BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1996

THE GOVERNOR'S CONCLUDING REMARKS

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Last year the Bank continued to seek greater administrative efficiency and operational effectiveness in the performance of its institutional responsibility to safeguard the currency and maintain financial stability and in the role it plays in national and international bodies.

The Bank's accounting system was refined in order to ensure that it fully meets the growing need for information and monitoring of the Bank's performance. This completes the overhaul of the technical procedures and organization of the branches; it brings about the complete automation of counter services and enhances accounting certainty.

The Bank responded promptly to the new legislation on safety at work by improving its accident prevention measures. A unit was established with specific responsibility for defining and ensuring compliance with the standards for the prevention of occupational accidents; the staff representatives were appointed and the arrangements for the performance of their mandate were defined.

The stability in the size of the Bank's staff in recent years and the containment of expenses testify to the attention paid to operational economy. As a result of the policies pursued, administrative costs have not risen by more than the rate of inflation in the last five years, despite the expansion in the Bank's tasks.

The negotiations on the renewal of labour contracts for the period from 1994 to 1997 concluded with an agreement that strikes a balance between operating requirements and the expectations of the staff. The salary structure was reformed in accordance with principles of rationality, within the limits set by Parliament.

The Report which we now submit to you on the state of the Italian economy, which includes a large section on the banking and financial system, has been prepared by the Research Department and the Banking Supervision Departments, assisted by all the Departments at Head Office and the branches.

The wide-ranging, rigorous and innovative analysis set out in the Report underlies our knowledge of the economy and of the financial system, both domestic and international; it provides guidelines for the regulation of credit and money, for intervention in credit markets and for the definition of market structures.

The staff of the Bank of every grade and rank, whether employed at Head Office or in the branches, are conscious of belonging to an institution whose sole purpose and ambition is to serve the nation.

I wish to express once again my appreciation and gratitude to the members of the staff for the dedication, skill and dignity with which they perform their duties.

The recent formation of the new Government, which succeeded that led by Lamberto Dini, saw the appointment of Carlo Azeglio Ciampi as Minister for the Treasury and the Budget. I send him my warm greetings and wish to express gratitude to him on behalf of myself, the Directorate and all the staff of the Bank for the work he has performed in guiding the Bank and the nation.

I would like to extend my best wishes to Mr Ciampi and Mr Dini as they prepare to perform their tasks in promoting the social advancement of Italy.

The world economy

Exchange rates and interest rates

The exchange rate gyrations following the crisis in Mexico, which had affected the dollar and all the other leading currencies in the first few months of 1995 and contributed to the sharp depreciation of the lira, have now completely abated. The return to orderly conditions is attributable to appropriate monetary and fiscal policies applied within the framework of international cooperation and to more considered assessments by the markets.

In the current situation of global markets and complete freedom of capital flows, instability tends to spread rapidly, causes movements in exchange rates and interest rates that are not always justified by economic performance and has adverse repercussions on investment and growth.

In April 1995 the depreciation of the US dollar by comparison with its level of the preceding December had reached 10 per cent in nominal effective terms; the Canadian dollar, the pound sterling and the lira had also weakened sharply.

The value of the yen had risen by almost 20 per cent; the German mark and the currencies linked to it had also appreciated considerably.

The fall in the value of the lira came several weeks before the movements in other currencies; by the end of February our currency had already depreciated by 7 per cent, despite intervention by the Bank of Italy; conversely, the mark had appreciated by almost 4 per cent. By the middle of March the depreciation of the lira had increased to 15 per cent.

Between February and March there began an exceptionally large and intense flow of capital from the weak currencies into the yen, the mark and the Swiss franc.

The volume of cross-border deposits, which are held largely by banks, increased substantially. After growing by 14 per cent in 1994, they rose sharply in the first three months of 1995 and did not come down again when exchange market tension subsided.

The aggressively expansionary monetary policy stance adopted in Japan from the end of April onwards reduced the appreciation of the yen. Measures were introduced in the summer to encourage investment abroad. The Bank of Japan made massive purchases of dollars and in September reduced the discount rate to 0.5 per cent. The direction of the capital flows that had caused the rapid appreciation of the yen was reversed and an exchange rate adjustment began. At the end of 1995 the value of the yen was 6 per cent lower than a year earlier.

The easing of monetary conditions was less pronounced in Germany; at the end of the year the mark still showed an effective appreciation of 3 per cent. The French franc and the other currencies linked to the mark within the European Monetary System showed a similar trend.

The $50 billion in financial assistance extended to Mexico at the beginning of 1995 by the International Monetary Fund and the US Administration with the support of the other Group of Ten countries contributed to the restoration of more orderly conditions.

The exchange rate of the dollar steadily improved during the second half of the year.

In Italy, the measures to bring the budget deficit down to the planned level, the agreement on reform of the pension system and two increases in the discount rate in February and May altered expectations and laid the foundations for a recovery of the lira. By December the exchange rate had returned to a level similar to that of a year earlier.

Intervention to support the lira had virtually ceased after the crisis in September 1992. It was resumed with determination in March during the period of greatest difficulty for our currency. In the changed economic policy environment, the markets responded positively to the signal from the central bank; the downward trend in the exchange rate was reversed, and the lira began to appreciate.

