BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY 2003

THE GOVERNOR'S CONCLUDING REMARKS

Ladies and Gentlemen,

The opportunities and risks presented by globalization and the need to pay attention to local realities inform and shape the work of the Bank, which it performs in the service of Italy, a country still marked by economic dualism but ever more open to international relations.

We are strongly committed to playing our part in the formulation of Eurosystem policy and to its implementation at national level. Our collaboration within the Group of Ten and the wider international community is intensifying.

Supervisory activity is aimed at further strengthening the banking system and individual intermediaries, in conditions of stability and efficiency, as a response to the needs of firms and to protect savings.

The safeguarding of competition between banks at national level is supplemented by surveillance of transparency and competition in more than one hundred provincial marketplaces. Working in close cooperation with the central departments, the Bank's branches are also responsible for the direct supervision of intermediaries of predominantly local significance. Regional data form part of the documentation on the Italian economy and the basis of our analysis of its performance.

The research and studies by the Research Department on the economy and the financial system and the contributions from other departments are set out systematically in the Report; they are the foundation on which these Concluding Remarks are based.

We are closely monitoring the process of governmental decentralization. The importance of public expenditure and taxation at local level should increase, within a necessary framework of solidarity.

In agreement with the Ministry for the Economy and Finance, we have taken on the task of designing the information system for the operations of public bodies. The project, which is nearing completion, will make it possible to record all items of revenue and expenditure daily on the basis of uniform nationwide criteria. It will provide an up-to-date picture of the financial activities of central and local government, filling gaps in information that cause uncertainty in interpretation and decision-making.

The new interbank settlement system will shortly come into operation; it will give Italian banks further opportunities in terms of operations and information and can also be used by other European banking and financial systems.

Construction of three new buildings has begun at the Donato Menichella Centre. Plans to improve the accommodation of some departments of the Central Administration are being examined.

Constant attention is paid to staff training and skills, recruitment and promotion.

Important agreements relating to career paths and grades have been reached with the representatives of the Bank’s staff; they accord even higher recognition to expertise and introduce greater flexibility in the use of personnel.

All the employees of the Bank, of every grade and level, work with dedication and professionalism in the service of the country. I wish to thank them on behalf of the Board of Directors, the Directorate and myself.

The world economy

In the advanced economies gross domestic product grew by 3.8 per cent in 2000 and by 0.9 per cent in 2001; the rate then recovered to 1.8 per cent in 2002. In the developing countries output growth was 5.7 per cent in 2000 and fell to 3.9 per cent in 2001 before accelerating to 4.6 per cent in 2002.

In the major industrial economies consumer price inflation is at an historical low; it amounted to 1.3 per cent in 2002, compared with 2.1 per cent in the previous year. The decline was largest in the United States and Germany; in Japan prices continued to fall.

In 2001 industrial activity had declined continuously in the United States and Europe and had fallen by 10 per cent in Japan; it had reached a low point virtually everywhere in the closing months of that year. There were widespread signs of recovery until the autumn of 2002, but the economy then slowed down once more in all the industrial countries.

Fear of terrorist attacks and the announcement of military action followed by the actual commencement of hostilities in Iraq in March of this year steadily depressed business and household expectations, share prices and investment.

In the United States, despite the fall in industrial production and employment, consumption had grown by 2.5 per cent in 2001, benefiting from cuts in personal income tax and the substantial reduction in interest rates. The rate of growth accelerated to 3.1 per cent in 2002. Public expenditure made a major contribution to domestic demand. Gross domestic product expanded by 2.4 per cent in 2002, compared with 0.3 per cent in the previous year.

In Japan household consumption had risen by 1.7 per cent in 2001, faster than the rate of growth of GDP; it increased again in 2002, by 1.4 per cent, although it stagnated in the fourth quarter.

In the euro area consumer demand had slackened in the second half of 2001; it remained hesitant throughout the first half of 2002 and picked up slightly in the second. Household spending was dampened by the perception among a large proportion of consumers - around 80 per cent - that the changeover to the euro had had a substantial impact on prices.

GDP growth in the euro area slowed from 1.4 per cent in 2001 to 0.8 per cent in 2002.

The uncertain outlook had repercussions on investment. In the advanced economies as a whole, fixed capital formation, which had increased by between 5 and 6 per cent a year from 1996 to 2000, declined by 1.6 per cent in 2001 and by 1.8 per cent in 2002.

The fall in investment was sharpest in Germany, where it amounted to 5.3 per cent in 2001 and 6.7 per cent in 2002, and in Japan, where the trend had already become uncertain by the middle of the last decade.

In the second half of the 1990s the rise in share prices and the low cost of capital had boosted investment in all the advanced economies. There had been an exceptionally large increase in corporate mergers and acquisitions.

The correction in the prices of high-technology stocks had begun in March 2000. As activity slowed at the end of 2000, the fall spread to all other sectors. It was aggravated by the discovery of serious irregularities in the management of some major corporations, notably in the United States.

To date, the US stock market index has lost 40 per cent of its value compared with the peak reached in 2000. In the euro area share prices have fallen by half. In Japan the index, which had already fallen by a quarter during 2000, has shed a further 35 per cent since the end of that year.

By the early months of 2003 share prices had moved back close to their equilibrium values. In all the main markets the price/earnings ratio has fallen well below the averages recorded in the second half of the 1990s.

Economic activity has been sustained by fiscal policy and public expenditure in the major countries. In the United States a budget surplus equal to 2.4 per cent of GDP in 2000 gave way to a deficit of 1.5 per cent in 2002. The deficit is expected to increase to 3.5 per cent of GDP in 2003, owing partly to the expansionary measures recently passed by Congress.

In Japan the budget deficit rose from 6.1 per cent of GDP in 2001 to 7.1 per cent in 2002.

In the euro area, even though governments are committed to contain the imbalances in their public finances in compliance with the Stability and Growth Pact, the budget deficit has risen from 1 per cent of GDP in 2000 to 2.2 per cent in 2002. The European Commission predicts that the deficit for the area as a whole will widen further in 2003, to 2.5 per cent.

Monetary policy has provided crucially important support to the economy.

In the United States flexibility in the use of factors of production allowed considerable scope for manoeuvre. In a little under two years the Federal Reserve reduced the federal funds rate from 6.5 to 1.25 per cent. In the euro area the rate on refinancing operations was cut from 4.75 to 2.5 per cent. In the United Kingdom official rates were lowered from 6 to 3.75 per cent, while in Japan they remained constantly close to zero.

Despite the weakness of credit demand, the money stock grew rapidly in all the major countries in response to the expansion in monetary base by their central banks.

The ratio of the money supply to GDP in the seven major industrial countries rose from 66 per cent in 1998 to 75 per cent at the end of 2002.

