BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 30 MAY 1998

THE GOVERNOR'S CONCLUDING REMARKS

Ladies and Gentlemen,

At the beginning of this month a historic political decision was taken in the process of economic and monetary integration within the European Union: the decision to move to a single currency in eleven of the fifteen member states of the Union.

From 1 January 1999 onwards the central banks of the eleven countries and the European Central Bank will consolidate their accounts for the purposes of monetary policy. A single interest rate will be applied to operations; the liabilities of the various central banks, redenominated in euros, will be interchangeable without limit.

The Extraordinary General Meeting of Shareholders of the Bank of Italy held in March approved amendments to the Bank's Statute in order to make it consistent with that of the European System of Central Banks.

In the Governing Council, the central bank Governors and the Executive Board will assume responsibility for assessing and pursuing the common interests of the euro area. The maintenance of price stability will be the primary objective of the European System of Central Banks.

In accordance with the principle of subsidiarity, operational activities will normally be decentralized. The European Central Bank will intervene directly in the money and foreign exchange markets only in emergencies.

The work that the Bank of Italy is called upon to perform in the fields of economic and legal research and analysis will become more demanding.

The new European framework will not alter the Bank's activities in the supervision of banking and financial intermediaries, the surveillance of markets and the protection of competition in the banking sector. Responsibility for these tasks will remain at the national level; there is increasing awareness of the need for and commitment to international coordination.

In the payments field, the domestic real-time gross settlement system will be integrated with those of the other countries; in collaboration with the European Central Bank, we shall develop more sophisticated and far-reaching surveillance to safeguard the operational effectiveness and security of the system.

The 500,000-lira banknote came into circulation last September; so far, the branches of the Bank have issued around 12,900,000 of these notes, worth 6,453 billion lire. We shall participate in the production of banknotes denominated in euros, which will come into circulation on 1 January 2002 at the end of the transitional period.

In 1997 the Bank drew up its corporate plan aimed at completing the changes that need to be made, increasing the effectiveness of the Bank's actions and enhancing operational efficiency. The first revision of the plan is now under way.

In the data-processing field, important infrastructure and applications projects have been developed, in particular to prepare for the changeover to the single currency and make the adjustments needed to cope with the year 2000. The new Central Credit Register came into operation; the integrated system for distributing financial information is already in use within the Bank; the procedure to enable the Treasury payment offices to handle computerized payment instructions was written.

Work has begun on the revision of the accounting procedures and annual accounts of the Bank; the firm that will be responsible for auditing the accounts has been appointed; integrated procedures are being used for the expenditure verification system; close attention is being paid to the control of costs.

This morning the Board of Directors of the Bank decided that the Services Centre in Frascati, which is at an advanced stage of completion, will be named after Donato Menichella.

On behalf of the Board of Directors and the Directorate, I would once again like to express sincere and warm thanks to all the staff of the Bank, not only for their commitment to the everyday activities of the institution but also for their exceptional efforts in planning and realizing the launch of the European System of Central Banks.

The world economy

Last year saw an acceleration in economic activity in North America and Europe and a drastic slowdown in Japan and the Asian economies. Inflation declined further. World trade grew by 9.6 per cent.

Gross national product in the United States increased by 3.8 per cent and unemployment fell to a very low level. Cost pressures were absent, thanks to productivity gains and the fall in the prices of raw materials;

producer prices declined during the year and consumer price inflation was especially low.

In the European Union output grew by 2.7 per cent, one percentage point more than in 1996. Unemployment remained high and inflation came down further to 1.9 per cent.

In Japan the recovery in growth in 1996 came to a halt; there is now a risk of deflation.

The growth in the US economy and the economic stagnation in Japan exacerbated the trade imbalance between the two countries, leading to substantial transfers of savings and reallocations of funds through the international financial markets.

The crisis in Asia has had a profound effect on confidence and the financial sector in Japan. The consequences for activity in the Western economies have been less serious so far; the outflows of capital from Asia have affected primarily the exchange rate of the dollar and securities prices.

The dollar appreciated by 12 per cent during last year, the yen fluctuated widely and the currencies of the leading European continental countries depreciated by between 2 and 3 per cent.

Efforts continued to be made to reduce budget deficits and halt the growth of the public debt in the major industrial economies.

The countries of continental Europe still have to address the problems caused by the excessive size and the structure of their budgets. The volume, composition and continued growth of current public expenditure and revenue are the ultimate result of social policies formulated and adopted decades ago, when both actual and expected economic growth were more rapid and the age distribution of the population and demographic trends were closer to normal. Those policies are no longer sustainable in the changed context of the world economy and in view of the rapid ageing of the population.

Unemployment in continental Europe has been rising since the mid-eighties; a source of serious individual and social deprivation, it reflects inefficiencies in the allocation of resources within economies, as well as prices, capital costs and labour costs that are incompatible with the creation of jobs. Investment is directed largely towards introducing technologies that will improve competitiveness and reduce the input of labour. The level of effective demand is still inadequate, particularly for capital goods, reflecting uncertainty about future growth.

Monetary developments and interest rates

Monetary policies in the leading industrial countries made a decisive contribution to bringing down inflation during the eighties and early nineties. It has been possible to adopt a more relaxed stance in the last three years.

Long-term interest rates declined, continuing the downward trend that had begun in the spring of 1995 once the disruptive effects of the Mexican crisis on the financial and foreign exchange markets had subsided.

In the United States the years 1992 and 1993, like the last three years, were marked by a declining trend in long-term yields, which spread to all markets. This came to an end when the Federal Reserve began to raise policy rates in early 1994. Long-term rates swiftly increased everywhere, culminating in the Mexican crisis at the beginning of 1995. In the space of a few weeks the dollar lost 7 per cent of its value; the exchange rate of the lira collapsed, the German mark appreciated significantly and the yen rose by 20 per cent. As a consequence of the crisis, yields on government securities exceeded 13 per cent in Italy and reached about 8 per cent in the United States, Germany and France.

During 1997 the fall in long-term rates was about 2 percentage points in Italy, 1.5 points in the United Kingdom and Spain, and less than one point in the United States, Germany and France. In the early months of this year yields stood at just over 5 per cent in Italy and were marginally below 6 per cent in the United Kingdom. In Germany and France they fell to less than 5 per cent; in Japan, where they were already extremely low at the end of 1996, they have declined to around 1.5 per cent in recent weeks.

In the early months of this year short-term interest rates in five of the seven leading industrial countries were the lowest recorded during the eighties and nineties.

The phase of monetary expansion that is still under way in Japan began in the middle of 1995; the lowering of short-term interest rates to nearly zero was accompanied by phenomenal growth in monetary base.

The value of the yen has fallen by almost one third from the peaks reached in March 1995; it is 16 per cent lower than in December 1994.

The Japanese central bank appears to be ensnared in a classic liquidity trap. Interest rates cannot be brought down further, monetary policy is unable to stimulate economic activity, and liquidity is spilling onto the international market.