The very large interventions to support the dollar, which were coordinated among the central banks of the leading countries, contributed to the restoration of more appropriate exchange rates from the summer onwards.

The improvement in the exchange rate of the lira in the second half of the year proceeded in close parallel with the recovery of the dollar. In April and May of this year the lira appreciated further, in connection with substantial inflows of capital.

At present the dollar is worth slightly more than in December 1994, the mark has returned to the level recorded at the end of that year and the yen has fallen by 22 per cent from the peak reached a year ago and is 8 per cent below its level at the end of 1994.

In recent years, and particularly in the first few months of 1995, large exchange rate fluctuations have been accompanied by similar movements in securities prices, especially in countries with weak currencies.

The yield differential between Italian long-term government securities and corresponding US and German paper rose to 660 basis points in March.

The variations in the prices of securities traded on international and national markets gave rise to massive movements of funds seeking short-term gains, which amplified the price fluctuations.

Although subject to wide price variations, the market in Italian government securities continued to operate normally, thanks to its depth.

The more fragile financial systems were destabilized. The crisis in Mexico threatened to spill over to other countries in Latin America and South-East Asia that had previously experienced extremely large capital inflows.

At their meeting in Toronto in February 1995, the Finance Ministers and central bank Governors of the seven leading industrial countries expressed their determination to seek solutions to the new problems posed by liquidity crises of sovereign debtors.

In Halifax in June the Heads of State and Government laid down guidelines for the establishment of procedures to limit the spread of the destabilizing effects of crises and to achieve a better understanding of the associated problems of banking and market supervision.

Over the year as a whole, the monetary policy stance was tightened in the countries whose currencies had suffered a steady and, in some cases, rapid depreciation. In the countries with more stable currencies, the easing of monetary conditions was gradual, except in Japan.

Long-term interest rates remained high despite low inflation, presumably owing to pronounced uncertainty and fundamental disequilibria in some parts of the public finances, especially pensions.

Had the central banks induced a universal reduction in short-term interest rates, they would have risked intensifying inflation expectations; such action would have had a positive initial impact, but it might then have led to even higher market rates, and not only in nominal terms.

The prudent approach of the monetary authorities in the leading countries is rooted in awareness of these risks and the still uncertain prospects for a durable reduction in budget deficits.

The ratio of public debt to output is increasing in the majority of the industrial countries. In the United States, despite major differences regarding the measures to be taken, the two main political parties agree on the need to balance the federal budget early in the next decade. It can be assumed that the level of real long-term interest rates in that country is responding positively not only to the size and liquidity of the financial market but also to the fundamental consensus on the adjustment of the public finances.

The turbulence in the foreign exchange and securities markets was not conducive to holding down the cost of capital. Nor did the large inflows of capital into some emerging economies benefit investment; the rapidity with which the funds were subsequently withdrawn was often a cause of instability.

In all the leading countries, the current level of real yields on long-term securities is significantly higher than the most optimistic forecasts of economic growth.

A reduction in long-term rates hinges on the credible prospect of a consolidation of the public finances; more generally, it requires nationally and internationally coordinated fiscal, monetary, incomes and structural policies that eliminate any expectation of a resurgence in inflation and provide the markets with certainty.

The business cycle and growth

The economic recovery in 1994 was especially rapid in Italy and the other countries of continental Europe. In the latter the expansion petered out during 1995, and activity entered a period of stagnation, if not recession. Growth lasted longer in Italy, persisting until the third quarter of last year.

If the hoped-for upturn that is forecast for the second half of 1996 fails to develop fully, the expansionary phase of the cycle in Europe will have been of modest strength and, above all, of limited duration.

In the United States, where the expansion has been under way for longer, the pace of growth has come back into line with that of productive potential.

Growth has been checked in the countries whose currencies have appreciated the most. In Japan the recovery did not begin until late 1995, after the yen had weakened. In Germany economic conditions have been affected by the pronounced appreciation of the mark and high real long-term interest rates; other major European economies remain competitive, but here too unemployment is still widespread.

The countries whose currencies suffered a sharp, albeit temporary, depreciation have had to contend with inflationary pressures.

Consumption has remained weak, particularly in Europe, reflecting the modest recovery in employment, the limited growth in labour incomes and the restrictive stance of budgetary policies.

Profit margins have reached historically high levels in all the European countries. Notwithstanding the ample resources available for self-financing, investment appears to be flagging everywhere.

The creeping crisis of confidence in some of the leading European economies is casting a shadow over the prospects for growth.

The weakness of the recovery in Europe is part and parcel of a generalized slowdown in activity in the industrial economies: in the nineties their output has risen by an average of less than 2 per cent a year. Growth rates in the emerging countries are at least three times higher; they are especially rapid in some areas of Asia.

The competitiveness of these countries' exports is due to their increasing capacity to combine the use of advanced technology with very low labour costs. Ultimately, it rests on the low standard of living of their population. In a context of global markets, it poses a challenge to the industrial economies to which they must respond, otherwise their growth and employment will decline further.

In recent years the advances in transport and communications, the liberalization of trade and capital movements and the sustained flow of direct investment from the industrial economies have enhanced the developing countries' ability to expand their shares of our markets.