Adjusted for consumer price inflation, short-term interest rates decreased by 3 percentage points between 1998 and 2002, reaching almost zero at the end of last year; in the United States they are now negative. Real long-term yields on government bonds fell by more than one percentage point.

The amount of government bonds outstanding continued to rise. Real-estate values increased sharply.

The decline in the cost of borrowing offset the restrictive effect of the fall in share prices and prevented the fall from becoming too large. The abundant money supply and its effects on the other components of wealth sustained consumer and investment demand, avoiding a decline in world economic growth. It was in fact possible to prevent instability among credit intermediaries in the major countries and on the world market.

Exchange rates

The balance-of-payments disequilibrium of the United States has become more pronounced over the past five years. Part of the expansion in the domestic money supply has thus spilled over onto the international financial markets, making them more liquid.

The US current account deficit amounted to 410 billion dollars in 2000 and 503 billion in 2002, equal to 4.2 and 4.8 per cent of GDP respectively. The country's net debtor position rose from 16 to 23 per cent of GDP between 2000 and 2001 and increased again in 2002, to 27 per cent.

The weakness of external demand and the appreciation of the dollar acted as a brake on exports, which dropped sharply in 2001 and again in 2002. The containment of imports was insufficient.

As a result of the fall in share prices and, above all, the economic slowdown, net inflows of capital to the United States have declined substantially. Direct investment, which had amounted to 130 billion dollars in 2000, was nil in 2001 and gave way to disinvestment of 93 billion in 2002. Portfolio investment offset only part of this reversal in the sign of direct investment.

Growing fears about the growth prospects for the US economy and the widening of the deficit on the current account of the balance of payments prompted international investors to adjust their portfolios, moving out of the dollar-based market and into the euro area and Asia. The increase in the supply of dollar-denominated liquid assets caused the dollar to weaken.

Since March of last year the US currency has depreciated by 9 per cent in effective terms.

In Japan the current account surplus increased as a percentage of GDP in 2002. This was offset by direct and portfolio investment in other markets. The official reserves continued to grow as a result of large-scale intervention in the exchange market to restrain the appreciation of the yen; they rose to 490 billion dollars, compared with 400 billion at the end of 2001.

Japan's net creditor position increased to 38 per cent of GDP in 2002. The country's sound capital account situation explains the strength of its currency, notwithstanding extremely low interest rates, the difficulties of its economy and the large proportion of non-performing bank loans.

For some time the currencies of the emerging Asian countries, which have run large current account surpluses since 1998, have also come under upward pressure, which has been countered by purchasing dollars. These countries added 167 billion dollars to their foreign currency reserves in 2002; the increase since 1998 amounts to almost 450 billion. China's official reserves total about 300 billion dollars and those of Hong Kong, South Korea, Singapore and Taiwan together come to nearly 500 billion.

The euro area's balance of payments on current account had moved from a deficit of 61 billion dollars in 2000 to virtual balance in 2001 in connection with the slowdown in domestic demand. In 2002 demand weakened further, leading to a surplus of 60 billion dollars, equal to 0.9 per cent of GDP; another surplus is expected this year.

Between 1993 and the middle of 2001 the price competitiveness of the countries that now form the euro area had improved owing to the steady depreciation of their currencies by 15 per cent over the period as a whole. From the middle of 2001 onwards, exchange rate movements considerably reduced the area's international competitiveness. By April of this year the deterioration amounted to some 17 per cent; over the same period the competitiveness of the United States and Japan improved by 2 and 12 per cent respectively.

Firms and banks

In the Group of Ten countries the expansion in financial activity in 1999 and 2000 had led to a surge in corporate fund-raising in the bond and equity markets. The annual amount of capital increases by listed firms had risen to 2.6 per cent of GDP, compared with 1.7 per cent in 1997-98. Each year 1,300 companies had been admitted to the stock exchange.

In 2001 and 2002 new listings of non-financial companies became less frequent. The annual volume of funds raised in the form of equity capital was 64 per cent less than in the preceding two years. In 2002 bond issues fell by 60 per cent compared with 2001.

In the major markets as a group 10 per cent of all firms with low credit ratings defaulted on bonds in the first half of 2002, a figure just below the level reached in the recession of the early 1990s.

In the United States and Europe life assurance companies were affected by the prolonged decline in the stock markets and the increase in the credit risk on corporate bonds. Injections of capital were necessary in a number of cases. In the casualty and reassurance sectors, the massive claims arising from terrorist acts and natural disasters curtailed profits.

The banking systems of the major countries had no serious difficulty absorbing the effects of the adverse economic situation, the fall in share prices, the troubles in the corporate sector and the tensions in the financial markets of Asia and Latin America; their stability was not compromised. The strengthening of banks’ capital bases in the second half of the 1990s was a contributory factor.

The growth of the markets, their increased liquidity and the innovations that had been introduced permitted better diversification of the sources of financing for borrowers and of the risks for creditors.

Cooperation has grown closer among the authorities responsible in the different countries for supervising the banking, insurance and financial sectors.

In 2002 banks’ capital and reserves amounted to 9.2 per cent of assets in the United States, substantially higher than in the previous years. In Germany the figure was 4.6 per cent and in France 7.2 per cent; in the United Kingdom it was 5.1 per cent in 2001.

In Italy capital and reserves are equal to 7.2 per cent of total assets.

Banks’ solvency ratios are generally higher than the minimum requirement in both Europe and the United States.

Between 1996 and 2001 the average annual value of bank mergers and acquisitions amounted to 1.4 per cent of GDP in the United States, 1.2 per cent in Italy and 1.1 per cent in the United Kingdom. This far-reaching reorganization made it possible to curb costs and expand the sources of income, in part by introducing innovative products.

In Japan and Germany the restructuring of the banking industry was more limited; the value of mergers and acquisitions amounted to around 0.4 per cent of GDP. Costs rose in relation to income.

In 2001 banks' staff costs were equal to 25 per cent of gross income in the United States, 28 per cent in the United Kingdom and around 37 per cent in Germany.

In Italy the ratio declined from 36 per cent in 1999 to 30 per cent in 2001; in 2002 it rose back to 33 per cent.

In the United States banks' return on equity rose to 14.5 per cent in 2002. Net loan losses were held in check by reducing lending to firms and increasing mortgage lending to households. Commercial banks have additional exposure via their ownership of securities issued or guaranteed by specialized federal agencies, which hold half of all mortgage loans; the interest rate risk is managed by means of complex transactions in derivative instruments.

In Japan the difficulties of the banking sector led to an overall contraction of 2.5 per cent in the volume of lending in 2002, after those of 1.8 per cent in 2001 and 2 per cent in 2000. The volume of credit decreased further in the first few months of this year. Bad loans have continued to be written off at a rate of between 2 and 3 per cent a year.

