italian banks is now high, both in comparison with credit systems in other leading countries and with respect to the internationally agreed solvency ratio. The number of Italian banks not complying with the minimum capital ratios fell from 48 in 1986 to 10 in 1991.

Equally significant changes have taken place in the branch structure and operational organization of banks and banking groups, especially of late. In the last two years 3,100 new branches have been opened, most of them small in size. The creation of banking groups has provided the occasion to rationalize the supply of financial services; special credit institutions are tending to abandon their sectoral specialization and to join banking groups. Banking-related activities are also being streamlined, with companies serving the same type of customer being merged or their business being absorbed by their parent banks.

The response to the law on the corporate reorganization of the public banks has been considerable. Eighty of the 142 banks and special credit institutions to which the law applies have changed their legal status by becoming public limited companies. Twenty four mergers have been approved, several of them between institutions of significant size; the intermediaries involved account for 21 per cent of the lending of the entire credit system. Through the formation of regional holding companies and nationwide groups, large credit institutions have increased their non-controlling interests in smaller institutions; the 65 institutions concerned provide more than one quarter of total lending.

In the years to come the credit institutions will have to find different profit opportunities to those they exploited in the eighties. They will have to cope with intensifying competition in domestic and international markets and tackle the rigidities that still remain in their operational procedures. Balance-sheet strategies and interest-rate policies will have to be adapted and production factors employed more efficiently if they are to be successful in the marketplace.

The Italian credit system has demonstrated its ability to cope with difficult market conditions. It has the capacity for continued, balanced capital growth, but it must also undertake a further restructuring of balance sheets. Partly in order to comply with the constraints on large exposures that will be imposed by Community rules, the banks must themselves promote a controlled disintermediation on the asset side that in some respects promises to resemble the disintermediation they successfully managed on the deposit side.

Now that the banks are less liquid than in the past, it is inconceivable for lending to continue to expand more rapidly than deposits, and monetary policy cannot allow deposit growth to accelerate. In liability management, transaction accounts should be rewarded with efficient payment services, not remunerated with interest rates comparable to those on less liquid instruments. This would permit the development of non-monetary fund-raising without increasing the average cost of funds.

During the past decade of abundant profits, credit institutions saw little need to economize on labour; however, large staffs, high unit labour costs and constraints on the utilization of personnel are now increasingly causes of rigidity. The incidence of staff costs, which is high by international standards, is proving difficult to reduce. In many banks the expansion of the branch network has been accompanied by organizational changes, but central administrations and large branches have still to be streamlined.

Competition and conduct in banking

If the economy as a whole is to benefit fully from the changes now under way, competition must operate and spread throughout the credit sector.

The elimination of administrative and statutory restrictions has attenuated long-standing geographical and sectoral segmentation of the market. The effects of increased competition have been reflected in the conditions for bank credit: average lending rates have fallen more rapidly than money market rates and the dispersion of the cost of credit within uniform categories of borrower has diminished.

On the legislative plane, the antitrust law has added a new dimension to the promotion of competition in banking by establishing controls on the behaviour of banks in the market. The law makes it possible to identify, discourage and, where necessary, prohibit conduct, agreements and concentrations which, even though complying with supervisory rules, create barriers to entry for other firms, retard product innovation and prevent the benefits of efficiency gains from being passed on to customers.

The risks of systemic instability, the fiduciary nature of bank money, the confidentiality and continuity of banks' relationships with their customers, and the forms and problems of competition in the banking field distinguish the credit sector from the rest of the economy. Its special nature, which Parliament has recognized, must be taken into account in assessing individual cases.

As the Italian credit system is one of the least concentrated in the industrial countries, amalgamations at national level are rarely harmful to competition, even when they involve the largest banks. The increase in business concentration inherent in the merger proposals examined to date has generally proved modest at local level as well, since the banks concerned mainly served different markets.

The technical evaluation of banks' merger plans consists of two procedures, one to assess the aspects of stability, efficiency and organizational adequacy from the point of view of banking supervision, the other to verify that they do not restrict competition. These procedures are entrusted to two distinct sections within the Banking Supervision Department.

