ACRI

Association of Italian Savings Banks

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Address by the Governor of the Bank of Italy

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Putting the value of stock market indexes at the beginning of 1995 equal to 100, by August 2000 the Standard and Poor’s 500 index had risen to 330. The European indexes had reached 316 in Germany, 323 in Italy, and 352 in France. Yesterday, the same indexes were down to 194 in the United States, 164 in France, 169 in Italy, and 143 in Germany.

Share prices began to fall in March 2000, starting with technology stocks, and then precipitated. The Nasdaq index is now a quarter of the value attained in the spring of 2000. Technology stocks rose faster and fell further in Europe.

Since September 2000 share prices have fallen overall by 46 per cent in Italy and 41 per cent in the United States.

The emergence of international political tensions, mounting apprehension about the veracity of listed companies’ financial statements, and the weakness of the economic cycle have considerably increased the risk premium that is demanded by investors, thereby reducing share prices.

The price-earnings ratio currently stands at around 22 in the US, 16 in Italy, 12 in France, and 11 in Germany. These levels are below the long-term averages for the European countries, while in the United States the ratio is slightly above average because of lower real interest rates and stronger expectations of long-term economic growth.

In the spring of 2000 I pointed out that the price-earnings ratio had risen to historically high levels in the leading countries, well beyond the normal margins of fluctuation.

We warned that in many sectors share prices were based on rates of growth in corporate profits that did not accord with the underlying economic conditions.

Macroeconomic data suggest that the overvaluation has now been absorbed. In many sectors, both in Europe and the United States, share prices appear basically in line with firms' growth potential and their ability to generate sufficient profits to provide a return on equity capital.

1. The international economy and finance

The steep rise in share prices began in the United States in the mid-1990s, at a time of robust growth in corporate investment, moderate inflation and ample liquidity. The opportunities for portfolio diversification afforded by more sophisticated risk-management techniques and greater recourse by savers to international institutional investors brought down the premiums levied on equity investments.

As the new technologies spread through the economy they gave a powerful boost to the growth in firms' productivity. Profits rose faster than gross domestic product and employment increased steadily. The low cost of capital encouraged mergers and acquisitions.

The prolonged economic expansion in the United States slackened in the second half of 2000, reflecting the slowdown in investment; the rise in oil prices was a further contributory factor. The cyclical weakness of the US economy became more pronounced in 2001 and spread rapidly throughout the world.

The monetary easing initiated by the Federal Reserve at the very beginning of 2001, together with the programme of tax cuts, had already stabilized output during the summer.

The terrorist attacks of 11 September created a climate of great uncertainty.

The prompt adoption of monetary and fiscal policy measures, coupled with the flexibility in the use of the factors of production in America, gave the economy a strong boost and helped restore confidence.

Since the end of 2000 the Federal Reserve has cut the federal funds rate by 4.75 percentage points, from 6.50 to 1.75 per cent. The large budget surpluses and the modest size of the debt allowed the federal government to adopt a decidedly expansionary fiscal policy.

In the fourth quarter of 2001 output began to grow again, at an annual rate of 2.7 per cent. The recovery gained strength in the first quarter of this year: the rate of growth in output rose to 5 per cent; the fall in investment almost came to a halt.

In the second quarter, output grew by only 1.3 per cent, reflecting the loss of confidence caused by fears of further terrorist attacks. While investment stagnated, spending on high-tech goods gained momentum.

The value of property owned by households increased by some $1,650 billion between the beginning of 2001 and the middle of this year, offsetting part of the $2,950 billion reduction in their financial wealth.

Most of the wealth invested in equities is concentrated among upper-income households and there is a delay before a fall in prices affects their spending decisions. An increase in real-estate wealth transmits a powerful stimulus to consumption as property ownership is more widespread and house prices less subject to variations.

The fall in interest rates and the increase in the value of real-estate guarantees have allowed households to raise new loans. By the middle of this year, their debt had risen to a very high level, corresponding to 95 per cent of disposable income.

The flexibility typical of the US economy made it possible for labour productivity to increase steadily throughout the recession in 2001 and then to rise sharply during the recovery. In the first half of this year, productivity in the non-farm business sector gained 6.5 per cent on an annual basis compared with the previous six months. This led to a substantial 3.3 per cent fall in unit labour costs.

Payroll employment in the non-farm sector fell continuously between October 2001 and April 2002; in recent months there has been no clear trend. Core inflation has decreased. In the first half of 2002, profits rose by 25.5 per cent compared with the previous six months.

