ACRI

Association of Italian Savings Banks

2000 World Savings Day

Address by the Governor of the Bank of Italy

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Rome, 31 October 2000

Contents

The rise in oil prices since the end of 1998 has caused consumer prices and production costs to come under pressure in the industrial countries.

In the euro area the pressure is augmented by the weakening of the common currency. The twelve-month rate of consumer price inflation rose from 0.8 per cent in January 1999 to 2.8 per cent in September 2000; in France and Germany it rose from 0.3 to 2.3 per cent and from 0.2 to 2.6 per cent respectively.

In Italy inflation rose over the same period from 1.5 to 2.6 per cent; it was close to the latter value in October as well. The inflation gap with the other countries was negative for the first time.

Considering core inflation, however, the comparison remained unfavourable to Italy.

Between January 1999 and September 2000, the inflation gap with respect to the rest of the euro area, excluding food and energy products, held steady at around 0.8 percentage points. A factor in Italy was the smaller decrease in prices in recently liberalized sectors such as telecommunications and electricity.

In the four leading euro-area countries the behaviour of domestic costs curbed the inflationary pressure coming from abroad. In 1999 unit labour costs increased by just over one per cent; in the first half of this year the rise in production and productivity kept the increase compared with the first half of 1999 to less than 0.5 per cent.

In Italy, where per capita earnings rose faster than in France and Germany, the productivity gains recorded in the first half of the year were a powerful restraint on the rate of increase in unit labour costs in industry. In the services sector Italy continues to lag behind in productivity growth as a consequence of the much smaller increase in the level of activity.

For the year 2000 as a whole the average increase in consumer prices is expected to be just over 2.5 per cent. Unless there is a sharp decline in oil prices, inflation is unlikely to fall below 2 per cent in 2001.

Within the incomes policy framework put in place in 1993, business and labour organizations must negotiate wage increases that take account of domestic inflation but not of imported inflation.

Economic developments, the balance of payments and competitiveness

The annualized rate of growth in euro-area GDP accelerated from 3.4 per cent in the second half of 1999 to 3.7 per cent in the first half of this year. A decisive contribution came from the expansion in domestic demand. Despite the faster rise in exports, fueled by the very substantial increase in world demand and the depreciation of the euro, the parallel rapid growth in imports limited the contribution of net exports.

The hike in oil prices during the summer cast a shadow over the economic outlook. The climate of confidence among households and firms deteriorated, order levels fell, and industrial production slowed.

In Italy, economic activity spurted in the first quarter, driven to an equal extent by domestic and foreign demand, but the rise in production and GDP subsequently slowed. In the first half of the year GDP expanded at an annualized rate of 3 per cent; the corresponding figures for Germany and France were 3.5 and 3 per cent respectively.

The growth in Italian domestic demand was in line with that recorded by the leading euro-area economies. The shortfall in overall economic growth was primarily due to the slower expansion in exports.

Household consumption benefited from the gradual rise in disposable income brought about by the increase in employment and grew at an annualized rate of 2.9 per cent in the first half of this year. Investment accelerated to more than 8 per cent on an annual basis in response to the persistence of good profits, the contraction in unused capacity and low interest rates. Investment in construction picked up significantly.

The growth in employment benefited from the recovery in production and, as in 1999, from firms' greater use of flexible employment contracts. In the first half of 2000 employment rose at an annualized rate of 2.5 per cent, one of the highest in the last twenty years. Permanent full-time employment also increased significantly.

Although the expansion of exports compared with the second half of last year was a substantial improvement on the disappointing results recorded in 1999, on an annual basis it still fell more than 5 percentage points short of that achieved by France and Germany. This result was only in part a question of price competitiveness. Measured in terms of producer prices and with reference to all the other industrial countries, Italy's competitiveness improved by 1.7 per cent, that of France by 1.9 per cent and that of Germany by 4.4 per cent.

Fueled by the robust recovery in the emerging economies Italian exports to non-euro-area countries grew by 16 per cent at constant prices in the first half of 2000 compared with the corresponding period in 1999. By contrast, exports to the euro area grew by only 5 per cent; those to Germany, Italy's biggest export market, grew by less than 2 per cent.

The expansion of 9.2 per cent in imports at constant prices was more evenly distributed, with those from the euro area growing by 8 per cent and those from the rest of the world by more than 10 per cent; despite the improvement in Italy's competitiveness, the growth in imports remained a high multiple of that in domestic demand.

In the first half of this year the trade surplus contracted by some 11 trillion lire compared with the first half of 1999. The balance on current account turned negative and showed a deficit of around 11 trillion; in the first half of 1999 the current account had shown a surplus of 4.7 trillion.

The increase in the cost of energy imports for the year as a whole can be estimated at well over 1 per cent of GDP.

After seven successive years of current account surpluses, there is likely to be a deficit of around 0.5 per cent of GDP in 2000.

During the summer there were signs of a slowdown in growth. Industrial production contracted in June and July; it appears to have picked up again in the two following months. Manufacturing firms saw the rapid expansion in demand as having come to a halt. The brusque deterioration in household confidence in September was followed by a partial recovery in October.

