BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY 2002

THE GOVERNOR'S CONCLUDING REMARKS

Ladies and Gentlemen,

The changeover to the euro has been achieved according to plan, with an orderly introduction of the new notes and coins. Two billion 454 million banknotes with a total value of €98 billion were printed between June 1999 and 31 December 2001. By yesterday, 96 per cent of the lira banknotes in circulation at the end of 2001 in terms of value had been withdrawn.

Managerial, clerical and production staff, both at Head Office and in the branches, have worked together for this important event intelligently and in a spirit of service.

The functions performed by the Bank are increasing, and are also becoming more complex.

The Bank of Italy participates in the setting of European monetary policy and is responsible for its implementation at the national level.

International cooperation calls for the Bank to make an active contribution in the European institutions, the Bank for International Settlements, multilateral organizations and the informal groups of the leading industrial and emerging countries.

The Bank is playing its part in the major changes occurring in the economy and finance through its intensive analysis, data collection and documentation, the monitoring of markets and payment systems, the supervision of the banking sector and the safeguarding of competition in that sector.

The branches have been assigned new duties in addition to their traditional activities. They have begun to verify that commercial banks' branches comply with the transparency regulations. The Regional Reports are gaining importance, partly as a result of the institutional and administrative decentralization introduced by the amendment to the Constitution. The Reports are a valuable source of information for the local economies, adding to the knowledge and analysis of the national economy.

The Bank's Departments are continuing to develop a programme for electronic treasury operations in order to integrate public sector transactions into the payment system. In collaboration with the banks, work has begun on expanding the services offered by the gross settlement system; together with the introduction of new procedures for the settlement of securities, these measures will make the Italian financial market more competitive.

The Bank of Italy and the Italian Foreign Exchange Office, working in conjunction with state authorities, are combating the financing of terrorism, a task in which there have been important instances of international coordination.

The results of the analysis of the Italian and world economies, the work of the Bank in monetary policy and banking supervision, together with accounting data and information on internal administrative activities, are systematically presented in this Report, which has been prepared by the Economic Research Department and, where applicable, by the Banking Supervision Department, with the collaboration of all the central departments. The Report is the fundamental document through which the Bank gives a detailed account of its operations.

In performing its functions and through its analyses and proposals, the Bank of Italy pursues the general interest, aims for the common good and serves the country.

Internally, it pays constant attention to technological innovation, training and the scientific and technical preparation of its staff.

On behalf of the Board of Directors, the Directorate and myself, I wish to express heartfelt thanks to the managers and all the members of the Bank’s staff.

The world economy

The tragic events of 11 September and the consequent political and military tensions caused turmoil in the financial markets and uncertainty that could have spread from the United States to other markets and economies. The prompt economic policy reaction and cooperation among the monetary authorities in the leading countries prevented the triggering of a profound worldwide crisis.

The rise in the price of oil and the abrupt slowdown in investment in technology had already put a brake on the growth of output in the industrial countries in the second half of 2000.

The growth rate in the developed economies, which was 3.9 per cent in 2000, declined to 1.1 per cent in the first six months of 2001. Output fell in the second half of the year, partly as a result of the recession in Japan and the slowdown in Europe. Growth remained rapid in the emerging economies.

World output rose by 2.5 per cent in the year as a whole, compared with 4.7 per cent in 2000.

World trade in goods and services had increased by 12 per cent in 2000 but fell sharply in the course of 2001 and remained stationary on an annual average basis.

The US economy

Economic activity in the United States declined only in the third quarter, in connection with the fall in consumption in September.

Monetary policy and tax reductions improved expectations and stimulated domestic demand. Consumption responded immediately. In the fourth quarter output began to grow once more at an annual rate of 1.7 per cent.

In view of the clear signs of an economic slowdown, official interest rates began to be cut at the very beginning of 2001. A further ten reductions were made as the year proceeded. The federal funds rate was brought down from 6.5 per cent at the end of 2000 to 1.75 per cent last December. Consumer price inflation declined from over 3 per cent in the first half of the year to 1.6 per cent at the end of 2001.

The fall in interest rates buoyed investment in housing. The liquid funds released by the renegotiation of mortgage loans increased household spending capacity.

The five-year programme of tax reductions launched in May 2001 raised consumption and firms' expectations and checked the fall in investment.

Taxes were cut by $70 billion in 2001. Revenue is scheduled to fall by $40 billion in 2002 as a result of the programme. The plan to extend the reductions for a second five-year period ending in 2011 will raise the permanent income of the private sector.

To meet defence and rebuilding costs, support the sectors worst hit by the crisis, encourage investment and increase unemployment benefits, new measures were approved immediately after 11 September and again last March, which will increase disposable income in the private sector by a further $100 billion in 2002.

The budget proposal for 2003, which was presented to Congress in February, provides for further tax cuts and increases in expenditure totaling $100 billion in 2002 as well. A new programme of expenditure on internal and external security costing around $30 billion was drawn up in April.

The budget measures adopted to date will inject the equivalent of 1.4 per cent of GDP into the economy this year. If the measures now under discussion are approved, the fiscal stimulus will rise to 2.5 per cent.

Continued productivity growth and competition have curbed inflation, allowing monetary policy ample room for manoeuvre.

Thanks to the scope for adjusting employment swiftly, labour productivity rose even as economic activity was declining. It increased by 1.9 per cent on an annual average basis in 2001 and by 5.5 per cent in the last quarter, benefiting investment earnings and encouraging the recovery to start up rapidly.

GDP growth leapt to 5.6 per cent in the first quarter of this year; labour productivity increased further, at an annual rate of 8 per cent. In April consumer price inflation was at a twelve-month rate of 1.6 per cent and the unemployment rate rose to 6 per cent; payroll employment began to rise again, after having declined by a total of 1,300,000 jobs over several months ending in March.

In the first quarter investment in housing began to rise again, consumption continued to increase, despite the fall in purchases of durable goods, and destocking virtually came to a halt. Public expenditure gave significant direct support to production.

Investment in equipment continued to fall but the decline in spending on machinery and software levelled off. After decreasing for five quarters, exports began to rise again, indicating an improvement in the world economy.

Sustainability of the recovery

During the decade-long expansion, consumption was fueled by the steady increase in employment and per capita earnings. After contracting in the first half of the 1990s, the share of value added accruing to payroll workers grew again.

The increase in consumption marginally exceeded that in GDP; as a result, households' saving rate fell to zero and their debt rose from 76 to 96 per cent of disposable income.

Consumption was also sustained by the increase in wealth in the form of securities and property.

The growth in investment lasted for ten years; its composition gradually shifted in favour of information technology and other high-tech capital expenditure. Investment was covered by firms' ample profits. The net financial flows of the corporate sector, which are normally negative in rapidly growing economies, swung from large deficits in the 1980s to balance in the first half of the 1990s; in the last few years they have turned negative again. In 2001 the sector's ratio of debt to shareholders' equity rose back to the level obtaining at the beginning of the 1990s.