In Europe it was German banks that were worst affected by the stock market turbulence on account of their large equity holdings. Lending by German banks stagnated in 2002, and loans to firms contracted in absolute terms. A plan has been approved to mobilize a substantial amount of bank loans by means of securitization. The financing will come from the market.

The growth of derivatives has greatly increased the opportunities for hedging risk, thereby reducing its cost, and the ability of markets and intermediaries to withstand adverse events. It has contributed to the stability of financial systems.

The notional value of derivatives traded on over-the-counter markets reached 128 trillion dollars last June, 60 per cent more than in 1999. In recent years a market in derivatives for hedging credit risk has developed; its size in December 2002 can be estimated at 2 trillion in terms of notional value. According to a recent survey of 150 major international financial intermediaries, US institutions accounted for nearly two thirds of the transactions and intermediaries based in European countries, including Italy, for most of the rest.

Use of these instruments has made it possible to redistribute credit risk in the market. The exposure of large banks has decreased, while that of smaller banks has increased.

The splitting of risk may cause intermediaries to base their investment decisions exclusively on the ratings of outside agencies, without carefully assessing the risk they are assuming, thus possibly leading to an excessive expansion of credit to particular sectors or countries. Every bank must accurately evaluate the risk-return profile of each operation, even when participating in syndicated loans organized by other intermediaries.

The use of complex, non-standardized financial instruments can be a source of opacity in the financial statements of the major international banking groups, whose organizational structures are highly ramified.

There is broad agreement on the need for uniform standards across countries for the accounting treatment of derivative positions; efforts to extend the disclosure requirements are being stepped up.

The supervisory authorities of the European countries are widely critical of the application of valuation techniques based indiscriminately on methods such as mark-to-market or fair value as a means of valuing bank assets.

The extension of these methods to traditional banking products would increase the variability of financial reports. It would somehow fail to recognize the banker’s true function based on the ability to evaluate creditworthiness accurately.

The new international accounting standards must produce methods for the valuation of financial instruments that can dispel all forms of opacity in financial statements. The European countries’ decision to make the international accounting standards mandatory for listed firms must be matched by a concrete commitment on the part of the United States to move towards a common set of rules.

The development of the backward countries

Economic development policies must be accompanied by specific programmes to foster the social inclusion of the poorest strata of the world's population and their participation in the benefits of economic growth.

In the less-developed countries the institutions responsible for managing the economy must be strengthened. It is necessary to invest heavily in human capital.

In line with the commitments made at the conference in Monterrey, Mexico, in 2002, the volume and effectiveness of development assistance must be increased. The debt-reduction initiative is encountering difficulties that must be surmounted as soon as possible. Like the other industrial countries, Italy is pledged to contribute 0.33 per cent of its GDP.

In order to raise the level of welfare globally and in the poorest countries, it is crucial to achieve tangible results on the multilateral trade liberalization front, in accordance with the objectives established in Doha, Qatar, in November 2001.

The level of support granted to agriculture in the major industrial countries remains high. According to OECD estimates, in 2001 the European Union provided subsidies to farmers, agricultural price supports and export aid amounting to 106 billion dollars, or 1.4 per cent of the area's GDP. Farm subsidies totaled 95 billion dollars in the United States and 59 billion in Japan, equal respectively to 0.9 and 1.4 per cent of GDP.

The protection accorded to agriculture by the richest countries is particularly harmful to developing ones, which have a comparative advantage in this sector.

In the recent meetings in Washington the Development Committee issued a strong call for an acceptable compromise to be reached by the summer regarding primarily agriculture. In this way the ministerial meeting of the World Trade Organization to be held in Mexico in September will be able to close important chapters of the Doha agenda, such as the reduction of customs duties on industrial products and the further liberalization of trade and direct investment in services.

Progress on this front is necessary in order to give fresh impetus to international cooperation, to overcome the divisions and mistrust engendered by the conflict in Iraq and the continuation of terrorist attacks and tensions in various parts of the world, and to achieve a better balance between the industrial economies and the developing countries.

The Italian economy

The difficulties of the international business cycle had repercussions on the European and Italian economies, which are characterized by structural rigidities and slower growth of potential output than those of North America or the emerging countries.

In the euro area GDP growth slowed from 3.5 per cent in 2000 to 1.4 per cent in 2001 and 0.8 per cent in 2002.

In Italy the increase of 3.1 per cent in output in 2000 was followed by rises of 1.8 per cent in 2001 and 0.4 per cent in 2002.

In the second half of 2001 economic activity in Italy slowed down abruptly owing to a fall in exports and a slackening of domestic demand. Investment, consumption and exports all continued to decline in the first half of 2002; GDP stagnated.

In the second half of 2002 a recovery in investment, largely due to the impending expiry of tax incentives, was accompanied by an increase in exports. Consumption also began to grow again, albeit modestly.

However, the increase in all the components of demand was not sufficient to stimulate productive activity; the expansion of supply stemmed from a large rise in imports. GDP growth picked up slightly.

The sharp decline in industrial activity during 2001 was followed in 2002 by a tentative recovery that lasted until the summer.

Production fell again in the second half of the year and contracted further in the early months of 2003; in March the index of industrial production fell back to the low registered in late 2001.

Despite the cyclical slowdown, employment continued to expand, rising at an annual average rate of 1.4 per cent. In 2001 and especially in 2002 permanent employment benefited from the tax incentives introduced at the end of 2000, which were suspended last July because of their excessive cost to the exchequer. The growth in employment was one percentage point higher than that in GDP; the expansion in labour-intensive services contributed to the decline in productivity.

On the basis of harmonized data, consumer prices rose by 2.7 per cent in 2001 and by 2.6 per cent in 2002. Inflation accelerated from mid-year onwards, rising to 3 per cent in December. The twelve-month rise in the harmonized index was 2.9 per cent in May.

An inflation differential is re-emerging in relation to France and Germany, our main competitors in the domestic and international markets.

Per capita earnings in Italian industry rose by 3 per cent in 2001 and by 2.8 per cent in 2002. Labour productivity increased by 1.6 per cent in 2001 and declined by 0.4 per cent in 2002.

Over the past two years earnings in the manufacturing sector in Germany have risen at just over half the rate recorded in Italy, while productivity has improved twice as rapidly.

Unit labour costs in Italian industry rose by 4.3 per cent in the two years, compared with 1.3 per cent in France and Germany. The gap vis-à-vis these two countries was thus 3 percentage points.

While world trade in goods and services grew by 3 per cent over the past two years, German exports increased by 7.8 per cent and French exports by 3.2 per cent.

Italy’s exports in 2002, measured in volume terms, were the same as in 2000.

Competitiveness

A look back over the years again highlights the weak growth of the Italian economy in the European and world context.

In the five years from 1998 to 2002 the GDP of the United States grew by an average of 3 per cent a year and that of Europe by 2.3 per cent. Italian output rose at an annual average rate of 1.8 per cent.