The weakening of the Japanese yen and the large volume of funds available in Japan at interest rates close to zero have made it easier for banks and international market operators to finance risk positions on foreign exchange and financial instruments. Against a background of low inflation, restrictive fiscal policies and relaxed monetary conditions in the leading countries, this has fostered a general decline in long-term interest rates; the Asian crisis was another contributory factor in the second half of last year, as it generated expectations of a slowdown in the world economy and a shifting of funds towards less risky markets.

The ever-closer parallel movements in bond yields and share prices across countries is increasingly associated with the activities of institutional investors. They handle an enormous volume of funds, raising liquidity in the currencies with the largest markets and the best terms and investing in accordance with expectations regarding exchange rates and risk and yield differentials, thereby transmitting expansionary or restrictive impulses from the key money markets to the global market.

The aggregate balance sheet total of these institutions has grown extremely rapidly in recent years. At the end of last year their total resources amounted to around $28 trillion, almost four times the annual output of the United States and 25 times that of Italy. Public and private sector bonds account for 36 per cent of their total financial assets.

Institutional investors also increased their equity investment last year. Their share portfolios exceeded $10 trillion at the end of 1997, close to the market capitalization of the US stock market and 30 times that of the Italian market.

The Japanese share price index declined by 20 per cent last year, whereas those of the other major industrial countries rose by between 20 and 60 per cent. The rise continued until recent weeks. The earnings/price ratio fell to a level close to the real yields on the most secure bonds; investors appear to consider that the risk is outweighed by expectations of further growth in profits or reductions in interest rates.

The economic cycle and payments disequilibria in the industrial countries. The Asian crisis

Domestic demand in the United States increased by 4.1 per cent in 1997. Investment grew by more than 10 per cent in real terms for the fifth consecutive year. At the same time, non-farm payroll employment again rose, by 2.3 per cent. Labour force participation is extremely high, about 67 per cent of the population of working age. The unemployment rate fell to 4.3 per cent in April 1998, the lowest level since 1970.

The state of industrial relations, the framework of labour contracts and technical progress have induced a sense of insecurity among workers that is curbing wage growth. Productivity gains and a flexible supply of labour, due in part to immigration, are continuing to hold down the rise in unit labour costs.

The growth in domestic demand nevertheless resulted in a further deterioration in the current account of the balance of payments. In 1997 the deficit amounted to $166 billion, even more than in previous years; a deficit of the order of $230 billion is forecast for this year.

The United States recorded a net inflow of portfolio investment of $300 billion last year; the country's net external debtor position now exceeds $1 trillion, equal to 12.3 per cent of GDP.

In Japan there was a severe downturn in economic activity in the second quarter, when domestic demand declined at an annual rate of 14 per cent. In an economic situation already made precarious by widespread financial instability and falling prices, consumption and investment were depressed by an increase in taxes as part of a plan for the structural adjustment of the public finances.

The surplus on the current account of the balance of payments could reach $120 billion this year, nearly twice as much as in 1996.

The substantial and growing funds deriving from the trade surplus were reinvested in the principal financial markets. Portfolio investment abroad, which had totaled $115 billion in 1996, amounted to $90 billion in the first three quarters of 1997. The direction of capital flows changed abruptly in the fourth quarter, when the crisis in the Asian countries prompted a large-scale repatriation of funds. More than half of outward investment goes to the United States; at the end of 1996 Japanese investors held US bonds worth $780 billion and shares worth $155 billion.

Japan has a net external creditor position of about $1 trillion, or 23 per cent of GDP.

For many years the availability of loans at very low interest rates from Japan, and also from Europe, facilitated the funding of current account deficits and sustained economic growth in the South-East Asian countries and Korea. Bank capital continued to pour into these countries from 1994 to early 1997. Loan quality progressively deteriorated. Competitiveness in these economies, which had already been eroded by inflation averaging about twice the worldwide rate, was further reduced by the appreciation of the dollar, to which their currencies were pegged. Their foreign debt, which is largely at short term and denominated in dollars, continued to grow. The sudden reversal of market expectations sowed doubt as to the sustainability of growth and the solvency of firms and banks, thus triggering the crisis. The rapid outflow of funds resulted in the halving of share prices and caused currencies to depreciate by an average of 50 per cent.

The scale of the crisis and its rapid spread in Asia required unprecedented efforts by the international community to restore market confidence. International organizations and the leading countries have committed resources totaling more than $110 billion to Korea, Indonesia and Thailand. The International Monetary Fund played the leading role in coordinating intervention and designing adjustment programmes.

The debate taking place in the various fora about the risks to world economic stability inherent in the present configuration and modus operandi of the global market has intensified. Consideration is being given to ways of countering liquidity crises without providing private lenders with full protection against risk and to initiatives aimed at enhancing the soundness of banking and financial systems by means of more effective supervision. The need for macroeconomic surveillance to reduce the risk of new crises is becoming increasingly evident.

The slowdown in demand in Korea and South-East Asia aggravated the economic situation in Japan, causing problems for the banking system, which had already been weakened by the depressed state of the economy and the fall in share prices. The currency of China has remained stable.

In the European Union the pickup in economic activity did not reduce the cyclical disparities among the major economies. In the United Kingdom, which had already experienced four years of expansion, economic growth accelerated to 3.3 per cent, generating inflationary pressures that necessitated a progressive tightening of monetary conditions. The recovery was still weak in the three largest continental economies, where the growth in consumption remains modest and investment demand hesitant. Some stimulus to economic activity is coming from export demand. On the whole, monetary policy has maintained a non-restrictive stance. The money supply has grown rapidly in several countries.

The weakness of internal demand fostered a further increase in the Union’s current account surplus, which rose to 1.4 per cent of the area’s GDP, compared with 0.6 per cent in 1995 and 1.1 per cent in 1996. France and Italy accounted for two thirds of the surplus.

Unemployment is still around 10.7 per cent of the labour force in the European Union. It is especially high in Spain, where it stands at 21 per cent; the rate in Italy, France and Germany is between 11 and 12 per cent. It is particularly low in the United Kingdom, where labour market flexibility is comparable to that obtaining in the United States.

The budgetary and labour market conditions for a sustained and vigorous expansion of investment demand in continental Europe must be created; this will also foster more balanced growth in the world economy.

Above all, there must be a recovery in consumption and investment in Japan, a feasible objective in view of the country's savings and large external assets. The stimulus must come from budget measures capable of inducing a resumption of growth. The Government's programme to cope with the difficulties of the banks, amounting to around $220 billion, appears adequate. The size and composition of the proposed expansionary measures, as well as their timing and implementation, must be such as to produce a durable recovery in domestic demand.

Japan's return to economic growth is indispensable to overcome the Asian crisis, avert the risk of further instability in the region and in other parts of the world, correct the large and growing trade imbalances and contribute to a better and more stable international financial system.

The European currency

On 3 May the monetary authorities of the eleven member states of the European Union that will adopt the single currency announced the bilateral exchange rates that will be used to set the conversion rates in relation to the euro. These values, which are the same as the present ERM central rates, are consistent with the fundamentals and competitive positions of the countries concerned.

In our opinion it is profoundly mistaken to view the relationship between the euro and the other major currencies, first and foremost the dollar, in terms of opposition or conflict.

