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# **Recovery and growth of the Italian economy**

Address by the Governor of the Bank of Italy

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## **1. Recent economic developments**

The decade-long expansion of the US economy came to an end in the first half of last year.

Investment in machinery and software, which had already turned slightly down at the end of 2000, fell by 4.2 per cent on an annual basis in the first quarter of 2001 and by 15.4 per cent in the second. Investment in plant, which had shown a further rise of 12 per cent on an annual basis in the first quarter, recorded a fall of the same order of magnitude in the second.

In the first half of 2001 the growth in GDP was sustained by consumption. The weakness of world demand was reflected in exports, which had already begun to contract in the last part of 2000.

A gradual recovery in economic activity had been expected to get under way in the closing months of last year, in view of the pronounced monetary expansion implemented from January onwards and the tax relief approved in May.

In a situation already marked by cyclical weakness, the events of 11 September caused a decline in consumption. Between the second and third

quarters GDP fell by 1.3 per cent on an annual basis. Investment in machinery and plant continued to contract, falling at an annual rate of 9 per cent.

In October war-related requirements caused orders for capital goods to rise by a very substantial 28 per cent; there was also an increase of 5.8 per cent in demand for non-defence capital goods.

In December the contraction in industrial production that had been under way since the last months of 2000 practically came to an end. The survey of manufacturing firms' purchasing managers showed significant improvements in November and December. The index for services, starting from 40.6 in October, had already reached 51.3 in November and rose to 54.2 in December, indicating a return to expansion.

The unemployment rate rose sharply in the autumn. Thanks to the flexibility of job shedding, labour productivity continued to rise even during the recession, thereby safeguarding the profitability of investments.

In addition to the tax refunds approved in May, for a total of \$110 billion in the two years 2001 and 2002, \$80 billion is to be spent on reconstruction and homeland security. In total the budgetary measures already approved to sustain the economy and speed up the recovery in production are equivalent to about 2 per cent of annual GDP. Other measures amounting to around \$70 billion have been proposed.

As early as October the foreign exchange and financial markets appeared confident of the start of a new period of economic growth. The dollar, after regaining its early-September level, has appreciated further. The risk

premiums on corporate bonds have diminished. Share prices have more than made good the fall recorded in the wake of the terrorist attacks.

In Japan GDP contracted by 2.2 per cent on an annual basis in the third quarter of last year; in the second quarter there had been a contraction of nearly 5 per cent. The expansionary fiscal policy stance and the abundant supply of monetary base do not yet appear capable of reviving domestic demand. The economy is weighed down by structural imbalances and is probably suffering from the consequences of a long period of investment in traditional sectors, which are exposed to growing competition from the newly industrialized Asian countries.

Consumer price deflation continues, with adverse repercussions on corporate revenues; the difficulties of firms and the fall in share prices are impinging on the banking system. The official figure for the ratio of non-performing loans, including allowances, to GDP was already 6.3 per cent in March 2001.

The December quarterly Tankan survey indicated a new worsening of the business climate. The Government has announced a second supplementary budget of around ¥4 trillion or 0.8 per cent of GDP to support domestic demand; it has pledged to promote the necessary structural reforms.

The euro area has been affected by the deceleration of the US economy and the persistent difficulties in Japan. After slowing down in the first half of 2001, economic activity stagnated in the third quarter. The performance of the German economy has been especially poor; after rising in the first half of 2001, industrial production has been falling for the last six months. Investment has been on a downward path since the last part of 2000; in the third quarter consumption also declined.

In Argentina, after a period of political instability and rioting triggered by the deterioration in economic conditions that ultimately led to the freezing of bank deposits, it was finally decided to abandon the parity with the dollar, which had clearly been unsustainable for some time. The servicing of the country's foreign debt was suspended. The peso was devalued by 29 per cent; the market has inflicted a much larger depreciation.

Turkey has made good progress in the adjustment of its public finances. There remains the problem of restoring the banking system to health. After contracting sharply in 2001, GDP should start to grow again this year.

## **2. Problems facing the world economy**

Recovery in Europe and the other industrial countries will depend crucially on the return to growth in the United States.

There are also signs of an upturn in Asia, particularly in the two most populous countries, and in the transition economies.

The need for policies that can make for more harmonious and sustained growth of the world economy is now evident.

Throughout the second half of the last century and especially in the last two decades, international integration has fostered the growth of investment and output in the emerging countries that have succeeded in producing industrial goods for which there is a large market.

Some parts of the world have been excluded from economic progress. In many emerging countries the expansion of output has been accompanied by recurrent financial and banking crises, with ruinous effects on employment and consumption and consequent social and political tensions.

