BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1995

THE GOVERNOR'S CONCLUDING REMARKS

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Ladies and Gentlemen,

As in the past, last year the Bank was involved in the statutory tasks of regulating monetary flows and supervising the banking system, both of which are described at length in the body of the Report, as well as performing internai managerial functions.

The staff of the Bank, both at Head Office and in the branches, played a generous, intelligent and active part in all of these activities. Close attention is paid to professional training for all members of the personnel.

The Bank's participation in the work of international organizations is increasingly important, and our activities under the auspices of the Group of Seven and Group of Ten leading industrialized countries intensified last year. The deliberations of the Basle Committee on Banking Supervision, which is under Italian chairmanship, acquired particular significane in the light of the new problems developing in the international financial markets.

The Bank widened and consolidated its involvement in the activities of the European Monetary Institute.

In its support for the state's efforts to counter organized crime, to which both the economy and the banking and financial system are exposed, the Bank is actively involved in the prevention of illicit activities, particularly money laundering and usury.

The eight new provinces that were created recently are now fully operational. In view of the functions the Bank performs, we believe it is essential to maintain a presence throughout the country to guarantee the provision of adeguate services at local level. At the same time we are examining ways of ensuring that operations meet sound economic criteria.

The construction of the Bank's new administrative centre to the South-East of Rome is the first step in the reorganization of our offices in the capitai.

The layout of the balance sheet has been revised in order to bring it into line with Community rules. The level of information and the modified accounting policies and valuation criteria, which were adopted some time ago, reflect the importance that the Bank attaches to the correctness and transparency of its operations.

Increasing emphasis is being placed on budgeting to ensure that expenditure is consistent with our strategies and the resources available. More cogent methods of cost analysis and control have been introduced.

The professionalism and motivation of the Bank's staff are essential elements in its autonomy and in its ability to satisfy the expectations of the country's institutions and of society. We are confident that ali members of the staff will continue to perform their tasks with the same dedication as in the past and in accordane with the interests of the country.

On 18 October 1994 the Board of Directors held an extraordinary meeting to appoint Vincenzo Desario, Deputy Director General, to the post of Director General.

The vacancy in the Directorate was filled on 23 February 1995 by the appointment of Pierluigi Ciocca, Central Manager for Economic Research, as Deputy Director General.

The world economy

The global market and exchange rates

The pronounced weakness of the lira, especially between February and Aprii of this year, reflected pessimism among Italian and foreign investors about the current and future state of the Italian economy and, more specifically, that of the public finances. The fluctuations of the lira occurred against the background of exchange rate turbulence among the leading currencies of a magnitude and intensity rarely observed in recent decades.

In the early months of this year the effective exchange rate of the yen was, at its peak, 19 per cent higher than in December 1994; the Deutsche Mark showed an appreciation of 7 per cent, while the depreciation of the dollar touched 10 per cent. The variations for the other leading currencies ranged between those for the yen and the donar; in mid-March the exchange rate of the lira was 15 per cent lower than in December 1994.

The turmoil in the foreign exchange markets was accompanied by large fluctuations in the prices of securities.

A world-wide market in securities and foreign exchange has taken shape in the recent past, particularly in the last few years. Within this global market, information circulates swiftly, is often interpreted in an unsophisticated manner and gives rise to massive spot and forward transactions in securities and foreign exchange. Financial techniques that require only modest amounts of liquid funds may accentuate the variability of the results of such operations.

A market of this kind gives economies and states much greater scope for raising finance than was available in the past. At the same time, market participants have become more aware of the risks involved. Rapid price variations reflect assessments of the consistency and adequacy of economic policies.

The wide fluctuations in exchange rates and interest rates are not without negative repercussions on the development of the world economy.

The market brings together economic agents with different time horizons, operational constraints and institutional aims. In a situation of highly volatile exchange rates, their buying and selling pattems may converge in the quest for short-term profits. They lose interest in more modest but enduring gains generated by the growth in real income, by the availability of productive capitai and by the employment of labour, the variables on which the prosperity of nations is founded. Market assessments therefore become highly uniform. Some currencies are seen as safe havens, while others depreciate to an extent that may bear no relation to economic fundamentals; the countries that suffer most are those such as Italy, where some sectors display serious disequilibria.

Operators react to stimuli that are often transitory and to information that is sometimes incomplete. If expectations are slow to adapt to changes in important variables, they may cause wide fluctuations, which may influence and alter the long-term trends on which they are superimposed.

Markets can be self-correcting, however. Over the longer term the underlying factors that govern exchange rates, such as the formation and investment of savings, the growth prospects of the economy and the economic policy stance, will tend to predominate. I dwelt at length on these factors in my remarks on this occasion last year.

Since the mid-seventies the Japanese yen has tripled in value in effective terms in response to a savings propensity that has exceeded even the very high rate of investment and which has resulted in persistent current account surpluses. At the end of last year Japan's net creditor position amounted to $690 billion, equivalent to 15 per cent of GNP. There appears to be no prospect of an imminent reversal of this trend.

The dollar continues to be the predominant settlement currency for world trade. More than half of the reserves of central banks are held in dollars, while the Deutsche Mark and the yen account for 16 and 9 per cent respectively. The value of the dollar has fluctuated considerably: if the average effective exchange rate for 1987 is set at 100, the dollar was worth about 115 in the mid-seventies and 145 in the mid-eighties. A further rapid depreciation occurred last year and in the first few months of 1995, so that the effective exchange rate of the dollar is now 80 per cent of what it was in 1987.

The United States generally had a current account surplus until 1981, but thereafter private saving was insufficient to cover investment and the budget deficit. In the second half of the eighties the rapid growth of the economy and the increase in the budget deficit caused the current account deficit to rise rapidly to almost 4 per cent of GDP; it could be financed relatively easily, however, in view of the dollar 's importance in world finance. The United States' net external position became negative in 1987 and exceeded $700 billion last year, equal to 11 per cent of GDP.

Between the mid-seventies and 1995 the effective exchange rate index of the Deutsche Mark rose from 68 to 113. Much of the increase occurred in the second half of the eighties, when Westem Germany's extemal creditor position rose from $54 to 360 billion, equalling 21 per cent of GDP in 1990. After the unification of Germany, the current account of the balance of payments recorded annual deficits equal to about 1 per cent of GDP and the mark's tendency to appreciate attenuated. Short-term interest rates were kept comparatively high, with the declared intention of curbing inflation. This led to substantial inflows of capital, encouraged by expectations of non-inflationary economic growth and international confidente in the German economy.

Appreciation of the currencies of economies with an external creditor position has an adverse effect on their competitiveness, but on the other hand it increases the scope for controlling economic activities in other countries. The financing role of banks and of the financial markets is also greatly enhanced.

In the long term, the availability of savings helps determine the scope for investment, and hence for economic growth and the maintenance of a balanced and competitive position.

The allocation of savings within each country may be distorted and diverted away from investment by the excessive size of the public sector and the level of debt, including private debt.