At the same time, these countries support productive activity in the more advanced economies through their demand for industrial goods that they are not yet able to produce in sufficient quantity.

In Europe several important branches of industry and the food and agricultural sector still enjoy the protection of customs barriers that have ensured their viability; the incomes of their workers have been supported, but to the detriment of the cost of living. These forms of protection are destined to disappear.

The structural response of the more affluent economies will have to include product and technological innovation, new ways of organizing production and the development of advanced services.

To strengthen the competitiveness of the industrial countries, it is necessary to limit the relative size of the public sector, which ultimately impinges on firms' labour costs and activity and is thus reflected in the prices of the goods they produce and export.

It is necessary to reconsider the nature and objectives of public intervention in the economy, the boundary between the public and private spheres.

The welfare state was born and developed in Europe; it is an integral part of our culture, one of its basic social values. The defence of the welfare state calls for a reformulation of the criteria governing entitlement to benefits and their size and nature; most of them were established in the post-war years, at a time when economic expansion was rapid, the population young and growth expectations more favourable than they are now.

The equilibrium of public pension systems is becoming a pressing problem everywhere. Expenditure on health services is tending to rise more rapidly than national income, owing mainly to the ageing of the population.

Fully-funded private pension plans that can supplement the benefits provided by public pay-as-you-go schemes are still in their infancy in several countries. The changes to health care systems have only limited the rise in the ratio of health spending to output.

Measures to reduce budget deficits can adversely affect demand and output in the short run. If they form part of a programme of structural adjustment, their repercussions will be more than offset by the positive effects of increased credibility. A consistent, sustained effort will build confidence, stabilize the financial markets and foster economic growth. The short-term impact on demand can be countered by means of long-term measures, including both tangible and intangible investment, to boost the productivity of national economies.

A reshaping of the role of the public sector, wage restraint and greater flexibility for the development of public and private investment require a high degree of political and social cohesion.

International monetary equilibrium

The exchange rate crisis of 1995 confirmed that the equilibrium of financial markets is precarious in a system with fiat currencies, highly mobile capital and economic policies that are not infrequently divergent.

Freedom of movement of capital has increased the opportunities for raising funds; it contributes to more efficient resource allocation worldwide.

Large and persistent disequilibria between the formation and use of savings, between the public and private sectors and between the balance-of-payments positions of the major countries are generating massive transfers of funds seeking higher returns.

Cross-border deposits currently amount to around $8 trillion, more than the GDP of the United States and one and a half times the value of world merchandise exports. Their growth is beyond the direct control of the central banks; their velocity of circulation is considerably increased by the use of derivative instruments.

The problems relating to the stability of financial institutions and markets are being analyzed and confronted by the Basle Committee on Banking Supervision. Risk prevention is based on the definition, application and wider use of prudential measures and supervision; it is pursued by promoting rigorous self-regulation. In this field there is growing cooperation among the authorities responsible for supervising the banking, securities and insurance industries.

The absence of an anchor, a centre of gravity at the international level, deprives markets of a secure point of reference and exposes the system to exchange and interest rate instability and inflationary risks.

The key to stability at the international as well as the domestic level lies in the pursuit of orderly conditions in the formation and utilization of resources within each country and in the establishment of a more direct link between money and the real economy.

The construction of a unified monetary area in Europe can contribute to the creation of a sounder world monetary and financial order. The project is based on compliance with essential parameters of economic performance, first and foremost limits on budget deficits and public debt.

Realization of the project is hindered by the difficult economic situation, which makes it harder for many countries to adhere to the limit for budget deficits.

The balance-of-payments disequilibria of the leading economies are tending to alter relationships between currencies, and they may generate exchange rate tensions within Europe as well.

Italy is endeavouring to meet the conditions for participating in the creation of the single currency; they are valid in themselves and are indispensable for stable growth of the economy.

The return to monetary stability and lower interest rates, which will alleviate the public debt and promote growth, can be brought about only by pursuing fiscal, incomes and monetary policies that reinforce Italy's convergence with the more stable economies.

This is the contribution that Italy can and must make to the development of the economies and markets in Europe and throughout the world.

The Italian economy

The balance of payments and the external position

The current account of the balance of payments showed a surplus of 45 trillion lire in 1995, or 2.5 per cent of gross domestic product.

Italy's net external debt fell to 84 trillion lire at the end of last year, equal to less than 5 per cent of GDP; three years earlier it had stood at 164 trillion lire, or 11 per cent.

After a strong expansion in the previous two years, exports increased by 12 per cent at constant prices and continued to stimulate aggregate demand and output. The prices of export products rose significantly faster than costs; this contributed to the formation of large profits in manufacturing industry.

Imports grew by 10 per cent in volume; an increase of 12 per cent in their lira prices had a considerable impact on costs and inflation.

Exports are now equivalent to a quarter of Italy's gross domestic product, whereas by the end of 1992 they had declined to less than a fifth. Over the last three years they have benefited from the depreciation of the lira and the stability of unit labour costs.

The competitiveness of Italian goods, measured in terms of producer prices, was 19 per cent higher in 1993 than in the first half of 1992.