A stable European currency can make a decisive contribution to the equilibrium and prosperity of the world economy.

The accumulation of foreign debt by the United States has been easily financed to date, thanks to an unflagging demand for dollars; this has been fueled partly by monetary expansion in Japan and, more recently, by the transfer of funds to the US market in the wake of the Asian crisis.

The single European currency can help stimulate the growth of the European economies. The benefits of a new period of stable growth will spill over onto other regions of the world. It will foster the reduction of imbalances, to the advantage of the international monetary order.

Growth in Europe appears to be restrained by the excessive size of government budgets, the poor quality of public services in some countries and overly rigid and constrictive regulations.

The Convergence Report of the European Monetary Institute emphasizes that price stability and competitiveness depend crucially on reforms to reduce current public spending and taxes, on an easing of the structural constraints that impede the proper functioning of the labour market and on more efficient resource allocation in the individual national economies.

After the demise of the Bretton Woods monetary order, a system of prices and costs dictated essentially by the level of wages came into being in the industrial economies and prevailed longest in continental Europe. To some extent, monetary and exchange rate policies were adapted accordingly. The result was a long period of inflation, high interest rates, slack investment and unemployment.

In the second half of the eighties and the early nineties monetary policy in the major countries brought inflation back down to very low levels, aided by an increase in domestic and international competition and in Italy by concertation between employers and trade unions that was effective in moderating wage growth.

Price stability requires replacing the labour standard by systems in which wages, relative prices and the allocation of resources are once again determined with reference to productivity, product quality and demand. Labour market flexibility must be increased while safeguarding adequate levels of income and social protection.

These are the prerequisites for the success of the single currency, for encouraging saving and capital formation and enabling the European economy to maintain and improve its competitiveness, return to a path of growth and aim at a new period of rising employment.

The Italian economy

In the second half of 1996 it became evident that the growth in GDP would not exceed 1 per cent for the year as a whole. Industrial production was declining sharply and overall employment was stagnant. The increase in output in 1997 would be less than the official forecast.

At the end of 1996 tax incentives were introduced to encourage the replacement of motor vehicles.

In February 1997 it could be foreseen that the budget deficit would overshoot the objective of 3 per cent of GDP by nearly one percentage point; its behaviour was influenced by the slowdown in economic growth and fiscal measures that were less effective than expected. At the end of March measures were adopted to reduce the deficit by a further 16 trillion lire.

The tax incentives contributed to the growth in household consumption, which increased by 2.4 per cent for the year; in particular, demand for durable goods rose by 8.6 per cent and purchases of motor vehicles by 32 per cent.

Industrial production responded promptly: over the year it rose by 8 per cent to equal the peak of two years earlier. In the first few months of 1998 it has been declining, although it has remained well above last year's average level.

About one third of the increase in production in 1997 appears to be attributable to the measures relating to motor vehicles. The higher growth in income also stimulated demand for non-durable goods.

Gross domestic product grew by 1.5 per cent.

The contribution from fixed capital spending was limited; investment in construction declined.

Exports rose by 6 per cent but failed to keep pace with the growth in world trade, owing to the loss of competitiveness and the briskness of domestic demand. The same factors, together with stockbuilding, caused imports to rise by 12 per cent.

The acceleration in economic activity had a positive effect on productivity, to the benefit of unit labour costs, production prices and consumer price inflation.

Labour costs per employee in the sectors producing goods and market services, which had increased by 5.1 per cent in 1996, rose by a further 4.1 per cent in 1997. Given the rise in productivity, the annual increase in unit labour costs came down from 4.6 to 2.2 per cent.

The growth in production brought benefits in terms of costs, as it had in 1995. On that occasion, however, against the background of the depreciation of the lira and the rapid expansion in domestic demand, the curbing of costs translated into wider profit margins.

In 1997 the stability of the lira and monetary policy made a decisive contribution to disinflation.

The monetary policy stance became less restrictive during the year. The gradualness with which official interest rates were reduced consolidated market behaviour consistent with price stability. Inflation expectations improved continuously, bringing the expected inflation rate close to 2 per cent at the end of the year. In December the twelve-month rate of inflation was 1.5 per cent in the case of producer prices and 1.9 per cent in that of consumer prices.

As a result, not only did nominal wages rise, but their purchasing power also increased; monetary stability ensured that the real value of financial wealth was maintained. However, households' income was eroded by the increase in the tax burden, the effect of which was only partly offset by the growth in social benefits. Households' propensity to save fell from 15.4 per cent in 1996 to 13.6 per cent in 1997, and that of the private sector from 27.8 to 25.0 per cent.

As well as the reduction in the budget deficit, there was a decline in saving by households and firms. The stagnation of investment was accompanied by a further considerable surplus on the current account of the balance of payments.

The balance of payments and capital movements

The current account surplus was only dented by the rapid growth in imports and the modest expansion in exports.

As in previous years, tourism made a considerable contribution to the balance of payments and national income; the sector's surplus was equal to 1.2 per cent of GDP.

Smaller interest payments on the foreign debt were another factor in the current account surplus. There was also a net inflow of EU budgetary funds, in contrast to net transfers to the EU in the preceding years.

Italy's net external position finally returned to balance at the end of last year. There was a further increase in the external debt of the public sector on the one hand and in the external assets of the private sector on the other, particularly those of households; the latter are aiming to manage their financial wealth more efficiently by diversifying their portfolios.

The net external creditor position of households and firms, including positions held via investment funds, rose by 119 trillion lire; their gross external assets increased to 591 trillion, or 11.4 per cent of their total gross assets. The public sector's liabilities to non-residents amount to 500 trillion lire.

The net external position of the Bank of Italy showed a further improvement.

Households accentuated the tendencies that had begun to emerge the previous year in their allocation of financial investments. They greatly reduced their demand for government securities and channeled savings to the domestic share market, foreign markets and intermediaries that then reinvested a substantial part of their funds abroad. Outflows of portfolio investment amounted to 113 trillion lire, double the figure for 1996.

Inflows of portfolio investment were again large, totaling 119 trillion lire, attracted by yield differentials, the rising prices of Italian securities and the stability of the lira.

With the advent of the single European currency, the public sector and firms will be able to raise funds in a larger and more liquid market.

The ability of the Italian economy to reap the benefits of the high domestic saving rate and to attract resources from abroad will depend crucially on the banking and financial system's efficiency in screening and selecting productive investments in Italy.

Increasing financial openness offers greater opportunities, but competition also involves greater risks for the market in government securities, the private capital market and the banking system. In the background there is the problem of the competitiveness of the Italian economy.

The balance between inflows and outflows of direct investment in the five years from 1992 to 1996 shows an average outflow of about 4 trillion lire a year. In 1997 there was a sudden acceleration in direct investment abroad by Italian firms and only a limited increase in inflows, which rose to 6 trillion. The rise in outflows brought the deficit to 12 trillion lire.

A flow of direct investment abroad is normal for advanced economies. For Italy, however, it raises the problem of the burden of tax and social contributions on the productive system in a context of growing fiscal competition; this problem is accompanied by insufficient flexibility in the use of the factors of production, often unduly restrictive regulation of economic activity and infrastructure deficiencies that are an impediment to business operations.