Growth of 2.8 per cent in 2000, the official forecast, appears to be an upper limit; it presupposes a rate of expansion in the second half of the year comparable with that achieved in the first half, with a sharp acceleration in the last few months.

In 2001 the adverse effects on growth of the rise in oil prices will be felt in full. In recent analyses international organizations have underscored the macroeconomic impact of an increase in energy costs on the industrial countries most dependent on imports. They estimate that the persistence of oil prices at their current high levels could reduce growth by up to half a percentage point compared with the forecasts released during the summer, which, on the assumption of a significant fall in energy prices, had indicated a growth rate of over 3 per cent for Italy.

Economic growth, competitiveness and saving

The rapid expansion of the Italian economy in the last twelve months has not yet been sufficient to close the gap with the other leading euro-area countries.

The slower growth in the first half of this year, as in the whole of the period from 1995 to 1999, was not attributable to the rate of increase in domestic demand but to an export performance that was much poorer than those of France and Germany.

Set equal to 100 in 1995, the index of industrial production, which is closely correlated with that of exports, had risen in June of this year to around 108 in Italy, 115 in France and 116 in Germany.

Between 1995 and July of this year Italy's price competitiveness deteriorated by 19 percentage points vis-à-vis the rest of the euro area and by 20 and 23 points with respect to France and Germany respectively. Econometric analyses show that the reduction in Italian exports' market shares is not completely explained by relative prices, thus indicating the existence of other reasons for the decline in their competitiveness. Forecasts of Italian exports in 2000 suggest that they will again grow less than world trade.

In a global marketplace marked by radical changes in technologies and forms of corporate organization, the structural lags of the Italian economy undermine the country's competitiveness. The boost given to productivity growth by the extraordinary development of information and communication technologies has been a feature of the performance of the US economy; it is beginning to be felt in the other leading European economies; it is less visible in Italy's.

The increase in international competition in sectors, such as services, that are less open to foreign trade is also contributing to the creation of new allocative advantages between and within countries; it is eroding rent positions of long standing; it benefits areas that adapt promptly to the new conditions.

Financing the Italian economy in order to support a rapid rate of growth requires the contribution of foreign investment. This is now much more subject than in the past to sudden shifts in location decisions at world level. There is a growing tendency for one of Italy's traditional resources, high savings, to be utilized abroad.

Direct investment flows, after showing a deficit of 21.7 trillion lire in 1998, came virtually into balance in 1999, largely owing to the acquisition by a foreign buyer of an important Italian telecommunications company. In the first eight months of this year there was a deficit of 3.1 trillion. The inflow dropped to 7.1 trillion; whereas the outflow, after rising fast in the three years from 1997 to 1999, fell to 10.2 trillion; a recent acquisition by a large foreign company has not yet shown up in the figures.

The balance of portfolio investment, in surplus to the tune of 73 trillion lire in 1996, subsequently contracted and was virtually nil in 1998. In 1999, after the convergence of Italian interest rates to the European level, there was a deficit of 79 trillion. In the first half of 2000 the net outflow fell to 1 trillion; the data available show that the balance remained negative in July and August.

The investment abroad of Italians' financial wealth is partly a reflection of the trend towards international portfolio diversification; it is also a consequence of the still limited development of Italy's private capital markets.

In past years foreign intermediaries mainly bought Italian government securities. The efficiency of the secondary market in such securities and the persistence of a positive, albeit small, yield differential with respect to the securities of the other euro-area countries contributed to this tendency. The bias was still present in the first half of 2000, when net purchases of Italian government securities amounted to 114 trillion lire, as in 1999. At the end of June 43 per cent of Italy's public debt was held by foreign investors, as against 13 per cent at the end of 1994.

As regards shares, non-residents invested 16 trillion lire in the Italian market in 1997 and 25 trillion in 1998. The trend then reversed and they made net sales totaling 16 trillion in 1999 and 23 trillion in the first half of 2000, when about two thirds of the disposals involved shares of non-financial companies. At the end of June foreign investors held less than 10 per cent of the stock of Italian listed companies, as in the mid-nineties.

The bulk of Italian portfolio investment abroad has been handled by specialized intermediaries. In the first eight months of this year Italian investment funds bought 54 trillion lire of securities in international markets, notwithstanding net redemptions in the period. At the end of August 55 per cent of funds' net assets consisted of foreign securities. The value of foreign equities in their portfolio was more than three times that of their holdings of Italian shares.

The banking system

The growth in lending by Italian banks in 2000 has been very rapid; at the end of September it was equal to 14 per cent on an annual basis. The acceleration reflects the expansionary economic phase as well as several large-value operations in favour of service and energy companies.

The conditions of loan supply in Italy remained relaxed even after the increase in official rates began last autumn. The upward adjustment of bank lending rates to the rise in money market yields was in line with the average recorded in the euro area.

In order to finance the expansion in lending, which was considerably larger than that in domestic fund-raising, banks sold government securities and ran down their external assets.