After a modest further improvement in 1994, competitiveness increased by another 13 points in early 1995. By May of this year it had declined again to just below the average for 1993 owing to the recovery of the lira.

The gain in competitiveness remains particularly large when measured in terms of unit labour costs; on this basis, it is still 5 per cent with respect to the average for 1993.

Sustainable growth in Italy's foreign trade requires that costs and prices be stabilized and the adjustment of the public finances continued.

Italy's good export performance and the improvement in the trade balance in the last three years have benefited from the growth in demand from non-European countries. More than 50 per cent of our exports go to the countries of the European Union; the slowdown in these economies is now affecting sales of Italian products abroad.

Import growth will also be weaker in 1996; the current account surplus will remain large, again amounting to about 2.5 per cent of GDP.

Italy's net external position will approach balance.

Since the complete liberalization of capital movements in the early nineties, the volume of cross-border financial transactions has grown rapidly. In December 1995 the country's external assets and liabilities both stood at about 50 per cent of GDP; the comparable ratios in France and Germany were about 90 and 70 per cent respectively.

Between 1992 and 1995 non-residents' holdings of Italian government securities and other forms of external public debt increased from 100 to 300 trillion lire.

The supply of foreign currency stemming from the current account surplus and from capital inflows was taken up by investors and firms to increase their external assets and reduce their liabilities. Households' net foreign assets exceeded 150 trillion lire; firms and other non-financial operators have moved from net external liabilities of 170 trillion lire in December 1992 to net assets of some 20 trillion.

Since the spring of 1995 capital outflows have been more than offset by the surplus on current account.

The improvement in the overall external financial balance and the net asset position of the private sector eased the pressure of demand for foreign currency and laid the basis for the strengthening of the lira.

Cyclical performance and economic development

In 1995 the Italian economy grew by 3 per cent, a faster rate than in the other industrial countries.

After contracting in 1993, economic activity had expanded vigorously in 1994, led by exports and investment. Output continued to increase strongly until the third quarter of 1995.

Over the last two years the growth of consumption has been modest, and distinctly slower than that of output.

Exports triggered a rapid and sustained increase in investment expenditure involving all branches of manufacturing and all types of enterprise.

After falling sharply in 1993, investment in plant and machinery grew by 7 per cent in 1994; it increased by a further 11 per cent in 1995. In the construction industry the contraction continued until mid-year; signs of recovery then began to emerge.

The introduction of a temporary tax incentive in mid-1994 gave additional impetus to corporate investment, partly by encouraging firms to bring forward the implementation of projects; in many industrial companies, expenditure was higher than originally planned. A large proportion of investment was directed to expanding productive capacity.

The depreciation of the lira and the growth in demand contributed to a redistribution of income in favour of profits. In 1994 the gross disposable income of households increased by 3.6 per cent and that of enterprises by more than 30 per cent. The shift in income distribution continued in 1995, with the two aggregates increasing by 6 and 20 per cent respectively.

Profit margins are now close to the historic highs recorded in the fifties, when the growth in investment and output was exceptionally rapid and prices stable. The widening of profit margins reflects price rises far in excess of the increase in unit costs.

The prospects for growth remain good in the United States, Japan and the United Kingdom. The sluggishness of the continental European economies is now affecting activity in Italy. Output began to decline at the end of 1995 and contracted by a further 2 per cent in the first quarter of 1996.

Even allowing for a rapid recovery in the second half of the year, economic growth in 1996 as a whole is unlikely to reach half the rate recorded in 1995.

A decline in inflation that enhances households' purchasing power and consumer demand could open up the prospect of steadier growth and have a positive effect on investment.

The expansion of activity, which has primarily involved manufacturing industry and the export sector, has not spread to the South; Italy's economic dualism has been accentuated.

Output in the South is barely above the level of 1991, whereas in the North and Centre it has increased by 6 per cent over the same period.

The unemployment rate in the North and Centre is 7.8 per cent, below the average for the European Union.

In large parts of the country, job creation has been boosted by small and medium-sized enterprises characterized by productive creativity, an ability to identify market outlets and flexibility in the organization of labour. The willingness of employees to vary their working hours according to the needs of the firm constitutes a form of worker participation in the fortunes of the enterprise.

In the South the unemployment rate has reached 22 per cent; the number of young people seeking their first job and that of the long-term unemployed have risen further.

The public, productive and social infrastructure of the South is inadequate; some large industrial plants recently established in the area are suffering the consequences.

The termination of the special development programme for Southern Italy has left a vacuum of central and local government initiatives.

Not until last year were procedures instituted to speed up the utilization of funds provided by the European Union for the period from 1994 to 1999, which total ECU 15 billion, or about 30 trillion lire. New investment assistance mechanisms have been activated.

Large and small industrial groups have shown renewed interest in locating factories in the less developed parts of the country. These regions have a reservoir of capable young workers; thanks to the constructive attitude of the national trade unions, they are prepared to accept employment conditions that take due account of external diseconomies.

If the southern economy is to be guided onto a path of stable growth, market forces and private initiative must be flanked by official action to alter the external factors, provide essential public services and, above all, ensure the conditions for orderly civic life.