Italian direct investment abroad is motivated increasingly by the desire to transfer production abroad in order to reap cost advantages. In many cases it involves the intermediate processing of products that are subsequently reimported into Italy. In others the purpose is to gain easier access to larger markets, reducing transport costs, surmounting trade barriers and benefiting from more favourable tax treatment. According to a Bank of Italy survey of a sample of Italian manufacturing groups, employment in Italian factories abroad, some of them in emerging economies, is estimated to be equal to about 10 per cent of industrial employment in Italy.

Employment and investment

The number of people in employment was the same in 1997 as in 1996 on an average annual basis; during the course of the year the number rose.

The strong growth in activity in manufacturing was reflected in both employment and productivity in the sector. In the Centre and North, where the bulk of plant capacity is concentrated, the twelve-month increase in January 1998 was equal to 71,000 workers, or 1.8 per cent, raising the region's overall level of employment and reducing its unemployment rate to 7.5 per cent.

During the year the manufacturing workforce also grew in the South, but because of the sector's lesser importance in these regions the increase was not enough to prevent a further decline in overall employment and a rise in the regional unemployment rate to 22.4 per cent.

The pattern of the two preceding years persisted: after falling sharply between 1992 and 1994, employment increased by 260,000 in the Centre and North over the next three years but decreased by a further 70,000 in the South.

Employment responded more rapidly to the upturn in industry than in previous cycles. This was due in part to the reduced number of underemployed workers, a point corroborated by the increase in overtime work. Recourse to the Wage Supplementation Fund diminished.

Forms of fixed-term employment are growing and additional shifts are being introduced to cope with cyclical fluctuations and seasonal factors.

The Bank's annual survey of manufacturing firms shows that more than half operate at least two shifts per day. Those surveyed have plant in operation for an average of 13.6 hours a day, with 5.2 working days to the week.

Employment in the construction industry remained at the low levels recorded at the beginning of last year. It has fallen by around 15 per cent since 1991, reflecting the decline in activity in public works and residential building. The employment outlook appears uncertain in the services sector as well, where there has been a pronounced contraction in the number of self-employed workers.

The problem of unemployment in Italy largely coincides with that of the economy of the South, which has been stagnating for several years, has a low level of industrialization and is uncompetitive, owing in part to infrastructure deficiencies and problems in the social environment.

A year ago I highlighted the continuous, prolonged decline in investment in relation to output; I stressed the close connection between this and the fall in the overall level of employment and the emergence of various forms of irregular work intended to circumvent regulations and nationally agreed wage rates.

Although total fixed capital formation was sustained in 1994 and 1995 by a large increase in investment in machinery and equipment, particularly in the market services sector, in the four years from 1994 to 1997 it rose at a moderate rate of around 2 per cent a year, only slightly faster than the growth in output. Investment in construction as a whole diminished by an average of 1.5 per cent a year; that in non-residential construction stagnated. The growth in gross fixed investment during that period occurred solely in the Centre and North, where it is estimated to have exceeded 3 per cent annually; in the South gross fixed investment contracted by between 1 and 2 per cent a year.

The annual flow of productive investment has grown around fourfold since the beginning of the seventies in the United States. In Europe it has doubled. The convergence of per capita GDP in the countries of the European Union towards the level of the United States has stalled in the nineties.

The less intense rate of investment in Europe reflects more uncertain expectations of growth; at the same time it is one of the factors responsible for creating less favourable conditions for higher employment and output.

The European economies face the prospect of a static or declining population and a deterioration in its age distribution. Among the ten leading industrial countries, Japan and Italy will soon have the oldest populations.

The consequences for expenditure on pensions and welfare will be considerable. They could cause labour costs and the budget deficit to increase.

In the advanced economies the ageing of the population and the high standard of living reduce the growth prospects of an industrial sector whose development in past decades depended on demand for durable consumer goods. The opportunities for expanding production must be seized in order to satisfy both the demand for services related to the new needs of the population and new forms of consumption and demand from more backward areas for industrial goods, including medium-technology products.

Taxes and social security contributions correspond to 32 per cent of GDP in the United States and 37 per cent in the United Kingdom; in Germany, Italy and France the ratio is between 43 and 48 per cent.

The heavier tax burden increases the cost of labour and products by comparison with other countries, especially when it is not matched by adequate public services and infrastructure that can contribute to the productivity of the economy.

In Italy the rate of tax on corporate profits rose from 36 to 53 per cent between 1980 and 1997. Since 1992 companies have been subject to an extraordinary tax of 0.75 per cent of their net worth. During the same period the other leading countries lowered their corporate tax rates. Italy's are at the same high level as Germany's and higher than those of France and the United Kingdom. In 1995 the ratio of corporate tax receipts to GDP was 3.6 per cent in Italy, compared with an average of 2.9 per cent in the European Union as a whole.

The recent reform of the tax system is intended to redistribute the burden among the factors of production: it eliminates the tax on net worth and reduces that on profits and labour inputs by shifting the burden on to debt capital; it reduces the rate of tax on profits, provided they are retained within the business. The greater simplicity and neutrality of the tax system will bring gains in efficiency. In the long term the tax burden is likely to diminish as a result of an increase in equity capital. In the medium term, however, the requirement that revenue initially remain unchanged means that the overall tax burden on firms will remain high.

In Europe, with the advent of the single currency, there appears to be an urgent need for agreements to coordinate the tax treatment of financial and entrepreneurial income; in the future it might be necessary to extend the agreements to cover personal income tax and the social security system.

Output growth is hindered in continental Europe and in Italy by labour market arrangements that ultimately penalize employment. In an economic environment increasingly open to international competition, the demand for labour tends to be close to levels consistent with production at the low points of the business cycle.

On several occasions in the past I have drawn attention to the need for pay arrangements that make it easier to adjust labour costs to the state of the economy, variations in production and the situation of the company, and thus create the conditions for a closer link between the interests of workers and those of the firm and foster competitiveness and employment.

In Italy a reduction in contractual working hours is under discussion; in France legislation providing for such a reduction has already been approved. The annual number of working hours laid down in labour contracts has shown a long-term downward trend: in Italian manufacturing industry it was around 2,000 in 1970; today it is 1,700.

Any mandatory ceiling on annual contractual working hours will need to permit large variations in the number of hours worked per week and per month, so as to allow production to adapt to seasonal and cyclical requirements. Employers and trade unions will have to find solutions that enable firms to adjust production to fluctuations in demand and create a closer correlation between labour costs and corporate revenues.

Significant steps are already being taken in Italy to adapt the supply of labour to firms' production and plant utilization requirements. Greater flexibility can be achieved by making more extensive use of the new forms of employment introduced on the basis of proposals put forward by the Minister of Labour. Labour contracts at company level are also increasingly providing for forms of variable pay linked to profitability; however, such solutions relate to a negligible proportion of less than 3 per cent of average earnings.

In order to make a significant impact on productivity, the fixed component of earnings, the part that is the same for all, will need to diminish, albeit continuing to be the preponderant element; the variable component will need to be able to increase and decrease.