In most of the developing countries agriculture and labour-intensive branches of industry still account for a large and sometimes predominant share of value added.

The liberalization of world trade has involved agricultural products and textiles only to a limited extent. In Japan, the European Union and the United States these goods continue to benefit from a high degree of protection.

The conclusion of the Uruguay Round in 1994 created the conditions for a more open system of trade based on more transparent rules. The subsequent implementation of the agreements has been marked by major contradictions. The failure of the meeting of the member countries of the World Trade Organization in Seattle generated new tensions.

Significant progress was made at the meeting held in Doha last November.

China and Taiwan were admitted to the WTO. Agreement was reached to proceed with the multilateral trade system and foster greater participation by backward countries.

As regards agriculture, the objectives set for the negotiations include a substantial reduction in industrial countries' import duties and domestic production support measures, together with the elimination of their export subsidies.

Important results should also come from the start of negotiations to attenuate the restrictions on direct investment and reduce import duties on industrial products, especially textiles and clothing.

The efficiency gains to be made by exploiting comparative advantages and economies of scale in production more effectively can increase world trade and output significantly; this will benefit the industrial countries as well.

We must proceed resolutely in the direction indicated, both at national level and in the competent international fora.

### *2.1 Financing the emerging countries and development assistance*

The flow of savings to the developing countries and above all foreign direct investment promote the transfer of technologies and the utilization of these countries' plentiful supply of labour.

Balanced growth requires favourable domestic conditions, first of all respect for human rights, the protection of private property and the certainty of the law. A stable monetary and credit system is indispensable.



In the early stages of development it is normal for a country to have recourse to foreign debt. The uses to which the borrowed funds are put must generate the means for their repayment.

The industrial countries must also be committed to spreading the benefits of globalization to the backward economies, especially where the basic conditions for attracting private capital are lacking.

The debt reduction initiative for the heavily indebted poor countries is well under way; it will make it easier for these countries to take part in world trade.

An important opportunity for coordinating the various initiatives to foster development will be provided by the conference the United Nations is organizing in March at Monterrey in Mexico. The conference should indicate ways to mobilize the resources needed to achieve the poverty-reduction objectives set in the Millennium Summit of September 2000.

Official development assistance has diminished considerably in relation to donor countries' GDP, from 0.7 per cent in the early 1960s to 0.2 per cent in the second half of the 1990s.

This trend must be reversed. Foreign aid has an essential role to play in triggering growth mechanisms; in the very poor countries it is the main source of finance. The industrial countries must commit themselves to meeting the objectives that have been agreed and resume the supply of aid and finance, which could rise to 1 per cent of GDP.

International relations free from tensions, the absence of conflicts and orderly social conditions within the emerging countries are prerequisites for faster growth and a fairer distribution of its fruits.

## *2.2 Migration*

Mass migrations have enormously influenced the history of the world's peoples and the evolution of the economy. International labour mobility is limited by the restrictive policies of the industrial countries.

In the present context of demographic decline and aging populations, immigration can make a positive contribution to our societies if it is regulated in a farsighted and discerning way. It can allow the high rate of economic growth of recent decades to be maintained.

We must be open-minded about immigration, especially in a period of rapid technological progress. Action is needed to facilitate the training of immigrants and their integration in the receiving countries. This is a task the advanced economies will not be able to shirk, not least in view of the pressures generated by population growth in the backward countries.

The policies of the European countries need to be coordinated.

The regulation of immigration is intended to guarantee security and legality. The cultural identity of our countries must be preserved and turned to good account. We must present immigrants, who come in search of better living standards, with a shared core of values, rights and duties that they should be asked to accept in full. It is not a question of interfering with their moral or religious convictions; it is necessary to foster their integration with the other members of the community. It is in the search for solutions to practical problems that prejudices are overcome.

### **3. The Italian economy**

In the fourth quarter of 2000 Italy's GDP was 0.9 per cent higher than the average for the year.

In the first quarter of 2001 output continued to grow at an annual rate of nearly 4 per cent; the excess of supply with respect to demand led to a substantial rise in stocks. In the second quarter the weakness of export demand and the downturn in investment resulted in GDP remaining basically unchanged. In the third quarter it grew by 0.6 per cent, sustained again by stockbuilding. Consumption and investment remained unchanged.

As world demand weakened, the fall in exports became more pronounced.

Investment in building and construction continued to grow in the first half of the year, boosted by tax incentives. On the other hand investment excluding construction remained on the downward trend that had emerged in the last part of 2000 after five years of rapid growth; in the third quarter it expanded by about 1 per cent, probably benefiting from the initial effects of the measure granting tax relief for reinvested profits.