The fall in share prices in the days immediately following the attacks of 11 September was rapidly reversed. Profits are still lower than in earlier years. Above all, expectations of earnings growth have been scaled back. The risk premium has risen during the period of slower economic growth; price/earnings ratios are still high. A clearer assessment of stock markets will only become possible as the recovery proceeds.

During 2001 the dollar appreciated against the euro and the yen. In the last five years non-residents' purchases of shares and bonds on US markets comfortably exceeded the increase in the country's net external debt. They created a reservoir of more than $1,500 billion for residents to invest abroad.

The inflow of investment depends on the outlook for growth and profits, but a further increase in the external imbalance may curb the volume of financial capital attracted to the United States by depressing the exchange rate of the dollar.

The structural adjustment of the public finances in the early 1990s and the prolonged rapid growth of the economy produced ever larger budget surpluses in the last few years.

According to the official forecasts published at the beginning of 2001, the budget surplus was expected to be $313 billion in 2002, rising to $800 billion in 2010 and nearly $900 billion in 2011.

The tax reductions approved in 2001 and the early months of 2002 will have a significant impact, reducing the forecast surpluses by about half.

The forecasts have been revised yet again in the light of the additional tax cuts and expenditure increases now under discussion. The budget is now expected to move close to balance during the rest of the decade. In this scenario, public debt would not rise in absolute terms and would fall from 57 per cent of GDP in 2001 to much less than that at the end of the decade.

Assuming that no additional expenditure programmes are introduced, the planned multi-year reduction in the tax burden appears sustainable in the light of the information currently available.

The spread of the new technologies in industry and services still has some way to go. Prudent estimates indicate that labour productivity will continue to increase in the next few years at an annual rate of between 2 and 2.5 per cent.

The strong growth in GDP in the first quarter was largely due to the smaller reduction in stocks, which will continue to contribute to output as restocking gets under way. The interest rate cuts made in 2001 have not yet produced their full effects.

Growth will inevitably slow down from the exceptional pace of the first quarter. The forecasts for the second half of the year indicate rates of between 3.5 and 4.5 per cent.

Outlook for the world economy

The recovery in the US economy will tend to gain momentum in 2003.

Its durability will depend in part on recovery and continued growth in the other industrial countries and the emerging countries.

The forecasts for the world economy were revised downwards several times in 2001 and again in the early months of this year.

The outlook was clouded by the difficult situation in Argentina and other Latin American countries and the fears caused by the failure of a large US corporation. The forecasts probably underestimated the effects of the expansionary economic policy in the United States.

According to the International Monetary Fund, GDP growth in China is likely to exceed 7 per cent this year and next; in India it should be between 5 and 6 per cent in both years and in the developing countries as a whole it will probably average 4 per cent this year and 5 per cent in 2003. The transition economies are expected to grow at rates of around 4 per cent.

In Japan industrial production fell by 15 per cent in the course of 2001; between the beginning of 1999 and the end of 2000 it had risen steadily by a total of 10 per cent in response to the sharp acceleration in world trade.

GDP showed a pronounced fall from the second quarter of 2001 onwards.

In the first quarter of this year industrial production began to rise again, benefiting from the recovery in the United States and the pick-up in world trade.

Japan's large current account surplus and the further increase in the country's net creditor position are responsible for the resilience of the yen, despite short-term interest rates being close to zero. Medium-term interest rates are also extremely low, but the combination of deflation, which raises the cost of funds, and the excess capacity created in the second half of the 1980s have impeded a recovery in investment. The ratio of capital to output is high.

The difficult situation and reduced profitability of firms are reflected in widespread losses on bank lending.

The allocation mechanisms are such that the enormous resources of the leading industrial economy of the Far East are underutilized. The economy is still beset by rigidities that make it difficult to switch labour and the other resources between sectors in response to market stimuli and international demand.

It is essential that the efforts to rehabilitate and consolidate the banking system continue.

For the economy to grow again, the recovery in foreign demand will have to be accompanied by an increase in domestic demand. Reforms have been sketched out that should ensure a better use of resources; by limiting investment in infrastructure, a start has been made on redirecting public expenditure with the aim of restoring the economy's flexibility and efficiency.

The European economies slowed down less than the US economy in 2001.

Against the background of cyclical weakness and a gradual easing of inflationary pressures, the Governing Council of the European Central Bank decided to reduce the reference interest rates on a number of occasions. Both nominal and real short-term euro interest rates are low today.

The growth in the monetary aggregates rose to a high level in the second half of the year, partly owing to temporary factors. The euro weakened slightly in effective terms during the year; it has strengthened appreciably in the last few weeks.

The slope of the yield curve has steepened in the early months of this year as the signs of a recovery in the world economy have strengthened; it implies that the markets expect short-term interest rates to rise by more than half a point by the end of the year.

The main euro-area economies continue to have structural rigidities that hinder the growth in productivity and a swift recovery in economic activity. Their public finances have deteriorated, reversing the earlier trend towards balanced budgets.

In Germany, where industry accounts for a larger part of the economy, output suffered more than in other countries from the sharp slowdown in world trade in manufactures. GDP grew by 0.6 per cent in 2001, compared with 1.7 per cent in the European Union as a whole.

Like other continental European economies, Germany has high costs and rigidities in the utilization of the factors of production; as a result, its ability to adjust during an economic slowdown is limited. Labour productivity in industry rose by 5 per cent in 2000, during the expansionary phase of the cycle; in 2001 it remained static. In France productivity in industry rose by 3.7 per cent in 2000 and by 0.3 per cent in 2001; in Italy it rose by 2.7 and 0.9 per cent respectively in the two years.

In economies open to international trade, the absorption of resources on a large scale by the public sector diminishes the propensity to invest and reduces competitiveness, especially if the services provided to citizens do not increase the overall efficiency of the economy.

In Germany, as in France and Italy, the ratio of taxes and social security contributions to GDP is in excess of 40 per cent, partly as a consequence of the demands of the public pension system.

The outlook for growth in Germany and other euro-area countries, and not just in the short term, appears to depend on a sustained expansion of the world economy that will generate demand for high-quality industrial products.

The transition countries of Central and Eastern Europe will be able to produce medium and low-tech goods at competitive prices, thanks to their potential for trade and integration with western Europe and their lower labour costs; they can provide a large market for exports of advanced products and services.

This is an opportunity that we must grasp at both the European and the national level.

In the first few months of 2002 the economies of the European Union also experienced a cyclical upturn. The expansion in activity will gain strength in the second half of the year; the rate of growth could rise to around 2.5 per cent in the last few months.

The growth in world trade in goods and services should accelerate during the year; it is expected to be around 7 per cent in 2003. The benefits will accrue to the countries best able to participate competitively in the recovery that is taking shape.

International finance

The monetary expansion that has been under way in Japan since the mid-1990s and in the United States since the beginning of 2001, together with the monetary policy in the euro area, has led to an increase in global liquidity and a fall in interest rates in real as well as nominal terms.