The mismatch between productivity and earnings encourages forms of irregular work, which I discussed at length last year. There is clearly an imbalance in the South that leads to a low level of legal employment and gives rise to forms of work that are equivocal, detrimental to competition and prejudicial for the workers, who are not covered by social security or insurance. These forms of employment are socially harmful, infringe legality, undermine the dignity of workers and blur the perception of the distinction between legal activities carried on in an irregular manner and illegal activities.

A solution is urgently needed in order to help improve social conditions in the most economically backward areas. Territorial pacts and area contracts are only an initial response to this serious problem. In a small number of cases they have made it possible to experiment with agreements that increase labour flexibility and keep down labour costs in the light of local conditions of production.

The public finances

The notable adjustment of the public finances achieved in 1997 is part of the consolidation that was begun in the second half of the eighties and intensified in the early nineties, when general government net borrowing still amounted to between 9 and 11 per cent of GDP. The improvement was substantial in 1995 and extremely large last year.

The primary surplus increased from 1.8 per cent of GDP in 1994 to 4.1 per cent in 1996; in 1997 it rose to 6.8 per cent. Net borrowing in the same three years fell from 9.2 to 6.7 per cent and then to 2.7 per cent of GDP.

The progress achieved last year was due to an increase of around 2 percentage points in the ratio of tax to GDP and to the effects of other measures that consisted partly in the postponement of expenditure. The reduction in the budget deficit also benefited from a fall of 1.3 percentage points in interest payments in relation to GDP, which reflected the curbing of inflation, favourable international monetary conditions, the increase in the primary surplus and the prospect of participation in the Monetary Union.

Total public expenditure in the European Union as a whole fluctuated around 48 per cent of GDP in the eighties and reached a peak of 53 per cent in 1993. In Italy it rose from 42 per cent in 1980 to nearly 58 per cent in 1993.

The tax ratio in Europe remained close to 41 per cent for most of the eighties and into the early nineties, rising to around 43 per cent in 1997. In Italy it increased by 13 percentage points in the thirteen years from 1980 to 1993, when it reached 44 per cent; it declined in the three years from 1994 to 1996, but last year it equaled the earlier peak.

Revenue in Italy remained consistently lower than expenditure, despite its very rapid growth; the high interest rates required to ensure the non-monetary financing of the large deficits and to bring down inflation contributed to the enormous accumulation of public debt.

Social security benefits played a major role in the growth of expenditure: they rose from 14 per cent of GDP in 1980 to slightly less than 20 per cent in 1993. They decreased temporarily in 1995 but then began to rise again; last year they increased at a rate well in excess of the growth in GDP.

Expenditure on public investment has contracted, falling from nearly 4 per cent of GDP in the early eighties to just under 2.5 per cent.

The budgets for 1996 and 1997, together with the restrictions imposed on cash disbursements, kept expenditure excluding interest payments at the level of 42 per cent of GDP reached in 1995 and more than 3 percentage points below the peak recorded in 1993. The reduction in the cost of debt servicing made it possible for total public expenditure to continue to decline in relative terms in 1996 and especially in 1997, when it fell to 51.5 per cent of GDP.

The underlying trend of the main expenditure items and the nature of the policies adopted in the last two years now call for structural measures to consolidate the results achieved and make further progress aimed at producing a significant reduction in the public debt.

The Convergence Report of the European Monetary Institute indicates the objectives that budgetary policy will have to pursue in Italy in the coming years to ensure that the ratio of debt to GDP approaches the reference value of 60 per cent at a satisfactory pace.

The Report stresses the need for ongoing concern with regard to the future development of Italy's public finances; more explicitly, it calls for rapid progress towards overall fiscal surpluses in order to bring down the debt in absolute as well as relative terms.

The Economic and Financial Planning Document indicates a reduction in net borrowing from the 2.6 per cent of GDP forecast for this year to 2 per cent in 1999, 1.5 per cent in 2000 and 1 per cent in 2001.

Advantage has been taken of the decrease in interest payments to make the objective for the primary surplus less ambitious: that for 1998 has already been lowered to 5.5 per cent of GDP, compared with the outturn of 6.8 per cent recorded last year. In order to achieve a rapid reduction in the debt, this figure will have to be considered a minimum for at least ten years.

The economic policies set out in the Planning Document move in the right direction. In the medium term the budget objectives will have to be made more ambitious in order to meet the commitments entered into at the European level.

It is necessary to aim, at least in the longer term, for a significantly larger reduction in the tax ratio than that of 2 percentage points announced for the four years from 1998 to 2001, which is attributable mainly to the expiry of measures temporarily bringing forward tax payments and increasing tax rates and to the decrease in the withholding tax on interest payments.

The steps taken to date in the health and pension fields do not appear sufficient to put a permanent brake on the expansion of expenditure unless a series of favourable assumptions all prove correct.

The need for a far-reaching overhaul of the existing arrangements for social security is recognized in all the industrial countries.

Reform of the social security system is necessary to ensure its very survival, make its benefits available to those who are still working and guarantee the necessary support for the weakest members of society.

The aim must be to encourage the development of supplementary pensions and private insurance schemes to protect against a broad range of health risks, by providing adequate tax relief where necessary, to lengthen working lives and to increase the cross-border mobility of workers without prejudice to their social security entitlements.

The law reforming central and local government and the important changes in the rules governing the budget, public administration and the production of public services lay the basis for improving productivity and adapting the machinery of government to the new needs of society. The achievement of these objectives will not follow automatically from the adoption of the rules; it calls for supervision and constant monitoring, at both the political and administrative levels, aimed at assessing the effectiveness and efficiency of public sector activities.

The extensive use of cash ceilings to curb the spending of local authorities and other public bodies has proved effective; the balances held with the Treasury have been reduced. It may also have made spending more efficient. However, investment in infrastructure and expenditure on the provision of adequate public services have been curtailed. The volume of expenditure carryovers has increased considerably. In some fields the contraction in outlays may prove to be temporary.

The curbing of disbursements must evolve into action to restore sound public finances that will extend to reconsidering citizens' rights and expectations and eliminate the benefits and services the public sector can no longer provide while safeguarding the fundamental tasks with which it is entrusted.

The ability to carry out investment projects will have to be improved. On several occasions we have drawn attention to the shortcomings in the planning capacity of local authorities, especially in the South of Italy, one of the reasons for the widening of the output and employment gap between the country's developed and depressed regions.

The benefits of the reduction in interest rates have not yet fed through completely to the interest payments on the public debt. The average cost of debt servicing is still above current market rates; assuming these remain unchanged, there is scope for a further fall of nearly one percentage point by 2001. However, such a virtuous outcome requires not only continued price stability but also favourable international monetary conditions and an enduring return to sound public finances. This reinforces the need for structural reforms aimed at producing a permanent reduction in expenditure.

In the new situation in Europe budgetary imbalances in the leading economies will be reflected in the cost of public debt and private finance throughout the area.

The Stability and Growth Pact commits the EU countries to the medium-term objective of budgetary positions close to balance or in surplus.