Employment followed a rising trend in 2001.

Some 335,000 new jobs, corresponding to more than four fifths of the increase over the year, were full-time and permanent; another 55,000 were part-time or fixed-term. The large proportion of more stable forms of employment can be attributed to the good performance of the economy in 2000 and the early

part of last year; the fiscal incentives introduced by the Finance Law for 2001 played a decisive role.

The unemployment rate continued to decline, falling to 9.2 per cent in October. In the North of Italy it fell to 3.8 per cent.

In the first eleven months of 2001 the overall balance of payments swung back into surplus as a result of the improvement in the terms of trade. This brought an increase in purchasing power; however, despite the increase in employment and the tax cuts provided for in the budget, household spending grew more slowly.

The twelve-month rate of inflation has been falling since April; in December it was 2.4 per cent. Last year the annual average rate of consumer price inflation was 2.7 per cent. Preliminary data for the largest cities showed a month-on-month rise in consumer prices of 0.4 per cent in January. In a situation of abiding wage moderation and weak energy prices, inflation will continue to come down over the year.

From the end of May onwards equity prices headed downwards on all the main euro-area stock exchanges. The terrorist attacks of 11 September caused a further fall. The action taken by the American and European monetary authorities and the tax measures enacted by the US government helped to restore market confidence. Equities have been recovering since mid-September; yesterday the main European stock market indexes were higher than at the beginning of September.

The current prices of Italian shares do not appear to be far from their equilibrium values.

Let me take this opportunity to remind analysts, investors and intermediaries of the need to value individual securities in the light of the growth prospects of the firm and sector in question in accordance with financial rationality and on the basis of reliable forecasts of the relevant monetary and macroeconomic parameters.

A repetition of the mistakes made during the earlier period of widespread euphoria would be deleterious. The confidence of investors in intermediaries and other market participants must be preserved, or better, reinforced.

#### **4. The public finances and structural reforms**

Excluding settlements of past debts and privatization receipts and including tax refunds paid through the Post Office, the state sector borrowing requirement in 2001 was 59 trillion lire, compared with 49 trillion in 2000.

For the broader general government aggregate, financing data show a borrowing requirement of 97.8 trillion lire in the first eleven months of 2001, compared with 84.1 trillion in the corresponding period of 2000.

In December the Treasury accounts recorded a surplus of around 35 trillion lire, compared with 20.2 trillion in December 2000.

Some 10 trillion lire of the substantial improvement in the central government finances in December can be attributed to the steps taken to accelerate the sale of public real estate and bring forward the receipt of the proceeds of lotteries. Restrictions on disbursements had been in effect since the summer. The result for the year was also influenced by one-off receipts.

In 1999 the general government borrowing requirement was 47.6 trillion lire; in 2000 it rose to 72.6 trillion. In view of the improvement that occurred in December, the figure for 2001 should not be significantly different.

Reducing the ratio of debt to GDP necessarily depends on reducing the difference between disbursements and receipts on a cash basis.

From 1991 to 1998 there was no substantial divergence between the general government borrowing requirement, on a cash basis, and general government net borrowing, on an accrual basis.

With the entry into force of the new European System of Accounts, the gap amounted to nearly 10 trillion lire in 1999 and widened to more than 38 trillion in 2000. The new system is designed to measure net borrowing on an accrual basis.

The state budget deficit on an accrual basis is much larger than general government net borrowing on the basis of the European System of Accounts.

The Minister for the Economy has set up a committee to investigate the large discrepancies between the various aggregates in view of their importance in obtaining a timely and accurate picture of the state of the general government accounts. It is necessary to analyze the causes of the wide gap between the

borrowing requirement on a cash basis, calculated using figures that are certain, and net borrowing, which is based on the new European System of Accounts.

Preparatory work is under way on a reform of the system for the definition of data and their computerized collection that will make it possible to obtain prompt and detailed information on the accounts of the various components of general government.

The need for such an overhaul has been made urgent by the amendment of Title V of the Constitution, which provides for a high degree of decentralization of the activities of the public sector.

The equilibrium of the public finances, an appropriate structure of expenditure and revenue, and the size of the aggregates themselves in relation to the size of the economy are the cornerstones of the Government's economic policy, which is aimed at promoting stability and growth.

The large reduction in the budget deficit in the 1990s was the result of the fall in interest payments and the rise in revenue; between the second half of the 1980s and the second half of the 1990s the ratio of taxes and social security contributions to GDP rose by roughly 6 percentage points.

The average rate of growth of the Italian economy in the 1990s was more than half a percentage point below that of the other European Union countries, where economic activity expanded modestly in comparison both with earlier decades and with the United States. There was no reduction in the size of the underground economy, where tax and social security obligations are evaded and safety rules widely ignored.