World trade in goods and services expanded by 28 per cent between 1997 and 2002. Italian exports increased by 16 per cent, while those of France and Germany rose by 31 and 38 per cent respectively.

The loss of competitiveness affects industrial value added and economic growth.

In the five years from 1997 to 2002 industrial production in Italy increased by 3 per cent. In France the growth was about 11 per cent, in Germany 12 per cent; in the euro area excluding Italy it was 14 per cent. The expansion of Italian firms’ production abroad - in the emerging and developing countries - has been substantial, but no greater than that of the other large euro-area economies.

Italy’s share of world exports had risen steadily from 2 per cent in the 1950s to 4.5 per cent in the 1980s.

Until the early 1970s the complete stability of the lira against the dollar and the other main currencies was accompanied by large gains in industrial productivity. During the 1950s and 1960s Italy’s GDP increased at rates of between 5 and 6 per cent as the country gained export market shares.

In the subsequent decades, following the oil crises, labour incomes and prices rose sharply, productivity growth slackened and the annual rate of output growth slowed by half. Italy’s share of world trade was defended by repeatedly devaluing the currency. Between 1971 and 1993 the nominal effective exchange rate of the lira against the leading currencies fell by about 70 per cent.

Competitiveness began to decline in the mid-1990s, bringing Italy’s share of world trade back to the level of the mid-1960s; at constant prices it fell from 4.5 per cent in 1995 to 3.6 per cent in 2002.

The loss affected all markets. The composition of Italian exports makes them vulnerable to changes in prices, which are necessarily linked to production costs. Italian goods are poorly represented in technologically advanced sectors, whereas they are prominent in those where success depends on taste and workmanship.

Italy’s share of world trade remains high in such industries as furniture, leather products and the working of non-metallic mineral products.

In machinery and mechanical equipment, Italy has a gradually declining share that now amounts to 9.6 per cent of world exports. In five years the country’s share in motor vehicles and parts has fallen from 3.6 to about 3 per cent, and in electrical equipment and precision instruments from 2.1 to 1.8 per cent. Our exports of electronic and information technology products are very small.

The United States maintained a world market share of about 11 per cent by volume throughout the 1990s. France and Germany have gained market shares since the middle of the decade, benefiting from intensified specialization in high-technology sectors. Japan’s share fell from 8.6 per cent in 1995 to 6.4 per cent in 2002; at current prices the loss was less marked, revealing an ability to sell at high prices owing to good product quality.

Chinese exports at current prices have expanded from 2.9 per cent of world trade in the mid-1990s to about 5 per cent, as the country has moved successfully into the production of medium-technology goods.

As in the rest of Europe, import penetration in the Italian market is growing. Domestic demand is being satisfied increasingly by goods produced in other countries.

Between 1990 and 1995 the net impact on production of the stimulus from exports and the restrictive effect of imports was positive, thanks to the recovery in competitiveness as a result of the devaluation of the lira in 1992. Between 1996 and 2002 the net effect turned negative; the rise in purchases of foreign products to meet a growing proportion of domestic demand for finished products and intermediate goods far outweighed the growth in exports.

Over these seven years the negative impact of foreign trade on GDP can be estimated at 2.9 percentage points. In the other euro-area economies increases in imports were more than matched by export growth.

Productivity

The unsatisfactory performance of the Italian economy has been due in large part to the slow increase in productivity.

In the United States between 1995 and 2000 the widespread application of information technology, increased investment, research, the wealth of human capital and flexibility in the utilization of labour fostered far-reaching organizational change and a shift towards the production of goods with a greater technological content. Hourly labour productivity in industry rose by 4.5 per cent a year.

In France productivity increased by 4.6 per cent a year and in Germany by 2.4 per cent.

In Italy hourly labour productivity in the manufacturing sector rose by 0.9 per cent a year between 1995 and 2000.

The loss in competitiveness has become more evident in recent years, but its origins lie further back in time.

In manufacturing, total factor productivity, which is a measure of technical and organizational advance, rose by only 1.3 per cent a year between 1980 and 1985, despite large-scale restructuring; in the economy as a whole there was virtually no increase at all.

From the mid-1980s to the mid-1990s total factor productivity in industry rose at an average annual rate of 1.5 per cent.

From 1995 to 2001 the growth of value added in manufacturing industry slowed down sharply. Investment increased, but not employment.

Total factor productivity stopped rising; over the period as a whole it declined by about one percentage point.

The increase in employment over these years was concentrated in the private service sector, where overall productivity increased slightly.

The contribution to output growth stemming from investment in information technology amounted to 0.2 per cent a year both in industry and in services.

Between 1995 and 2001 value added in the private sector increased by 13.1 per cent at constant prices. Of the overall gain, 5.8 percentage points can be attributed to labour, 5.2 points to capital and 2.1 points to the growth in total factor productivity.

The banking and financial sector accounted for one sixth of the productivity gain in the economy as a whole. Thanks to reorganization and investment in new technology, total factor productivity in the sector rose by almost 7 per cent during the period.

Transport and communications, agriculture, textiles and retailing also made significant contributions to the improvement in total factor productivity. In many branches of both industry and services the gain in productivity was practically nil; in others there was a decline.

Firms, research and economic growth

The paucity of the rise in productivity is attributable not least to the fragmentation of supply. Italian firms are small. The Census of October 2001 found that local production units in industry have an average of 6.3 workers, a very low figure compared with other European countries and the other major industrial economies.

This structure created abundant employment in past decades, and it is a reservoir of entrepreneurship. Unless it is complemented by large firms, however, it shows its limitations as regards productivity growth and the ability to compete in a world market where some new competitors benefit from minimum social protection and very low labour costs.

Studies by our Research Department of the economies of European countries reveal a close correlation between productivity growth and company size; in high-technology sectors size is decisive.

In Italy as elsewhere, firms are increasingly using information and communications technology, but they do not yet appear to have introduced production processes that have a significant impact on costs and productivity: the small scale and inherently simple model of production have not provided much scope for improving the organization of small businesses.

More efficient organization of the economy as a whole, through networking to replicate on a national level some of the characteristic advantages of local industrial districts, could generate significant productivity gains.

Italy's under-representation in technologically advanced sectors and its slowness to apply information technology to production processes and organization are ascribable partly to the limited amount of resources allocated to innovation and research, both by the public sector and by private firms. Total spending was 1.3 per cent of GDP in 1990 and fell to about 1 per cent in 1995.

In the United States expenditure on research rose from 2.4 per cent of GDP in 1994 to 2.8 per cent in 2001. In the other large industrial countries it ranges from 3 per cent in Japan to 1.9 per cent in the United Kingdom.

Public sector expenditure on research and development in Italy comes to about 0.5 per cent of GDP, a low figure by comparison with the other large industrial economies. According to the latest data, firms' investment in research and development is also about 0.5 per cent of GDP; it has declined since the early 1990s.

