BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1993

THE GOVERNOR'S CONCLUDING REMARKS

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To Guido Carli, who died in April, the Bank of Italy owes its transformation into a modern central bank. His contribution to the activity of this institution, as Director General from 1959 to 1960 and as Governor from 1960 to 1975, was part of five decades of uninterrupted service to the nation.

From the period of reconstruction onwards, Carli was a committed advocate of Italy being an open country, a full participant on the international stage and a founder member of a united Europe.

During the period of Carli's governorship, Italy completed the transition from an agricultural to an industrial economy.

He actively promoted research, encouraging the Bank's Research Department to introduce modern theories and techniques of economic and monetary analysis, which fitted in well with the tradition established by Paolo Baffi.

In the early sixties the Italian economy was subject to severe internal and external shocks. Monetary stability and industrial relations came under strain simultaneously. From 1964 onwards the trade-off between inflation and employment was a central issue of economic policy. The public sector deficit emerged as another major problem in the early seventies. The international monetary system created at Bretton Woods began to crumble in the early years of that decade.

Carli responded to the challenge of these events by using the classical instruments of monetary policy and introducing new ones. He involved young people in the study and implementation of monetary and economic policy measures.

Those in the Bank who were privileged to work with him benefited from his extraordinary analytical and decision-making ability. From the very beginning of his governorship his openmindedness and modernizing vision led him to initiate a far-reaching programme to renew the Bank's human, material and technological resources. Unforgettably generous with his time, he engaged in a continual dialogue with young members of the staff, who were selected solely on their academic and professional merit. He helped to form a class of future leaders.

Carli fought tirelessly against attitudes and institutions that could hinder the working of a free economy. In the high positions he held after leaving the Bank he remained committed to guiding the Italian economy along the path of modernization.

As Treasury Minister, Carli strove, to ensure that the concept of privatization took root in Italy; he negotiated and signed the Treaty of Maastricht. The restoration of sound public finances was denied even to Carli, who understood better than anyone the urgency of action in this domain. He made a decisive contribution to completing the transformation of the banking and financial system. His last act for the Bank of Italy, which he cherished, and for his country was to ensure that the central bank was granted full powers to set official interest rates.

Carlo Azeglio Ciampi resigned as Governor of the Bank of Italy on 29 April to assume the higher responsibility of leading the Government during one of the most difficult periods in the history of the Italian Republic. To respond to the call for political renewal at a time when the economy is in difficulty requires exceptional personal skills, intelligence, independence and international prestige.

In Dr. Ciampi, the combination of these characteristics is the fruit of deep learning coupled with moral and intellectual discipline.

When Dr. Ciampi entered the Bank of Italy in 1946 he already possessed a wide and varied range of knowledge and experience. His career within the Bank took him from the provincial offices to the Research Department, to the position of Secretary General and to the Directorate. In October 1979 he was appointed Governor in succession to Paolo Baffi, at a difficult time in the history of the Bank and the Italian economy. In his first Report, presented on 31 May 1980, he noted that "the events that preceded Paolo Baffi's resignation as Governor leave us with another, no less demanding responsibility. They have given substance to the twofold misgiving that in Italy the scope for individuals of great competence, moral integrity and respect for the established institutions has become more confined, and that the tradition of central bank efficiency and autonomy may be undermined. We are conscious that it is also one of the Bank's tasks to dispel these misgivings through its own conduct."

Under Dr. Ciampi's guidance, the Bank of Italy dispelled those misgivings.

On the domestic front, the monetary policy of the eighties was developed further along the lines charted and pursued by his two predecessors; on the external front, the path followed was that of joining the European Monetary System, which had already been decided. This decision was interpreted and implemented with great determination. There was a firm conviction that the economy needed not so much a temporary improvement in the balance of payments as the removal of the structural constraints that hampered it.

The Bank's achievements under Dr. Ciampi were substantial in the areas most directly influenced by its policies. Inflation was brought under control in a few years, notwithstanding the strength of the dollar and the persistence of exceptionally high oil prices.

The restructuring of industry, the stabilization of expectations and the reduction of inflation coincided with a long period of expanding production; the benefits accrued to employment, which never fell during the last decade. More recently, as the notion of a united Europe acquired new momentum, Dr. Ciampi promoted it with great personal commitment and idealism. He linked it with the need to overcome once and for all the unsolved problems afflicting Italy, primarily the failure to restore budgetary discipline.

Decisive progress was made in rewriting the monetary constitution, for which Dr. Ciampi called insistently and clearly from the very start of his governorship. The functional separation between monetary policy and budgetary policy was confirmed in practice and sanctioned by law; the money and financial markets were developed; the effectiveness of monetary policy was enhanced; and greater emphasis was placed on market forces rather than administrative measures. A similar approach was followed in transforming the structure of the banking and financial systems, without detriment to their stability, which has its foundations in the efficiency and solidity of intermediaries.

The Bank of Italy will shortly celebrate the hundredth anniversary of its foundation. Through all the events that have shaped Italy's history, one distinctive feature has marked the activity of the Bank, namely its unswerving commitment to the sole aim of serving the nation by performing its assigned tasks and exercising the autonomy laid down in its statutes.

Today's economy is profoundly different from that of one hundred years ago; it is open to Europe and the world and its financial markets are complex and in continual evolution. In this setting the Bank has the resources — first and foremost the moral and professional resources of the persons who work for it — to continue to fulfil its responsibilities in the regulation of credit and money.

To mark the centenary, the Bank has been engaged for some time in a wide-ranging programme of research, not in order to chronicle its own history, but to enable scholars and the general public to gain further insight into its activities in the economic and financial spheres over the last hundred years, both at home and abroad. This initiative will be flanked by others of a broader cultural and social nature. They have the common aim of celebrating the institution's centenary with a call for the Bank to remain firmly committed to pursuing the interests of the nation and the common good.