In recent months, the impact of the fall in share prices on economic activity has been compounded by the effects of heightened uncertainty in a context of new world-wide political tensions. Consumption has nonetheless picked up quite strongly, leading to an upturn in output in the third quarter. A fall in the growth rate of output is projected for the fourth quarter.

The international financial system and banks, first and foremost those of the United States, have had to cope with the repercussions of the fall in the value of equities, the crises in Latin American countries and the slowdown in economic activity.

The problems of the Japanese banking system persist. In mid-September the Bank of Japan announced its intention of purchasing shares held by banks in order to avert the danger of still further price declines. The Government has devised a plan for dealing with banks' bad debts.

Some major German banks have been hit by the economic slowdown in that country.

As a whole, the banking systems of the leading countries have absorbed the adverse impact of recent events on their balance sheets, thanks to the reorganization of operational structures and the capital strengthening effected during the second half of the 1990s. The Italian banking system has drawn vigour from the far-reaching transformation under way since middle of the last decade.

The development of the market in derivatives has increased the opportunities for hedging risk, thereby reducing its cost. Between 1990 and 2001 the notional value of derivative instruments traded in the global market rose from 18 to 111 per cent of the GDP of the seven largest economies.

The expansion of the market for hedging credit risk has been particularly significant. This risk is now distributed among a wide variety of national and international operators, partly as a consequence of the growing importance of institutional investors with long-term liabilities that are marked to market.

However, the degree of leverage made possible by derivative instruments has also favoured the emergence of highly speculative positions, which may have contributed to the overvaluation of share prices during the years of rapid growth. In the same way, they have certainly been a factor in their rapid decline.

The distribution of risk may foster the excessive growth of credit to certain industries or countries. Every bank, and not just the largest or most internationalized, must always carefully assess the profitability of each loan.

Both nationally and internationally, we are strengthening action to improve information on the magnitude of the risks assumed by banks via derivative instruments. Fuller disclosure and more detailed information on market risk will be required in financial statements. International discussion is under way of initiatives to track bank loans to intermediaries that do speculative business, such as hedge funds.

The expansion of world trade induced by the acceleration of US imports during the first half of 2002 benefited mainly Canada, Mexico and the newly industrialized countries of Asia. In the latter group, the impetus from exports was transmitted quickly to domestic demand.

In the last few months the Japanese economy has weakened further. In Argentina the economic and financial situation remains precarious. Since this summer, some emerging countries have been severely affected by political uncertainty. Access to the financial markets has become very costly, and currencies have depreciated significantly.

In China and India economic activity has continued to expand at a rapid pace. This year, growth rates of 7.5 and 5 per cent respectively are forecast.

In Europe, following the events of 11 September the Governing Council of the European Central Bank lowered its reference rates. The size of the reduction was limited by the re-emergence of inflationary pressures.

In the major countries of the area, given the state of the public finances, support to the economy continued to come solely from built-in stabilizers. Tax cuts enacted in earlier years, but not matched by adequate spending curbs, have produced a worsening of budget balances.

The economic upturn forecast by the main international organizations at the end of 2001 in connection with the quickening pace of economic activity in the United States did not take place. The stagnation that set in during the second half of 2001 is being overcome only slowly. The European economies are weighed down by structural rigidities, slowness in the introduction of new technologies and innovative activities and unpropitious conditions for an expansion in investment.

Gross fixed investment contracted at an annualized rate of 2.6 per cent in the first half of 2002 compared with the second half of 2001. Household spending in the area as a whole remained stationary. Consumption continued to increase in France and Spain, but in Germany it diminished further by 1.6 per cent.

Exports did not increase, pointing to problems of competitiveness for the area as a whole.

The twelve-month rise in consumer prices, which had accelerated to 2.7 per cent in January, slowed to 1.8 per cent in June but then rose to 2.1 per cent in September. Core inflation, which had increased in the previous two years owing to the higher prices of imported inputs, has remained at about 2.5 per cent since the start of 2002.

In the last part of the year economic activity should continue to expand at about the same rate as in the first half. The latest forecasts by international organizations are that GDP growth for the year will not reach 1 per cent.

2. The Italian economy

In Italy, output growth in the first half of the year was sustained solely by the rebuilding of inventories. Employment continued to grow owing to the impetus stemming from tax and social contribution incentives and the elements of flexibility introduced in recent years.

In the first six months of 2002, while world trade expanded at an annual rate of 4.2 per cent, Italian exports of goods and services contracted by 2.4 per cent. At the same time, French and German exports increased by about 2 per cent.

Italy's continuing loss of world market share reflects structural factors: scant presence in high-technology sectors, a lower rate of labour productivity growth compared with earlier decades and the other advanced economies, and the intensifying competition of the emerging economies in low- and medium-technology products.