Firms in the United States and Japan invest more than 2 per cent of GDP in research, four times the Italian ratio. In Germany the figure is 1.8 per cent; in France and the United Kingdom it is between two and three times as high as in Italy.

The application of new technology to the coordination and control of production as part of an overhaul of processes to improve efficiency entails improving the skills of the work force, adopting new organizational models and redefining relationships with suppliers and distributors.

It requires adaptability on the part of workers, intelligence and high levels of skill.

The proportion of the population aged between 25 and 64 with post-secondary education is 36 per cent in the United States and around 30 per cent in Japan, the United Kingdom, Sweden, Finland and Belgium; in Italy it is 10 per cent, owing in part to a high university drop-out rate. Graduates in engineering and other scientific disciplines account for a smaller share of the total than in any other leading industrial country.

Investment in secondary and university education is indispensable if the technical and scientific training of the younger generation is to be improved with a view to reorganizing production processes in industry and especially in services to achieve greater flexibility and adaptability to changing demand.

A sound background in the humanities is needed to comprehend an economic and social environment in which intercultural relations are changing swiftly, owing in part to advancing globalization.

Investment in education rewards the individual with a rate of return close to double digits within a relatively short time span. The social return can be much greater than the individual yield alone.

The business start-up rate in Italy is comparable to that in other economies, but firms' subsequent expansion faces impediments both in Italy and in Europe.

The institutional, legal and fiscal obstacles to the growth of small companies must be eliminated. Services must be liberalized further. The labour legislation now being drafted moves towards easing the constraints on the utilization of the factors of production.

Employment regulations that are consistent with an industrial economy focusing on standardized mass-produced goods, and the related costs, are among the causes of the large number of self-employed workers and the abnormally high proportion of irregular employment.

The small size of production units, the proliferation of self-employment and the spread of the underground economy are also a response, albeit an unhealthy one, to the slow growth and poor competitiveness of the regular economy.

A new stage of development calls for reorganization of the structure of the economy and an increase in the size of firms.

Mergers and restructuring within the banking system have given a considerable boost to productivity in the sector. The long period of investment in information technology, the growing size of banks, the progressive replacement and training of staff, and greater employment flexibility are bearing fruit in terms of return on equity and the ability to serve households and firms.

Industry too needs to form stronger groups capable of product and process innovation and able to withstand growing competition in the domestic market and to move more confidently onto the world stage.

Corporate mergers and acquisitions call for careful market analysis and evaluation of productive synergy; they must be initiated by entrepreneurs.

More advanced forms of corporate organization and financial structure are needed. Universities can play an important role in cooperation between groups of firms for the purposes of introducing new technologies.

An innovative economic policy for research, education and technological progress together with industrial relations suited to the new environment of greater openness and competition can halt the slow but steady decline in competitiveness and improve productivity in industry and services.

We must strengthen existing production capacity and make it more economically viable and dynamic, in order to prevent backsliding and achieve a new stage of development.

The South

The economic disparity between the two main regions of Italy narrowed until the 1970s, thanks to large-scale investment in infrastructure and basic industry under the southern development programme, but it has widened again in recent decades.

The Centre and North are home to 85 per cent of Italy's industrial capacity. The local environment, the distance from the affluent regions of Europe and the lack of efficient transport networks make production in the South less competitive than in the rest of the country.

The consequences are lower employment rates, higher unemployment and a high proportion of underground economic activity and irregular work.

Since the mid-1990s the ratio of gross fixed capital formation to GDP has ranged between 18 and 20 per cent in the North. In the South it has averaged one percentage point more. The final domestic consumption of households and general government amounts to 97 per cent of output in the South and 74 per cent in the rest of the country.

Imports of goods and services to the South, which come predominantly from other parts of Italy, exceed exports by more than 50 billion euros. Only a very small part of this deficit, equivalent to 18 per cent of the area's output, is offset by net receipts from tourism.

Balance is achieved through the action of general government, in that public expenditure is roughly correlated to the number of inhabitants while tax revenues are more than proportional to income.

The South's balance of payments on current account is roughly in equilibrium. The region is not accumulating external debt.

Through their lending and fund-raising activities, banks channel a net flow of funds to the South, albeit a modest one. The branches of banks based in the Centre and North lend more in the South than they raise in the region, a tendency that has become more marked in recent years.

Capital transfers by northern companies investing in the South are substantial. Industrial firms with 50 or more employees made investments totaling 35.1 billion euros in 2001, including 6.3 billion in the South, but only 2.4 billion of this investment was by firms whose registered offices are located in the area.

According to the 1996 Census, more than 12 per cent of private sector employment in the South was in firms whose registered offices were outside the area.

Labour costs make the output of the South less competitive, owing to lower productivity because of external diseconomies. Government aid does not bridge the gap with the rest of the country.

At the beginning of 2003 the unemployment rate, which has declined in recent years, was 18.6 per cent in the South, compared with 4.2 per cent in the North-West, 3.7 per cent in the North-East and 6.9 per cent in the Centre. The employment rate of the working-age population was 43.2 per cent in the South, 58.4 per cent in the Centre and 63.7 per cent in the North.

In Europe the employment rate is over 64 per cent.

The number of irregular workers is extremely high in the South, accounting for as much as half of total employment in some branches of activity.

In the last few years substantial net emigration to the Centre and North has resumed.

The South's medium-term growth potential is greater than that of the rest of Italy, owing precisely to its lower starting level, its demographic vitality and plentiful supply of young workers more open to learning the new techniques and skills required by a modern economy.

The contribution of tourism is modest in relation to total resources. Tourist receipts in 2001 came to 9.5 billion euros in the South, compared with 50.2 billion in the Centre and North. It is necessary to foster the industrial and high-technology activities that are already emerging in some areas.

Faster growth in the South will also benefit the economy of the North, with its rapidly ageing population and widening gap between the capacity for saving and the opportunities for investment.

Decentralization and fiscal federalism cannot afford to ignore the profound civil, social and economic ties that exist between the different parts of Italy.

They must aim at the development of the national economy as a whole.

Banking and the financial markets

During a cyclical slowdown overlaid by the destabilizing effects of the fall in share prices, large corporate failures and the difficulties of emerging countries, the Italian banking system is among those that have shown greatest resilience.

In the on-site inspections carried out at 342 banks in 2001 and 2002, the assessments were entirely positive in 139 cases. This is basically the same ratio as in the preceding two years, when 136 of 326 banks received a favourable assessment. The proportion of negative evaluations declined from 25 to 19 per cent; they concerned banks that accounted for 2 per cent of the system's total assets.

The progress made since the mid-1990s is reflected in the positive judgement made by the financial markets. Setting the values of the start of 1995 at 100, the share index of Italian banks now stands at 245, some 15 points higher than the average for banks of the euro area and 44 higher than the Italian stock market index.