In August the ratio of banks' liquid assets — cash and securities — to their total financial assets fell to a historic low of 16 per cent. It is now particularly modest by comparison with the ratios prevailing in other main euro-area countries.

Italian banks' profit and loss accounts for the first half of 2000 show an improvement in profitability. The rapid expansion in lending resulted in net interest income being 2.8 per cent higher than in the first half of 1999. There was robust growth in income from services. Gross income rose by 11.7 per cent. Profits were higher than in the first half of 1999; the annualized return on equity rose to 12 per cent.

If the rapid increase in lending is to continue, domestic fund-raising will have to grow considerably faster than up to now, with repercussions on the overall cost of funding.

Staff costs remained unchanged, despite the decrease of 1.4 per cent in the number of employees. Total operating expenses rose by 4.5 per cent, partly owing to increased investment in information systems.

It is necessary to reduce costs further in relation to the volume of business.

The prolonged phase of high corporate profitability has contributed to the significant improvement in loan quality. Loan losses in relation to the loan portfolio have fallen to the lowest level in more than a decade; in the first half of this year they amounted to 3.3 trillion lire, some 2.1 trillion less than a year earlier.

In August bad debts were 13 per cent down on a year earlier, reflecting both the writing off of non-performing loans and a series of major securitization transactions. Bad debts, net of writedowns, were equal to around 28 per cent of capital and reserves, an intermediate level among those registered in the euro area.

The improvement in banks' profitability in the last three years as a result of the expansion of the range of services offered and the action taken to rationalize organizational structures and credit management procedures has helped to strengthen the stability of the banking and financial system.

The risks that can arise from the evolution of world economic conditions make it necessary for banks to pay more attention to loan quality.

The yield differential between corporate bonds and government securities in the Euromarket has widened by around one percentage point this year. The increase has been especially marked for firms that have stepped up their borrowing to finance investment in new technologies.

The share of loans by Italian banks to sectors with a past record of high risk is rising. The concentration of creditor positions has increased.

The rapid growth in credit will translate into lasting benefits for intermediaries and bank customers only if there is close and continuous examination of the quality of investment plans. The experience of the main banking systems indicates that during expansionary phases of the economic cycle, when banks have the best opportunities to increase their respective market shares, the attention they pay to evaluating the medium-term prospects of borrowers tends to lessen.

The solvency ratio, calculated on the basis of consolidated data, declined from 11.3 to 10.6 per cent in 1999; on the basis of the data of individual banks, it appears to have stabilized this year. The solvency ratio of Italian banks active in international markets was low in 1998 compared with the leading banks of the Group of Ten countries; however, Italian banks' capital contained a higher percentage of core capital, consisting of equity and reserves.

The reform of the capital adequacy ratios now under study in international fora requires that banks equip themselves with internal credit-rating systems that are analytically rigorous and make full use of information on counterparties' financial positions. These systems must be fully integrated into banks' organization and their procedures for formulating operating objectives, disbursing loans and monitoring risks. The need for this is particularly cogent in recently formed banking groups now engaged in the reorganization of large intermediaries.

An intense effort aimed at the internal strengthening and consolidation of groups is necessary in order to reap all the benefit of larger size and successfully face mounting competition.

The growth of Italian banks' business and their expansion abroad must be preceded and accompanied by an adequate increase in their own funds. The raising of equity capital must proceed in parallel with the consolidation of the results achieved so far through concentration.

Conclusions

Savings, labour and entrepreneurial ability are resources that Italy has in abundance. It is necessary to create a virtuous circle for them to be turned fully to account, to lock Italians' savings into Italy's productive economy and to offer economic agents stable prospects and the markets clear indications.

It is crucial that action be aimed at boosting competitiveness.

Structural constraints, accumulated over the course of decades and not completely removed, are a burden. They lessen the economy's efficiency and thus raise firms' tangible and intangible indirect costs. The weakness of the external accounts reveals the difficulty domestic production has in taking full advantage of the expansion of the world economy. Net capital exports diminish the prospects of growth.

The reforms begun in recent years in the public administration go in the direction of reducing inefficiencies. They must be completed and brought into better harmony with the needs of an economy increasingly open to international competition.

The reduction in the tax burden initiated with the Finance Law must be continued in a medium-term perspective. It cannot be achieved without a revision and redistribution of social security sector benefits that shift a part of pension provision to private insurance systems; those for whom adjustment to the new demands of production is more difficult must be protected. A far-reaching overhaul of the education and training system for the younger generations needs to be considered, not excluding recourse to non-state institutions. It will result in an increase in human capital, the resource that in the current context is increasingly the foundation of countries' economic development.

The ability of firms to rise to the challenges of innovation remains essential.

Forty years ago Italy became an industrial country with the decisive contribution of entrepreneurs who trusted in their own ability to compete in European markets, without protection. The information technology revolution offers opportunities that, if adequately exploited by manufacturing and services, can contribute significantly to raising productivity in the years to come.

Today, in the same way as in the fifties and sixties, it is the bet on the future underlying investment decisions that, in the final analysis, can render savings productive, drive growth and employment and enhance the welfare of the population.