Italian exports declined by nearly 10 per cent in the first quarter by comparison with the fourth quarter of 2001. They picked up again in the second quarter, in conjunction with the upturn in economic activity in other European countries.

Household consumption contracted for the second consecutive half-year, reflecting the modest growth in disposable income and the prolonged deterioration in confidence. In a period of uncertainty, the reduction in purchases bore on consumer durables.

The impact of the stock market decline on the Italian economy has been moderate, given the small proportion of equities in total household wealth, more than four fifths of which consists of real estate. House prices rose by 12.8 per cent in real terms between the first half of 2000 and the first half of 2002.

The impact on prices of the cash changeover to the euro was modest, all things considered. It was more pronounced for the most frequently consumed goods and services, such as those provided by bars and restaurants, and especially food products. In a period of modest growth, the effect on consumption was not negligible.

The annualized decline in Italian capital formation in the first half of the year compared with the second half of 2001 was 5.8 per cent. All branches except residential building contributed to the decline. Non-construction investment fell by 8.7 per cent on an annual basis, non-residential construction by 4.5 per cent.

The Bank of Italy’s sample survey of investment by firms in industry and services, carried out in September, shows a reduction in expenditure on capital goods compared with firms' spending plans at the beginning of the year.

A study conducted by the Bank’s branches on a sample of construction firms shows that the value of public works built fell in the first half of the year; it began to expand again in the second half and has risen back to the level recorded in the last part of 2001. Thanks in part to the impulse imparted by governmental bodies and the start of work on some major infrastructure projects, activity is expected to intensify in 2003 and thus contribute to supporting aggregate demand and the revival of economic activity.

Italian products’ loss of market share in recent years is attributable not least to the troubles of the automobile industry, which has also seen its share of the domestic market shrink.

A large industrial group is a common asset. It is in the interest of all that it be safeguarded, that it regain competitiveness through renewed investment in research and innovation.

In compliance with banking regulations derived from Community legislation and aimed at limiting the concentration of risks, banks decided at their discretion to make loans to the Fiat group on the basis of evaluations of its industrial and financial plans.

The emergence of operating difficulties has been carefully examined by the same banks. Last May a plan was drawn up for the group’s financial reorganization, to be achieved through the sale of assets and the consolidation of short-term debts. The volume of loans to the group is commensurate with the value of its assets. A strategic turnaround in production will need to be underpinned by new providers of finance, by fresh capital.

3. The banking system

In today's difficult cyclical situation banks have supported the Italian economy by increasing their lending to households and firms more rapidly than the growth in GDP. Lending to residents expanded by 5.7 per cent in the twelve months to September.

Lending to firms grew by 5 per cent, reflecting the weakness of investment and the drying up of demand connected with major corporate actions. Lending to households continues to grow at a very fast pace; in the first half of 2002 mortgage loan disbursements for the purchase of housing totaled €17 billion, almost 25 per cent more than in the same period of 2001. The rate of growth in consumer loans by banks was also very high, exceeding 15 per cent.

Interest rates on short-term loans diminished further by a small margin in the first nine months of the year, declining to 5.8 per cent; those on longer-term credit remained basically stable and now stand at 4.8 per cent for firms and 5.8 per cent for households.

Credit conditions have remained favourable even for smaller firms and companies based in the South. There is no sign of supply-side tensions.

The spread between the average lending rate and the minimum rate, which usually widens during periods of tightening of credit supply, has remained stable.

Banks' annual accounts will reflect the provisioning and value adjustments connected with their exposure to Latin America and major international corporations. The decline in profits should be limited to the current year. The return on equity was 7.2 per cent in the first half of 2002, compared with 12.4 per cent in the first half of 2001.

Operating costs, which have increased appreciably in the last two years, must be kept under control.

Compared with ten years ago, the banking system's indicators of efficiency and soundness have improved significantly. At the start of the 1990s the system included a large number of banks that were too small to achieve economies of scale and make the massive investments necessary for the development of innovative services.

Privatizations and the growing competition bred by anti-trust action, the integration of financial markets and the legislative and regulatory reforms have focused attention on the return on banks' equity and encouraged the pursuit of larger bank size.

Italian banking groups can now operate in all segments of intermediation and offer high-value-added services. The five largest group's share of total bank assets has risen to 54 per cent, compared with around 33 per cent in the mid-1990s. Some groups are also acquiring important positions in the Central and Eastern European countries.

The country's banking groups are engaged in a far-reaching organizational overhaul.

The system's capital base has grown at an average annual rate of 5.9 per cent in the last five years. The rapid expansion in lending has been reflected in a slight decline in the solvency ratio, to 10.2 per cent at the end of 2000.