The world economy

The economies of the industrial countries are passing through a period marked by cyclical uncertainty and rising unemployment, especially in Europe as regards the latter. The growth in output in the OECD countries amounted to 1.5 per cent in 1992 and will remain weak in 1993. Inflation, which averaged just over 3 per cent last year, continues to decline in a number of countries.

Uncorrected financial disequilibria and exchange rate tensions contributed to the difficulties encountered in stimulating a resumption of growth. In Germany the monetary policy stance was kept restrictive for fear of a rise in inflation. By contrast, the authorities in the United States and Japan gradually eased monetary conditions; in North America economic activity revived in the final part of the year.

This combination of circumstances nurtured the factors that led to the laceration of the European Monetary System, which in turn exacerbated the cyclical downturn.

The crisis in the European Monetary System

Following a long period of stability that began in 1987, five realignments were effected within the EMS from last September onwards; the participation of the lira and the pound sterling in the Exchange Rate Mechanism was suspended and the Scandinavian countries severed the link between their currencies and the ecu. Central bank intervention on an unprecedented scale and sharp increases in interest rates were not sufficient to stem speculative capital movements and fluctuations in exchange rates.

The currency crisis confirmed the difficulty of managing a system of fixed but adjustable exchange rates in the presence of high capital mobility whenever there is insufficient convergence between economies and, above all, when the coordination of economic and monetary policies operates badly.

The disparities in the economic policy priorities of the EC countries had been growing more pronounced since the end of 1991. In Germany, the problems associated with unification proved to be greater than expected; the widening of the budget deficit and the acceleration in wage growth induced the Bundesbank to tighten monetary conditions. The exchange rate link with the Deutschemark became increasingly burdensome for the countries suffering from a cumulative loss of competitiveness and disequilibria in their public finances; it was also a constraint on the economies where inflation was lower than in Germany.

Until the middle of 1992 the prospect of European Monetary Union, which had been reinforced by the conclusion of the Maastricht Treaty, had lent stability to exchange rates and led the markets to believe that the countries whose economies had not yet met the convergence criteria would take the necessary corrective measures. The uncertainty that emerged during the summer as to the future of Monetary Union exposed the fragility of the EMS. The market reacted swiftly and forcefully; the direction of the large capital flows that had previously been attracted to countries with high interest rates was reversed. The divergence of monetary conditions between the United States and Germany added to the difficulties, provoking a pronounced depreciation of the dollar, whose value fell to a historical low in September in both nominal and real terms.

The Report on International Capital Movements and Foreign Exchange Markets, which was compiled under Italian chairmanship for the Group of Ten, places the foreign exchange turbulence in the context of the profound changes in the size and structure of international financial markets that have occurred in recent years. The total amount of foreign securities held by residents of the United States, Japan and Europe has reached $2.5 trillion. The volume of foreign exchange transactions has tripled since the mid-eighties and now totals nearly $900 billion per day, and there has been rapid growth in forward markets and in the use of derivative instruments. Institutional investors, such as investment funds and pension funds, are playing an ever more important role in the management of savings and foreign assets; in the United States and the United Kingdom the volume of funds managed by such institutions exceeds the gross national product.

These developments have benefited the international allocation of financial resources; however, the risk of instability associated with variations in exchange rates and interest rates has increased significantly. The solution lies not in the reimposition of restrictions on the movement of capital, but in greater coordination of monetary and fiscal policies among the leading countries. This is an essential condition for maintaining order in the markets, whatever the exchange rate regime. To limit the risk assumed by financial institutions, which could develop into systemic risk, the Report recommends the adoption of prudential measures regarding capital adequacy, the use of derivative instruments and payment and clearing systems.

An integrated European Community with a fully implemented internal market requires stable exchange rates. What is needed is not so much a modification of the rules of the EMS as the full cooperation they envisage and presuppose; this was lacking during the recent crisis. The proper functioning of the system depends on the sense of responsibility of member countries individually and on their common commitment. A country's monetary policy may not be sufficient to defend the exchange rate; it must be supported by sound public finances and a rate of nominal income growth that preserves the competitiveness of the economy. Moreover, some degree of collective management of the system is essential for assessing the suitability of exchange rates, agreeing necessary adjustments and defending the parities considered appropriate.

Ratification of the Treaty on European Union should strengthen the coordination of monetary policies and instruments. The European Monetary Institute will be called upon to perform this important task; its establishment represents the next institutional step towards Economic and Monetary Union.

The economic situation

The recovery in the United States, which began in the second half of last year under the stimulus of a monetary policy that had been expansionary for some time, is still not fully established, and economic activity in Japan and the European Community is weak. In Germany, output in the Western regions is expected to decrease by around 2 per cent in 1993, while the expansion in the Eastern regions is sustained by massive public transfers and is accompanied by strong upward pressure on prices.

The cyclical disparity among the leading industrial countries is reflected in larger current account imbalances. The structural nature of the US deficit has been confirmed; the shortfall is forecast to rise from $60 billion in 1992 to almost $100 billion this year. The trade deficit with Japan increased and the surplus with the European Community narrowed. The Japanese current account surplus rose to $118 billion in 1992.

Inflation declined in the industrial countries as a group, partly as a result of low prices for energy products and other raw materials. The rate of increase in consumer prices in the European Community was 3.4 per cent in April this year.

The economic problems facing the republics that came into being after the dissolution of the Soviet Union remain severe and are associated with the breakdown of civil society and with political instability. The programme of assistance agreed with the Group of Seven countries and the international financial organizations may help sustain the reforms now taking place in Russia.

In the United States, Japan, the United Kingdom and Sweden, the recession has been prolonged by the difficult financial situation of businesses and households, albeit at different times and with differing intensity. The large volume of debt accumulated in the last ten years at interest rates that are still high in real terms has caused a contraction in planned investment and consumption. The deterioration of creditworthiness and the consequent need to restructure balance sheets and limit risk have prompted banks to curb lending, which has slowed down the transmission of the easier monetary conditions to the economy.