The money stock in the seven leading industrial countries rose from 66 to 73 per cent of their combined GDP between 1998 and the end of last year. Bank deposits held by non-residents have increased very rapidly. The uncertainties that affected markets last year have resulted in a pronounced preference for liquidity.

The volume of public and private sector bonds outstanding has grown in line with GDP.

Interest rates have reflected the growth in the money stock and its ratio to the volume of bonds.

Adjusted for inflation, short-term interest rates came down from 2 per cent in 1997 to less than 1 per cent at the end of last year; long-term interest rates declined from 4 to 3 per cent. The capitalization of the stock exchanges of the seven leading industrial countries rose from 60 per cent of GDP in the mid-1990s to 130 per cent in 1999; in 2001 the ratio fell to around 90 per cent.

The notional value of derivatives rose gradually until 2000 and then surged in response to the risks associated with the volatility of asset prices; by the end of 2001 it had reached 110 per cent of the GDP of the seven leading industrial countries.

Abundant liquidity, low interest rates and the reduction in the cost of capital encouraged an exceptionally large number of mergers and acquisitions. Far fewer transactions of this kind were carried out last year, owing to the fall in share prices.

The wide availability of credit and the low cost of capital also fostered investment, which increased steadily and substantially in all the industrial countries between the mid-1990s and 2000. In 2001 the upward trend came to a halt, and in several countries it was reversed.

On earlier occasions I have drawn attention to the contribution that global liquidity and financial market conditions made to the recovery in the industrial countries in 1999.

However, the growth in demand and the related rise in oil prices led to higher inflation that stifled growth, especially in economies with widespread structural rigidities.

This led to the pronounced slowdown of 2001.

Capital flows to the emerging countries contracted from 1997 onwards in the wake of the crises in Asia, Russia and Latin America. Net portfolio investment in these countries dried up completely and there were massive outflows of bank lending and trade credit.

Direct investment continued to increase; net inflows rose from $117 billion in 1996 to $155 billion in 1998 and $176 billion in 2001. Most of the resources went to countries in Asia and Latin America and to the transition countries.

Foreign investment has contributed to the development of innovative products and to the use of advanced technologies, but the volatility of financial markets and shorter-term financing can have serious consequences for the economic and political stability of the weakest countries.

The regulation and supervision of financial intermediaries are generally inadequate in these countries; inefficiency and sometimes corruption are widespread. The public finances are often precarious.

Market forces, which have driven the expansion and globalization of financial flows, are not on their own able to produce an efficient allocation of resources on a world scale.

The Mexican crisis of 1995 had already prompted the first steps towards closer cooperation between the monetary authorities of the seven leading industrial countries.

In the absence of a world government, it is necessary to rely on international cooperation to draw up and disseminate rules and practices for credit and money that the developed countries have applied for decades, ever since the Great Depression of the 1930s. An informal body has been set up to disseminate standards for the regulation and sound management of financial intermediaries and markets.

In 1999 the Group of Twenty was created to discuss issues relating to economic development and the governance of global finance.

The serious situation that has arisen in Argentina is a spur to reform the mechanisms for restructuring public debt and strengthen those that facilitate coordination among creditors in the management of crises.

In this context the Bretton Woods institutions are called upon to perform surveillance of individual economies, to provide and guide credit for investment, and to contribute to the adoption of adequate rules for the supervision of financial intermediaries.

The political initiative and strategic guidance must, of necessity, come from the informal groupings of the major countries.

The development of the backward economies

The rapid growth of the world economy from the end of the war until the early 1970s was fueled by the progressive liberalization of world trade in manufactures; the exchange rate system was set within the framework of the rules established in the Bretton Woods Agreements.

A group of highly industrialized economies emerged in which per capita income more than doubled in a span of twenty years.

The period since then has been distinguished by floating exchange rates and the liberalization of capital movements. New industrial economies have risen in which labour costs are very low compared with those in the countries where industrialization occurred earlier.

The second half of the last century saw an exceptionally rapid increase in the world population and even faster growth in output. However, the disparities between countries in terms of income and living conditions became more pronounced. While many countries made progress, others marked time or even slid backwards.

The number of persons living in extreme poverty is still enormous.

At the global level, the reduction of inequality is the social question of the beginning of the new century.

The highest moral, religious and political authorities have explicitly stated that poverty creates conditions in which terrorism can take root and flourish.

The systematic fight against poverty is a valid objective in itself; it can also be the means of achieving conditions of security and peaceful relations between peoples.

In 2000 the United Nations solemnly set itself a series of goals for reducing poverty and improving the living conditions of the most disadvantaged populations over the following fifteen years.

Rapid growth of the world economy must be accompanied by the promotion of global public goods able to ensure the sustainability of growth and its steady extension to the countries that missed out in the tumultuous expansion of recent decades.

The liberalization of trade and finance has proved to be a potent instrument of progress; however, it needs to be accompanied by rules and policies capable of eliminating or at least attenuating the most serious repercussions on income distribution.

The widespread use of information technology can make a decisive contribution to the development of the backward economies and to narrowing the gap between them and the most advanced countries. It requires adequate investment in education, in human capital.

Last year saw the start of the debt-reduction programme for the poorest heavily indebted countries, aimed at enabling them to participate in the process of economic growth.

The recent Monterrey Conference examined ways to increase development aid and improve its effectiveness. The richest countries renewed the pledge to boost their aid to at least 0.7 per cent of GDP. Programmes must be coordinated in order to avoid waste and inefficiency. This is another field in which the contributions of the IMF and the World Bank will be essential.

The development potential of many emerging economies continues to depend on exploitation of the natural and agricultural resources they possess, or can possess in abundance, given appropriate investment. The richest areas of the world – the United States, Japan and the European Union – protect their domestic producers by paying large subsidies to their farm sectors and erecting tariff and regulatory barriers to imports. Obstacles to free trade are also present in other labour-intensive sectors.

An increase in the output of the most backward countries, made possible by unfettered access to the richest markets, would also benefit consumers in the developed countries. Barriers and subsidies must be removed, in the same way as they were for industrial products in the decades following the Second World War.

The agreements signed at the WTO Ministerial Conference held in Doha last autumn move in this direction. The objective should be a new configuration of world production that gives full play to the principles of specialization and comparative advantage.

This will bring considerable benefits not only for the global economy but also for political stability in the world.

The Italian economy

Between 1995 and 2001 the economy of the fifteen European Union countries grew at an average annual rate of 2.4 per cent; growth averaged 3.6 per cent a year in the United States and 4.6 per cent in the emerging countries as a group.

In Japan growth was just over 1 per cent.

In Italy GDP increased by 1.9 per cent a year over the same period. In the fourth quarter of 2001 industrial production was 5.1 per cent higher than it had been in 1995; the corresponding increase for the twelve euro-area countries was 15.8 per cent.

Competitiveness and productivity

The underlying cause of the weak growth of the Italian economy is a loss of competitiveness in both the domestic and international markets.

