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A crucial passage for the global economy and for the Italian economy

Address by the Governor of the Bank of Italy
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After the events of September 2001 and the swift monetary and budgetary policy reaction, 2002 brought positive results in the United States. Demand and output were prevented from spiraling downwards; the growth rate of GDP rose from 0.3 per cent in 2001 to 2.4 per cent.

The performance of output in Europe was disappointing; within the European Union GDP grew by 1 per cent, compared with 1.5 per cent the year before. The economy is encumbered by structural rigidities and there is little scope for counter-cyclical economic policies.

In Asia economic activity expanded at a fast pace; in Japan it showed signs of recovery.

World output increased by around 2.5 per cent in 2002, but in recent months the recovery has been restrained by a sharpening of international tensions.

The international financial system has successfully absorbed the effects of the cyclical slowdown, the discovery of serious irregularities in the accounts of major corporations, the terrorist attacks, and the deep crisis of some Latin American countries.

Stability has been preserved thanks not only to the policies to support the economy, but also to the development of the markets and more efficient means of distributing risk, the progress made in reorganizing banking systems, and the advances in crisis prevention and banking and financial supervision.

1. Developments in 2002

The long expansion under way in the United States since the early 1990s came to an end in 2000.

The cyclical weakness in 2001 grew more pronounced and spread rapidly to the other industrial countries and to the emerging economies. The easing of monetary policy and the programme of tax cuts approved by Congress in the spring prepared the ground for a turnaround in the cycle.

The September 2001 attacks could have had serious repercussions on consumption, investment and the outlook for growth. The further reduction in interest rates by the Federal Reserve, together with the additional measures to provide tax relief and boost public spending, led to 2.7 per cent annualized growth in GDP as early as the fourth quarter of 2001. Household consumption increased by 6 per cent. After falling sharply in the wake of the terrorist attacks, share prices began to rise rapidly.

In the first quarter of 2002 the rate of growth in output rose to 5 per cent. Consumption increased by 3 per cent and the decline in investment virtually came to a halt. At the time, the main forecasters predicted that economic activity would expand in the fourth quarter of 2002 by about 3.5 per cent compared with a year earlier.

In the spring the dollar began to weaken; the price correction of technology stocks continued; the decline in the prices of traditional shares gathered pace; the downward movement of long-term interest rates became more marked.

Fears of new terrorist attacks and tensions with Iraq acted as a brake on the economic recovery. In the second quarter GDP grew by 1.3 per cent; the slowdown was due to a let-up in household expenditure. In the third quarter output increased by 4 per cent, buoyed by purchases of consumer durables; total investment continued to stagnate, but spending on advanced technology, which had been recovering since the beginning of the year, rose by almost 14 per cent.

In the autumn the international political tensions grew stronger. Industrial production fell by 0.8 per cent between July and October before stabilizing in November. Non-farm payroll employment, which had begun to rise again in May, decreased by 84,000 jobs in September and by a further 88,000 in November.

The deterioration in economic conditions prompted the Federal Reserve to cut the reference rate by another 0.5 percentage points to 1.25 per cent, the lowest level since 1948. Real short-term interest rates are estimated to have turned negative by 1 percentage point.

In December a further 100,000 jobs were lost.

The latest estimates by the main private forecasters indicate that GDP will have remained virtually flat in the fourth quarter; the increase with respect to a year earlier is put at just over 2 per cent, which is less than the figure forecast at the beginning of the year. In 2002 as a whole GDP is estimated to have grown by 2.4 per cent; the trade deficit continued to widen; the economic situation still appears uncertain.

The performance of the US economy in 2002 affected economic activity in Europe and Japan.

In the United Kingdom the average of the annualized GDP growth rates in the first three quarters was 2.5 per cent, thanks to the resilience of consumption.

In the euro area output rose by only a little more than 0.5 per cent in the first nine months of 2002 compared with a year earlier; this reflected the weakness of economic activity in Germany and Italy. Consumption stagnated; investment declined; from the second quarter onwards a contribution to GDP growth came from the recovery in exports. For the year as a whole GDP is estimated to have grown by 0.7 per cent, compared with 1.4 per cent in 2001.

In view of the inflationary tensions that developed during 2001, the Governing Council of the European Central Bank lowered interest rates by only 1.5 percentage points. In December 2002 they were lowered by half a percentage point in response to the slowdown in economic activity and the improved outlook for inflation.

The public finances sustained economic activity through the operation of the automatic stabilizers. The tax cuts introduced in previous years had an expansionary effect; they were not matched by structural measures to curb expenditure.