In comparatively open economies, variations in the exchange rate will tend to have repercussions on the currency's domestic purchasing power.

The central bank's efforts to control inflation are hindered by the scale of public expenditure, budget deficits and public debt. Restrictive monetary policies bear most heavily on the private sector of the economy; the more statile the level of costs, particularly labour costs, the less the impact on economic activity, investment and employment.

By comparison with other countries, Italy's budget deficit and public debt are especially high, but so too is households' propensity to save. In 1993 and 1994, that is to say since the lira's withdrawal from the European exchange rate mechanism and the start of the adjustment of the public finances, a substantial surplus was recorded on the current account of the balance of payments. By the end of 1994 Italy's net foreign indebtedness had fallen to $72 billion, egual to 7.2 per cent of GDP. The tight monetary stance did not curb production, thanks above all to trends in labour costs.

Interest rates

Persistently high public sector borrowing requirements and public debt, widespread market fears of a shortage of savings in the world economy, especially in major countries, and the markets' perception of difficulties in the intemational coordination of economic policies in an extremely responsive global market in securities and foreign exchange have been at the root of the variability and high level of interest rates over the last decade.

Nominai interest rates have been consistently lower in Japan than in other countries. In the United States they have benefited from the dollar 's status as the leading international currency. In 1994 US monetary policy, which was avowedly geared towards attaining domestic objectives, triggered a generai rise in interest rates in other countries, despite greater price stability than in the past and, in Europe, substantial spare produttive capacity.

By mid-1992 the federai funds rate had fallen to 3 per cent, compared with more than 8 per cent two years earlier. The downward trend was reversed at the beginning of 1994; the Federal Reserve raised the rate in stages to stand at 6 per cent in February of this year.

Long-term interest rates moved in parallel with short-term rates. Yields on medium and long-term government securities in all the leading financial markets, including the Italian market, rose in tandem with those on dollar-denominated securities, increasing by about 2 percentage points on average in the Group of Seven countries in the course of the year.

In the first half of 1994 the European central banks sought to reverse this tendency by reducing the cost of money in order not to impede the recovery, which was stili fragile. However, the reduction in short-term rates was not matched by a decline in long-term rates. The yield curve, which in 1993 had been fiat or, in some cases, inverted, acquired a sharply rising slope everywhere in 1994. Sectors that borrow at short terni nevertheless benefited from the fall in the cost of money, which continued in the first half of the year in Italy and elsewhere.

Underlying these developments were massive capitai movements; in view of the low cost of dollar loans, capitai flowed finto the deep and liquid markets in government securities in the leading European countries in 1992 and even more markedly in 1993. Sudden and substantial sales of securities in early 1994 led to a universal decline in securities prices. The Japanese market witnessed movements similar to those observed in Europe, but nominai yields remained far lower than in the US and European markets; the disparity was less pronounced in real terms.

The current account deficit of the United States continued to generate a substantial supply of dollars. In the three years from 1992 to 1994 the dollar-denominated assets of non-residents with the US banking system increased by $200 billion. Despite outflows of non-bank capitai, the external liabilities of the Japanese banking system decreased owing to Japan's persistent current account surplus.

In the early months of 1995 the supply of dollars and the demand for Deutsche Mark and Japanese yen increased, reflecting substantial portfolio adjustment. Liquid funds in sterling, lire, Canadian dollars and Swedish kronor were caught up in the movement towards currencies regarded as safe havens.

On some occasiona, substantial central bank intervention in the foreign exchange markets only dampened the more erratic movements in exchange rates. The size of the flows was partly reduced by the lowering of official interest rates in Germany and Japan.

Economic developments and prospects

The underlying movements in exchange rates are unaffected by adjustment for inflation. This has important consequences for the geographic distribution of world trade and for activity in the major economie s .

Between 1991 and 1994 the United States' share of exports of manufactures by industrial countries, valued at constant prices, rose from 16.5 to 17.9 per cent, while those of Germany and Japan declined from 19.1 to 17.6 per cent and from 14.6 to 12.7 per cent respectively. Italy's share, which had fallen by 1.5 percentage points between 1985 and 1991, rose from 7.8 to 8.5 per cent. However, the external imbalances of the major countries have not been corrected, owing to divergent trends in domestic demand and hence in the volume of imports.

The world economy as a whole performed well last year. Merchandise trade, which had increased by 3.8 per cent in volume in 1993, grew by 9.4 per cent in 1994 owing to the sustained expansion in the United States and the recovery in Europe. The substantial increase in exports by developing countries again contributed to the growth in trade, which was the largest for almost twenty years.

With unit labour costs falling, inflation slowed down to less than 2.5 per cent in the industrial countries, despite the sharp rise in the prices of raw materiale that are sensitive to cyclical developments.

Output grew by 3 per cent in the industrial countries and by 6 per cent in developing regions. The situation of Central and Eastern European countries improved, thanks partly to the intensification of trade with more advanced economies; the trend is still downwards in the countries that avere formerly members of the Soviet Union, owing partly to continued uncertainty regarding organizational matters and institutions.

The US economy has grown by almost 10 per cent in the last three years, boosted by a strong expansion in investment and by exports. In the European Union, where investment declined until the end of 1993, output increased by only 3 per cent over the same period; the recovery gained momentum in 1994, however, thanks to domestic demand.

Among the major industrial countries, Japan performed less well than expected, and hence did not contribute towards world growth and adjustment of the structure of trade. In the United States the growth in the economy led to an increase in the trade deficit.

In the absence of national policies that impinge directly on the supply of and demand for savings, exchange rate movements are not sufficient to eliminate external imbalances.

Forecasts by international organizations indicate that the industrial countries will continue to perform well in 1995; the slowdown in the United States is expected to be offset by growth in Europe in line with the current trend. World trade is expected to slow down only slightly and inflation to remain low.

There remain grounds for concern, however. High and volatile real interest rates are impeding a continuation of the economic expansion. Current exchange rates could lead to a further redistribution of world trade; this would boost activity in the United States, but it would also check the recovery in Germany and Japan. The current account imbalances among the main economic areas, which are the underlying cause of the unrest in stock markets and currency markets, would remain unresolved. This in turn would adversely affect the prospects for growth in the world economy, and as a result would slow down the reduction in unemployment, which remains at record post-war levels in Europe.

Issues of international cooperation

In the present configuration of the international monetary system, financial activities are spread across a multitude of regions, currencies and instruments beyond the control of individual countries; the regulation of flows of credit and money is becoming a problem and encountering serious limitations. Destabilizing forces may set in, which in the first instance would affect emerging countries.

Doubts are beginning to be raised as to the appropriateness of massive inflows of short-term capital to finance development in these countries; a rapid outflow in response to a change in conditions could endanger the stability not only of individual banks but of entire economies. The effects could spill over onto the financial markets and currencies of more developed countries, given the growing links between the two groups of countries.