The volume of Italian exports increased by 25 per cent between 1995 and 2001. Over the same period world trade grew by 45 per cent and the exports of the other eleven euro-area countries by 55 per cent. Italy's share of world trade in goods, at constant prices, fell from 4.6 per cent in 1995 to 3.7 per cent in 2001.

The output and value added of Italian industry are cyclically and structurally dependent on exports. Sectoral studies have found that firms exporting a larger proportion of their output systematically achieve higher profits, increase employment and raise productivity.

World trade in high-tech products is growing at twice the rate of trade in other goods. Innovative products enable their producers to increase market share in high-value-added sectors and to improve their countries' terms of trade.

Many industrial countries have increased their specialization in high-technology sectors over the past few decades. In Germany high-tech products rose from 12 per cent of total exports in 1991 to 15 per cent in 2000; in France they increased from 20 to 25 per cent and in the United States from 26 to 30 per cent. In Italy the proportion remained unchanged at around 8 per cent.

At the end of the nineties high-tech products accounted for about 6 per cent of total manufacturing value added in Italy. The comparable figure was 10 per cent in France, 26 per cent in the United States and 14 per cent in Japan.

Middle-technology goods manufactured at relatively low cost in the emerging economies now compete strongly in the domestic as well as the export market. Large companies, which have been slow to react because of organizational and operational rigidity, have been losing market share, as have the smallest firms. Imports of manufactures rose from 16 per cent of GDP in 1995 to 20 per cent in 2001.

Productivity is the key to competitiveness in both the domestic and international markets.

In Italy labour productivity growth slowed down perceptibly between the eighties and the nineties.

In food processing the average annual increase in productivity declined from 2.6 per cent in the eighties to 1.4 per cent in the nineties. In chemicals and synthetic fibres it fell from 9.5 to 2.7 per cent, and in machinery and transport equipment from 3.7 to 1.3 per cent.

The competitiveness of Italian industry has suffered from the fragmentation of output among a plethora of small firms. Small firms give the economy flexibility but make it more difficult to develop innovative products and techniques and limit efficiency.

The tax burden and labour market rigidity undermine the economy's productivity and competitiveness. They may push firms towards sub-optimal size.

Competitiveness is also affected by the degree of efficiency of public services, infrastructure deficiencies and the cost of energy.

The low number of persons in employment in relation to the working-age population, widespread self-employment and the abnormally large scale of underground activity are the ultimate result of arrangements that have become unsuited to the new global economic environment of fierce competition and the continual introduction of new products and technologies.

Economic growth and firm size

The extraordinary growth of the Italian economy in the fifties and sixties was fueled by large public and private firms.

In the late sixties labour market regulation and industrial relations began to be shaped in accordance with a steadily and rapidly growing economy and firms of substantial size.

The oil crises and inflation of the 1970s caused growth to slow down and to become more erratic, falling from an average annual rate of nearly 6 per cent in the two previous decades to 3.8 per cent.

Sharp conflict over the distribution of income led to an enormous increase in the cost of labour and a reduction in profit margins for large companies. Smaller firms were better able to respond to the changing economic and social environment; they increased their penetration of foreign markets by exploiting the depreciation of the lira.

In the 1980s major restructuring and substantial technological investment enabled the largest enterprises to restore their efficiency and profitability.

However, inflation and the poor state of the public finances necessitated high interest rates. Public expenditure crowded out productive investment. The growth rate slowed to 2.4 per cent a year.

In the 1990s a further slowdown in growth, greater demand volatility and intensifying international competition again curtailed investment to expand the scale of production.

The periodic currency devaluations of the seventies and eighties had offset the weaknesses of the Italian economy by producing gains in competitiveness, which proved short-lived, however. The 1992 devaluation also led to an appreciable increase in exports in the years that followed. Agreements on wages and industrial relations helped to restrain the cost of labour.

Monetary policy was tightened severely in 1995 in order to revalue the lira and reduce inflation. Italy's return to the Exchange Rate Mechanism of the EMS at the end of 1996 helped to restore monetary stability.

However, productivity growth slowed down sharply in the following years. Between the end of 1996 and the end of 2001, Italian competitiveness vis-à-vis the rest of the euro area, measured in terms of unit labour costs, deteriorated by 8.6 per cent.

The modest rise in real wages resulted in a redistribution of income in favour of profits. Adjustment of the public finances consumed an ever larger share of income.

The loss of competitiveness in foreign markets has been greatest in mature industries and in sectors with a high proportion of small firms.

The average size of firms in the industrial countries peaked in the sixties. The subsequent reduction reflected the increasing importance of the service sector and decreasing employment in large manufacturing concerns. The spread of information technology and the drive to increase efficiency through reorganization are leading to a less vertically integrated structure of production.

In Italy the average size of firm, which was already smaller than in other leading countries, has declined more sharply than elsewhere.

In manufacturing industry, firms with more than 500 employees accounted for 31 per cent of total employment in 1971; this share fell to 19 per cent in 1991 and 15 per cent in 1996. In France employment in large firms fell from 55 to 43 per cent of the total between 1977 and 1994, while in the United Kingdom it declined from 54 to 50 per cent. In the United States employment in firms with more than 500 employees accounted for nearly two thirds of the total in the mid-nineties.

Ninety-five per cent of Italian firms have fewer than ten employees. Firms in that category account for 47 per cent of total employment, compared with 21 per cent in Germany, 22 per cent in France and 27 per cent in the United Kingdom.

The average Italian firm in industry or services is about 60 per cent as large as its counterparts in the other countries of the European Union.

The proportion of medium-sized companies is especially low in Italy.

Small enterprises have made a decisive contribution to Italian economic development in past decades, but fragmentation now threatens to undermine the capacity for growth.

Innovation demands substantial initial investment, which can best be afforded by large companies or by consortia of medium-sized and small firms. The public sector and the banking system can provide important impetus.

Italian investment in information technology is low by international standards. One significant potential benefit of the spread of the new technologies is a more efficient configuration of intersectoral relationships. Some of the advantages enjoyed by firms in industrial districts can be extended nationally.

It is necessary to move towards a new employment charter that protects the rights of all working people but adapts flexibility and costs to the new realities of production and the utilization of the new technologies.

The social safety net must be strengthened. The portion of wages that depends on company performance must be increased.

Tax and social security contribution rates must be progressively lowered, in connection with the necessary reform of public expenditure.

In small firms family control is a decisive factor at the launch of new business projects and in the initial phase of development, but subsequently it may become a barrier to expansion, for lack of capital and managerial resources.

The path to restoring the efficiency and competitiveness of the entire economy necessarily passes through Italy's large firms. They are indispensable for propagating technological advances, stimulating research and creating managerial skills.

It is essential to remove the regulatory and fiscal obstacles that have curbed the growth of small firms. The conditions for a revival in investment must be created and reforms must be introduced to unlock Italy's abundant entrepreneurial resources.

It is the growth of small and medium-sized enterprises that can make the greatest contribution to an increase in employment.