Despite the recovery, the growth in employment has been hesitant even in the United States. In many sectors, however, innovation and restructuring are being translated into productivity gains and may sustain a more stable expansion of the economy in the future.

In the European Community, employment in industry is declining and job creation in the services sector appears to be waning. At the end of 1992 the unemployment rate was 2 percentage points higher than in 1990; it is expected to continue rising this year and to reach the highest level since the mid-eighties. The number of unemployed now stands at 17 million. The increase in unemployment in the Community reflects lower competitiveness and slower economic growth compared with Japan and less flexible labour regulations and costs compared with the United States.

After growing more slowly for three years, international trade in manufactures picked up in 1992, expanding by 5 per cent; the impetus came from North America and the developing countries in Asia and Latin America. The Chinese economy, in particular, continued to grow rapidly as output increased by 13 per cent and imports by more than 20 per cent in volume terms.

The future of world trade is clouded by the uncertainty surrounding the outcome of the Uruguay Round negotiations and the recent escalation of trade disputes between the principal economic areas. A decisive injection of further liberalization would contribute to world economic recovery, benefiting above all the developing countries and the industrial countries themselves; it would help the international economy to overcome the present condition of underemployment in which it might otherwise linger.

The return to sustained growth requires the leading industrial countries to honour the commitments that they confirmed at the recent meetings in Washington. In the United States the proposals for structural correction of the budget deficit submitted to Congress by the new Administration are essential in order to consolidate and accelerate the decline in long-term interest rates. In Japan, where there is a surplus of saving over investment and the public debt is small, the expansionary measures announced by the Government must be implemented in full.

Economic policy presents greater complexity in Germany and in Europe in general, where budget deficits and public debt are limiting the scope for fiscal stimulation of demand. Net of cyclical effects, the budgetary position has worsened in the last three years, reversing the previous improvements. The risk of further structural deterioration must be avoided; indeed, resolute action is necessary to restore sound public finances. Such action will benefit the allocation of resources and the availability of savings to finance productive investment. It will lend momentum to the decline in interest rates that has been glimpsed and is now possible, especially in the case of long-term rates.

The Italian economy

The year since the previous Annual General Meeting has been marked by tumultuous events. The country could not avoid the trauma of a sharp devaluation of the currency and came to the brink of financial instability.

In brief, the economic results for 1992 consisted in a deceleration in the growth of output to 0.9 per cent, a reduction in inflation by one percentage point to 5.3 per cent and a widening of the deficit on the current account of the balance of payments to 2.2 per cent of GDP.

These figures fail to convey the prevailing impression of the situation of the Italian economy between last summer and the first few months of this year, namely that it was hanging in the balance between the stagnation of output, with the risk of a resurgence of inflation, and the first stirrings of a recovery. This precarious condition was the product of a loss of confidence among entrepreneurs, consumers and savers caused by social and political events.

The currency crisis

By the time of the parliamentary and presidential elections in the spring of 1992, the Italian economy was in a weakened state owing to delay in implementing economic policy measures. The "management of the economy" had become an urgent issue.

The excessive growth in public expenditure, the wastefulness and poor quality of some services and the inefficiency of the tax system reflect the more general problems in the governance of the country and the operation of the public institutions.

As awareness of these failings spread, the unfavourable assessment by economic agents was reinforced and radicalized to the point where it became a blanket judgment on the country as a whole.

Last May the Bank of Italy chose to make a detailed contribution to the examination of the problems and to the design of an economic strategy. It described and quantified measures of immediate but enduring effect that needed to be taken with regard to the public finances and incomes policy. The suggested action was consistent with Government pronouncements and based on analyses and prescriptions that had been debated at length in political and academic circles.

An econometric exercise showed the way in which the economy could be diverted from a course that risked leading to a major crisis and set on the path of stable growth, albeit after an unavoidable period of adjustment. This integrated set of measures, combined with the economy's capacity for production and saving, would have given the markets sufficient confidence in the Italian economy and its development. If necessary, the lira's central rate in the EMS might have been realigned at a later stage in order to compensate for any loss of competitiveness not offset by productivity gains.

Time was of the essence. The lira came under heavy pressure in early June following the negative outcome of the Danish referendum on the Maastricht Treaty, and strains developed in the financial market. Even before the month had ended, institutional and foreign investors had begun to sell Italian government securities and the net inflow of capital had given way to an outflow. Any failure of the market in government securities, even a limited one, could have had devastating repercussions on the foreign exchange market.

The Bank of Italy used the instruments at its disposal to defend the lira and check the decline in confidence. Interest rates were raised and monetary base creation was restricted; the growth of the money supply was curbed and kept appreciably below the 7 per cent ceiling for 1992 previously indicated to the Interministerial Committee for Economic Planning.

The new Government began to act with full powers on 4 July; in that month it enacted a package of measures to reduce the budget deficit by 30 trillion lire. It confirmed that exchange rate stability was the cornerstone of the policy of economic adjustment, a stance endorsed by the Bank of Italy. It announced its intention to proceed with the privatization of state-owned assets. The guidelines for the reform of major public expenditure programmes were set out and embodied in a draft enabling law.

At the end of July, with the intercession of the Government, an agreement was reached between employers and trade unions. The significance of the agreement was immediately apparent, although its far-reaching importance did not fully emerge until later. By reducing the disparity in wage growth between the public and private sectors and abolishing the *scala mobile,* it offered the prospect of wage moderation, to the advantage of competitiveness.

Delays in the implementation of budgetary measures, the political and institutional complexities of the budgetary process and certain actions that proved inadvisable made it impossible to change market expectations.

The Bank of Italy, which was committed to defending the exchange rate, entered a race against time, on the assumption that the necessary budgetary measures would shortly be enacted. The markets viewed the date of the French referendum as a test of the strength of the European Monetary System. The member states of the Community feared that a realignment of central rates might jeopardize the outcome of the referendum and believed they could defend the EMS simply by means of the public and formal declarations made on 28 August and 5 September reasserting their resolve to keep central rates unchanged.