Over a period of ten years the portion of bank assets held by institutions in which more than half of the equity is owned by public bodies and banking foundations has fallen from 66 to 10 per cent. The greater focus on profitability and the need to attain an adequate volume of business to compete at international level have impelled the system towards consolidation, greater operating efficiency and the provision of new services.

Considerable productivity gains have been achieved. Between 1995 and 2002 the stock of IT capital per employee rose roughly fourfold; the number of staff decreased by 4.5 per cent.

The process of consolidation was particularly intense from 1995 to 2000. Following a pause in 2001, there have been another 36 mergers and acquisitions since the beginning of 2002.

Banks have expanded the supply of asset management services. The Italian investment fund industry has become the second largest in Europe in terms of assets under management.

The main banking groups have chosen to extend their presence in the countries of Central and Eastern Europe. Italian banks occupy significant positions in some of those that will join the European Union. Nevertheless, our banking system's international activity remains small by comparison with that of banks from the other main euro-area countries.

Drawing on the knowledge of the markets gained in the course of supervision, we have taken steps to ensure that consolidation is accompanied by an increase in competition, even at local level.

The abolition of operating restrictions and geographical barriers has increased the opportunities for competition. Today there is one bank branch for every 1,900 inhabitants, compared with one for every 3,400 at the beginning of the 1990s. It has become easier to compare the conditions and products offered.

The spread between the return on loans and the cost of funds was 3.8 percentage points in 2002, compared with 6.1 points in 1995. The differential between the average and minimum lending rates has narrowed; the dispersion by geographical area has decreased.

Banks' profitability and the supply of credit

In the mid-1990s banks' return on equity was around 2 per cent for the system as a whole, with considerable variability from area to area; in 2000 it was 11.5 per cent. The increase, which was systemwide, was more pronounced for the large groups.

In the last two years profitability has been reduced by the economic slowdown, the need to provide against the risks connected with the exposure to Latin American countries and large international firms, and the contraction in income from asset management services.

Profits fell to 8.8 per cent of capital and reserves in 2001 and to 6.2 per cent in 2002. The reports for the first quarter of 2003 indicate an improvement with respect to the end of last year.

The return on equity of German banks declined from 5 to 3.7 per cent between 2000 and 2001; last year it fell further. In France the banking system's profitability was on the order of 9.5 per cent in 2000 and 2001; for the major banks, which account for two thirds of the system, it fell by around 2 percentage points in 2002. Bank profitability is higher in the United States and the United Kingdom, where GDP growth has been faster in recent years.

Credit risk has risen very slightly in Italy. In 2002 new bad debts amounted to 1 per cent of total lending; the ratio had reached 3.6 per cent in the wake of the 1993 recession and remained above 2 per cent until 1996.

The small scale of new bad debts primarily reflects the more balanced financial situation of corporate borrowers in both industry and services, where profitability remained high despite the weak economic situation; gross operating profit declined from 37.6 per cent of value added in 1995 to 36 per cent last year. The fall in interest rates caused interest charges to contract from 22 to 15 per cent of gross operating profit. Capital spending was low; the share financed internally remained high.

The large industrial groups, which in 2000 and 2001 had financed acquisitions by borrowing heavily from banks, subsequently disposed of non-strategic assets and reduced their debt. This helped banks comply with the limits on risk concentration. The Bank of Italy systematically monitors lending to large companies. Industrial groups with annual sales of at least 50 million euros account for 10 per cent of banks' total assets, a low proportion compared with other leading countries; in Germany the figure is around 30 per cent.

Statistical studies based on the financial statements and credit reports of 126,000 companies indicate that in the last four years banks have channeled an increasing share of their lending to firms with a low likelihood of default.

Among firms with annual sales of less than 5 million euros, lending to those with a probability of default below 0.5 per cent increased by an annual average of 11 per cent; lending to firms whose probability of default was higher than 1 per cent grew more slowly, by 5 per cent. A similar pattern is also found in lending to large firms.

Credit supply conditions remained relaxed.

Lending slowed down until last autumn. The annual rate of growth subsequently picked up, rising to 7.1 per cent in April. It is currently 3 points higher than that for the euro area. In France the increase in lending amounted to 4 per cent in 2002; in Germany it was virtually nil.

The expansion in lending was mostly at medium and long term, ensuring greater stability in the financing of firms. The undrawn margin on credit facilities remains large; it has increased for the manufacturing sector.

After the reductions in the euro-area reference rates, the average cost of short-term loans fell by 0.1 percentage points in December and by another 0.5 points in the first four months of this year. Today it stands at 5.2 per cent, the lowest figure for half a century. Bank interest rates are in line with the levels elsewhere in Europe.

Banks' capital resources, which represent the main guarantee of their ability to finance the economy on a stable basis, exceed the minimum requirement. Between the end of 2001 and the end of 2002 the solvency ratio rose from 10.4 to 11.2 per cent; for the main groups, it increased from 9.3 to 10.6 per cent.

The banking foundations have played an important role in the reorganization and privatization of the banking system. It is essential to ensure the continuity of the role they play as private non-profit institutions.

In the South, the contraction in the flow of new bad debts in relation to lending was also significant.

In the mid-1990s around 6 per cent of loans became irrecoverable every year in the southern regions, three times the figure for the rest of the country. Shortcomings in loan selection were common, particularly in the publicly owned banks.

The reorganization of banking in the South was achieved by privatizing the principal banks and with the entry into the area of better capitalized and managed intermediaries. The contribution of public resources was small and conditional on staff costs being brought into line with those in the rest of the banking system.

In the three years from 1999 to 2001 bank lending to southern firms grew by an average of 6.5 per cent a year, which was lower than in the Centre and North. In 2002 the growth in lending in the South amounted to 7 per cent, a higher rate than in the rest of the country. The flow of new bad debts declined to 1.6 per cent of lending, compared with 0.9 per cent in the Centre and North.

The differential between the interest rate on short-term corporate loans in the South and that in the Centre and North narrowed from 2.3 percentage points in 1996 to 1.6 points in 2002; it is less than one point when adjusted for the different sectoral and size composition of firms in the two parts of the country. The spread for medium and long-term loans is also very small, on the order of half a percentage point. The disparity with the rest of the country reflects the higher credit risk and is attributable to external diseconomies.

In recent years the interest rate on households' bank deposits in the South has gradually come into line with that in the Centre and North. The regional disparities in the remuneration of bank deposits have been eliminated.

The new Capital Accord

The Capital Accord currently in force dates back to 1988; it has been applied in more than 100 countries; it has made a major contribution to increasing the stability of banking systems and expanding their volume of business.

Since its adoption there has been considerable growth in banks' activity in international markets as well, new products have been introduced and new financial instruments have been created.