Countries with a high level of public debt must achieve this objective rapidly in order to foster growth, permit further reductions in interest rates and free resources for productive investment.

The outlook

Average daily output rose to a peak in December and January and then declined in February and March; in the first quarter of this year the index was 0.3 percentage points lower than in the fourth quarter of 1997. Preliminary estimates indicate that output stagnated in April but picked up in May.

The growth in households' final consumption will accelerate during the year, but on an annual average basis it will be less than in 1996 owing to the slowdown in the demand for consumer durables.

Investment in machinery and equipment should stage a strong recovery, largely as a result of the fall in real interest rates; the growth is expected to amount to 7 per cent, a figure that is confirmed by the Bank's own survey of industrial firms. The construction industry should also come out of the doldrums as a consequence of the introduction of tax incentives for the restructuring of residential buildings.

The growth in GDP will not be less than 2 per cent; the surplus on the current account of the balance of payments is expected to increase further in both absolute and relative terms. Economic activity will tend to accelerate during the year, which will have a positive effect on the results for 1999.

The persistence of a large current account surplus coupled with high unemployment indicates that there is substantial scope for domestic demand to expand. The increase in economic activity will need to be stimulated by a reduction in labour costs in the regions where unemployment is highest and by an ability on the part of both central and local government to plan and implement projects that will boost the volume of public investment, in part by seeking to involve private investors.

According to estimates based on the pattern that has emerged to date, the growth in investment, production and employment up to 2001 will be less than that indicated in the Economic and Financial Planning Document. Employment in the private sector excluding agriculture appears likely to rise by around 450,000, total employment by slightly more than 300,000.

The exercise shows inflation will be in line with that in the other leading countries. The level assumed for short-term interest rates is that expected by the financial markets for the euro area.

In order to sustain the growth in economic activity and employment indicated in the Planning Document, investment will have to increase more rapidly than is envisaged.

The Planning Document presupposes a change in the way the economy operates; if the employment objectives are to be achieved, the structural change must be defined and brought about in terms of the efficiency of government, the policies for supporting private investment, the attraction of foreign direct investment and the conditions regarding the supply and cost of labour.

The easing of monetary conditions towards the end of last year has been accentuated. The official discount rate was lowered in December and again in April by a total of 1.25 percentage points; since the beginning of 1997 it has been reduced by 2.5 points. The spot and forward exchange rates are consistent with the parities that have been announced.

The growth in the monetary aggregates in 1997 exceeded the targets, partly owing to the changes in the tax treatment of bank deposits but also on account of the sharp fall in yields on government securities and the shift in households' portfolio preferences. The same phenomenon has been observed in other countries, coupled in some cases with innovations in the financial system; it has been fueled by the abundant supply of international liquidity. In regulating the supply of funds to the banking system, we took account of the risks associated with an excessive increase in the money supply and of the structural factors that contributed to its growth. After pausing in the last few months of 1997, monetary growth has accelerated again in Italy; credit is also expanding, in line with the rising trend of economic activity.

Between the end of 1995 and April of this year the interest rate on short-term bank loans fell in Italy from 12.9 to 8.3 per cent; in Germany the rate on comparable loans denominated in marks declined from 8.3 to 7.7 per cent. The differential between the nominal rates in the two countries narrowed from 4.6 to 0.6 percentage points.

Net of the increase in producer prices, interest rates on short-term bank loans in Italy are now in line with those in Germany.

Comparison of the rates on medium and long-term loans to corporate borrowers also shows a narrowing of the differential, from around 3 percentage points at the end of 1996 to 0.6 points today. In Italy the current rate on new corporate loans is 6.8 per cent; in Germany the rate on fixed rate loans is 6.2 per cent.

Money market differentials remain wider; they will be eliminated by the end of the year, taking account of the money supply and the increasingly large flows of inward and outward portfolio investment.

Inflation in Italy is around 2 per cent according to the harmonized consumer price index. The differential with Germany and France is just over one percentage point. The markets expect the gap to narrow.

The renewed soundness of the lira in foreign exchange markets, and at home in terms of purchasing power, is based on Italy's overall net external position and the competitiveness of the economy.

By achieving a net external position close to equilibrium towards the end of 1997, Italy is able to stand alongside the other founder members of the Monetary Union with a balance sheet in which the saving accumulated by its citizens matches the total capital stock and the large volume of public debt.

The competitiveness of the Italian economy will cease to be reflected in the exchange rate, as far as the other EMU countries are concerned; it will retain its importance as a contribution to the strength of the European economy, but above all it will be decisive for the creation of wealth and the production of income within Italy.

Gains in competitiveness will have a direct effect on the ability to generate saving and accumulate wealth, on the growth in investment and on the expansion of economic activity and employment.

Banking and finance

The globalization of financial activities requires intermediaries and markets to become more efficient in order to seize the new opportunities and withstand keener competition; it calls for institutional and organizational changes that will enable the resulting risks to be controlled.

The international openness of markets will increase. Competition between national systems will intensify; business will tend to be concentrated where the financial industry is most efficient.

The progress made by the Italian economy in the last five years and the return to monetary stability have accelerated the transformation of the financial system.

The financial market

The Italian capital market is still small in relation to the size of the real economy: at the end of 1996 the gross value of financial assets was 4.9 times GDP, compared with factors of 5.6 in Germany, 7.4 in the United States, more than 8 in France and Japan, and over 10 in the United Kingdom.

The changes in households' investment preferences are contributing to the financial deepening of the Italian economy; institutional investors, whose development has been impeded by the high level of public pension provision and health cover, must play a larger part.

An expansion of the private capital market and a broadening of the range of intermediaries and their activities are urgently needed in order to meet investors' demand for diversification and to assist firms in placing debt instruments and raising equity capital, both in Italy and abroad.

Fund-raising by institutional investors, which had already increased considerably in 1996, doubled to 260 trillion lire last year. The growth in their resources contributed to the large rise in the gross value of Italian households' and firms' holdings of foreign assets. These were equal to 30 per cent of GDP at the end of last year, three times the figure recorded at the end of 1990 but still less than in other leading countries.

The stock exchange is still small for the size of the economy. The supply of new shares, both from companies already listed and new entrants to the stock market, was limited last year, despite the heavy demand and the prolonged rise in share prices and turnover. The increase in the total float was mainly the result of privatizations. Share issues recovered moderately in the early months of this year.

Admission to listing in regulated markets and introduction to the stock exchange enhance the transparency and reputation of companies, not only with investors but also with the banking system; it increases the interest of foreign investors.

The European currency will increase the opportunities for firms to raise capital in other markets. Italy's financial industry will have to respond by enlarging its European and global operations and expanding its supply of services with a high value added.

The range of services provided to small and medium-sized enterprises will have to be broadened and their quality improved. Such companies play a major role in the Italian economy. At the beginning of the nineties persons working in firms with fewer than 20 employees accounted for 57 per cent of total employment in industry and services, more than twice the figures for France, Germany and the United Kingdom. Small firms have high operating profits, but they are much more highly geared than large companies. Their financial liabilities are almost entirely towards banks and consist mostly of short-term loans; their financial costs come out of income and considerably reduce their return on equity.