The task of safeguarding the lira was left to monetary and exchange rate policy. Exchange market intervention intensified from 24 August onwards. On 4 September the official discount rate was raised to 15 per cent and the rate on fixed-term advances to 16.5 per cent; monetary base was rationed. The overnight rate rose to more than 30 per cent, but even at these rates the demand for liquidity in the market was not fully satisfied.

Restrictions on capital movements were ruled out, as they would have violated the established policy of relying on market instruments to control the foreign exchange situation. Such measures would have been ineffectual in any case, given the changed economic and institutional context and the existence of very large markets and innovative financial instruments.

On 12 September, recognizing the gravity of the crisis, the Italian and German authorities decided to request an adjustment of the central rate between their currencies and to propose that the other members undertake a broader realignment, which would have been accompanied by a significant reduction in German interest rates. The failure of some governments to acknowledge that the crisis threatened the system as a whole prevented this opportunity from being seized. In the event, the realignment decided on 13 September affected only the central rate of the lira, and German interest rates were reduced by no more than half a point.

When the markets reopened, funds totaling more than $3.5 billion flowed back to Italy, while pressure on sterling intensified. On 16 September, despite repeated increases in interest rates, outflows from the British market amounted to tens of billions of dollars. In the wake of the difficulties affecting sterling, market turbulence spread to the lira and the peseta. The pound was withdrawn from the Exchange Rate Mechanism; a similar decision was taken with regard to the lira, and the peseta was devalued. Sterling declined rapidly against the Deutschemark, depreciating by 14 per cent between 16 September and the beginning of October.

Intervention in support of the lira between the beginning of June and mid-September totaled $48 billion. Even after the Maastricht Treaty had been approved in the French referendum, albeit by a slender margin, the EMS continued to be subject to severe strains. Speculation focused on the French franc, forcing repeated intervention on a massive scale. The systemic nature of the crisis was confirmed.

Treasury bills worth 3.3 trillion lire had remained unsold at the auction at the end of August. In September, while the Government was finalizing its budgetary proposals, fears of extraordinary financial measures began to spread. The stock of government securities held by non-bank investors declined by more than 11 trillion lire owing to the non-renewal of maturing paper and sales on the secondary market. At the end of the month unsubstantiated rumours of extraordinary measures affected bank deposits as well, and there was a wave of cash withdrawals. The Bank of Italy called on the banks to reassure their customers and supported their actions to that end.

The sequence of events threatened to trigger a financial crisis. The uncertainty did not relate to the soundness of the banking system, but if the fears had taken root, especially those relating to public debt instruments, confidence in bank money would also have been undermined, with further repercussions on the exchange rate and on prices.

Between mid-September and mid-October the progress of the public finance measures announced on 17 September, the soundness of the banking system, the professionalism of dealers and the revival of investor confidence countered the impending crisis. Within the space of a few weeks market conditions favourable to investment in government securities had been restored.

Thanks to its depth and efficiency, the secondary market in government securities withstood the shock, albeit at the cost of exceptionally wide and rapid price fluctuations. Until May 1992 the prices of ten-year Treasury bonds had been relatively steady at between 98 and 99; in early October they plunged to 87 before recovering to 95 in November. Last week the bonds were again trading at around 99. Nominal after-tax yields on Treasury bills rose from 11 per cent in the spring of 1992 to 15.6 per cent in September and then eased to 12.1 per cent in December. At the latest auction they fell to below 10 per cent, the lowest level in four years.

The Italian futures market in government securities came into operation on 11 September, in accordance with long-standing plans. Far from being impeded or overwhelmed by the incipient crisis, the fledgling market developed rapidly and helped stabilize expectations.

The liquidity of the government securities market remained satisfactory at all times. The interventions by the Bank of Italy at critical moments were limited in amount. The market ensured continuity of trading for both Italian and foreign intermediaries and, indirectly, for the millions of savers who had placed their trust in Italian government securities.

Immediately after its withdrawal from the fluctuation band of the EMS, the lira depreciated rapidly in a foreign exchange market that had become thinner and less liquid owing to the heightened perception of exchange risk. In the first week of October the lira traded at 927 to the Deutschemark, compared with 750 in May. In October and again in November there were renewed inflows of non-bank capital, which more than offset the reduction in the banking system's external liabilities. As tensions within the EMS eased, the lira/DM exchange rate improved to about 850.

The lira again came under pressure from mid-November onwards in connection with renewed turbulence on the European scene. As the political climate in Italy deteriorated, the lira depreciated steadily against the Deutschemark to reach nearly 1,000 at the beginning of April. It subsequently regained some of the lost ground, so that last Friday it stood at 922 to the mark. The foreign exchange reserves have been replenished by more than $22 billion since mid-September, largely as a result of foreign currency swaps.

Households' consumption has declined since the foreign exchange tensions of last summer; on an annual average basis, it is very unlikely to show any increase this year compared with 1992. Among durable consumer goods, the fall in car purchases has been particularly pronounced, and comparable to the one that followed the first oil crisis; a similar tendency can be observed in the other main European markets.

The fall in investment will be larger this year than last. The level of economic activity is being sustained by the boost that the depreciation of the lira has given to exports, which will grow far more rapidly than world demand.

Industrial output declined by an annual average of half a percentage point in 1992; during the first five months of 1993 it stagnated at the depressed level recorded at the end of last year.

The continuing fall in investment, the rise in labour costs in the three years between 1989 and 1991 and the uncertain prospects for growth in Italy and abroad have affected the demand for labour. For the first time in many years there has been a sharp contraction in employment: in the twelve months to January 1993 total employment fell by no less than 380,000, or nearly 2 percentage points. The contraction was very rapid during the second half of 1992 but now seems to be slowing down, although no sign of a reversal of the trend is yet evident.