Slowly but surely, a willingness to take concrete measures to tackle the problems is developing at national level and through international cooperation.

For cooperation to be lasting and effective, each country, but especially the leading ones, must adopt domestic policies to prevent and correct imbalances that can jeopardize non-inflationary economic growth.

Compatibility between saving and investment should be achieved primarily by means of fiscal policy. There is international agreement about the need for a further reduction in the US budget deficit over the medium term. In order to prevent a slowdown in the world economy, this must be matched by an expansion in output in Japan, led in the first instance by domestic demand and of necessity stimulated by public expenditure, in accordance with the commitments given and confirmed by the Japanese Government.

Efforts to re-establish an area of monetary stability in Europe should be intensified; as an essential precondition, there must be greater convergence between the economies of the Member States of the European Union, especially as regards the adjustment of the public finances, not least in order to facilitate a reduction in interest rates. Orderly monetary conditions in Europe can also contribute to the stability of monetary and financial relations in the world in generai. International institutions and the surveillance performed by the International Monetary Fund can help prevent the risk of instability in emerging countries.

Cooperation among centrai banks is intensifying in the fields of banking supervision and the oversight of financial markets and payment systems. The present situation in the international monetary system is similar to that which faced each country internally in the last century, as institutions and financial markets carne into being and acquired their individua) identities. These developments were highly beneficiai, but they were also the cause of crises and financial instability, which were tackled by adopting specific legislation and through the special role acquired by centrai banks. At the international leve), there appears to be an increasing need for dose coordination among the centrai banks of the leading countries in order to avert the risk of instability not only in individuai banks but also in entire monetary and financial systems.

The Italian economy

The balance of payments and the exchange rate

In 1994 Italy 's merchandise exports totaled 305 trillion lire, an increase of 15 per cent on the previous year, while imports rose by 16 per cent to 248 trillion; the trade surplus rose from 52 to 57 trillion lire. The services account returned to surplus. Net interest payments to non-residents declined for the first time for seven years, falling to 24.7 trillion lire; they had been unchanged in 1993.

The surplus of 25 trillion lire on the current account of the balance of payments compares with one of 18 trillion in 1993 and large deficits in the preceding years. The return to a current account surplus in the last two years was a consequence of the relative weakness of domestic demand and the improved cost and price competitiveness of Italian products.

At the end of last year Italy 's net external debt amounted to 118 trillion lire, equa) to just over 7 per cent of gross domestic product. As recently as

1992 the ratio had been nearly 11 per cent. The persistence of a large current account surplus will eliminate the debt in just a few years. Medium-term projections prepared by the International Monetary Fund indicate that among the seven leading industrial countries only Japan and Italy will record large current account surpluses over the next five years.

Notwithstanding the improvement in Italy 's external balance sheet, the exchange rate of the lira has continued to fall. In 1994, when the dollar depreciated by 10 per cent against the mark, the lira declined by 6 per cent against the German currency. The depreciation became even more pronounced in the early months of this year.

The current account results were overshadowed by capital movements, especially on account of portfolio investment. The demand for foreign exchange against lire exceeded the supply.

In 1993 inward portfolio investment, the bulk of which consisted of purchases of government securities, had given rise to an inflow of foreign capital of 103 trillion lire, of which only part was financed in lire. This had greatly boosted the supply of foreign currency in the Italian foreign exchange market. The inflow continued in January and February 1994. From then until March of this year foreign investors made net sales of Italian securities, except in the last two months of 1994. The pressure these outflows exerted on the exchange rate of the lira was largely offset by the related repayment of bank loans. The reversal of the direction of foreign investment in Italian securities was part of the change in the international financial situation triggered by US monetary policy.

Purchases of foreign securities by Italian investors, which have been taking piace for some time as part of a normal process of portfolio diversification, accelerated last year, giving rise to a net outflow of 52 trillion lire. An additional outflow of 5 trillion was recorded in the early months of this year.

In the two years 1993-94 households made a major contribution to the outflow of capital, in part via investment funds. Enterprises were responsible for net outflows totaling at least 60 trillion lire, generated partly by direct transactions and partly via the banks from which they had obtained foreign currency loans; they invested part of their export proceeds abroad.

It is estimated that at the end of last year some 37 per cent of the corporate sector 's financial assets, excluding shares, consisted of foreign securities and deposits abroad. The corresponding share of households' financial assets was around 3 per cent.

In 1994 as a whole the current account surplus, the state sector's further borrowing abroad and non-residents' purchases of Italian securities were far outweighed by the demand for foreign exchange associated with capital outflows.

The lira strengthened in the first part of 1994, but weakened rapidly again from June onwards. In February and March of this year the declive became precipitous.

The deterioration in the exchange rate was accompanied by a fall in the prices of government securities and shares in the summer of 1994 and to an even greater extent in the early months of 1995. The differential between the yield on ten-year Treasury bonds and that on comparable German securities, which had reached a low of 2.5 percentage points in April 1994, rose to 6.5 points in March of this year.

The outflows of capital, though related to international instability, were fueled by doubts as to whether the adjustment of the public finances would continue.

At times in the last few months there was the danger that a vicious circle of capital flight, currency depreciation, rising inflation and falling securities prices would develop. This risk was averted, partly by means of interventions in support of the lira that blocked the more erratic exchange rate movements. Above all, however, it was the continuation of the adjustment of the public finances, more balanced assessments of the underlying soundness of the economy and the tightening of monetary policy that slowed down the depreciation of the lira and made a recovery possible. The effective exchange rate, which had declined by 4 per cent in 1994, fell by 15 per cent between the beginning of 1995 and the middle of March; yesterday the depreciation since the beginning of the year was 9 per cent.

Economic developments, monetary policy and prices

The depreciation of the lira has made exports more profitable than even exporters themselves had expected. At the same time it has generated inflationary pressures in the economy via import prices and expectations.

Manufacturing industry was the most dynamic sector as regards foreign trade, increasing its exports by 11.5 per cent in volume terms. The firms that took most advantage of the opportunities were those that had focused on product quality and those with consideratile spare capacity. Exports and capacity utilization rates rose to very high levels in the branches producing motor vehicles and machinery, as well as in those making traditional products; sales of intermediate goods and basic materials for industry were also substantial.

Italian industry has always depended heavily on export demand. This link, which is also cyclical, was further reinforced in the last two years by the relative weakness of domestic demand on the one hand and the profitability of exports on the other.

For about ten years the proportion of total manufacturing turnover generated by exports remained around 27 per cent. In 1993 it rose to 31 per cent and in 1994 to 35 per cent. Half of the increase was due to growth in the quantity of goods exported.

Domestic demand and gross domestic product had begun to rise again in the fourth quarter of 1993. The recovery continued and gained momentum in 1994. The domestic stimulus carne from investment in machinery and equipment and expenditure on durable goods. The increase in households' total consumption was smaller than that in GDP and slowed down in the second half of the year. The growth in investment in machinery and equipment continued throughout the year, averaging 6.5 per cent. However, there was a further fall in expenditure on construction. The acceleration in domestic demand caused imports to rise rapidly.