Despite the sizable investment both by individual banks and in the banking infrastructure and the increase in competition, appreciable improvements have yet to be seen in the quality of banking services supplied to firms and households in areas such as the speed of handling payments, customer information, financial assistance, savings management and business advisory services. It is important that credit institutions make full use of quality of service as a factor of competition and a source of income, and, at the same time, that they work together when the quality of the service that each bank can provide depends on interbank cooperation. Membership of the new payment system procedures must now be extended rapidly to include all the banks. In addition, the general format of banking contracts needs to be revised in order to give the customer the best possible service, not just to protect the provider of banking services.

The law on transparency in banking and financial transactions and services strengthens the protection of customers' interests. The instructions recently issued by the Bank of Italy are designed to ensure maximum disclosure of information on charges and certainty as to contractual conditions, but allow scope for flexibility.

The legislative innovations, structural improvements and new instruments I have described represent far-reaching changes in banking and finance and are shaping a new relationship with the real economy. The work that remains to be done is not inconsiderable; nonetheless, the progress achieved permits us to view the imminent deadline of 1 January 1993, after which it will be possible to provide banking and financial services anywhere in the European Community, as a difficult challenge but one that is not beyond the reach of the Italian banking system.

This transformation is part of the renewal that must be achieved by the Italian economy, which is affected in its entirety by the decisions to adopt the principles of free trade and competition and promote European integration.

Both the content of Economic and Monetary Union and the timetable for its implementation have now been defined; ratification by the Parliaments of member states will make the commitment irrevocable. All twelve signatories to the Maastricht Treaty have a dual obligation to ensure that they meet the agreed institutional and economic conditions for participation in the Union and to act in such a way that the plan is translated into reality. The final edifice will conform to the approved plan, but its details will depend on the influence each country will be able to exert over its construction.

Italy is one of the countries furthest from meeting the conditions for participation in the final phase of EMU. For years we have been unable to eliminate an inflation differential due entirely to domestic factors, or to resolve the imbalance in the public finances. Hence our loss of competitiveness, our current account payments deficit and the growing tendency for production to be transferred abroad, a disturbing symptom of the ills threatening our economy.

Harm can be averted only if fiscal and incomes policy work in conjunction with exchange rate stability towards attaining the common objective, namely the regeneration of the entire economy.

Too often in the past, the reform of major items of public expenditure and of the procedures for preparing and implementing the budget has failed to materialize; it can be postponed no longer. The fight against tax evasion must be made truly effective. The budget deficit must be reduced to a size compatible with the solemn commitments the country has made in international fora; the growth in the public debt, which is stifling the vital forces of the economy, must be curbed.

There is an urgent need for employers and trade unions to conclude the agreement on new procedures and criteria for determining pay and working conditions. The limits and guidelines laid down by Parliament to contain the growth in public sector salaries and improve the efficiency and productivity of public services must be scrupulously observed. Excessive wage and price increases in sectors not exposed to competition lead to unemployment and decline in industry and in the other sectors that do have to compete.

We look to entrepreneurs to provide an innovative thrust that will enable Italian firms to meet the European challenge in terms of product quality and production methods.

The state of the economy and the accumulation of unresolved problems call for action without further delay. Of necessity, remedial measures will entail a cost; those who govern the affairs of the nation have a duty to ensure that it is spread equitably, through their management of fiscal policy.

Appropriate measures will not be slow to produce results, particularly as regards inflation: it can and must be reduced to a level close to the rates prevailing in the most stable European economies. A reduction in inflationary expectations will give the financial markets renewed confidence, revive the propensity to save and to invest and restore social cohesion at home and credibility abroad. If, on the other hand, the measures are only partial and sporadic, the imbalances will worsen, leading to the enfeeblement of the productive sector and the underutilization of labour and capital and relegating our economy to a secondary position. We may then have to bear the grave responsibility for hindering the construction of Europe.

The analysis contained in this Report enables us to reply with conviction and confidence to those who ask whether we can extricate ourselves from this difficult situation; as we said when double-digit inflation appeared to be incurable, the solution lies in our own hands.

It is unacceptable that a society with a clear awareness of the nature of the problems it faces, which has identified the instruments and means of resolving them, defined its objectives, and has the resources to achieve them, is incapable of translating this into action. We cannot, must not, lack the impulse to act not in accordance with narrow, short-term interests but for the common good and in the interests of future generations, an impulse that releases the energy and unity of purpose needed to translate the possible into reality.

The stakes are high. The road will be arduous and will require steps we all know to be inevitable. The sooner and more resolutely we begin, the more certain we shall be of success, and the less pain it will involve.