France recorded a slight increase in investment last year. In Germany, the economy grew by 0.2 per cent over the year as a whole; consumption declined. On the investment front, the crisis in the construction sector was accompanied by a sharp downturn in the other components.

The performance of the Italian economy was unsatisfactory. Exports fell in the first quarter of 2002, continuing the negative trend under way since the middle of the previous year. In the second and third quarters they picked up strongly, leading to an acceleration in economic activity. Investment began to increase again in the third quarter under the stimulus of tax relief measures.

In the first nine months of 2002 Italian exports fell by 1.1 per cent compared with a year earlier, despite having increased at an annualized rate of 14 per cent in the second and third quarters. In Germany exports rose by 1.6 per cent and in France they remained stationary.

Among the other main industrial countries, Canada achieved better results than the United States. In Japan, after the collapse in output in 2001, the economy showed signs of recovery in the second and third quarters, sustained by buoyant exports. It began to weaken again towards the end of the summer as exports slowed down and confidence waned.

In the newly industrialized Asian countries, economic activity, which is already structurally expanding at a fast pace, was further boosted by exports. The growth in GDP in 2002 is estimated to have been 4.7 per cent. In China, the rate of growth of GDP remained high at around 8 per cent in the first three quarters; in India, the estimated growth rate of output for the year just ended is 5 per cent. The increases in GDP were also pronounced in the transition economies of Central and Eastern Europe.

In Latin America, countries in crisis exist alongside others where economic activity continues at a fairly satisfactory pace.

2. Financial markets

Share prices continued to fall in 2002 in the high-tech sectors; the decline in those of companies in traditional sectors became more pronounced from the spring onwards. In the United States the Dow Jones Industrial Average fell 17 per cent and the Nasdaq 100 index 38 per cent; in Japan the Nikkei 225 index was down 19 per cent; the Euro Stoxx index lost 35 per cent.

In three years, from the end of 1999 to last December, stock market capitalization fell by 36 per cent in North America and Europe, 42 per cent in Latin America and 51 per cent in Asia. In the seven leading industrial countries the markets' value fell by 37 per cent, a figure comparable to that recorded in the 1970s at the time of the first hike in oil prices.

The economic slowdown that began in mid-2000 has revealed the inconsistency between share prices and corporate profits in the leading countries.

The overvaluation that built up in the second half of the 1990s has been largely reabsorbed.

In the leading industrial countries the dividend yield is below the figure prevailing in the years between 1975 and 1994. The earnings/price ratio is closer to the average for the period. The payout ratio has fallen.

In the United States share prices are higher in relation to both earnings and dividends than the average levels for the years between 1975 and 1994. The earnings/price ratio is now in line with the theoretical value obtained, on the basis of current long-term real interest rates, assuming economic growth of close to 3.5 per cent and a risk premium reflecting the greater depth of the markets.

In the last three years the fall in the stock markets and the perception of higher risks associated with finance to emerging countries have led to a shift of funds into the government bond market, most notably that of the United States.

Notwithstanding the growth in supply produced by the deterioration in the public finances, the greater demand for bonds has caused a fall in interest rates, reinforced by the dimming prospects of growth. The yield on ten-year securities in the United States has come down from 5.1 per cent at the end of 2001 to 4 per cent in the last few days. In Europe the decline has been less pronounced. The fall in rates has been smaller for corporate bonds, particularly those with lower credit ratings.

The yield differential between the securities of the emerging countries and US government securities has widened sharply. In 2002 lending to these countries declined further from the already low levels of the two preceding years. Net private flows are estimated to have contracted from $126 billion in 2001 to $113 billion last year, mainly owing to a reduction in lending to Latin American countries. Foreign direct investment, which had held up well in earlier years, also fell sharply, from around $170 billion in 2001 to $145 billion last year.

3. Banking systems

The slowing of the world economy and stock market turbulence have generated strong pressures in financial systems, both in the advanced countries and in the emerging economies and the developing countries.

Compared with similar phases in the past, banks have shown a high capacity to absorb the effects of the downturn; there have been no serious episodes of instability.

The greater resilience of the banking systems is related above all to the reorganization and capital strengthening carried out in many countries in the second half of the 1990s at the prompting of the supervisory authorities.

Substantial direct fund-raising by firms has limited the volume of bank intermediation; investment in shares by savers has spread.

In the past four years there has been rapid growth in bond issues, which carry higher yields and greater risks than those typical of bank fund-raising instruments. In the United States the volume of issues rose by 30 per cent with respect to the four preceding years, to more than $2 trillion; in the euro area they doubled, rising to $1.2 trillion.