The increase in value added in the economy was accompanied by exceptional productivity gains, especially in manufacturing industry; employment fell.

The improvement in productivity was partly due to a generai framework and climate of industrial relations that permitted a more flexible use of labour.

The rigidities that developed in employment conditions at the beginning of the seventies were equivalent to a reduction in produttive capacity; today's greater flexibility means that production can also be increased by using plant more efficiently.

The rapid rise in output and the sustained growth in domestic and foreign demand have revealed capacity shortages in several sectors and cali for additional investment.

Monetary policy had successfully countered the inflationary pressures caused by the sharp rise in the cost of imports in the first half of 1993. The satisfactory behaviour of domestic prices — in which the agreement on labour costs was a crucial factor, in terms both of its immediate impact and of its effect on expectations — permitted interest rates to be lowered, albeit gradually, thereby fostering the recovery in investment. The reduction in interest rates continued in the first half of 1994.

In June, when the recovery in production appeared to be firmly established, the perception that producer prices and inflation expectations were coming under pressure prompted the Bank of Italy to ration monetary base; money market rates rose above the rate on fixed-term advances. In July the signs that the process of disinflation was about to end were confirmed, even though they had stili not been fully appreciated by the markets or the public.

The Bank took the view that the pressure on prices was attributable to the recovery in domestic demand, the depreciation of the lira and the prospect of supply bottlenecks in some sectors.

At the end of July the Government presented the Economic and Financial Planning Document for the three years 1995-97, which foresaw supplementary budget measures amounting to 5 trillion lire in 1994.

On 1 August, in a parliamentary hearing to comment on the Document, I pointed out the risk of a revival of inflation and reaffirmed the need for clear guidelines to restrain domestic demand by means of budgetary measures.

On 11 August the Bank decided to make an initial increase of half a percentage point in the discount rate and the rate on fixed-term advances.

Since the middle of May the market yield on ten-year Treasury bonds had risen by nearly 2 percentage points and the differential with respect to German securities had widened from 2.6 to 4 points. The tensions in international financial markets were compounded by domestic causes of uncertainty. Italy's markets were more seriously affected than those of other European countries.

After an initial period of adjustment, the increase in official rates curbed the deterioration in the long-term interest rate differential with respect to the other leading markets. The growth in the domestic money supply slowed down considerably.

The Finance Bill for 1995 presented in September provided for a correction of budgetary trends mainly through reductions in expenditure, a large part being in the social security budget. On the other band, interest payments on the public debt were calculated on the assumption of a rapid fall in interest rates. In December the measures relating to long-service pensions were removed from the budget; they were to be redrafted as part of a comprehensive reform of the pension system to be approved by the middle of 1995.

The prospect of tax measures and reform of the pension system, the limited growth in earnings and the continuous rise in the number of unemployed held back consumption.

Total credit expanded by 5.5 per cent in 1994, which was less than the growth in nominai GDP. Among the counterparts, those of a more liquid nature showed a particularly moderate increase. The money supply grew by 3.1 per cent.

Producer prices had already begun to accelerate in the middle of 1994. The rate of increase in consumer prices and the cost of living also rose as the year proceeded, albeit to a lesser extent. The twelve-month rise in the cost-of-living index reached a low of 3.6 per cent in July; by December it had risen to 4.1 per cent.

In 1993 the fall in domestic demand, the deterioration in households' confidente and the wide margin of spare capacity had led firms to trim their domestic profit margins in order to absorb the increase in costs due to the depreciation of the lira. Foreign producers reduced the foreign currency prices of their exports to Italy considerably. The tightening of monetary policy, the stability of labour costs and the increase in productivity made it possible to limit both the duration and the size of the initial price impact of the fall in the exchange rate and to reduce inflation further.

The annual rate of growth in domestic demand rose from 2.6 per cent in the first half of 1994 to 4.9 per cent in the second. The cost of primary and intermediate products continued to rise, driven by the increases in the world market prices of raw materials and the depreciation of the lira. Costs in manufacturing industry accelerated. On the other hand, the downward trend of unit labour costs became more pronounced.

The recovery in demand led to a widening of the margin between industrial firms' domestic prices and their production costs. The share of profits in industry rose to almost the levels of 1988-89, the highest since the early seventies; in the services sector it reached a record high.

At the beginning of this year the deterioration in the outlook for prices led the Bank of Italy to tighten monetary conditions further. On 21 February the discount rate was raised by 0.75 percentage points to 8.25 per cent and the rate on fixed-term advances by 1.25 points to 9.75 per cent.

The tensions that had developed in international foreign exchange markets were compounded by uncertainty regarding parliamentary approvai of the supplementary budget proposals. The lira and the prices of government securities carne under heavy downward pressure, which persisted even after the approvai of the measures in the middle of March. The supply of monetary base to the banking system, which was heavily in debt to the centrai bank, was again rationed. The overnight rate rose to 10.5 per cent.

Market tensions eased at the end of Aprii. The improvement in the prices of long-term securities, which had been under way in the other leading countries since the beginning of the year, spread to Italian government securities as investors perceived a reduction in political tensions. The announcement of the agreement on pensions reform was also a factor. The improvement in the prices of government securities was accompanied by a rise in the effective exchange rate of the lira.

Since the middle of May tensions have reappeared in the securities and foreign exchange markets. The strength of the growth in output and domestic demand was confirmed; credit to the private sector had been expanding again since the early months of the year. In such conditions the higher costs caused by the undervaluation of the lira can more easily be passed on to final prices.

On 26 May the Bank of Italy raised the discount rate and the rate on fixed-term advances by 0.75 percentage points. They now stand at 9 and 10.5 per cent respectively.

Regional disparities and unemployment

About 85 per cent of Italy's manufacturing capacity is located in the northern and centrai regions. The present export-led recovery began in the most industrialized parts of the country and has been strongest there; gross output grew by about 2.5 per cent in the Centre and North last year, as against 1 per cent in the South.

The South is home to more than 35 per cent of the country 's population and just over 30 per cent of the labour force, but generates 25 per cent of national income. In these regions the proportion of persons employed in agriculture, construction, the distributive trades and government is higher than the national average. In 1994 the decline in construction activity for the third consecutive year and the smallness of the recovery in consumer spending again impinged heavily on employment in the South. Between the beginning of 1994 and the beginning of this year the number of persons employed fell by 225,000, or 3.9 per cent. Almost all the jobs lost were in the private sector. The decline in employment in the economy as a whole carne to 1.6 per cent.

The unemployment rate in the Centre and North is 8 per cent, whereas in the South it has reached 21 per cent. The number of persons in work in this part of the country is substantially lower now than at the beginning of the eighties.