In line with the approach agreed at international level, we requested major banks to formulate plans for strengthening their capital bases. By the end of 2001 this action had already led to a slight rise in the banking system's solvency ratio, to 10.6 per cent.

The growth in lending to the holding companies of major industrial groups and to the largest companies has slowed down in the course of this year; banks' exposure to the telecommunications sector is diminishing but nonetheless remains high.

The former banking foundations have played a leading role in the reorganization of the banking system. Once the rule-making phase has been concluded promptly and with adequate consideration given to both local and general interests, it will be necessary to seek a new dialogue and positive convergence among all the interested parties, in order to give impulse to the foundations' activity.

4. Southern Italy

The restructuring of the banking system in the past decade was especially intense in the South.

In the early 1990s the economic slowdown culminating in the recession of 1993, the ending of extraordinary development support and the decline in public investment had brought activity to a standstill in important sectors of production and led to the collapse of numerous firms. Employment fell by more than 8 per cent between 1991 and 1996; the gap in per capita output with respect to the rest of Italy widened.

The difficulties of businesses were reflected in banks' balance sheets: the proportion of credits that proved to be non-performing rose to high levels. The losses had a destabilizing impact on intermediaries, first and foremost the large public-sector banks, which were also burdened by low operating efficiency and relatively modest capital endowments.

We were called on to make an exceptional effort. The evaluation of banks' situations on the basis of an examination of their annual accounts, meetings with corporate officers and on-site controls at almost all the southern banks made it possible to identify the roots of the impaired situations, circumscribe their effects and indicate appropriate methods for the necessary reorganization.

The rehabilitation of the southern banking system was achieved first of all by promoting the transfer of the principal banks to private shareholders.

The use of public money, in limited amounts by international standards and subject to rigorous corporate restructuring, helped to prevent the spread of financial instability and to preserve the markets' confidence in the Italian banking system.

The interests of depositors were protected and the conditions created for maintaining adequate flows of credit to the local economy.

In the last ten years more than 200 mergers and acquisitions have taken place, involving institutions accounting for two thirds of the total assets of banks based in the South. The transactions have been carried out at the initiative of banks coming from other areas of Italy and endowed with the capital and professional resources that are indispensable for the rehabilitation and revival of southern banking structures.

The reorganization of loan disbursement procedures has raised the capacity to select borrowers on the basis of their correctness and competence in business as well as the validity of their investment plans.

The rehabilitation of the credit system in the South is shown by banks' improved profitability and stronger capital bases.

The productive economy and the households of the South have seen an increase in the availability of corporate finance and professional asset management services, which could not have been supplied on a small scale.

In the three years ended in June 2002 customer loans in the South grew at an average annual rate of 6.3 per cent, twice as fast as in the preceding three years and faster than the growth in nominal income. The largest contribution to the financing of the southern economy came from the banks of the Centre and North, which used all the funds they raised in the South for local lending.

Thanks in part to the steady decline in the ratio of bad debts to total loans, the interest rates charged to customers in the South have approached those prevailing in the rest of Italy. Between 1998 and the second quarter of 2002, the gap narrowed from 2 to 1.6 percentage points for short-term loans to firms. It is much smaller for medium and long-term loans. The differential reflects the risk premium associated with southern firms' lower profitability, modest capitalization and high short-term indebtedness, and also the scant effectiveness of judicial procedures for the recovery of claims.

In the second half of the 1990s a revival got under way in the southern economy. But the improvement has been modest in relation to the size of the gap between the South and the rest of the country. Between 1995 and 2001 average annual growth in output in the South exceeded that in the Centre and North by only 3 tenths of a percentage point.

Per capita output in the South is currently 58 per cent of that of the rest of Italy; it has still to regain the level at which it stood in the early 1990s.

The exclusion of human resources from the labour market is on an abnormal scale in the South: the employment rate for persons aged between 15 and 64 is just above 44 per cent, some 17 percentage points less than in the Centre and North.

Partly as a result of the restructuring of many large firms, especially those that had previously been in the public sector, the average size of local industrial units has decreased to a greater extent than in the other parts of the country. The underground economy has grown larger: irregular employment is 38 per cent of the total in agriculture and 29 per cent in the construction industry. The area has only a very limited ability to attract investment from abroad and the rest of the country.

The weaknesses of the southern economy are reflected in a 15 per cent difference in productivity compared with the Centre and North. This gap stems partly from a lack of infrastructure that is much more pronounced than in the rest of the country, especially as regards airports, power plants, energy grids, water supply, waste water treatment, telephony and information technology.