A decisive qualitative improvement must be made in the *modus operandi* of central and local government. In order to make use of grants from the European Union and loans from international institutions, it is important to restore an ability to plan and execute both large public works and smaller projects.

Countercyclical measures are necessarily geared to the performance of the economy as a whole, which principally reflects developments in the more prosperous regions. A reduction in inflation and a recovery in domestic consumption will bring especially large benefits in the South. A strengthening of the economy of these regions could promote cyclical stability in the North and Centre, thus fostering the growth of the Italian economy as a whole.

The stagnation in output, the weakness of consumption and the crisis in the construction industry are at the root of the difficulties afflicting banks in the South. For some credit institutions, the problems of poor organizational efficiency and high costs have been compounded by a decline in activity in the economic sectors where lending is concentrated.

The measures that have been enacted and the restructuring programmes undertaken are designed to safeguard the value of depositors' savings, create the conditions for a more efficient banking system and prevent the difficulties of these institutions from having further severe repercussions on an already debilitated economy.

Monetary policy and prices

The annualized monthly rate of increase in consumer prices reached a cyclical low of 3 per cent in the middle of 1994.

The possibility of a rekindling of inflation was signaled in June of that year by the rise in the yields on longer-term securities and at the end of July by the expectations revealed in business opinion surveys and by assessments of cyclical conditions. The budget deficit was tending to exceed the objectives. Demand was rising rapidly.

Monetary policy began to take on the restrictive stance that still prevails today. Monetary base creation was curbed; short-term market interest rates began to rise as early as the middle of 1994.

The official discount rate was raised from 7 to 7.5 per cent in August 1994 in order to counter the deterioration in expectations and the intensification of inflationary pressures.

Concern that the budget deficit would overshoot the target for the year increased in subsequent months. The yield on ten-year government securities rose above 12 per cent, the differential with respect to securities denominated in marks widened and inflation expectations deteriorated further.

At the beginning of 1995 the political situation prevented the prompt adoption of measures to correct the imbalances. Towards the end of February the Bank decided to raise the discount rate by a further 0.75 percentage points and the rate on fixed-term advances by 1.25 points. The new Government introduced a substantial package of fiscal measures.

The lira weakened under the influence of the turbulence in foreign exchange markets and the political difficulties at home; inflation accelerated; the increase in indirect tax rates pushed up prices; yields on ten-year government securities rose to nearly 14 per cent.

At the beginning of May the situation in the securities market improved and the lira strengthened, but inflation remained high; expectations deteriorated; market participants and commentators came increasingly to doubt that inflation would slow down in the second half of the year.

Towards the end of the month the Bank decided to tighten monetary conditions further: both the official rates were raised by 0.75 percentage points, to 9 and 10.5 per cent. At last year's Annual Meeting I suggested that there was a possibility of inflation easing before the end of the summer. I announced the Bank's determination to bring the rate below 4 per cent in

1996, thus essentially confirming the target of 3.5 per cent indicated by the Government.

The tightening of monetary and budgetary policy, the halt in the depreciation of the lira and its subsequent recovery reversed the trend of expectations. Securities prices rose; inflation slowed during the summer to an annualized monthly rate of around 4.5 per cent.

During the autumn inflation accelerated again; the Bank considered the desirability of raising official rates again, but was dissuaded from doing so by the steady improvement in expectations signaled by the performance of the exchange rate and long-term interest rates.

In the last few months of 1995, and to an even greater extent in the early months of this year, the maintenance of a wide differential between short-term lira and mark interest rates fostered a decline in long-term rates.

By the end of last year the yield on ten-year government securities had fallen to 10.9 per cent; by May of this year it had declined to 9.7 per cent, with future benefits for interest payments. The differential with respect to comparable German securities, which had risen to 660 basis points in March 1995, had fallen to 480 by the end of the year and yesterday stood at 310. This indicates that the markets expect the inflation differential with Germany to remain on the order of 3 percentage points over the medium term.

The exchange rate of the lira has risen steadily since the autumn.

The underlying conditions in the economy are consistent with a decline in the rate of increase in prices. However, the observed rate of inflation is proving slow to reflect the improvement.

In April and May the monthly rate of increase in consumer prices exceeded 4 per cent on an annual basis, even when random factors are excluded.

Monetary policy continues to be geared to curbing inflation.

In 1997 and subsequent years the rate of increase in prices will have to be close to those in the other leading industrial countries and less than 3 per cent.

This objective calls for consistent budgetary and incomes policies.

Italy's manufacturers and distributors display an inflationary bias when setting producer and retail prices. In many cases this reflects inadequate competition.

Firms' prices and profit margins rise rapidly at times of strong demand and depreciation of the lira; in contrast with other countries, they are resistant to downward movements even when there is a pronounced weakening of demand and a recovery of the exchange rate. The factors that had caused a resurgence of inflation in the spring of last year no longer apply or have changed sign.

Aggregate demand is being weakened primarily by the erosion of consumers' purchasing power and the uncertain outlook for incomes.

This vicious circle, which tends to spread to employment and investment, can and must be broken by halting inflation and, as in other countries, by widespread price reductions.