Although average unemployment rates are comparatile, the unemployment problem in Italy is radically different in nature to that in other industrial countries, where the geographic disparitier in the structure of the economy are less pronounced and unemployment less concentrated.

In some parts of the Centre and North, where the stimulus to production from exports and investment has been strongest, the economy is operating dose to the full employment level.

In the South the very low labour market participation rate, the large number of people seeking permanent employment and the rapidity with which these two problems worsened in the last two years reveal economic and institutional dysfunctions, which have repercussions on the manner in which society operates.

The labour market must be encouraged to adopt greater flexibility in wages and terms of employment, regional development policy must be overhauled and public infrastructure investment increased. Above all, there is an urgent need for a radical qualitative improvement in the functioning of public administration instìtutìons in the South.

The cyclical recovery in the Italian economy will alleviate unemployment in the southern regions only marginally. Nationwide growth in output and investment will generate the resources and create the conditions for relaunching a development policy for this part of the country.

The agreements reached within the European Union require the elimination of the social security contribution relief that manufacturing firms located in the South have received in recent decades. These subsidies can and must be replaced by an effective, coordinated policy of regional development, with the European Union financing part of the expenditure on infrastructure and investment, including intangible investment.

The average productivity of industrial workers in the South is 20 per cent lower than in the rest of the country. Until now, this competitive disadvantage has been offset by reducing the social contribution component of labour costs.

The situation calls for a wage structure and methods of labour utilization that reduce unit labour costs. Experiments already taking piace in major centres of production have raised productivity by introducing greater flexibility in the use of labour, which has made it possible to utilize plant more intensively.

There is no lack of examples of successful entrepreneurship in the South. We detect a willingness to accept new forms of employment if the business initiatives proposed are sound. The fact that the overwhelming majority of those seeking steady jobs are young people makes the use of these new forms of employment both urgent and feasible.

To a large extent, the lower productivity of manufacturing industry in the South is due to factors beyond the control of the firms concerned: disadvantages in geographical location, the inefficiency of local govemment and shortcomings in basic, productive and social infrastructure.

The amount of public capital available in the South is less than in the more affluent parts of the country and less than the average for the other leading European countries, in some cases by as much as 50 per cent. There are stili shortcomings in transportation, in the water and electricity supply systems, in communications and in some social services.

Public investment has been drastically reduced in recent years. A resumption in capital expenditure could provide cyclical relief as well as having a structural effect. The new rules simplifying and streamlining the procedures for the award of public works contracts are thus welcome. The necessary criteria for selecting, planning and monitoring the implementation of projects, which have yet to be applied, should guarantee correct conduct, ensure that public works meet development needs, and contain costs. Investment need not be financed entirely by the public sector. Private entrepreneurs who recognize the business opportunities in the provision of services for which charges will be levied can also play a role.

Adeguate infrastructure and public investment are necessary prerequisites for economie development, although of themselves they cannot generate such development. The special development assistance scheme has not yet been replaced by coordinated administrative and planning capability, especially at the regional and locai level.

The Community funds that are available have been used late or have remained unspent. It is only recently that steps have been taken to facilitate the use of these funds and a number of instruments introduced to support private investment and the financial adjustment of small and medium-sized firms. Further measures need to be taken, and quickly. A great many projects are stili incomplete. The uptake of loans from international institutions is low for want of fundable projects.

An improvement in political and administrative performance, which seems inescapable, will prevent the Southern problem from recurring in its familiar form. The geographical mobility of labour must be seen as a means of achieving greater flexibility in the efficient allocation of resources; it must not become a cause of social isolation and tension.

Overcoming regional disparitier is the necessary condition for the lasting, sustainable development of the country. The problem of productive employment, in which the question of the growth and equitable distribution of national incorre is largely subsumed, coincider in Italy with that of the economic and social development of the backward areas.

The public finances

In 1994 fiscal policy was directed towards stabilizing the primary budget surplus of the state sector at 32 trillion lire. The budget measures were designed to impinge mainly on expenditure, with around half of the reduction being in capitai spending. It was assumed that interest rates would continue to decline, not only in 1994 but also thereafter. The borrowing requirement was set at 144 trillion lire.

Expenditure was to be curbed not only by reducing budget allocations, but also by rationalizing the structure of central government departments, simplifying procedures, increasing the autonomy of local authorities and assessing the efficiency of public sector agencies. On the revenue side, the authorities did not intend to offset the decline in the tax burden that would result from the expiry of one-off measures adopted in previous years.

Notwithstanding the supplementary measures that were introduced in July, the state sector borrowing requirement amounted to more than 155 trillion lire last year. The primary surplus was 18 trillion lire, 14 trillion less than the target. Tax receipts fell short of the initial forecasts: the ratio of tax and social security receipts to GDP diminished by 2.8 percentage points, compared with the planned reduction of 1.3 points. Capital expenditure was 12.5 trillion lire less than projected.

The slowdown in the activity of government departments and the budgetary cutbacks made in recent years caused public investment to fall: between 1991 and 1994 it declined from 3.3 to 2.3 per cent of GDP.

The Economic and Financial Planning Document for the three years from 1995 to 1997 maintained the objective of halting the growth in the ratio of public debt to GDP by 1996. For 1995 it envisaged an increase in the state sector primary surplus to 2 per cent of GDP and a total borrowing requirement of no more than 139 trillion lire.

The budgetary policy approach for this year and the following two did not reflect the interest rate trend that was beginning to emerge. The progressive improvement in the primary surplus that was needed to achieve the objective hinged on a further reduction in current expenditure in relation to output; the ratio of tax and social security receipts to GDP was kept at the level foreseen for 1994.

In the statement I made to Parliament on 1 August concerning the Document, I pointed out the inadequacy of certain spending cuts, the one-off nature of some of the revenue-raising measures and the uncertainty surrounding the hypothesis that interest rates would decline sharply in the second half of the year.

Further corrective measures were taken in September to compensate for the increase in interest payments, which were stili calculated on the assumption that interest rates would come down rapidly in the final part of the year.

At the joint hearing on budgetary policy for 1995, held on 18 October by the Budget Committees of the Chamber of Deputies and the Senate, I observed that the effectiveness of some of the spending cuts and revenue increases would depend on the manner in which they were implemented. I also remarked that projected interest payments were underestimated by an amount that at the time could be calculated to be equal to just under 1 per cent of GDP.

In February of this year the new Government swiftly introduced a series of corrective measures that focused primarily on the revenue side, and particularly on indirect taxes. As a result, the ratio of tax and social security receipts to GDP will recover by around one percentage point.

The borrowing requirement for the year will be reduced to 7.4 per cent of GDP, below the limit previously set, owing partly to more rapid growth in nominai output than had originally been forecast. The estimates for interest payments in 1995 appear realistic. The ratio of the public debt to GDP could diminish, albeit only slightly.

On the basis of the intentions announced yesterday by the Government, the aims of fiscal policy in 1996 are more ambitious than those indicated in last year's Economic and Financial Planning Document, thanks to the effects of the measures already adopted and the favourable macroeconomic scenario.