As I have already mentioned, the indications from the export front augur well for economic activity. The available data show that the value of Italian exports to countries outside the Community was almost 30 per cent higher in the first four months of this year than in the same period of 1992. Italian products have also strengthened their position in the domestic market. The improvement in the trade balance and the recovery in Italian exports' share of the world market reflect the fall in domestic demand and the gain in competitiveness.

For the first time since the decline in the price of oil in 1986, the current account of the balance of payments should show a marked improvement in 1993 and could be in balance in 1994. The lower exchange rate of the lira offers an opportunity that the economy and economic policymakers must grasp. It can be the springboard for restoring the growth in output. The gain in competitiveness will produce lasting benefits if it is not canceled out by higher inflation; it must not lessen the commitment to improve Italian manufacturing industry's specialization in international trade. In goods with a high research and development content, Italy has by far the largest trade deficit among the leading industrial countries.

Reassuring signs are discernible in the performance of consumer prices. Their twelve-month rate of increase slowed down from 5.3 per cent in August to 4 per cent in May, notwithstanding the depreciation of the lira. The containment of inflation is attributable not only to the monetary policy stance, but also to the weakness of domestic demand, the decline in the foreign currency prices of imported goods and wage moderation.

The determining factor has been the decision of the two sides of industry not to entrust the protection of wages and salaries to the workings of the wage-price spiral.

Following the withdrawal of the lira from the Exchange Rate Mechanism, interest rates were reduced in conjunction with the implementation of the budget measures, the revival of confidence in the government securities market and the verification that the growth in credit and money was not forming a vicious circle with currency depreciation and price inflation.

The official discount rate was progressively reduced in six stages to 10.5 per cent. An important factor in the transition from the situation of greatest tension to the more relaxed market conditions that now prevail was the informal monitoring of lending, which was carried out until the end of March with the collaboration of the banking system.

At the beginning of February the Minister of the Treasury issued a decree to reduce compulsory reserves in respect of bank deposits by around 35 trillion lire, with the result that the effective average reserve ratio declined from 18 to 13 per cent. The rate of interest on reserve deposits averages around 6 per cent.

Initially, the cost of bank credit was slow to respond to the easing of money market conditions. Lending rates have adjusted more rapidly since the turn of the year, with minimum rates coming down to levels that are among the lowest for a decade. A more general reduction in firms' interest expenses is impeded by the deterioration in loan quality and the downward rigidity of deposit rates, which needs to be eliminated.

In the first half of the eighties real interest rates on medium and long-term securities in Italy were well below the average for the other six leading industrial countries. From the second half of the decade until the height of the crisis last summer, real rates in Italy were broadly in line with those in the other leading countries, or a little higher.

The real cost of money is currently higher in Italy, owing partly to the increased risk premiums that are a legacy of the crisis. In a situation of international integration, which enhances efficiency and opens up new possibilities for corporate financing, the scope for the further reduction in interest rates that the state of the economy requires is limited by the level of rates in the other industrial countries.

Action to regulate the nominal volume of credit and money, contain the budget deficit and limit the aggregate amount of debt and financial assets remains decisive for the purposes of continuing the process of disinflation and stabilizing the foreign exchange market.

The withdrawal of the lira from the ERM cannot be allowed to lead to wide and protracted exchange rate fluctuations. In a fully open economy such as ours, they raise the cost of foreign transactions, transmit instability to the financial market and increase the risks inherent in investment decisions. Full confidence must be restored in the markets in order that the lira may re-enter the ERM. The programmes for adjusting the public finances and reducing the public debt in relation to GDP, which are also conditions for the loan agreed with the European Community in January, must be implemented to ensure the credibility of economic policy action and avert the risk of financial instability.

With the aim of keeping this year's budget outturn in line with the objectives stated in the Report on the Borrowing Requirement in March, the Government has adopted corrective measures amounting to 12.4 trillion lire, half of which is to come from additional tax revenue and the remainder from spending cuts and funds deposited on the centralized Treasury account. Net of interest payments, the state sector should therefore achieve a budget surplus of at least 37 trillion lire, compared with 8 trillion in 1992; the overall deficit should be limited to 155 trillion lire, compared with 163 trillion last year.

The presentation of the Finance Bill for 1994 will be brought forward to July. It is essential that measures be taken to reduce the borrowing requirement in absolute terms in 1994 and subsequent years, with the objective of reversing the growth of the public debt in relation to GDP within a period of three years. Increasing surpluses net of interest payments will have to continue to be achieved until the deficit on current account has been eliminated.

It is necessary to press ahead with the policy of containing wages and salaries and the other main components of public expenditure. There is an urgent need to restore the efficiency of spending on public works and on the procurement of goods and services and to relieve it of improper charges. The incidence of taxation will have to be consolidated for taxpayers; it may increase at the macroeconomic level, partly as a result of necessary measures to eliminate tax evasion and avoidance. By reducing government borrowing in the market, the decline in the deficit will be reflected in lower interest payments as a result of the smaller risk premium and the lower cost of the debt.

The containment of wage growth in the private sector must be confirmed: this will first halt and subsequently reverse the decline in employment.

Principles and rules need to be defined that will avoid excessive industrial disputes and ensure flexibility in the use and cost of labour, taking account of the general condition of the economy, the state of firms and regional differences. A diversification of labour costs does not necessarily imply that real income in the less advantaged areas, where the cost of living is lower, will be less than in the rest of the country.

Over the medium term, regional policy must seek not to provide financial compensation for the productivity gap arising from environmental problems but to eliminate its causes by means that include investment in infrastructure. In the less developed regions the high rate of unemployment among young people interacts with the deterioration in the social environment, Throughout the country the Bank of Italy, in conjunction with the state authorities and the banking system, is engaged in combating money laundering and preventing the exploitation of the financial sector by organized crime.

The ultimate measure of economic and social development will be the growth of employment. The resumption of lasting economic growth in Italy cannot be achieved unless a similar recovery takes place in the rest of Europe and in the other industrial countries.