The public finances and the return to growth

The scale of government debt, the inefficiency of public services and the complexity of the tax system diminish Italy's chances of returning to a path of stable growth.

The size to which the debt has grown drives up interest rates, impedes capital formation, hampers the conduct of monetary policy and exposes the country to the risk of instability arising from turbulence in international markets.

The equilibrium of the financial system and the sustainability of the public debt have been ensured so far by the high level of households' saving.

Various factors, especially those of a demographic nature, are tending to reduce the propensity to save.

On the other hand, there is a growing need to boost investment so as to increase the competitiveness of the economy and permit employment to grow.

Participation in the process of European integration requires a reduction in the public debt; in the immediate future it calls for a decisive curtailment of the borrowing requirement; subsequently it may be necessary to achieve budget surpluses.

Between 1994 and 1995 the ratio of the state sector borrowing requirement to gross domestic product fell from 9.5 to 7.4 per cent and the public debt began to decline in relation to GDP.

This good result is to be attributed in the first instance to the approach adopted in the Finance Law for 1995.

In October 1994 I had pointed out that the target set for the budget deficit would be exceeded by around 1 per cent of GDP owing to the trend in interest payments.

The budgetary adjustment of around 1.2 per cent of GDP introduced by the new Government in February 1995 more than offset the foreseeable overshoot.

The growth in real incomes and the level of inflation, both of which were higher than expected, contributed to the improvement.

The Finance Law for 1996 reaffirmed the objective set in the Economic and Financial Planning Document for 1996-98 of reducing the state sector borrowing requirement to 110 trillion lire, or just under 6 per cent of GDP. It was decided to make adjustments amounting to 32.5 trillion lire, based to a large extent on cuts in transfer payments to public bodies with autonomous spending powers.

Invited by Parliament to present the Bank's assessment of the budget for 1996, I pointed out a number of weaknesses in the corrective measures.

The results for the first few months of this year confirm the Bank's evaluation. Expenditure has risen more rapidly than expected and revenue has been affected by the slowdown in economic activity.

It now appears that the target for the borrowing requirement may be exceeded by more than 1 per cent of GDP; in order to keep the budget deficit on course, it will be necessary to make a larger adjustment than originally envisaged.

The new Economic and Financial Planning Document must set the objectives for the three years from 1997 to 1999. In presenting the Government's programme, the Prime Minister confirmed the objective of reducing the budget deficit to less than 3 per cent of GDP by 1998.

Demanding but credible objectives for this year and next are a necessary condition for the equilibrium of the financial markets and further reductions in interest rates.

The action that must be taken in the short run must be set within a longer-term framework ensuring consistency over time, with which future budgets will also have to conform.

For any given level of the budget deficit, expenditure cuts are more effective in countering the fall in the saving rate. In some fields public intervention can be replaced by private initiative.

On the revenue side it appears essential to reduce the complexity of fiscal obligations and intensify action by the public administration to counter evasion.

The revival of public investment will have only a limited impact on the deficit if it is financed partly by the private sector and use is made of the funds allocated by the European Union for depressed areas.

Imbalances in the public finances cloud the prospects for all the industrial countries; many began to take corrective measures several years ago. The action to restore sound public finances must continue. It is a prerequisite for increasing the efficiency of the economy and meeting the need to make better use of Italy's resources.

Finance and banking

The financial markets

The Italian financial system is undergoing sweeping changes.

A substantial and increasing portion of residents' financial wealth is invested abroad: at the end of last year it amounted to 11 per cent of total assets. As a counterweight, a large volume of foreign savings needs to be invested for the long term in Italy.

The markets are moving towards a situation in which they will be predominantly private-law self-regulating organizations; they will be accessible to all types of operator, both Italian and foreign. Italian intermediaries, and the banks in particular, must improve the operation of market mechanisms and offer a wider range of services.

The Italian market in government securities has achieved a level of efficiency comparable to that found in the other leading industrial countries. Even at times of greatest difficulty, as in the second half of 1992 or the first quarter of last year, trading was orderly and price variations swiftly led to a matching of demand and supply, thereby ensuring continuity of transactions. A deep and liquid market is essential for the proper management and protection of the substantial portion of national savings invested in it.

Private finance has made considerable progress in recent years; nonetheless, the stock exchange is still small and the bond market underdeveloped.

Total bank bonds in circulation amount to 215 trillion lire, only a small proportion of which are listed on official markets; corporate bonds total 27 trillion lire. Savers are investing increasingly in lira bonds issued by foreign companies and banks and by international organizations; securities of this kind worth a total of 12 trillion lire were sold in Italy in 1995, a substantial increase over previous years.

Market efficiency and liquidity are achieved by listing bonds and standardizing their features. For banks, bonds can provide an increasingly large share of resources. In the case of corporate securities, creditworthiness must be assessed by rating agencies.

In relation to GDP, the volume of equity capital raised through the issue of shares has been higher in Italy than in the other leading industrial economies since the beginning of the eighties.

Italy has a multitude of profitable enterprises that are in continual transformation and have growth potential. The stock exchange should be the vehicle for assessing industrial and financial strategies, placing substantial portions of the capital of privatized public enterprises and allocating ownership efficiently.