The borrowing requirement will be held down to 110 trillion lire, equivalent to 5.8 per cent of GDP. The primary surplus, which is expected to amount to 60 trillion lire this year, will increase to 80 trillion, or 4.3 per cent of GDP. Achievement of these objectives will make it possible to bring down the level of yields on government securities substantially, reduce the cost of the public debt and accelerate the contraction in the borrowing requirement.

A virtuous circle of a diminishing budget deficit, a falling ratio of public debt to GDP and declining interest rates may develop; this would release resources to finance the expansion in productive investment.

Vigorous action to adjust the public finances is equally necessary in order to check the overheating of the economy.

Total public spending amounted to 54.5 per cent of gross domestic product in 1994; the weighted average for all the countries of the European Union is just above 50 per cent. The difference reflects the higher level of interest payments in Italy, which in turn is attributable to larger public debt. The higher expenditure on pensions in Italy is offset by lower spending on other social benefits, and particularly on unemployment benefits.

The bili to reform the public pension system provides for a graduai raising of both the minimum age and the minimum contribution period for long-service pensions, a closer correlation between contributions and benefits as a result of switching from an earnings-based system to one based on contributions, and harmonization of the public employees' pension system with that for the private sector. The package of proposed measures will generate an increase in revenue, largely from contributions which would otherwise have ceased, and during the transitional period will result in annual expenditure savings estimated at 0.3 per cent of GDP.

The transition is too graduai, however. Even when the new system is fully operational, it will continue to be at variance with those of the other leading countries; in particular, it will stili be possible to receive pensions at a lower age, and the ratio of pension to wages will remain higher. Assuming rates of economic growth comparable to those recorded in the past, the replacement ratio for wage and salary earners would be higher than that which the current legislation would eventually provide. No limit is placed on the amount of benefit paid.

As regards tax and social security receipts, it should be noted that the ratio to GDP is lower in Italy than in other European countries with a comparatile ratio of expenditure to GDP. The difference is due not to lower tax rates but to a smaller tax base in relation to national income, which is attributable to various forms of tax evasion and avoidance.

The composition of revenues is also skewed by the excessive incidence of personal income tax. This is the result of past inflation-induced fiscal drag, which was only partly offset by periodic revisions of the tax rates and income brackets.

Given the level of rates of value added tax, receipts from this source are inadeguate: they are the lowest in Europe in relation to GDP. It is estimated that VAT evasion may amount to as much as one third of the tax actually due. A series of indirect indicators also suggest that the evasion and avoidance of tax on the incomes of sole proprietorships and the self-employed are consideratile. It is estimated that the shortfall in revenue due to the various forms of avoidance and evasion is equivalent to a large proportion of the annual budget deficits.

Tax evasion generates economic rents, distortions in income distribution and inefficiency in resource allocation. The scale of this phenomenon is such that the entire economy is adversely affected. It must and can be substantially reduced; significant results can be achieved as early as next year.

Efforts to combat tax evasion require a reorganization of the tax administration along the lines set out by successive Governments in recent years. The limited number of tax audits, the complexity of disputes procedures and the recurrent use of tax condonations impair the effectiveness of the action taken on this front.

The taxation of corporate income in our country is biased in favour of debt financing as opposed to equity financing. It reaches excessive levels for companies that abide by the rules and have no scope for deductions or avoidance; it distorts competition, putting Italian firms at a disadvantage compared with those established in the other countries of the European Union.

On several occasions I have dwelt on the need for comprehensive reform of the taxation of financial assets. In a situation of free capital movement, the disparities of treatment are causing serious distortions in the allocation of savings among the countries of the Union. The Jack of adeguate agreements among the tax authorities facilitates evasion.

The attempts to coordinate national legislation have not produced results so far. The harmonization of the taxation of corporate income is still under examination.

Competition between economies is tending to lessen the tax on assets whose circulation within the Union is subject to fewer obstacles and lower costs.

In the past few years appropriate emphasis has been laid on the curbing of public expenditure, the quality and effectiveness of government measures and administrative efficiency; it is necessary to continue to strive resolutely in this direction. On the other hard, too little attention has been paid to these aspects on the revenue sfide of the public accounts. Even if their initial impact may be modest, the implementation of concrete measures to increase both the volume and the distributive equity of tax revenue is essential for a country that wishes to compete with other and more advanced economies, and that intends to ensure employment and better living standards for its people.

The economic recovery now under way

In last year's Report we described the incipient economic recovery that had begun in the export sector and was spreading to productive investment and to the other components of demand. We feared that consumption would grow excessively, and signaled the danger of a resurgence of inflation.

Many of those tendencies, both positive and negative, have been confirmed in the last twelve months. Although the growth in consumption has remained modest, imports are again rising in connection with the increase in aggregate demand.

Private sector saving remains high by international standards and is sufficient to finance the public sector borrowing requirement as well as private investment. The balance of payments is showing a substantial surplus on current account.

From last summer onwards, a domestic loss of confidence in addition to unfavourable international developments led to a rise in interest rates and a depreciation of the lira.

These factors reappeared even more forcefully at the beginning of this year, when they interacted with the turbulence that had developed in world financial markets. Once again, the exchange rate of the lira and the prices of Italian securities were affected.

The weakening of the lira generated renewed inflationary pressure, which first manifested itself in producer prices. The recovery in domestic demand in combination with the weakness of the lira allowed firms to widen their profit margins considerably, both in industry and in the services sector.

The twelve-month increase in the cost of living, which had fallen to a low of 3.6 per cent in July 1994, rose to 4.9 per cent in March and 5.5 per cent in May. The rise in prices in the last few months can be ascribed partly to changes in indirect taxation, but it also signals the re-emergence of inflationary pressures, including some of domestic origin.

Monetary policy, which was already geared towards containing the expansion of credit and the money supply, was progressively tightened by rationing liquidity to the banks and raising official interest rates.

More recently, it has appeared increasingly likely that inflation will continue to worsen in the coming months. In order to halt the deterioration in expectations, the discount rate has been raised to 9 per cent and the rate on advances to 10.5 per cent.

A slowdown in the monthly rate of increase in prices, after adjustment for the usual seasonal factors, is possible by the end of the summer. The improvement would be reflected in the twelve-month rate some time later.

Inflation can be curbed if demand grows in an orderly manner, firms refrain from widening their profit margins further and wage moderation is maintained.

The annual average rate of consumer price inflation, net of the effect of the increase in indirect taxes, could then be held below 4.5 per cent. It will have to fall below 4 per cent next year.

If price trends over the next few months show a tendency to diverge from the pattern I have just described, we shall not hesitate to tighten credit conditions stili further.

It is essential that the Finance Law for 1996 implement the Government's declared intention of reducing the budget deficit further in continuation of the action initiated in March.

If inflation does slow down, the growth in GDP could exceed 3 per cent this year, one of the highest growth rates in the industrial world, and it will remain rapid in the years to come.