The downward rigidity of long-term interest rates, which remain at high levels net of expected inflation, cannot but be a cause for concern in the Community during a phase of economic stagnation or actual recession. Italy can contribute to a reduction in interest rates first and foremost by redressing its public finances and halting the growth of the public debt.

A financial system at the service of enterprises

The distinguishing features of Italy's financial system are a large public debt, of which half is held by households, a low level of household debt and a lower ratio of total financial assets to GDP than in the other advanced economies. Italy has the highest level of public debt among the seven most industrialized countries and the lowest level of household debt, equal to 22 per cent of GDP. In all the other countries except Germany, household debt is equal to or larger than the public debt.

The revision of the methodology for compiling the financial accounts of the economy recently carried out by the Research Department does not show the corporate sector to be undercapitalized. On the other hand, capital does not circulate in the market and thus escapes the appraisal and selection performed by financial operators.

There is a striking contrast between the financial and economic aspects of the public and private sectors. In order to meet its funding requirements, the state can count on a market in public debt securities that is one of the most efficient in the world, whereas enterprises do not have a market to which they can turn to finance their strategies.

The high saving rate in Italy and the volume and composition of real and financial wealth suggest that there is ample scope for the development of finance oriented towards enterprises and private investment.

The international openness of Italy's financial system has increased considerably. Nonetheless, at the end of 1991 residents' holdings of foreign assets amounted to 8.5 per cent of their total financial assets, compared with values of between 12 and 23 per cent for France, Germany and the United Kingdom.

International financial integration can be expected to continue. In the first two decades following the Second World War agriculture and manufacturing industry were opened to trade and their productive structures were transformed accordingly. In the last five years the process of integration has involved the financial sector; it has become a permanent feature of our economy and law.

The management of the public debt

The objective of reducing the state sector borrowing requirement cannot be achieved by applying simple formulae. The surplus net of interest payments will have to rise to the level needed to halt the growth in the ratio of the public debt to GDP.

Only the part of interest payments that relates to an increase in the public debt in real terms constitutes a charge on the resources of the public sector, but this does not mean that the nominal component is unimportant; high nominal interest rates inflate the borrowing requirement, hamper the management of the debt and, in conjunction with the inflation from which they stem, damage Italy's standing in financial markets.

We have never ceased to look for ways in which efficient debt management can contribute to the adjustment of the public finances. In this respect the last twenty years can be divided into three periods. The creation of a primary market for short-term government paper in the second half of the seventies in response to the inflation induced by the first oil crisis was followed by a period of heavy recourse to floating rate paper, which made it possible to lengthen the average maturity of the debt and reduce the risk of instability associated with its frequent renewal. In recent years the issue of fixed rate bonds has diversified the market and increased the manoeuvrability of monetary policy by insulating the cost of the debt from fluctuations in short-term interest rates. Other types of security have been tried, but they have not been a lasting success with investors. The outstanding debt is divided almost equally between the three main categories of security.

The prospect of budgetary adjustment, the possibility of a decline in European interest rates and the lira's lower exchange rates have led to consideration being given to increased borrowing in the international market and the indexation of government securities to foreign currencies. The success of a debt management policy along these lines depends to an even greater extent on the outcome of the measures to redress the economy.

The planned further rise in the budget surplus net of interest payments over the next few years would create a virtuous circle by fostering a decline in nominal interest rates to the levels prevailing abroad. The ensuing reduction in interest payments in the second half of the nineties would restore the flexibility of the budget. Simulations indicate that a fall in inflation and interest rates would help produce a rapid decline in the ratio of the borrowing requirement to GDP and that the ratio would reach a very low level by the end of the decade. There would be some advantage in issuing a larger volume of securities indexed to foreign currencies, but this would not have a decisive influence on the trend in the public finances.

Any form of coercive action with respect to the public debt would be iniquitous and fraught with danger; in practice, any such action would be impracticable, given the widespread possession of government securities and the growth and integration of the financial markets. Only an increase in the primary surplus combined with careful management, in a context of falling inflation, can reduce the burden of the public debt and fully restore the confidence of market participants and, above all, of savers.

A source of monetary base creation that is at present beyond the control of the central bank will be eliminated by the reform of the Treasury's current account with the Bank of Italy. The reform bill, which was recently reintroduced in Parliament, also provides for compulsory bank reserves to move more strictly into the ambit of monetary policy instruments.

The stock exchange and the banking system

The growth of an economy and the full employment of its human and material resources are underpinned by the working of efficient capital markets at the service of corporate finance.

The markets in goods and services provide indications about the validity of the choices firms made in the past and their ability to produce at competitive prices, but well organized capital markets are indispensable in order to screen today's choices, which are directed to the more or less distant future. Such markets make it possible to foster new opportunities for growth and, when necessary, to modify the ownership or simply the control of firms.

Those who control and manage firms and those who finance them share a common interest, but they are also dialectically counterposed: the former seek to exercise their command function to the full, while the latter seek to obtain the highest possible return on their investment.

In Italy the control of a large part of the productive system in public ownership is not subject to screening by the market. In the private sector, and not only among small and medium-sized firms, the prevalence of forms of ownership based on securities that are not traded has ensured stability of control but has often hindered the raising of equity capital to finance expansion. Only 5 per cent of Italian businesses are organized as companies, compared with 13 per cent in Germany and 15 per cent in France; in turn, about 6 per cent of Italian households own shares, compared with 12 per cent in Germany, 14 per cent in France and much higher percentages in the Anglo-Saxon countries. The inadequacy of the market becomes evident at critical moments in a firm's life, when its management, production decisions and strategies have to be scrutinized.

Over the years Italian industry has had considerable recourse to public sector support, especially in times of difficulty, benefiting from the transfer of unprofitable companies to the public sector, state aid and special incentives for debt consolidation arrangements. These forms of subrogation have protected output and employment, but they have also imposed a burden on the public finances and diminished the role of financial institutions. Entrepreneurs and the financial community will now have to find ways to overcome difficulties by themselves.