Employment

Employment in the euro area expanded by 1.3 per cent in 2001 on an annual average basis. In France and Spain the increase was 2 and 2.6 per cent respectively, in Germany just 0.2 per cent.

In Italy the number of persons in work rose by 2.1 per cent last year. In 2000 the gain had been 656,000, of whom 370,000 were permanent full-time employees. Between January 2001 and January 2002 employment increased by 370,000, including 300,000 full-time positions.

As in the past, most of the jobs were created in the service sector. Employment in construction increased for the third consecutive year. However, the number of manufacturing workers decreased, continuing a decline that began in 1998.

Last year the rate of employment growth was faster in the South than in the Centre and North. As in the rest of the country, the gain was concentrated in services and construction, but there was also a continuing gradual expansion in industry.

In a setting of weak economic growth, employment was favoured by wage moderation. From 1997 to 2000 firms made extensive use of fixed-term and part-time contracts.

The tax relief introduced by the Finance Law for 2001 reduces the cost of labour for new permanent employees by 15 per cent in the Centre and North and 30 per cent in the South until the end of 2003. The direct cost to the Treasury was €530 million in 2001. This incentive helped increase the number of stable jobs. It is estimated that by the end of the year more than 150,000 workers had benefited, 60,000 of them in the South.

It can be assumed that a significant proportion of the new contracts replaced existing precarious jobs.

The underground economy remained substantial during the nineties. According to official estimates, the value added of undeclared economic activity rose from 15.8 per cent of the total in 1992 to 17.7 per cent in 1997 and then fell to 15.4 per cent in 1998.

Italy's employment rate, including undeclared work, remains the lowest in the European Union; in 2001 it was 55 per cent, 10 points below the average for the other member countries. In the South it was 43 per cent.

All countries in Europe have employment incentives in the form of public funding for training, recruitment, direct job creation and self-employment.

In Italy the budgetary cost of labour policies declined from 1.6 per cent of GDP in 1996 to 1.3 per cent in 2000.

Unemployment benefits, including payments by the Wage Supplementation Fund, amount to about 0.5 per cent of GDP. This is one of the lowest figures in the European Union. In 1999 unemployment benefits were equal to 0.8 per cent of GDP in the United Kingdom, 2.1 per cent in France and 2.5 per cent in Germany.

The reforms introduced in the last few years, together with tax relief, have led to a significant increase in employment. However, the labour market still suffers from high costs and insufficient flexibility, which keep the participation rate low and the incidence of undeclared work high.

Social security contributions, though far from sufficient to cover expenditure by the pension institutions, amount to 40 per cent of gross per capita earnings.

To reduce high unemployment, combat underground employment, which is frequently accompanied by poor safety conditions, and stimulate participation by those now discouraged from entering the labour market requires a resolute shift towards new and more modern forms of employment regulation. At the same time the pension system must be reformed to permit the lowering of social contributions, which impinge directly on labour costs and earnings.

Far-sighted action is needed to enable the potential of economically backward regions to contribute to the growth of the Italian economy, to lower the high rates of youth and female unemployment and to offer the nation the prospect of economic and social progress.

The public finances

The total general government borrowing requirement on a cash basis declined to €8.5 billion in 1999; it rose to €25.8 billion in 2000 and €40.8 billion last year.

Net of settlements of past debts and privatization proceeds, the requirement amounted to 2.2 per cent of GDP in 1999. It rose to 3.2 per cent in 2000 and then declined to 2.9 per cent in 2001.

The net borrowing requirement on a cash basis came to €34.8 billion last year. Settlements of past debts amounted to €10.3 billion, or 0.8 per cent of GDP. This amount should be attributed to the requirements for previous years.

General government net borrowing on an accruals basis, calculated in accordance with the European System of Accounts, was estimated at 1.7 per cent of GDP in 2000 and 1.4 per cent in 2001. The difference between the borrowing requirement and net borrowing, equal to 1.5 per cent of GDP in both years, is presumably due not only to financial items but also to accrued but uncollected revenues and to expenditure and tax reimbursements relating to previous years.

The reconciliation account between the two aggregates needs to be clarified.

The decrease in the general government borrowing requirement and net borrowing in 2001 was small compared with the final results for 2000. There was a considerable improvement in the second half of the year by comparison with the trend in the first six months, owing to tight control over spending, higher-than-expected revenue of €5 billion from the extraordinary tax on the revaluation of corporate assets, and securitization operations that produced €5 billion on a cash basis and €7 billion on an accruals basis.

For this year, the Quarterly Report on the Borrowing Requirement projects a net state sector borrowing requirement of 2.1 per cent of GDP. It estimates the public sector requirement, excluding privatization proceeds and including €10.4 billion of settlements of past debts, at 3.2 per cent of GDP.

The Stability Programme sets a general government net borrowing target of 0.5 per cent of GDP in 2002, based on forecast economic growth of 2.3 per cent. In 2003 the budget should be balanced. In the light of present trends, the borrowing requirement and expenditure must be carefully controlled.

Above all it is necessary to undertake a structural adjustment of the public finances in the course of this year.

The ratio of taxes and social security contributions to GDP rose by 6 percentage points between the second half of the eighties and the second half of the nineties. It must be brought down gradually in the coming years, in accordance with the plan laid out in the Economic and Financial Planning Document and along the lines of the draft enabling law now before Parliament.

The implementation of the tax reform depends on curbing the growth in public spending net of interest payments.

Efforts to contain expenditure on public sector wages must rely on hiring controls; savings can be made by outsourcing some activities. In the past, spending on health care has risen more rapidly than GDP. The measures already enacted, agreements with the regions, the rationalization of the system and the assignment of health care provision to private sector operators that meet defined standards must prevent the ratio of health spending to GDP from rising above its current level of 6 per cent. Without increasing the level of spending, these measures must provide for prompt provision of services, an increase in quantity and satisfactory quality.

Public expenditure on goods and services can be held constant in nominal terms, or even reduced, by carrying out a far-reaching rationalization of purchasing procedures.

As in other European countries, the public pension system in Italy suffers from a structural imbalance between benefits and contributions. Even excluding the outlays that actually constitute welfare benefits, the private sector employees' pension fund still shows a gap of more than 4 percentage points between the actual contribution rate of 32.7 per cent of wages and the equilibrium rate.

More than a third of the public debt derives from central government transfers to public social security institutions. Current demographic trends, which can change only very slowly, will aggravate the imbalance.

In the long run the system is unsustainable. Action must be taken, while safeguarding the entitlements and, to a large extent, the expectations of workers now approaching retirement; the average age at retirement must be raised, on a voluntary basis, but with the prospect of substantial savings; a significant part of retirement provision must be shifted to private, funded pension plans.

The importance of spending on education and research in the present situation must be emphasized. These are investments whose returns are deferred in time but high, well above current interest rates.

Expenditure on public works must be increased substantially in the more advanced regions and above all, especially in the short term, in the less developed ones, to overcome the widespread deficiencies of infrastructure.