The surplus on the current account of the balance of payments could show a further significant increase. Continued growth in output will also bring about a recovery in employment.

An examination of firms' intentions does indeed show that there is the possibility of a substantial acceleration in productive investment, primarily in industry and especially in small firms. A revival in both public and private investment is needed in the South. This will require on the one hand more efficient public administration and on the other employment conditions that make it economically viable to install productive capacity in that part of the country.

The continuing adjustment of the public finances, the stability of labour costs and the progressive slowdown in producer and consumer price inflation will help bring about a reduction in interest rates, to the advantage of companies' finances and investment.

Italy will be able to return to a sound path of sustained growth.

The banks and the financial system

In an international monetary system characterized by freedom of capital movement and substantial capital flows, changes in the demand for and supply of financial assets have an impact on exchange rates and can cause wide fluctuations in securities prices.

Italy has a particularly high saving ratio. At a time when institutional and private investors are showing increasing interest in investment abroad and in portfolio diversification, it is essential to continue to strengthen our financial market so as to underpin the value of the currency, offer better opportunities for the productive investment of domestic savings and attract foreign investment.

Heightened competition, the reduction in the role of the state in the banking sector and the need to make amends for past omissions are spurring the banks to seek sounder and more efficient structures. The reorganization of bank ownership and branch networks has become more widespread and is proceeding at a rapid pace; it is being entirely driven by the independent initiative of managers and shareholders. The restructuring will strengthen the Italian banking system. The Bank of Italy is firmly committed to ensuring that it is carried out in the proper manner, respects competition and meets the needs of Italy 's widely dispersed productive sector. The difficult economic situation increases that commitment.

Loan quality and the reorganization of the banking system

The improvement in the performance of the corporate sector has not yet been reflected in the average quality of outstanding bank loans.

Company accounts for 1993 already showed an improvement by comparison with the previous year, but they also revealed a dichotomy between exporting firms, which are mainly located in the Centre and North, and others reporting slender operating profits or a loss. More than six thousand of the twenty-nine thousand companies on which the Company Accounts Data Service holds information reported gross operating profits that were insufficient to cover their interest charges; they incurred an overall operating loss of 4.6 trillion lire.

The operating profits of Italian companies as a whole rose in 1994. Their financial deficit, which amounted to 108 trillion lire in 1992 and 36 trillion in 1993, was virtually eliminated in 1994. Credit demand was exceptionally low, while bad and doubtful debts increased by 30 per cent to 90 trillion lire, rising from 6.3 to 8 per cent of total lending.

There was evidence of a deceleration in bad and doubtful debts and a recovery in loan demand in the early months of 1995.

The need to improve loan quality has induced the banks to review their lending criteria and procedures. Many have refined their customer classification methods, which also play a useful role in determining the rate to charge. Organization has been improved to enhance the coordination of information on borrowers.

Comparison with banks in the other countries of the European Union confirms the validity of this approach; it reveals the scope for improvement through more integrated sector analysis as a basis for lending decisione, more detailed examination of group relationships when lending to individual companies, and greater attention to the customer 's earnings prospects.

Less fragmented relationships with borrowers would enable banks to obtain a fuller picture of the situation and plans of firms and to offer them more comprehensive financial assistance. This would ease the financial constraints on corporate investment and limit credit rationing during economic downturns.

The banks have taken up some of the opportunities offered by the new Banking Law. Activities that were previously conducted through specialized companies are now being performed internally. Medium and long-term lending has increased, primarily in connection with the restructuring of the debt of companies in difficulty. The acquisition of equity participations is proceeding slowly.

Banks' operating profits declined from 1.6 to 1.1 per cent of total assets in 1994. The decrease is attributable to a number of factors: the narrowing of the spread between lending and deposit rates, the fall in securities prices and loan losses. Self-financing was negative by 3.9 trillion lire. For banks operating in the South, the recession accentuated the difficulties associated with the increased riskiness of firms, inadeguate loan assessment procedures and cost structures that are often inflexible due to overstaffing.

The banks maintained their capital bases by issuing new shares and subordinated loans; the average ratio of capital to risk-weighted assets remained at about 12 per cent, in line with that in the other leading countries. Capital held in excess of the minimum capital requirement increased to 62.2 trillion lire, while the total shortfall of banks not meeting the requirement rose to 1.8 trillion.

The reduction in bank profitability cannot be blamed entirely on the recession; the economic recovery will allow profits to improve, but not necessarily to previous levels.

The banks stili need to diversify their sources of income and significantly reduce their operating costs. Services provided to customers account for a larger proportion of gross income in the other leading countries than they do in Italy. Italian banks are finding it difficult to develop new services; commissiona averaged 9 per cent of gross income over the last three years, the same as ten years earlier.

Over the past decade banks' operating costs averaged 63 per cent of gross income. Two thirds of the total consisted of staff costs, a high proportion by international standards.

To increase efficiency, measures must be taken to adjust staff composition and size as well as infrastructure to the banks' effective requirements. It is a difficult task, but one that has yielded productivity gains for a number of banks. Delay in adopting such measures will have an adverse effect on profitability.

In recent years the banks have considerably enlarged their branch networks, to the extent that coverage is now nationwide. A period of rationalization should follow. Banks should pay much greater attention to the structure, operational capabilities and profitability of their foreign establishments; the banks appear to be uncertain whether to concentrate on support for the commercia) activities of Italian businesses, interbank operations, intermediation in the leading financial markets or retail banking.

During the recession a larger number of banks found themselves in difficulties, as revealed by Bank of Italy inspections. In the last three years inspections were carried out in 539 banks, selected mainly on the basis of the periodic banking returns; they represented one third of the banking system in terms of the volume of lending. Inadequacies in loan assessment skills, risk control and organizational efficiency were found in 14 per cent of banks with 9 per cent of total lending. Shortcomings of this kind were discovered in 30 per cent of the banks located in the South.

As an adjunct to the analysis of prudential returns and inspections, frequent meetings are held with management to identify and discuss the measures needed to tackle problems and deficiencies. In 1994 the supervisory authorities made 160 formai approaches to banks among the leading three hundred, in which they requested the reorganization of procedures for assessing loans and market risks, the strengthening of capitai bases and in some cases the convening and replacement of governing bodies.

The reorganization that has been set in train in the last few years should enhance competition and help resolve the problems I have described.

In the last five years 89 banks with a combined market share of 16 per cent were merged with other banks or became part of a group; in the preceding five years 53 banks with 4 per cent of total assets had been involved in such operations.

Many of these mergers served to resolve crisis situations. Of the banks that in the last five years showed significant irregularities, 58 merged with other banks; they had accounted for 11 per cent of total lending and 23 per cent of total bad and doubtful debts, for which capital backing was provided in this way.