Within the financial system there is a need for greater complementarity between credit intermediaries and the share market. It is in the nature of banking that credit institutions should play an active role in all of the three interconnected aspects of corporate finance: credit, consultancy and equity capital. Even when banks do not acquire direct interests, their assessment of firms' creditworthiness involves the appraisal of entrepreneurial ability and can help to determine corporate control; banks can use the knowledge acquired in their day-to-day relations with firms to advise them on the restructuring of their liabilities, the raising of debt and equity capital, and the search for investors in connection with the reorganization of ownership.

The task of strengthening firms' capital structures, achieving more widely spread ownership and ensuring its renewal falls primarily to the stock exchange. Banks can play a supporting role with their corporate advisory services and the underwriting and marketing of share issues. They will have to assist smaller firms on a broader front, helping them with financial management, fostering their growth and, where appropriate, preparing them for market flotation.

The emergence of institutional investors able to play an active role in the companies in which they have interests, coupled with the effects of the legislation on the disclosure of information, is likely to increase the demand for shares, including that of households, whose willingness to invest in the stock market is influenced by their confidence in its proper working and in the effectiveness of the protection afforded to small shareholders. The Bank of Italy is collaborating with the Consob on these matters.

The Bank will recommend that the Interministerial Committee for Credit and Savings adopt provisions allowing banks to acquire interests in non-financial companies, thereby completing the range of operations they can undertake in the field of corporate finance. The size of the shareholding a bank can acquire in a company will be determined by reference to the bank's capital, organizational structure, profitability and the quality of its operations. A similar procedure will be followed to broaden the scope for listed firms to issue debt instruments in the market. Unlisted companies will be required to employ the services of supervised intermediaries to place their securities.

Together with the other competent authorities and with the cooperation of securities firms, the Bank of Italy will promote a study of the feasibility of creating an efficient secondary market in corporate bonds, based on the experience gained with the market in government securities.

The implementation of the privatization programme laid down in Law 359 of 1992 will provide important impetus for the transformation of private sector financing and will put it to the test for the first time. If this programme is really to contribute to improving the decision-making and efficiency of both private and public industry, as it is expected to do, ownership structures will have to be created that are both stable and open to renewal, and exposed to scrutiny by investors who have the instruments and expertise required to perform this role.

Banks must not serve as shareholders of last resort nor convert the debts of lame-duck firms into shares. Companies that offer the prospect of a return to profitability should be assisted by introducing differential tax treatment aimed at fostering recovery, rather than reviving the temporary subsidies paid in the past.

Permanent arrangements could be introduced for the deferment of tax liabilities in connection with debt restructuring linked to the reorganization of production, almost as though the tax authorities were making an investment. The reorganization plans would have to be agreed between firms and their creditors within the framework of a clearly defined procedure for corporate rehabilitation. Similarly, it may prove necessary to review the existing bankruptcy procedures in order to overcome the limitations that have emerged as regards the possibility of salvaging corporate activities that are still viable.

Risk and profitability in the banking system

Greater attention is being paid at the international level to the problem of financial fragility, following the serious episodes of instability that have occurred in several countries in recent years. Caught by the cyclical slowdown at a time of high interest rates, sizable parts of the banking systems in the United States, Japan and Scandinavia have run into difficulties that have sometimes entailed heavy costs for the public finances.

Studies of the experience of the countries belonging to the European Community confirm that the insolvency of borrowers is still the main cause of banks' difficulties. Market risks have nonetheless triggered crisis situations, especially among smaller intermediaries lacking adequate organizational arrangements.

Taken as a whole, the Italian financial system has remained unscathed by the instability that has affected other countries. The cases of insolvency among securities firms have been on a minor scale. New markets have been created that have contributed to the stability of the financial system; mechanisms have also been established to guarantee the execution of contracts and thus ensure smooth trading.

Despite the large increase in lending, banks have achieved capital ratios that are above the international average; their off-balance-sheet business is mostly in connection with their traditional lending activity and the breakdown of their assets and liabilities by maturity and type of instrument shows that they are relatively sheltered from fluctuations in interest rates and exchange rates.

New challenges await the Italian banking system. The reorganization of public enterprises will affect their position as borrowers. The Community legislation on large credit exposures will oblige banks to reconsider their lending to major public and private sector customers. In accordance with the procedures developed in international fora and on the basis of several years of experience with solvency ratios, prudential controls will be extended to other aspects of risk. The growing complexity of banking, which is a consequence of despecialization, requires credit institutions to make more effective use of the instruments and information that are available for assessing market risk and borrowers' solvency and for treasury management.

Since the law on the reorganization of public sector banks came into effect, 67 mergers have taken place, reducing the number of banks in operation by 75. Competition is spurring the weaker members of the system, which are unable to cope with the forces at work in the market, to look for new solutions by linking up with their stronger brethren.

Such selection is likely to make the system more robust. The expansion of the most efficient banks should be achieved primarily through amalgamation. A similar trend towards greater rationalization can also be discerned among securities firms, where the level of operating costs will make it difficult for all of today's 200 or so firms to stay in business, notwithstanding the prospect of an increase in turnover.

The monitoring of developments in these fields by the Bank of Italy is conducted partly in connection with the performance of the tasks it has been assigned by the Anti-trust Law. The action it has taken, which is described in the body of the Report, benefited from cooperation with the Anti-trust Authority and the competent bodies of the European Community.

There is scope for reducing the cost of banks' fund-raising by accentuating interest rate differentiation according to whether deposits are held for transaction purposes or as a store of value. Compared with other countries, Italy is conspicuous for the high average balance on current accounts and their very large total value. An efficient secondary market in certificates of deposit would probably make fund-raising costs more flexible. As regards banking services, apart from the need for correct pricing, it will be necessary to improve their quality, hold down the cost of provision and develop appropriate marketing policies. The success of the current expansion of branch networks also depends on banks' ability to broaden the range of services they supply to customers. Direct and indirect staff costs consume a larger proportion of banks' gross income than in other leading countries. Some aspects of the sector's wage agreements, including the very fact that there are several, encourage leapfrogging, limit the effectiveness of incentives and hinder mobility.