These tendencies have to be reversed.

The Economic and Financial Planning Document moves in that direction.

The Government plans a radical simplification of the revenue-raising system with far-reaching implications for firms and individuals and a significant reduction in taxes and social security contributions in relation to GDP. Bringing irregular activities into the open will permit a better distribution of the tax and contribution burden, to the advantage of all those who fulfil their obligations.

Given Italy's exposure to international competition, this will help to improve the country's competitiveness and thereby have a positive effect on investment and employment.

The planned reduction in taxes and social security contributions is to be achieved through a progressive reduction in the ratio of public expenditure to GDP on the order of one percentage point per year for the next five years.

The decrease in the ratio is also entrusted to an acceleration in GDP.

The reduction in current expenditure, with respect to its trend value and not in absolute terms, must be appropriately distributed among the various components.

The changes for pensions envisage a lengthening of employees' working lives and a speeding up, through use of severance pay provisions and tax incentives, of the growth of supplementary pensions. This is an essential aspect of a reform of the pension system intended to adjust the balance between the public and private components.



The reduction in social security contributions for newly-hired workers fosters employment, but pension expenditure must be curbed in relation to GDP to ensure the financial sustainability of the public pension system. In the EU countries the ratio was 10.4 per cent in 2000; in Italy it was 13.8 per cent for the main pension schemes.

Pension expenditure is set to increase as a consequence of the aging of the population. Bringing part of the underground economy into the open will immediately help to attenuate the imbalances in the pension system by increasing contributions. Looking ahead, a gap remains between equilibrium and actual contribution rates; under the law in force today the shortfall would be equal to 15 percentage points for private-sector payroll workers in 2010.

The ratio of healthcare expenditure to GDP, equal to 5.3 per cent in 1998, is estimated to have risen to around 6 per cent in 2001. The recent agreements between the central government and the regions should keep it at this level. The plans to overcome the inefficiencies in the sector will help to improve the quality and increase the quantity of the services provided.

Parliament is examining proposals for new labour market rules that will strengthen and supplement the changes made in the last few years. It is these changes, together with a reduction in the incidence of social security contributions since 2001, that have made it possible in the last four years to recoup the large fall in employment that occurred between 1991 and 1995, when some 1.2 million jobs were lost. At the end of 2001 employment was 2.3 per cent higher than ten years earlier.

## **5. The outlook**

The dramatic events of 11 September heavily affected the US and world economies.

The cyclical upturn was set back by around three months.

Economic activity reached its lowest point in America in the second half of the year. According to preliminary estimates, there was already a small increase in GDP in the fourth quarter.

The indicator of confidence among non-manufacturing firms pointed to a moderate expansion as early as December. That for manufacturing firms improved to 49.9 in January; the indicator of consumer confidence also rose.

The unemployment rate declined to 5.6 per cent in January, from 5.8 per cent in December.

The first quarter of this year could mark the start of the recovery. GDP is expected to start growing again in the second quarter, at an annual rate of 2 per cent. The recovery will gain strength in the second half of 2002, with forecast annual growth rates of at least 3.5 per cent.

Expectations of a new phase of growth in the United States are sustained in the short term by the strongly expansionary stance of fiscal policy and monetary policy, and in the medium term by the fundamental strength of the American economy.

A reallocation of resources among the various sectors is likely. Those hit hardest by the events of last September are suffering from a deterioration in profitability, with repercussions on employment and investment. But the rate of productivity growth for the economy as a whole is not likely to be affected in the medium term.

The diffusion of the new technologies is still far from complete. Available estimates indicate that labour productivity should continue to increase over a relatively long period by between 2 and 2.5 per cent a year.

The international organizations forecast a return to growth of between 3.5 and 4 per cent in 2003. The rise in capital spending in that year is also expected to be robust, on the order of 5 per cent.

In the European Union, the slowdown in 2001 was less intense; GDP increased by 1.7 per cent. Growth of around 1.5 per cent is forecast for 2002. The potential growth rate is estimated at between 2 and 2.5 per cent, well below that of the United States owing to the slower growth in both the labour force and productivity.

Given the initial level of spare capacity, in 2003 the increase in output is likely to exceed the potential rate.

In 2001 the Italian economy achieved growth of around 2 per cent. In the summer the official projections had indicated an increase of 2.4 per cent.

Industrial production fell steadily during 2001 in Italy and in Europe, reflecting the negative trend in world trade.

In Italy electricity consumption points to a substantial increase in industrial production in December, followed by a modest decline in January.