Excessive debt and an inadequate capital base are detrimental to operational flexibility and an obstacle to investment and growth, especially for young companies in innovative sectors.

Banks enjoy an informational advantage in assisting small and medium-sized firms because of their local roots and regular contacts with borrowers; a larger flow of fee income would improve the banks' profitability.

The Consolidated Law on Financial Markets has created legal conditions favourable to the development of the capital market. Together with the 1993 Banking Law, it provides the basis for the new regulatory framework for the Italian financial sector. The new law improves the quality of the information provided to the public, lays down a transparent procedure for seeking and collecting proxies, increases the involvement of minority shareholders in the governance of companies, amends the rules on take-over bids and reconciles the objective of not hindering changes in ownership with that of protecting the interests of small shareholders. All in all, it establishes a model of corporate governance on a par with those of other important financial systems.

In the asset management field the new law fosters product innovation by streamlining the earlier provisions and allowing intermediaries greater operational flexibility. It eliminates the separation of asset management on an individual basis from that performed on a collective basis, gives the Bank of Italy responsibility for setting prudential criteria for the management of portfolios and makes it easier to adapt the regulations to changes in the market.

The Bank's powers to introduce secondary legislation on settlement systems for transactions in financial instruments, to be exercised in agreement with Consob, have been widened; responsibility for the supervision of companies engaging in the centralized management of financial instruments is shared between the two regulatory bodies.

The law confirms the transformation of Italy's securities markets into private sector companies and entrusts the surveillance of the interbank market and the wholesale market in government securities to the Bank of Italy. In terms of transparency and liquidity, these markets bear comparison with the other leading financial centres; now that they are in the private sector and open to international competition, their competitiveness is a matter for the intermediaries themselves. The Bank is ready and willing to support their actions within the ambit of its supervisory powers.

The expansion of the market for private capital will be given additional impetus by the recent reform of corporate taxation, the continuation of the programme of privatizations and the modernization of the legal system.

The ability of the financial and real economies to compete in Europe would benefit from a simplification of the procedures for enforcing court decisions, a reduction in the duration of civil suits, and a reform of company law that, within the framework provided by Community directives, accorded with the needs of Italian firms, especially those of small and medium size.

The banking system

Italian banks have suffered from low profitability for several years, raising doubts about their ability to compete in an open market if they fail to reorganize and cut costs.

The banks' labour costs in Italy are significantly higher than those of their competitors in continental Europe and much higher than those of banks in the United States and the United Kingdom.

In performing our supervisory duties, we took the exceptional step in January 1997 of calling on banks to make a sharp reduction in their operating costs.

We informed the Presidency of the Council of Ministers and the Ministers of Labour and the Treasury of this initiative.

The banks and trade unions reacted positively, and the Government urged them to come to an agreement.

The parties reached an understanding in February of this year. They have committed themselves to reducing the ratio of staff costs to gross income towards the European average within four years by restructuring labour contracts, revising wage levels and carrying out a programme of phased redundancies.

The agreement sets out guidelines for the renewal of the labour contract that will lead between 1998 and 2001 to a reduction in unit labour costs, closer linkage between wages and company performance and increased labour flexibility.

The banking systems of the other leading continental European countries are restructuring in order to reduce costs and increase revenues. In France, Germany and Spain the ratio of staff costs to gross income averaged around 38 per cent in 1996; in Italy the ratio is currently 43 per cent. The agreement represents a first, crucial step forward. The new labour contract must strive to eliminate the differential.

In the course of the Bank’s supervisory activities, high staff costs were also found in banks with insufficient revenues and located in economically distressed areas. We consider that the requirement for “sound and prudent management of credit” is not met if the intermediary does not consistently achieve an adequate level of profitability.

Cost reduction must be accompanied by policies to broaden the range of services offered, which are still inferior in terms of quality and earning capacity to those found in the other leading systems. Organizational arrangements and information systems must also be adapted to handle the transition to the single currency and the date change in the year 2000.

The Bank of Italy has been promoting the liberalization of banking since the eighties. Since 1990, acting as the guarantor of competition in the sector, it has prevented local and national markets from being distorted by the formation of dominant positions, abuses and agreements aimed at restricting competition. Cooperation with the Competition Authority proved fruitful both in decisions on individual cases and in conducting the survey of services in the field of corporate finance, which was completed in 1997.

The banks have extended their branch networks to areas they had not previously served and there is now considerable overlap between rival networks. The redistribution of market share has intensified. Foreign banks have established a significant presence in the areas of business services, lending to households and asset management. Quantitative studies reveal a sharp decline in banks’ market power.

Despite the increase in bad debts as a proportion of total lending, the spread between lending and deposit rates narrowed from 7 percentage points in 1989 to 5 points in 1997. Bank rates declined in line with money market yields last year, reaching levels close to those in the other leading European countries.

Stability and competition are complementary objectives. Both require allocative and operational efficiency, which is the foundation for the sound and prudent management of credit.

In 1997 net interest income declined by 3.6 trillion lire, mainly owing to the narrowing of interest rate spreads by 0.7 percentage points. The fall was largely offset by the large increase in income from asset management activities. Total revenues from banking and services declined. Large value adjustments to balance sheet assets caused profits to fall to 1 per cent of capital and reserves.

The increased profitability and improved financial structure of firms were reflected in a slowdown in the growth of bad debts, even in the South; the twelve-month rate of increase gradually declined from a peak of 30 per cent in 1994 to 6 per cent last March. New bad debts in 1997 were 15 per cent lower than in the previous year; more than one fifth involved construction firms, which receive 7.5 per cent of total bank loans. Credit quality was affected by the crisis in the sector and the decline in property prices, which has eroded the value of mortgages; losses on loans to construction firms since 1993 are estimated at more than 17 trillion lire, around one fifth of the total. The revival of the sector will also benefit the banks.

Supervisory activity was directed at finding ways to eliminate shortcomings in credit quality, company organization and profitability. On the basis of supervisory data and inspection reports, about one fifth of banks received unfavourable assessments on more than one aspect of their business.

Banks that were not able to correct the irregularities were absorbed by sounder institutions. The severest action available under the law was taken in the most serious cases, with nine banks being placed in special administration and five compulsorily wound up. Similar measures were taken with regard to securities firms, with six being placed in special administration and four liquidated.

During the year authorization was granted for the formation of 21 new banks; 16 applications were rejected for lack of adequate programmes or failure to satisfy the requirements for directors or principal shareholders.

At the end of last year the own funds of the banking system amounted to 212 trillion lire. Thirteen banks did not satisfy the capital adequacy standard, showing a total shortfall of 1.6 trillion lire, less than half the level of 1996. The remaining banks had excess capital of more than 79 trillion lire.

Experience confirms that the stability of banks depends on the strength of the real economy, even more so in the extremely competitive environment that exists today. Symptoms of an endemic crisis emerged in the South's banking system, owing partly to inefficient organization and cost structures but above all to the grave difficulties facing the economy of the southern regions.