The construction and operation of public infrastructure on which it is possible to earn a return from user fees should be entrusted to non-state operators, subject to appropriate controls. Such projects can be financed by private lenders or by the capital market. Lending which entails an indirect cost for the Treasury must be managed and supervised in accordance with banking criteria.

Privatizations and the disposal of assets not needed for the production of public services can accelerate the reduction of the public debt in proportion to GDP. Better administration of public assets can improve the efficiency of the economy.

The institutional and administrative decentralization introduced by the amendment of Title V of the Constitution offers an opportunity for a reorganization of government, in order to bring decisions concerning public services and the way they are financed closer to citizens.

This task needs to be tackled urgently, not least to avoid a further widening of the gap between economically advanced regions and less developed regions and areas. It is necessary to decide the source and amount of the envisaged solidarity fund and the criteria for distributing it.

The process of deciding budgetary policy must be reconfigured to permit coordination of the demands of the different levels of government and the preparation of an overall plan for the expenditure and revenue of central government and local authorities.

The wide range of functions and services entrusted to local government could raise the overall level of public spending.

It is necessary to reform the public accounting system, to harmonize budgetary rules and to form a timely picture of all central government and local authority expenditure and revenue with the aid of information technology. The measures under discussion in Parliament go in this direction.

Implementing provisions must be adopted that allow institutional decentralization to be achieved within a comprehensive framework.

These are momentous tasks, issues to be faced with clarity and resolution to avoid a further erosion of the efficiency of our economy.

Their solution will bring opportunities for growth.

The financial markets and banking

The large fluctuations in securities prices and the risks of instability arising from the terrorist attacks and the crises in important emerging countries, at a time when equity prices were falling back from the levels reached in the spring of 2000, were overcome thanks to the improvements in market organization, the liquidity supplied by the central banks and the use of advanced hedging techniques.

Since January of last year share prices have fallen by 13 per cent in Japan, by 19 per cent in the United States and by between 24 and 28 per cent in Germany, Italy and France.

In the euro area the number of initial public offerings declined from 419 in 2000 to 132 last year. In Italy it fell from 45 to 17 and the amount of capital raised decreased from €9 billion to €6 billion.

The difficult economic situation fueled fears about the markets' willingness to finance firms, especially those that had increased their leverage during the upswing.

Monetary policies helped to maintain easy conditions in the credit market.

Euro-area firms made net bond issues of €190 billion, as in 2000; placements by Italian companies rose from €23 billion to €61 billion.

The bankruptcy several months ago of a major US energy group that also operated in the financial sector has raised questions about the adequacy of the safeguards designed to ensure correct corporate governance and the faithful representation of business management activities.

The orderly functioning of the capital markets requires timely, correct and complete information. The importance of transparency in accounting policies grows in proportion to the intangible assets in a company's balance sheet and operations. The distortions that may stem from the performance of consulting and analysis by firms with interests in their client companies must be avoided.

Financial statements, internal controls and the auditing of accounts are governed in our law by the general principle of true and fair reporting of the company's situation. Correctness, competence and professional ethics are essential; they are the foundation on which firms' reputations and market confidence are built.

The role of the financial markets in serving the economy has wider implications in the current international context. Enhancing the scale and quality of the structures of the Italian financial marketplace is essential for the competitiveness of our economy; it contributes to the strength and efficiency of the European market.

The reorganization of market structures and operating systems is continuing with a view to improving the quality of services offered to participants. The banks are taking part in the growth of the financial markets with renewed commitment and a wider range of investment services.

Credit conditions

In 2001 bank lending continued to grow at a lively pace in Italy. Interest rates came down by one percentage point over the year.

The increase in lending was equal to 7.4 per cent, higher than in the euro area and above the rate of GDP growth. The expansion was rapid in the first half and more moderate in the second.

The cyclical downturn dampened the demand for funds to finance both investment and consumption. There was a sharp decline in demand for loans connected with corporate mergers and acquisitions. In recent years these had increased the banking system's exposure to large industrial groups; in the past few months the largest groups have embarked on debt-reduction programmes.

Net interest income, which had surged in 2000, grew by 5.5 per cent. It benefited not only from the increase in the volume of business but also from a shift in the composition of assets in favour of loans, at the expense of bonds.

Market volatility curbed households' demand for investment and asset management services; net fee income fell by 12.5 per cent.

Total operating costs rose by 3.8 per cent compared with the previous year. Expenditure on the use of information technology increased by 11.8 per cent and rose to 15 per cent of total operating costs.

Average staff costs per employee rose by 0.9 per cent to €61,100; they remain high compared with other leading European countries.

Return on equity in the banking sector fell to 8.9 per cent, compared with 11.6 per cent in 2000. The decline was largely due to losses on loans and investments, which were almost twice as large as in the previous year and equal to 40 per cent of operating profit. In particular, investments in two banks operating in Argentina were written off.

The flows of impaired loans and bad debts in the domestic portfolio were small in relation to the volume of lending. The cyclical slowdown of 2001 could affect loan quality this year, given the lag with which the health of the real economy is reflected in bank assets. However, the profitability and financial situation of firms are stronger now than during the downturn of the early nineties.

By international standards, the ratio of banks' total assets to GDP is low in Italy.

Lending to firms is in line with that in the other main euro-area countries. Lending to households is less developed. It is a sector with scope for expansion, even taking into account the specific characteristics of Italy’s economic and social structure.

Borrowing can enable households to achieve a better allocation of saving over the life cycle. Competition, which has already increased, will have to grow further, in order to reduce the cost of loans and stimulate the supply of services.

Securities trading and asset management services for households have expanded substantially in the last few years.

We renew the call we have made on previous occasions for greater professionalism on the part of intermediaries and their staff in selling financial products so as to avoid the illusions and errors of the past.

The banking system is already moving in this direction.

It is necessary to strengthen and consolidate the relationship of trust with savers.

It must be made explicit that high yields entail risks of capital loss and that the nominal value of an investment is guaranteed only in the case of deposits.

Any undertaking of this kind made in respect of other financial products is subject to transparency obligations; adequate capital reserves must be set aside and the related contingent liabilities must be expressly stated in the accounts.

The concentration and reorganization of banking groups

Since the mid-nineties, the banking system has evolved from one consisting of small and medium-sized banks engaging mainly in deposit-taking and lending in local markets into a web of larger groups able to offer a wider range of products and increasingly active in international markets.

Banks have pursued high rates of return on equity by striving for efficiency in resource allocation and developing intra-group synergies. Competition has intensified in the national and local markets.

Between 1996 and 2001 mergers and acquisitions involved banks accounting for 40 per cent of total assets.

Four large banking groups were formed that hold 49 per cent of total assets. If the other two leading groups are also counted, the figure rises to 60 per cent.

In authorizing mergers and acquisitions we acted so as to prevent the formation of dominant positions in the national and local markets.

With the possible exception of one last major operation, we consider the consolidation in the top tier of Italy's banking system to be complete; further amalgamations would lead to a decrease in competition.