The opportunities for expanding business and profits have increased, but new risks have emerged.

The new Accord proposed by the Basel Committee on Banking Supervision establishes a closer link between capital requirements and level of risk in the light of the developments in banking over the last fifteen years. The reform is intended to encourage the application of more advanced methods of risk measurement and management, bolster the effect of market discipline on banks' policies and strengthen the action of supervisory authorities.

Empirical tests and consultation with a broad range of banks have made it possible to align the proposed new Accord with best management practice and to shape it in accordance with the operations of the various categories of credit institution. Banks are offered more ways to calculate their capital requirements; they can choose according to the configuration of their activities and the structure of their internal control systems.

The more advanced methods of calculating capital requirements will be used primarily by large banks that are active in international markets and by medium-sized banks specializing in innovative sectors.

Smaller banks, engaged in the traditional business of deposit-taking and lending, will be able to use a simplified method comparable to the present one.

At the end of April 2003 the Basel Committee released the third consultative paper with a view to launching the new Accord by the end of the year. Like the earlier versions, the paper is available for policy makers, market participants, trade associations and experts to comment on and make suggestions for amendments. These will be examined by the Committee in drawing up the final text. The new Accord is not expected to come into force before the end of 2006.

Compared with the initial draft, studies conducted by the Bank of Italy and the supervisory authorities of other countries have led to the introduction of specific methods for calculating capital requirements in relation to loans to smaller firms; their validity has been confirmed by simulations carried out by around 350 banks in more than 40 countries.

The new methods take account of the smaller exposure of the mass of small firms to the business cycle and the greater predictability of losses on portfolios of loans to smaller customers. The capital requirements for exposures to companies with sales revenues of up to 50 million euros are lower, for the same risk of default, than for exposures to larger firms. Loans of 1 million euros or less will receive even more favourable treatment. Under the new rules it will be possible for collective loan guarantees provided by consortia and cooperatives to be recognized for risk-mitigation purposes.

The new mechanism reduces the fluctuations in capital requirements with changes in cyclical conditions.

Analyses carried out by the supervisory authorities of several countries and tests performed by banks do not indicate any rationing effects or distortions in the allocation of credit as a consequence of the application of the new Accord.

By inducing a better use of capital resources, the new Accord ultimately aims to strengthen banks' stability further in order to protect the savings they manage.

It also aims to produce a more efficient allocation of credit to the economy.

Objective factors are taking on greater importance in the evaluation of creditworthiness. This is increasing the need for transparent financial reports giving a complete picture of firms' earnings and financial position.

Relationships between banks and firms must be based on mutual confidence and they must become more stable. This shift towards more advanced procedures and methods is necessary for both banks and firms. A better allocation of credit will help exploit the potential of the extensive network of small firms that is a feature of the Italian economy.

Savings and the financial market

After reaching a new low in 2000, household savings rose to 12.5 per cent of disposable income in 2002. A growing proportion was invested in medium and long-term bonds, largely government securities; house purchases increased.

Returns on financial investments fell short of savers' expectations in 2001 and 2002; after enjoying high interest rates for years, investors are finding it hard to realize that high yields necessarily imply high risks.

Some banks displayed shortcomings in the evaluation of risks, the recording of commitments in their accounts and their conduct towards customers.

In some cases it was necessary to initiate special procedures to safeguard the soundness of banks' operations.

In the four years from 1999 to 2002 the Bank of Italy undertook on-site inspections at 11 of the 100 or so asset management companies, most of which belong to Italian or foreign banking groups, and at 29 of the 170 Italian investment firms. Consob also carried out inspections.

Our checks at asset management companies found that on the whole their situation was satisfactory; in some cases organizational shortcomings came to light, leading the Bank to initiate sanction procedures. Some investment firms were found to have fragile ownership structures and serious organizational deficiencies; in some cases the Bank initiated sanction procedures and in others it imposed special administration or liquidation.

On-site inspections and the checks made at bank branches by the Bank's decentralized supervision units found some omissions in the information provided to customers; instances of non-compliance with the rules on transparency were also uncovered; in 2002 the Bank initiated sanction procedures against 25 banks.

Acting on a proposal from the Bank, the Interministerial Committee for Credit and Savings approved a comprehensive revision of the provisions implementing the primary legislation on transparency. New rules have been introduced with the aim of providing more effective investor protection; additional information has to be disclosed on the contractual terms and conditions, costs and risks associated with banking transactions, lending and fund-raising.

Banks and non-bank intermediaries must give investors accurate information and prudent advice on the investments best suited to their needs and consistent with their means. They must offer financial instruments that are easily comprehensible and without needless complexity. They must always ensure that products are comparable.

Ethics and professionalism are essential.

In the second half of the 1990s mistakes were made and excessive expectations were raised against the background of generalized optimism in the financial markets of the leading countries. Employees must undergo regular training based on the principle of customer service.

Customer confidence, which underpins financial institutions' stability and operations, must be strengthened.

Today there are 265 Italian companies listed on the stock exchange, down from 276 at the end of 2001. There are 715 listed companies in Germany, 737 in France and 2,405 in the United Kingdom. The listed Italian non-financial companies account for one sixth of the value added of such companies.

The small number of non-financial companies listed on the Italian stock exchange reflects the small size of our firms, but above all their low propensity to seek listing. The firms in the lowest quartile of listed companies by market value are eight times larger than their counterparts in Germany and five times larger than those in France.

According to research by Borsa Italiana, nearly 1,200 companies have the characteristics required for listing. More than half have been approached by merchant banks, commercial banks and management consultants with a view to admitting outside shareholders or floating on the stock market. So far the response has been unsatisfactory; listing increases the exposure to external scrutiny.

It is essential to proceed with reform of the rules and the removal of the constraints that hold back the activity and growth of firms.

The new company law is an important step in the process of overhauling the legislative framework.

This reform encourages entrepreneurship, increases directors' autonomy, better defines their responsibilities and improves the rules on conflicts of interest within firms and conglomerates. The difference between the legislation on companies with listed securities and that applying to other companies limited by shares has been reduced. The steps taken in this field must be completed by a reform of Italian bankruptcy law.

Labour market reform and a reduction in the tax burden must create conditions conducive to growth in the size of firms and the start of a new investment cycle, especially in high-tech sectors.

The challenge facing Italian firms is to achieve, mainly through consolidation, a scale of production that permits higher efficiency, more research, and innovations able to broaden the range and improve the quality of their products.

With their new size and organizational structures, banks, working closely with the capital market, must now contribute in a more determined fashion to the modernization of our economy, make their wealth of information available to firms, and assist them in planning mergers and acquisitions and finding more advanced forms of financing.

The efficient allocation of credit has a high social value, especially in today's difficult economic climate; it is essential in order to protect savings, support businessmen with a drive to innovate, and contribute to the growth of the economy by financing the best investment projects.