There are signs that major enterprises are preparing to open up their ownership structures. Dynamic medium-sized firms are enlisting the aid of financial institutions to raise capital from the public.

More effective forms of corporate governance and control are needed, together with full protection of the interests of minority shareholders and wide disclosure of information, along the lines envisaged in the powers granted to the Government to amend the legislation on listed companies.

The tax system should be rendered more neutral in its treatment of different forms of corporate fund-raising in order to facilitate firms' recourse to the stock exchange. It should not impede share trading, and it should encourage companies to seek listing.

The widening and diversification of companies' shareholder bases calls for the resources and expertise of institutional investors and specialized intermediaries. The banks' contribution should consist initially in broadening their lending function, with a view subsequently to bringing enterprises to market.

Until now, the banks have invested in industrial shares mainly for the purpose of restructuring borrowers in financial difficulty; between 1993 and 1995 they acquired participations worth approximately 4 trillion lire, a large portion of which were later sold in the market.

The law of 7 March 1996 introduced new penalties for usury, the main victims of which are households and small retail and artisan businesses. It is often the means whereby organized crime gains a foothold in the productive sector. The problem is one of public order.

The specification of usurious rates of interest for different types of loan is intended to fix an objective yardstick for identifying illicit money-lending. The predetermined limits and their application to regulated intermediaries as well could have the effect of increasing interest rates on small loans and lead to a rationing of credit to marginal weaker customers.

The banks, and particularly local and cooperative banks, are endeavouring to pay more attention to the needs of smaller businesses in order to encourage them to carry out proper financial planning.

Usury cannot be prevented without more widespread awareness of the dangers of borrowing from unauthorized lenders and education in the responsible use of money.

The banks

In the last three years the net profits of Italian banks have fallen to 2 per cent of their capital and reserves, compared with 10 per cent between 1983 and 1992. The sharp decline in net interest income has not been matched by a sufficiently large reduction in operating costs.

The effective rate of taxation of bank profits, which was already high compared with that of non-financial companies and foreign banks, has increased. The new rules on the value adjustment of loans will reduce their overall tax liability.

In recent years the banking systems of the leading industrial countries have suffered crises and undergone fundamental reorganization.

In France and Spain it was necessary to tackle difficulties at major institutions. In Japan the fall in real estate values and the emergence of non-performing loans equivalent to around 8 per cent of GNP gave rise to severe and widespread instability. In the United States, following the crisis among savings and loan associations, the banks recovered their high profitability during the long period of economic expansion.

Overcoming the difficulties has required restructuring and organizational changes to increase productivity and reduce costs. Large injections of public funds have been necessary.

The Italian banking system has been exposed to the forces of change for some time. Administrative constraints that once hindered competition have been removed, and it has increased steadily in the savings market. Banking activities and the supply of services are increasingly open to international competition.

The spread between the average rate of return on lira loans and the average cost of funds has narrowed from 7.6 to 5.8 percentage points since the mid-eighties.

Competition has led to significant changes in the control of banks. In the last ten years there have been 177 mergers and acquisitions of control, excluding those involving minor banks. In terms of total assets, more than a fifth of the system has passed into new ownership. The supply of banking services is becoming less fragmented; the increase in the size of banks is enhancing their competitiveness by raising efficiency.

As the guarantor of competition in the banking sector, the Bank of Italy has scrutinized concentrations to ensure that they do not restrict competition in local markets. The Competition Authority has concurred with the Bank's decisions.

Banking stability is a public good of supreme importance. Deposits have always enjoyed protection in Italy.

The major changes under way at the international level and the increase in competition require that Italian banks review some of their organizational structures, develop new products, enhance the human capital on which their competitiveness ultimately depends and take vigorous action to reduce costs.

Between 1983 and 1992 average staff costs rose at a real annual rate of 2.1 per cent, while the number of employees increased at a rate of 1 per cent.

The banks have taken cost-cutting measures which have been facilitated, as far as staff costs are concerned, by the agreement on incomes policy reached in 1993. Between 1993 and 1995 the number of employees remained virtually unchanged; expenditure on staff fell at an annual rate of 0.9 per cent in real terms.

Labour costs remain higher than in other sectors and higher than in banking in other countries. Greater use must be made of flexible arrangements that reinforce the correlation between pay and company performance measured in terms of income and productivity.

There is an urgent need for banks engaged in the difficult task of restoring their profitability to take the necessary measures to reduce excessive staff levels and staff costs per employee.

The reorganization of the banking system will benefit from the privatization of public sector banks.

The prime objective of transforming public sector banks into joint stock companies was to nurture a profit-oriented culture and strengthen capital bases through recourse to the capital market.

The deterioration in bank balance sheets and the downturn in the stock market have forced the postponement of privatization in a number of cases; in others, the shareholding bodies do not consider it expedient to dispose of their holdings at current prices.

Privatization must continue resolutely, with disposals being appropriately timed to take account of differences in the profitability of banks and the development of market transparency and liquidity. It must be able to attract a steady flow of domestic savings and international investment. The disposal of public sector holdings must provide an opportunity to raise new capital in order to strengthen the banks' capital bases.

Privatization procedures must ensure that the controlling shareholders are identifiable; acquisitions founded solely on borrowed funds make this unclear. Stability in the management of banks must be safeguarded.