The difference in labour costs is smaller than that in productivity. There are major external diseconomies. These factors are an obstacle to the use of the available labour.

Exports from the South contracted by 6.3 per cent in value in the first half of this year compared with the first half of 2001, those from the Centre and North by 5.1 per cent. In industry excluding construction more than a quarter of southern firms have reduced their planned capital spending for this year, a larger proportion, albeit only a little, than in the Centre and North. The value of public works built has fallen more in the South than in the North.

The South has a potential for growth that has not yet been turned to account. Policies aimed at fostering employment have contributed, according to the first three Istat surveys in 2002, to increasing the number of persons in work by nearly 2 per cent compared with the corresponding period in 2001; this was similar to the increase in the Centre and higher than that in the North. In July the unemployment rate fell to 17.9 per cent, down from 19 per cent twelve months earlier; employment rose above the levels of 1991-92.

There is considerable scope for measures to exploit the opportunities inherent in the availability of human, environmental and cultural resources, in the accumulation of savings, in the scale of the needs still to be satisfied, in the presence of unutilized professional abilities and in the existence of economic and physical openings for the development of new productive activities.

It is up to economic policy to create the conditions permitting these opportunities to be grasped. The measures to upgrade the supply of water for residential and industrial uses are a step in this direction.

The strengthened structure of the southern banking system means that it can provide financial support for the development of the South.

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The uncertainty caused by international political tensions is having an adverse effect on the behaviour of consumers and investors.

Countering terrorism in all its forms and safeguarding collective security cannot be separated from efforts to create conditions that will avoid conflicts. With a view to the dignity of man and a better distribution of world output, it is necessary to strive for a period of détente and development of international relations.

There is still considerable uncertainty regarding the American economy. The underlying conditions nonetheless remain favourable; the estimated annual rate of increase in productivity in the medium term remains high, between 2 and 2.5 per cent. Moreover, with share prices at their present level, conditions for profitable investment have been restored.

Reabsorbing the present international tensions will allow the US economy to return to a path of rapid growth.

The latest forecasts indicate a slight acceleration in world economic activity from the first quarter of 2003 onwards. The recovery in the United States is seen as gathering strength over the year, with the other industrial economies benefiting. In the emerging countries of Asia, including China and India, GDP is expected to grow by more than 6 per cent; in Latin America it is also expected to rise, after falling in 2002.

The weakening of the economic indicators in the euro area has increased the uncertainty about the prospects of an upturn in the last part of the year.

Italy will achieve only limited growth in 2002.

The recovery in economic activity is likely to gather strength next year; international trade should grow faster. Consumption will be stimulated by the changes made to personal income tax. Fiscal policy in the present difficult cyclical conditions is designed to reconcile curbing the budget deficit with providing support for economic activity.

There continue to be obstacles and delays in the improvement of administrative efficiency and the process of liberalization. The organizational innovations within companies and in dealings between companies are held back, even more than in the rest of Europe, by shortcomings in infrastructure, deficiencies in public services and the law. Rigidities in the markets for productive factors still have adverse effects.

The lack of infrastructure is serious in the South but there are also shortcomings in the North. The creation of infrastructure is a prerequisite for increasing Italian firms productivity.

An upturn in economic activity is within our reach. The possibility of lifting the GDP growth rate above 2 per cent in 2003 depends on the planned construction of public works actually getting under way on a major scale.

Looking further ahead, the Italian economy can achieve a rate of growth above the European average.

The Finance Bill is being examined by Parliament; amendments have been announced, especially in favour of the South. When it is approved, further, decisive steps will need to be taken to solve the structural problems of the Italian economy.

Measures regarding the labour market and the protection of saving are important aspects of the planned reforms.

The economic and fiscal factors that diminish competitiveness and stunt the growth of firms must be removed; principles of economic democracy must be applied; wages must become more closely linked to productivity. Progress on these fronts is likely to increase employment and improve its quality.

Compared with ten years ago, the banking system is in a better position to assist the economic recovery. As research and surveys reported in institutional fora also show, the enormous changes that have taken place, starting with the legal framework, which is now one of the most advanced in Europe, have strengthened the system. Competition has increased. Unfounded doubts should not be sown. It is necessary to make further progress in the development of entrepreneurial skills and the ability to innovate.

Savings are an indispensable resource, protected by the Constitution. Their profitable investment is essential for growth. It is necessary to arrive at a better balance between the public and private sectors in the management of retirement savings; channeling a growing a part of such savings to the market will provide financing for investment and by this means fosters growth.

Italy has underutilized resources. Firms' will to invest and innovate, cooperation between the social partners, a coherent economic policy are the keys to making full and good use of the resources available, to the revival of growth.