In the South the number of banks from other regions has increased, to the extent that they now have 40 per cent of the branches. Competition has intensified. In addition to salvaging individuai banks, intervention at a number of southern banks contributed to the introduction of products and management criteria developed in the financially more advanced areas of the country.

As the guarantor of competition in the credit market, the Bank of Italy not only assesses proposed mergers but also systematically scrutinizes operational agreements between banks and presses for the removal of clauses that might be detrimental to competition. As regards the terms and conditions for banking transactions, the Bank considers that the inflexibility and detail of the uniform terms pose a significant obstacle to differentiation in the conditions offered and has requested their amendment. In the case of a number of interbank agreements regarding payment services, the benefit to customers in terms of the speed and efficiency of services justified the granting of authorization for a limited period.

The transformation of public sector banks finto companies limited by shares has almost been completed. As the supervisory authorities have consistently held, the purpose of reducing the role of the public sector in the banking system is to give greater weight to the market's assessment of management strategy. It provides an opportunity to broaden our capital market. It can and must involve a net injection of savings that strengthens the capital base of the banks. The form and timing of public share issues and capital increases must find favour with investors, ensure that those who acquire control are financially sound and guarantee separation between the interests of industry and those of finance.

The capital market

By international standards, the Italian market in government securities is both very large and efficient. Italy 's private capital market, on the other hand, is stili underdeveloped in relation to the economy's capacity for production and saving.

Stock market capitalization remains low: the value of listed firms is egual to 18 per cent of gross domestic product, compared with 33 per cent in France and 110 per cent in the United Kingdom. Many non-financial companies, including large ones, meet the profitability and capitai requirements for listing. Even medium-sized and large corporate groups with one or more companies listed on the stock exchange continue to raise an insufficient proportion of their capital from the public.

The underdevelopment of the market is attributable to factors on both the supply and demand sides.

The demand for equity capitai has been satisfied up to now largely by tapping a narrow circle of investors. Firms will not seek listing, nor will they raise capital in the amount and manner that will make the structure of corporate control more open, if entrepreneurs do not perceive that in the medium term the advantages of greater resources can outweigh the supposed disadvantages of visibility and accountability for their decisions.

The average return on investment in shares in Italy has been broadly in line with that in other industrial countries and in the long run it has been competitive with that on alternative forms of investment. The factors that deter savers are the high variability of returns and the inadeguate protection for small shareholders.

It is the task of the financial institutions to reconcile the needs of firms with those of savers. Their role as shareholders and advisers and in the monitoring of business strategies is stili very limited; the conditions are being created in which it can increase.

The banks can help firms obtain stock market listing, not least by acquiring direct equity interests; the scope for them do to so remains consideratile. An expansion in their activity in this field presupposes and at the same time fosters a deepening of the securities markets, which will make it easier to dispose of shareholdings. The banks will need to develop suitable professional expertise in order to manage this more complex relationship with firms and operate as active shareholders.

The involvement of institutional investors in formulating investment strategies and exercising voting rights requires that their own corporate structure accord with the interests of the savers who have entrusted funds to them.

Institutional investors and banks must have the necessary instruments to represent the interests of savers in the companies in which they hold shares. A legislative proposal now under discussion is designed to extend and regulate the soliciting of proxies for shareholders' meetings; it will have to ensure timely and adeguate disclosure of information to shareholders and competition among various options.

Supplementary funded pension schemes can help to deepen the share and corporate bond markets. The decision to distinguish between the functions of a pension fund and those of its manager requires, in the interests of beneficiaries, that the former be responsible for laying down generai investment guidelines in its agreements with the manager and that the latter be responsible for administering the resources independently. In managing pension funds, specialized intermediaries will have to invest in assets, firms and productive sectors that offer the best prospects for incorre and for preserving capital values.

In the field of investment services, the more active involvement of highly qualified foreign institutions is increasing competition, accelerating the spread of financial innovation and stimulating the drive for efficiency. In the securities markets, the migration of business to financial centres abroad ceased when competition led to a reorganization of the Italian market in order to improve its liquidity and transparency. This required intermediaries to invest in human resources and technology.

The retail and wholesale markets in shares, corporate and government bonds and derivatives carne finto existence at different times and with a diversity of rules, forms of organization and controls that was not always operationally justified. It is now necessary to lay the legislative foundations for a coherent market architecture. The National Companies and Stock

Exchange Commission and the Bank of Italy are working conscientiously towards this objective.

Ladies and Gentlemen,

Last year saw a resumption of growth in the world economy, and especially in the industrial countries; the increase in investment ensures that it will be continuous and sustainable. Nonetheless, the problem of unemployment remains unresolved in many areas and countries, particularly in Europe. Inflation declined further to one of the lowest levels of recent decades, thanks partly to monetary policy but primarily to the slowdown in costs, above all labour costs.

Exchange rates displayed exceptional variability last year, even among the leading currencies; consequently, securities prices and interest rates were also highly volatile.

These developments, which are associated with the substantial expansion in international lending and investment, stem from disequilibria in economic and financial conditions in the leading countries and may be an obstacle to orderly growth in the world economy.

It became evident that economic policy in each country, of whatever size, needs to be geared continuously and credibly towards monetary and financial stability, the containment of public debt and consistent behaviour regarding nominai incomes.

The lira and the Italian financial markets were affected by the international fluctuations in exchange rates and securities prices. Orderly conditions were maintained, however, thanks to the depth of the market in government securities, the strength of the banking system, the restrictive stance of monetary policy and the firm line of incomes policy.

The efficiency of the economy and the savings of the private sector brought the current account of the balance of payments back into surplus, thereby initiating a reduction in the country 's foreign debt.

Corporate profits performed particularly well, reflecting the stability of costs, the rise in productivity and the depreciation of the currency; this must translate into a slowdown in domestic retail prices.

An efficient capital market helps to keep the internai and external value of the currency consistent with the economic fundamentals. The Italian capitai market must develop so that the privatization process can continue in a manner that ensures wider share ownership, adeguate privatization proceeds and the mobilization of genuine private savings.

Recent events have shown that there can be no slackening in the adjustment of the public finances.

In addition to efforts to reduce the budget deficit, there is an increasingly urgent need to examine and tackle the problems of the efficiency and quality of both expenditure and revenue.

Once approved by Parliament, the reduction in the deficit proposed by the Government, together with the commitment displayed by the two sides of industry and the restrictive stance of monetary policy, will help bring down inflation rapidly towards the levels recorded in countries with more stable currencies.

At present, Italy meets all the prerequisites for a further period of stable economic growth, which should also lead to an increase in employment.

The value of the currency in the domestic and international markets reflects both the strengths and the weaknesses of the Italian economy and financial system.

The Bank of Italy carefully monitors and analyzes the factors that play a part in determining the value of the currency. It considers it has a duty to report systematically on the results of its analysis and to give account of its actions. It seeks to maintain the stability of the currency and of the banking system, in accordance with the responsibility conferred upon it by the Constitution and the Banking Law and by virtue of the trust placed in it by the country.