The crisis at one of the largest southern banks was resolved last year. With the aid of public funds and considerable financing from the banking system itself, a banking group was created that will be able to achieve profitability and contribute to the development of the southern economy once the necessary rationalization measures have been taken. Paying heed to the view expressed by the Competition Authority, the Bank of Italy ordered Banco di Sicilia to reduce the size of its branch network over the next two years, in part by selling branches to competitors, in order to safeguard competition in some provinces in the region.

The reorganization plans launched at the main southern banks improved efficiency; staff numbers declined by 12 per cent and unit labour costs by about 2.5 per cent compared with the end of 1995.

The measures that were taken safeguarded the continuity of lending relationships and depositors' funds, while shareholders suffered a capital loss. Governing bodies were replaced. In 1997 the average short-term lira lending rate fell by more in the South than in the rest of the country; lending to industry began to grow again.

The action taken by the Government and Parliament prevented a systemic crisis in the area and initiated the process of restructuring.

Concentration in the banking and financial sector

Since the mid-eighties the globalization of capital markets and the easing of regulatory constraints have forced financial intermediaries to seek efficiency improvements, create new services for customers and increase in size. The result has been an intense process of concentration: the value of mergers and acquisitions carried out between 1985 and 1995 is estimated at

$2 trillion; in the last two years the value of such operations was more than $600 billion.

In the banking sector this trend has been accentuated by the decline in profitability recorded in all the leading countries at different times. In the United States concentration in the banking market began in the eighties and has recently gathered momentum following the removal of restrictions on interstate banking.

In Europe the value of mergers and acquisitions in the banking sector doubled from about $70 billion in the five years from 1988 to 1992 to $150 billion between 1993 and 1997. Mergers have led to a reduction in the ratio of operating costs to revenues, above all in the United Kingdom; the impact has been smaller in Germany and France, owing to greater labour market rigidity.

At last year's General Meeting I reaffirmed the Bank's willingness to support efforts to increase the average size of banks and improve their efficiency and competitiveness, to be realized by means of operating agreements and mergers between Italian banks or with foreign intermediaries.

We have maintained a continuing dialogue with bankers as a basis for the examination and approval of merger and restructuring plans.

In monitoring bank ownership as required by law, the Bank of Italy refused three requests to increase holdings above the ceiling of 5 per cent of the share capital. In two of these cases, the application was turned down to prevent violation of the letter and spirit of the banks' statutes, and in the third to prevent uncertainty or instability.

The number of Italian banks, excluding cooperatives, stood at 297 at the end of 1997, a decline of 107 since 1990, largely as a result of mergers and takeovers. Over the same period 87 acquisitions of control were also carried out.

Concentration must be accompanied by firm action to rationalize costs and exploit the full potential offered by the production and distribution of services with a high value added.

The fund set up to manage redundancies among bank staff should make it possible to achieve efficiency gains in the wake of the concentrations.

In the case of banking groups, ensuring the effectiveness of corporate strategies calls for clearly defined command structures and the simplification of decision-making procedures.

Three of the leading banking groups were privatized last year and two other large groups were merged.

The privatizations were accompanied by share issues in the market to strengthen the capital bases of the institutions involved. When the operations now under way have been completed, the share of total assets held by banks controlled by the state or banking foundations will decline to 25 per cent, compared with 68 per cent at the end of 1992.

The main mergers and acquisitions carried out in 1997 or announced in the first few months of this year involved banks accounting for 42 per cent of total bank lending. Possible mergers and acquisitions now under consideration regard banks responsible for a further 15 per cent of lending.

The way has been paved for the creation of intermediaries with adequate capital, size and operational capabilities to meet the challenge of foreign competitors.

The financial sector can help the Italian economy to return to a higher and more stable growth path, to the benefit of an increase in income and employment.

Ladies and Gentlemen,

Italy stands on the threshold of a change of immense importance, similar to those it faced in the post-war years when it joined the Bretton Woods institutions and opened its economy to world trade, and again when it became a member of the European common market. These decisions, which were taken in an orderly international context conducive to growth, greatly benefited the development of the country and its transformation from an agricultural economy into an industrial economy.

In the seventies domestic and international pressures generated a wave of inflation, a rapid increase in labour costs and a deterioration in the public finances. The macroeconomic environment changed radically, affecting the country's growth prospects for the decades that followed. Interest rates rose, growth slowed down, employment fell and the public debt began to increase.

In the eighties monetary policy brought down inflation. It lacked support from budgetary policy and, in general, from a combination of measures able to guide the economy back onto a path of stable growth.

The fundamental disequilibria in the economy were highlighted by the currency crisis of 1992. The radical change in fiscal policy aimed at reducing the budget deficit played a part in restoring a balanced external position and preventing a rekindling of inflation.

The tighter monetary policy stance adopted from the summer of 1994 onwards curbed inflation expectations, and within two years it had closed the differential in the rate of price increase between Italy and the other industrial countries.

On several occasions we have exhorted the Government to complete the structural reform of the public finances and called upon firms and workers' organizations to pursue profit and wage policies consistent with disinflation.

The reduction in the budget deficit that has been achieved in recent years has made a decisive contribution to restoring the confidence of the domestic and international markets and bringing down interest rates.

Adoption of the single European currency sets a lasting seal on monetary stability. It can be a source of growth, employment and sound public finances if economic policies and the behaviour of the two sides of industry are compatible. Otherwise, it will lead to a loss of competitiveness, a weakening of the industrial fabric and an increase in unemployment.

The outcome depends crucially on the policies pursued with regard to the public finances and labour costs; in the preceding pages we have sought to indicate the direction these should take and some of the hurdles. It also depends on the economy's response to the need for greater flexibility in the allocation of resources and the use of the factors of production.

In exercising our responsibility for the supervision of the financial markets and the banks, we will continue with the action we began more than a decade ago to adapt the financial sector to the new demands of the economy and international openness.

The present configuration of the international monetary and financial system is the result of the spontaneous developments that have taken place over the last few decades. This train of events has had a beneficial effect on the growth of the world economy but, precisely because of its tumultuous pace, has created weaknesses and risks and a need for rules.

The efforts made by the international community to contend with the crises have been immense; it is absolutely essential to prevent other outbreaks of systemic instability. This requires constant scrutiny of the emerging and newly industrialized economies and a strengthening of supervision over banks and financial markets. The International Monetary Fund must take on greater responsibility for the analysis and prevention of crises.

Money and credit cannot always achieve equilibrium unaided. Recurrent crises, fraught with economic, social and political consequences, led in the first half of this century to the establishment of central banks as we know them today. A similar development must take place in the international monetary system.

The central banks of the eleven countries that will adopt the single currency will not only consolidate their accounts for the sake of European monetary policy but above all pool their resources of technical knowledge, experience and popular confidence, which have been acquired over the decades.

The financial markets have expressed confidence in the launch of the European currency. Its success requires structural changes and flexibility in participating economies. Confidence on the part of firms will be measurable in terms of a recovery in investment, which would trigger renewed growth and bring down unemployment.

Cooperation among sovereign states, to which credit must be given for having achieved this important step in European integration, will now be directed towards higher objectives in order to consolidate the achievements that have already been made, to meet citizens' aspirations and their expectations of an improved social environment and prospects of work for young people.