The transformation of the banking system stands to gain from a better balance between competition and cooperation. Closer cooperation in fields such as training, wage bargaining and the standardization of procedures and products would not limit the scope for competition; on the contrary, action to promote the definition of the rules of the market and the spread of information leads to a more rapid improvement in the efficiency of the system. A shift in the composition of balance sheets, new patterns of costs and prices, and effective competition will improve the quality of customer service and reduce the cost of corporate credit.

The economies of the industrial countries are not fully exploiting the resources at their disposal; employment and growth are suffering as a consequence. A wide-ranging reorganization of economic activity is taking place, prompted partly by the cyclical slowdown, and at the same time the worldwide distribution of production is changing, albeit slowly and gradually. It is becoming increasingly obvious that goods embodying even intermediate technology can be produced in countries and areas where the cost of labour is a fraction of that in the developed countries.

In the late eighties the shortcomings of budgetary and incomes policies placed difficult and sometimes contradictory demands on monetary management in many countries. This had an adverse effect on economic activity, generated balance-of-payments disequilibria, speculative capital movements and exchange rate strains, and has left a legacy of high real long-term interest rates that are above current and projected rates of economic growth.

The Italian economy, which is highly integrated into the European and world economies, is being affected by the weakness of the international economic cycle, the fall in investment and the crisis of the European Monetary System. It continues to be afflicted by problems of its own caused by the size of the budget deficit and the public debt, the unsatisfactory quality and efficiency of public expenditure and the deficiencies in public services.

This year growth in Italy will be no faster than the modest rate recorded in 1992; the country's good export performance may revive economic activity in the latter part of the year and improve the prospects for 1994.

It is essential that the competitive gains deriving from the depreciation of the lira should not be canceled out by inflation.The annual rate of increase in consumer prices has fallen to 4 per cent, the lowest level for a quarter of a century, aided by the weakness of domestic and foreign demand, the non-accommodating monetary stance and, most important of all, the slowdown in labour costs.

The prevention of a resurgence of inflation is the primary objective of the central bank, pursued in parallel with fiscal and incomes policies, which are the responsibility of the Government and the two sides of industry.

A fundamental reform of the public finances in the fields of social security, health, local finances and public employment was set in train in the budget for 1993. The quantitative objectives it lays down must be achieved.

The efforts to restore sound public finances must be continued in 1994 and subsequent years. Some of the measures the Government is preparing to take are designed to offset the expenditure and revenue trends deriving from current legislation that lead to a growth in the borrowing requirement. The package of measures as a whole must reduce the deficits in absolute terms in order to reverse the rising trend in the ratio of the public debt to national income over a three-year period.

If such a reversal is no longer a prospect, interest rates, which we have reduced with difficulty to less abnormal levels, will tend to rise and the virtuous sequence of stable prices, export growth, investment growth and rising employment will be jeopardized.

Widespread corruption in dealings between the corporate and public sectors have inflated public expenditure, hindered the proper functioning of the market and obstructed the selection of the best suppliers and products. The scale of this improper impost, which ultimately falls on the public, and the consequent distortion of the allocation of resources are proving to be of appalling dimensions.

The eradication of these practices may have the temporary effect of depressing economic activity, but it will rapidly produce benefits in terms of the working of market mechanisms, more profitable use of the resources our economy possesses and faster growth.

Decision-making processes made more efficient by the new political and institutional arrangements that society has requested and new forms of popular representation in Parliament and in local authorities will make a crucial contribution to monitoring the volume and transparency of public expenditure, improving its quality and rationalizing the tax system.

The control of labour costs, flexible employment practices, an adequate supply of labour with appropriate skills, improved labour productivity and stronger employee identification with the objective of development, not only in macroeconomic terms but also at the level of the sector and the firm, must be combined with a revival of business confidence and entrepreneurial drive. The growth in output and employment is based on investment, primarily by business. It is for the state and the public authorities to provide efficient services and to promote cost-effective investment in infrastructure and other public projects, which do not necessarily have to be publicly owned or financed.

All of these steps are essential to bring our economy out of the downward spiral of low output, declining investment, stagnating consumption and consequent unemployment; they will enable it to participate fully in the international recovery. The restructuring that is now taking place in all the major economies is increasing productivity and laying the foundations for stable growth.

International capital movements on a scale that was not seen until a few years ago are raising new problems for the monetary system, which can be tackled only through international cooperation.

In Europe, the single market came into effect this year; it provides the basis for pursuing more stable exchange rate relationships within the European Monetary System. Initiatives aimed at fostering the recovery in economic activity and employment in the Community are to be considered at the forthcoming Council of Heads of State and Government in Copenhagen in June. The development and prosperity of the nations that make up the Community is the ultimate objective, the *raison d'être,* of cooperation and integration in accordance with the original spirit of the Treaty of Rome.

Both the non-inflationary reduction of real interest rates and economic development call for effective economic policy coordination, not just at Community level but among all the leading industrial countries, and further trade liberalization.

Conscious of the scope of its actions but also of the limitations to which it is subject and of the national and international context in which it operates, the Bank of Italy will continue to perform its tasks of regulating credit, money and interest rates. It will promote the efficiency and diversification of financial markets, to the benefit of enterprises. It will continue to foster the modernization of the banking system and its international openness, in accordance with the policy initiated and pursued with great determination by Governor Ciampi.

I would like to adopt an expression that is dear to him: "it is up to us". Businessmen, bankers and organized labour are all called upon to contribute to the economic and social advance of the country, each acting in their own sphere and in complete autonomy.

Fully aware of the scale and seriousness of the problems facing us, but also of the underlying strength of the economy, the efficiency of the institution I have the honour to lead and the civil motivation and professionalism of those who work for it, the Bank will continue in a spirit of public service to perform the tasks with which it is entrusted.