As we have insisted on previous occasions, it is necessary to integrate the organizational structures within groups, centralizing the functions of corporate planning, product design and risk control.

Organizational rationalization is bearing fruit, with positive effects on banks' efficiency and the quality of new lending. Nevertheless, there is still a long way to go before the scope for synergy is exhausted. There have also been uncertainties in command structures owing to tensions in important parts of the system where the influence of the previous public ownership was strongest.

We pay special attention to the availability of loans for small enterprises. Detailed studies indicate that at the provincial level bank consolidation has not led to credit rationing or a deterioration in conditions for small businesses.

Relations with local customers need to be enhanced in qualitative terms; in important cases, especially in the South, this can be accomplished by preserving the original bank names within groups.

The drive for greater scale must now primarily involve medium-sized banks. With their characteristic statutes, cooperative banks combine attention to the local economy with the supply of high-quality services; they enrich the diversity of our banking system.

The number of cooperative banks has fallen from 100 at the end of 1992 to 39, mostly as a consequence of mergers and acquisitions within the category. Their market share has increased from 12 to 15 per cent. These banks generally have good efficiency indicators.

It is important to increase collaboration within the category. A recent operation between two of the largest intermediaries points to ways of achieving further consolidation.

Ownership structures and banking foundations

The number of listed banks has increased; these institutions account for 80 per cent of the system's total consolidated assets. At the end of last year six Italian banks figured among the top thirty in the euro area by market value.

The share of total assets attributable to banks in which the government or foundations held majority interests was still 58 per cent in the mid-nineties. It has now fallen to 10 per cent.

Banking foundations have played a key role in the consolidation of the system by gradually disposing of their holdings in banks. The transfer of ownership has fostered the creation of stable cores of controlling shareholders in which major insurance companies and leading foreign intermediaries are represented.

With a single exception, the majority of the capital of all the largest banks has been sold. The foundations hold more than 50 per cent of the capital of 25 small banks with an aggregate market share of 4 per cent.

The measures introduced in the Finance Law for 2002 allow foundations to postpone the sale of controlling interests in banks until June 2006, provided the controlling shareholdings are entrusted to asset management companies with a mandate to administer them according to principles of economic efficiency.

Rigorous criteria are being defined, on the basis of which the Bank of Italy will identify control situations.

The foundations will be able to retain shareholdings in banks for income-producing purposes.

The law established the criteria for appointing the members of foundations' boards. They will be designated predominantly by the local authorities of each foundation's home area.

"Predominantly" suggests a proportion of more than 51 per cent. A proportion of around 60 per cent reflects the spirit of the law; it can constitute a balanced solution for the representation of civil society.

In foundations constituted as associations, 50 per cent of the members of the board are elected by the general meeting; the remainder are appointed in the proportions laid down for foundations with an institutional basis.

In a financial market in which institutional investors are less developed, the completion of the transfer of control of banks must proceed by ensuring that banks have stable governance.

It is necessary to complete the process that in less than a decade has led to a banking system that is largely privatized, consists of intermediaries of much greater average size, has returned to the international markets after a long pause and is able to serve savers and firms effectively.

Banking supervision

The sound and prudent management of banks is the responsibility of their directors. As confirmed by the recent Ecofin Council meeting in Oviedo, proximity to the supervised institutions is essential for effective supervision.

The supervision performed by the Bank of Italy consists first and foremost of an examination of the data supplied at regular intervals by individual intermediaries, according to reporting formats designed to give a complete view of operations and the state of the accounts.

Meetings are held on a systematic basis with banks' corporate officers to discuss aspects that point to weaknesses. A total of 424 such meetings took place last year, including 227 held at branches of the Bank. Supervisory measures are aimed at ensuring compliance with the rules and strengthening banks' organizational structures and internal controls; they may consist of formal reprimands.

On-site inspection of each intermediary takes place, on average, every six years. Inspections are more frequent for banks in difficulty.

In the four years from 1998 to 2001 inspections were performed at 694 banks accounting for 54 per cent of total assets. Assessments were completely positive for intermediaries with market shares amounting to 26 per cent of total assets and completely negative for banks with 6 per cent. Intermediate evaluations were made for the remaining 22 per cent.

Between 1994 and 1997 inspections were performed at 726 intermediaries, representing 52 per cent of the system. The banks that received completely positive evaluations accounted for 12 per cent of total assets, those with completely negative evaluations for 11 per cent.

The findings of on-site supervision confirm the improvement that can be seen in the aggregate data.

Special importance has been attached in the most recent period to organization, cost trends and performance in terms of transparency and correct conduct towards customers.

Last year, the desire to meet savers' expectations of high returns led some banks to fall short in risk evaluation, contractual regularity, disclosure of information and accounting for the commitments they had entered into.

Examination of banks' situations and on-site controls brought to light inadequacies in organizational structures, internal auditing systems and the actions of banks' governing bodies. The procedures for sanctioning the irregularities were activated. Measures were taken to restore sound and prudent management.

In 2001 Bank of Italy branches made on-site visits to check local compliance with the rules on the transparency of contractual terms and conditions for banking services. Checks at 698 branches of 154 banks uncovered instances of non-compliance for which corrective action was requested; administrative sanctions were imposed in the most serious cases.

In international fora it has been found appropriate to recommend that the largest banks, which are most exposed to the risks of the global market, raise their capital to levels substantially above the minimum requirement.

In the three years from 1998 to 2000, in connection with the rapid growth in lending, the capital of Italian banks fell from 11.4 to 10.2 per cent of their risk assets, weighted on the basis defined in the international accords. The capital adequacy ratios of the largest Italian banks, in particular, were low by comparison with those of the other Group of Ten countries.

We called for the launch of a programme to strengthen the capital base of our country's largest banks.

The capital of Italian banks grew to €129 billion in 2001. The average capital ratio rose to 10.6 per cent; the amount in excess of the minimum requirement of 8 per cent increased to €33.5 billion.

Within the Basel Committee it has been agreed that capital requirements will be computed on the basis of agency ratings or models developed by individual banks in the light of their specific operations and the composition of their assets, subject to validation by the supervisory authorities.

Criteria for assessing the credit risk of small firms in ways that avoid an increase in their cost of borrowing have been accepted, partly at our initiative.

In the light of their complexity, the problems require further study. The new Capital Accord is expected to become operative in 2006.

Corporate finance

There is an increasing tendency in all countries for large and medium-sized companies to raise funds in the capital market.

The leverage of Italian firms declined over the last decade; today it is not out of line with the levels in France, Germany and Spain.

In the last three years Italian companies raised €38 billion in equity capital, equal to an annual average of 1.9 per cent of the stock market capitalization, and issued €59 billion in eurobonds. The presence of Italian banks in underwriting syndicates enabled 25 medium-sized companies, which do not generally have a credit rating from the specialized agencies, to make their début in the eurobond market.