Ladies and Gentlemen,

Last May, in the light of the improvement in economic performance after the events of 11 September, we had indicated that the GDP of the United States could be expected to increase by at least 4 per cent between the end of 2001 and the end of 2002.

The serious international tensions and subsequent developments curbed the recovery. Output grew by 2.9 per cent during 2002.

Growth in the euro area over the same period was only 1.2 per cent.

The cost of the dramatic international events, in terms of forgone growth, can be estimated at around one percentage point of GDP in the industrialized countries.

In the first few months of this year the economic situation was still dominated by the repercussions of war and terrorism.

In Japan prices are continuing to fall.

In the United States economic policy is geared strongly towards countering the slowdown in activity and combating unemployment. Inflation is being held in check by the reduction in costs associated with large productivity gains and the intensification of competition.

Gross domestic product increased at an annual rate of 1.9 per cent in the first quarter of 2003. Economic activity should accelerate in the second half of the year, boosted by low interest rates, a new programme of tax cuts and the depreciation of the dollar.

The growth forecasts for the fourth quarter in relation to the same period of the previous year range between 2.2 and 3 per cent. The increase in GDP for 2003 as a whole is likely to be between 2 and 2.5 per cent, still below potential growth.

A full recovery is widely expected to materialize in 2004.

Growth in the euro area was almost zero in the latter part of 2002 and the first quarter of 2003; it will be less than 1 per cent in the year as a whole.

The strong appreciation of the euro is affecting activity. The scope for budgetary measures is limited; in some countries the deficit is well above the 3 per cent limit.

The weakness of growth in continental Europe is attributable in large part to the rigidities that built up during the decades of rapid development after the Second World War, the ageing of the population and the associated heavy burden of pension and welfare spending.

In the major countries the launch of monetary union has not been followed by the structural reforms needed to bring about a better utilization of resources, first and foremost labour, and to compete in a profoundly changed economic and financial environment.

If the European objectives for growth and employment laid down in Lisbon in 2000 are to be achieved, the necessary measures must be taken in each country. Easing the tax burden presupposes a reduction in the ratio of public expenditure to GDP; state pensions have to be adjusted to take account of increased life expectancy; the development of supplementary private pensions will generate new resources to finance investment.

At a time when the economy is weak, the balance of payments in surplus and prices are stable, demand and growth can be stimulated by the resumption of a programme of major infrastructure works, on the basis of well-defined projects and timetables.

In the first quarter of this year Italy’s gross domestic product remained at the same level as in the latter part of 2002.

Industrial production continued to fall in the three months to March; according to our preliminary estimates, it rose slightly over the following two months.

Exports should increase by 2 per cent in volume terms this year, thanks to the recovery in world demand; the loss of market share is continuing, owing partly to the appreciation of the euro.

Consumption should begin to grow again, albeit slowly. The availability of credit is conducive to investment in construction.

Imports are still outpacing exports; this will hold down production and the growth in national income.

It is difficult to see GDP growing by more than 1 per cent in 2003.

Companies' spending plans, influenced by expectations of weak demand, point to a contraction in investment, especially in manufacturing.

In 2002 public investment was 7 per cent higher than in the previous year. According to a survey by our branches, expenditure on public works is recovering from the slowdown observed in the first half of 2002; it should gain momentum during the current year.

Investment on construction in the fields of health, water supply, education, energy, transport and communications amounted to 3.3 per cent of GDP at the beginning of the 1990s; it fell to 2 per cent in 1995 before rising again to 2.5 per cent more recently.

Infrastructure deficiencies impinge upon growth in the North, but they are more severe in the South, where they are associated with far lower levels of productivity, employment and income.

Partly on account of the unfavourable economic climate, the performance of the public finances is not consistent with the repeatedly proclaimed objectives for consolidation and adjustment.

Net borrowing on an accruals basis ultimately worked out at 2.6 per cent of GDP in 2001. It fell to 2.3 per cent in 2002, with temporary measures responsible for an improvement of more than 1 percentage point.

The balance for 2003 is expected to be the same as last year in relation to GDP.

The primary surplus, that is to say the budget balance net of interest payments, which at the time of entry to Monetary Union we had committed ourselves to keeping at 5.5 per cent of GDP, fell to 4.6 per cent in 2000; it is expected to be 3.2 per cent in 2003.

In the current difficult phase of the cycle temporary measures make it possible to curb the deficit without cutting into permanent income, but there remains the problem of replacing them with structural measures.

The ratio of tax and social security contributions to GDP declined by half a percentage point between 2001 and 2002, from 42.1 to 41.6 per cent, thus sustaining domestic demand. The ratio of current primary expenditure to GDP rose by 0.4 points last year.

The gap between permanent revenue and permanent expenditure is widening; the gradual reduction in the tax burden that has been announced will have to be based on a reduction in expenditure.

There remains a large disparity between the cash deficit and net borrowing on an accruals basis.

Structural measures are essential to adjust the public finances once and for all, offer the certain prospect of an easing of the tax burden and improve business and household expectations. The incidence of unfunded pension liabilities must be contained, the retirement age raised and the ratio of primary current expenditure to GDP gradually reduced.

Market confidence is being eroded by international tensions and the resulting economic difficulties. In Italy, as elsewhere in Europe, clear economic policies centred on an improvement in the public finances and consistent with a new prolonged phase of economic growth are proving slow to emerge.

Action must be taken before uncertainty gives way to pessimism.

A medium-term plan must again be proposed along the lines put forward by the Government in the Economic and Financial Planning Document published in the summer of 2001.

Low inflation, a high propensity to save and extremely low interest rates are ideal conditions for an acceleration in both public and private investment.

The easing of the tax burden on firms, the low cost of capital and the knowledge which banks can contribute can help reduce the fragmentation of the economy and stem the slow but steady decline in productivity.

The efforts to improve secondary and university education must be combined with an increase in funding for basic and applied research and more efficient use of the funds available. It is essential that firms renew their efforts in research and development aimed at offering new products and introducing new production techniques.

Small firms are a vital part of our economy. Mergers and forms of cooperation that make widespread use of information and communications technology are the way to improve competitiveness.

The authorities must persevere with the measures aimed at raising the efficiency of the public administration, to serve the population and sustain economic activity.

The economic recovery in the United States should strengthen towards the end of the year. Conditions must be created for Italy to benefit fully from this, by removing the structural obstacles to growth.

Italy is on the point of assuming the Presidency of the European Union at a time of enlargement to admit new member countries. The new configuration will be strengthened if adequate arrangements are made for sharing sovereignty and the correct balance is struck between national and European interests; it must be inspired by the deep-rooted values that have united the peoples of Europe over the centuries.

We have the resources to grow. It is the duty of business, labour and politics to harness these resources in order to foster employment, assist the younger generation, promote economic and civil advancement and return to the path of growth.