During the 1990s the growth in Italian industrial production was very disappointing in comparison with the previous decades and with the other European economies. The response to both domestic and foreign demand, in terms of the type and quality of production, was totally inadequate and the capacity to produce high-tech goods insufficient.

The loss of competitiveness in manufactures reduced Italy's share of world trade from 5 per cent in 1990 to 3.7 per cent in 2000. The re-entry of the lira into the European exchange rate mechanism in the second half of the decade was not accompanied by an increase in productivity in line with that of the other main industrial countries. Unit labour costs rose more rapidly, partly owing to the high level of taxation and social security contributions.

The labour market reforms introduced towards the end of the decade gave an immediate impulse to employment growth, even if with fixed-term jobs.

The measures covered by the enabling bill now before Parliament are intended to complete the reform of the labour market. More flexible forms of employment will allow the supply of labour to better match a demand that must necessarily take account of international competition far more than in the past. Adjustments to legislation will foster the spread of more stable forms of

employment, with beneficial effects on workers' training and skills, productivity and, hence, investment.

A structural increase in the labour force participation rate is necessary.

An end to the more precarious forms of employment and the absorption of the wide swathe of irregular jobs into the formal economy, at least on a partial or limited basis, will require greater economic growth, the elimination of the most serious rigidities and, looking ahead, a progressive reduction in the tax burden.

The aging of the population will make public pension expenditure rise faster than GDP.

While safeguarding the entitlements of workers who are retired or nearing retirement age, changes must be made to raise the average effective age of retirement in order to avoid a further increase in the ratio between retirees and active workers.

The monetary cure of the second half of the 1990s, culminating in the adoption of the single currency in 1999, and the improvement in the public finances must now be followed by an adjustment of the underlying structures that will put the economy back on a path of sustained growth.

This is the challenge for the decade that has just begun.

The keystone of an economic policy aimed at stability and higher potential and actual growth is a reduction in the ratio of current public expenditure to GDP.

The progressive reduction in the burden of taxes and social security contributions and a more diversified, and above all more flexible, labour market will help to recoup the competitiveness lost by the Italian economy during the last decade.

Economic recovery requires an impulse from investment demand.

The ratio of public investment to GDP fell during the 1990s. The insufficient infrastructural endowment of many developed areas in the North became more evident.

The environment and natural resources must be safeguarded, or better, enhanced. Investments in this direction bring deferred but high profits and immediate benefits to society.

In the economically most backward regions, the negative externalities connected with the lack of public capital must be reduced and eventually eliminated. Innovative business investment can count on human capital consisting of an increasingly well-trained pool of workers who are able and willing to contribute to the development of those regions.

The new law for the planning and execution of major public works must bring a substantial increase in activity in this sector. Additional investment, amounting to a significant share of GDP, must contribute to the acceleration of growth during this year and the subsequent ones.

European funds must be fully utilized. Substantial support can come from the higher share of expenditure that can be financed by supranational institutions, in line with the recommendations of the Council of Europe.

The financial market has seen the volume of transactions expand remarkably over the last five years, rising to levels well above those of the first half of the 1990s; the Italian market is in the vanguard in Europe for operational efficiency and technology.

In the last five years the structures of the banking system have been strengthened. By historical standards, the progress made is exceptionally great. Average bank size has grown appreciably, the privatization of the banking system has nearly been completed, and profitability has increased. In a context of progressive deregulation, competition has grown, to the benefit of households and firms. Further major consolidations are under way. Additional progress is necessary in the quality of services provided, costs and profitability.

These advances make a larger share of national savings available to the private sector than in the past. A contribution will come from the repatriation of capital.

The process of decentralization inspired by principles of federalism that was introduced with the amendment of Title V of the Constitution is laden with consequences.

An allocation of public spending closer to the needs of local communities, in accordance with the principle of subsidiarity, can improve the efficiency and competitiveness of the economy.

However, the decentralization of legislation and administration could lead to an excessive growth in public spending while also aggravating the disparities

between the more affluent and the disadvantaged regions. Instances of tax competition could arise.

A framework law is needed to define the procedures for applying the new rules and to serve as a base for coordinating the activity of the public sector at central and local level. The balanced-budget requirement will brake the expansion of expenditure. The solidarity fund will help to correct disparities in welfare.

The opportunity for a far-reaching reorganization of government must be grasped, so that public administrations more effectively serve the population and the productive sector.

The ability of the economic system to produce wealth and to distribute it equitably is entrusted in the first place to private enterprise, which has to be regulated and supplemented by the action of public institutions.

We must take up the challenge and succeed in achieving an efficient economy, greater growth and full participation by the entire population — above all young people — in the fruits of that growth.