The gross profits of Italian companies rose from 25 to 33 per cent of value added between 1992 and 2001. The decrease in their debt from 58 to 38 per cent of their financial liabilities and the fall in interest rates reduced the ratio of net interest expenses to gross operating profit from 31 to 15 per cent.

There was no improvement in the financial structure of small enterprises during the nineties. Their investment continues to be financed almost entirely from internal resources and bank loans, mainly at short term.

Their productive efficiency is offset by the burden of interest charges due to their heavier debt. This affects their profitability, which is lower than that of European firms of comparable size and below that of larger Italian companies.

The measures taken by Parliament and the regulatory authorities in recent years have created the conditions for an improvement in the operation of the markets; they have fostered the demand for shares by increasing the protection of minority shareholders and introducing new types of institutional investor.

It has been primarily companies not belonging to listed groups that have taken advantage of the tax incentives for initial public offerings. The growth of the market has also been boosted by the listing of privatized companies.

However, Italy still appears to be caught in a vicious circle between the small size of firms and the low demand for financial services. This is hampering the development of the equity market and reducing the availability of long-term capital; firms are failing to grasp opportunities for investment and growth.

The fall in share prices discouraged firms from seeking stock market listing last year.

The ratio between stock market capitalization and gross domestic product fell to 48 per cent. The number of listed companies is small, and non-financial enterprises are under-represented.

Labour market reform and a reduction in the tax burden could help overcome the reluctance of Italian firms to operate on a larger scale and to raise external finance.

Banks should deepen the relationships they already have with firms and will have to be joined by new intermediaries that specialize in assessing and financing small and innovative enterprises in order to facilitate their access to the capital market and assist their development.

Since the end of 2000 the number of Italian venture capital companies has increased from 11 to 21 and that of closed-end investment funds from 16 to 33.

During the technology investment boom, almost half of the resources that flowed into the venture capital sector in the United States came from pension funds.

The Italian financial system needs to see a similar increase in investors with a medium-to-long-term horizon.

Ladies and Gentlemen,

Despite the consequences of the attacks of 11 September, the economy of the United States is recovering strongly, thanks to its efficiency, labour market flexibility and timely, effective economic policy.

Growth is bound to slow down from the exceptional rate of the first quarter; investment is likely to rise in the second half of the year. GDP can be expected to increase by at least 4 per cent between the end of 2001 and the end of 2002.

The European economy is recovering slowly; the structural adjustment of the public finances has not been completed, the ratio of tax to GDP remains high and there are still market rigidities, especially in the labour market.

The Italian economy is also proving slow to join in the world recovery. The difficulties in initiating reforms and the consequences of the terrorist attacks have set back an upturn in economic activity by at least six months.

In the first quarter industrial production was on average 0.2 per cent higher than in the last three months of 2001.

In March production was 4 per cent lower than twelve months earlier. According to preliminary data, it recovered in May but was still between 1 and 2 per cent below the level of a year earlier.

The incipient recovery in world trade, as evidenced by the export performance of the United States, France and Germany, does not yet appear to have had significant effects on industrial production or on Italian exports, which have in fact declined.

We have regained the benefit of monetary stability, but Italian products are increasingly less competitive.

Productivity growth slowed down in too many branches of industry during the last decade. Industrial activity in Italy is tending to contract.

There is a rising trend in orders, but consumption remains weak. Productive investment stagnated in the final quarter of last year. It has begun to grow again in 2002, but more slowly than in recent years.

The possibility of achieving GDP growth of more than 2 per cent in 2002 depended on the programme of public works being launched in the first few months of the year.

A survey carried out by our branches in the first two weeks of May indicated an increase in activity in the infrastructure sector in most regions; in others there are fears that it will decline. The positive outlook that is emerging for the medium term depends on implementation of the enabling law. The infrastructure gap in relation to other European countries must be narrowed. Infrastructure is particularly deficient in the South.

The legislation and administrative formalities can be completed quickly. Conflicts between the powers of central government and those of the local authorities must be resolved.

Construction projects must get under way as soon as possible. Works in the second half of the year totaling €5 billion, equivalent to 0.4 per cent of GDP, could raise the growth rate significantly above 1.5 per cent in 2002 and generate a stronger expansion in 2003.

The crucial requirement for a growth-oriented policy is a reduction in the ratio of current public expenditure to GDP.

It is a precondition for credible tax reform; it will generate benefits for households, in terms of their spending power, and for firms, in terms of their propensity to invest.

It is necessary to proceed rapidly to define the measures for the labour market and the pensions sector.

In the background, there is the need to begin the overhaul of the public pension system. The structure and level of the social safety net must be reviewed.

The launch of far-reaching reforms can set the economy on a virtuous circle of growth, employment and balanced public finances.

It is essential that this strategy be implemented. We have the resources to bring it to fruition. The markets are calling on us to do it, and qualified international observers expect it of us. It is in the interests of society.

There is need for a profound change – a metanoia, as it were – in the way in which relations between employees and firms are conceived.

Negotiations in defence of legitimate interests must be transformed into strategic collaboration on the basics, with the ultimate objective of achieving growth, improved conditions for those already in work and the prospect of stable employment for those in precarious jobs and those others, many of whom are young, who aspire to a better future.

It is up to firms to return to the path of growth by introducing new technologies and products, in a regulatory and social setting that has been made more favourable.

In the service sector, where inventiveness and human capital are most prevalent, there is ample scope for expansion. We must grasp the opportunities.

The banking system has undergone profound change over the last five years; it has grown in size and in the range and quality of operations.

The financial markets are also extending their activities and improving their efficiency, thanks to changes in legislation and the effective action taken by the regulatory authorities.

Problems remain to be resolved and further progress must be made. But only a few years ago the country lacked a modern financial infrastructure. The banking system and the financial market now have the means to enable large industrial companies to overcome difficulties, to foster their development and to support the growth of small enterprises. We constantly monitor current events, paying attention to the general interest.

The success of the operation to repatriate capital from abroad provides our banking and financial system with €30 billion, which can be invested in Italy, in the financial market and in enterprises, if the conditions for profitable investment are created.

Italy does not make full use of the resources at its disposal. The regions in the South will be able to contribute to the growth of the economy as a whole if labour market innovations, adequate infrastructure and improvements in security foster the establishment of enterprises by reducing external diseconomies.

A more resolute economic policy is needed to achieve the necessary structural reforms, stimulate productive activity and offer better growth prospects for our economy.

The monetary stability provided by the euro must be but one element in a broader, far-sighted vision in which Europe can take effective economic policy measures by assuming a clearer political identity.

The historic signature of the Rome Declaration lays a firmer basis for security and the easing of international tension; it opens the door for closer cooperation between East and West, and between Western and Eastern Europe.

The economic benefits may be substantial; the Declaration holds out the prospect of closer integration by repairing the chain of cooperation and trade that was broken in the early decades of the last century.

It gives grounds for optimism.

We must be equal to the test of our times, each acting calmly and resolutely in his appointed field.

To a large extent, our future rests in our own hands.