These goals can be achieved by reorganizing ownership to combine a broader base of small shareholders with a small group of investors who share responsibility for monitoring strategies. The banking foundations can play a useful role in identifying potential shareholders among institutional investors and non-financial companies.

Between 1992 and 1995 the stagnation of economic activity coincided with a reduction in state transfer payments to the South, including funds for previously approved projects, and with the halt in activity in the construction and public works sector. During that period, about 900 of the 4,800 companies in the South on which the Company Accounts Data Service held information were unable to meet their obligations to the banks. Many sole proprietorships collapsed, especially those operating in the services and construction sectors.

In December 1995 banks based in the South had bad loans equal to 23 per cent of their lending to southern customers; the proportion was 17 per cent for loans granted by banks from other areas of the country, more than twice the level for their lending in the North and Centre.

Average lending rates on loans to southern customers are currently more than 2 percentage points higher than those in the North and Centre.

However, if the amount needed to cover loan losses is deducted, there has been no regional difference for several years. The average cost of funds has been much the same in the different areas of the country for even longer.

At the end of 1995 banks based in the South had outstanding loans of 161 trillion lire, equal to 13 per cent of the total. Loan losses for the year amounted to 5.4 trillion. Eight banks had capital below the supervisory minimum; after taking account of capital injections already approved by the Treasury and local authorities, the overall shortfall amounts to 2.4 trillion lire. Conversely, 263 southern banks have excess capital totaling 6.3 trillion lire.

The activity of the supervisory authorities, which is already intense in the South, has been made even more demanding by the deterioration in economic conditions in the area.

Of the 318 southern banks operating in 1991, 264 were inspected between 1992 and 1995; they accounted for 90 per cent of total lending by southern banks.

On the basis of the inspection findings, banks were invited to rationalize their domestic and foreign networks, reorganize their internal procedures, strengthen their capital bases and, in some cases, make changes in their governing bodies.

The reorganization of the banking system in the South first requires that operating costs be reduced, especially staff costs, which are higher in proportion to total assets than for banks in the North and Centre. Operational efficiency and staff expertise must be increased. The public sector can participate in reorganizations when it is necessary to safeguard the primary role of banks in serving the economy, on condition that restructuring programmes are formulated and responsibility for implementing them is entrusted to capable managers. The prospect of recovery will attract private capital and pave the way for the subsequent sale of the bank.

Economic growth requires an efficient banking system, and vice versa.

Southern Italy is still a rich source of the raw material of banking, namely savings. The banks find it difficult to invest in profitable local ventures. Many banks from economically and financially stronger regions lend a larger proportion of their deposits from the South to borrowers in that area than do the southern banks themselves. This demonstrates that they have identified potential for developing business in southern credit markets and have confidence in the growth of the economy. Their capital and the experience they have gained in dealings with small and medium-sized firms can help foster the development of enterprises in the South.

Fourteen months ago, at the end of March 1995, one German mark was worth 1,237 lire and the yield on ten-year Italian government bonds was 13.5 per cent. Yesterday the mark stood at 1,014 lire and government bonds yielded 9.5 per cent.

The depreciation of the lira and the fall in the prices of government securities were triggered by the conditions prevailing in the world economy, but they were exacerbated by the state of Italy's public finances and by political difficulties at home.

The crisis was overcome thanks to budgetary adjustments, wage restraint and a monetary policy that reduced inflation and stabilized the markets.

The recovery in the exchange rate, which was unprecedented in the recent history of our country, is an indicator of renewed and enhanced confidence in our currency on the part of the international community and markets.

In other major countries that have experienced currency appreciation, the improvement in the exchange rate has been followed by domestic price stability. This effect has proved slow to materialize in Italy.

The path towards a resumption of growth lies in continuing the consolidation of the public finances and curbing inflation. The development of the country, in social as well as economic terms, requires that the unemployed be integrated into productive activities.

Unemployment is concentrated in the South, an area which has a large labour force, especially young people, but is deficient in economic and social infrastructure. The situation calls for investment that raises productivity, labour costs that enhance competitiveness, and full involvement on the part of the state.

The challenge facing our economy is of great moment; it also involves the financial system and the banks. In the next few years the banks must radically alter their *modus operandi,* reduce their costs and place themselves at the service of a growing economy.

The action to consolidate the public finances must be continued with determination. It is necessary in order to reduce the ratio of public debt to GDP, foster a decline in interest rates and create room for investment.

Wage and salary earners have made a decisive contribution to economic stability over the last three years. Profits benefit the economy insofar as they enhance competitiveness and strengthen the industrial base. Continued growth in profits should be achieved not by increasing profit margins but by expanding production.

Money is the focal point of both the strengths and the weaknesses of the country's economy, society and institutions.

To defend the currency is ultimately to defend the wealth and income of the nation.

Monetary stability will enable the Italian economy and Italy to return fully to their rightful place in the international community and in Europe.

In the management of the currency and in the supervision of the banks, we remain resolute in our pursuit of monetary stability, in the conviction that it safeguards prosperity, orderly social relations and participation by all members of society, and especially young people, in the fruits of economic progress.