All the major countries have seen an increase in corporate defaults. According to Moody's, in the international markets 171 companies with low credit ratings, most of them large firms, were unable to meet their commitments to bondholders in 2002. The defaults amounted to more than $170 billion, 50 per cent more than in 2001; the defaulted bonds were largely concentrated in the telecommunications sector. The proportion of companies that defaulted, equal to about one tenth of the total, was similar to that recorded in the cyclical downturn of the early 1990s.

The development of derivatives markets has expanded the opportunities for hedging financial risk by distributing it over a great many investors and to institutions better able to manage it. In the last two years credit derivatives have spread; at the end of 2002 the volume outstanding is estimated to have been nearly $2 trillion. Investment companies and institutional investors now figure among the holders of risk, which was previously concentrated on banks' balance sheets.

The impact of insolvencies on banks' balance sheets has been less severe than in past downturns. In the United States banks' net loan charge-offs in the first three quarters of 2002 were equal on an annual basis to 1.1 per cent of total lending, one third lower than the ratio recorded during the recession of the early 1990s.

In Germany banks' net provisions on loans were equal to 0.7 per cent of total lending, a figure not unlike that of the early 1990s. In Italy the comparable indicator was equal to 0.7 per cent in 2001 and the first half of 2002, whereas in 1993 it had exceeded 1.5 per cent.

The fall in the stock markets has had a limited effect on US banks, whose shareholdings amount to 0.3 per cent of their total assets. The return on equity, which was equal to 13.6 per cent in 2001, appears to have risen further in the first nine months of last year, benefiting from the low cost of borrowed funds and capital gains on bond portfolios. The decline in lending to industrial and commercial firms has been offset by the sharp increase in credit to households, largely to finance the purchase of housing at a time of very rapidly rising property prices.

US banks' capital adequacy ratios have risen to 13 per cent, a value well above the required minimum.

The conditions of the Japanese banking system have worsened as a consequence of the fall in share prices and the long period of economic stagnation. Asset quality has continued to deteriorate; a part of the losses has yet to show up in banks' accounts. The interventions of the agency that was created in 1999 to take over bad debts have been limited. Last September the Bank of Japan announced its intention of buying shares held by banks, with the aim of curbing the effects of any further drop in equities; its purchases up to December amounted to around $2 billion. The action plan presented by the supervisory authority to deal with the problem of bad debts aims at halving them as a percentage of total assets by the end of the 2004 fiscal year.

In Europe the effects of the drop in share prices have been most pronounced in the banking systems, such as Germany's, where some institutions have large equity holdings. In several countries investments in insurance companies, whose profitability has fallen, have been a factor.

In the international market the yield spread of insurance companies' bonds over government securities widened to 100 basis points last October; a similar worsening was recorded in the credit derivatives market.

European insurance companies were affected by the low returns on their securities portfolios. The profit and loss accounts of casualty and reinsurance companies were weighed down by the substantial claims arising from acts of terrorism and natural disasters. Life insurance companies were affected by the costs incurred in connection with savings plans with guaranteed minimum returns.

European bank shares fell by about a quarter in 2002, compared with nearly 50 per cent for insurance companies. In the United States, the shares of the two industries lost respectively 11 and 16 per cent.

After falling in 2001, European banks’ return on equity declined again last year, partly as a consequence of some major banks’ high exposure to emerging countries in economic difficulty. In the second half of 2002 the risk indicators for some large international banks worsened, although they improved somewhat in November.

Bank lending slowed down in the euro area in 2002, with large differences between countries. In Germany, where the credit deceleration began earlier, lending was stagnant. Lending to non-financial firms contracted.

In Italy credit expanded by 6 per cent, basically in line with the trend in investment and corporate self-financing. Interest rates on short-term loans, which were stable until November, fell 20 basis points to 5.5 per cent in December, following the lowering of the official rates. Longer-term rates fell 30 basis points in December to 4.4 per cent for firms and 5.4 per cent for households. Undrawn current account overdraft facilities, which tend to diminish during periods of credit contraction, remained at high levels.

Banking profits declined from 11.6 per cent of equity in 2001 to 7.2 per cent in the first half of 2002. The fall reflects temporary factors, including very substantial value adjustments and allocations to provisions against the risks of the international business of the main banking groups.

The reorganization of the credit system proceeded apace last year. New medium-sized groups were formed; the largest groups adopted organizational models better able to serve household and corporate clients.

The need to continue to rationalize structures and curb costs remains.

The increase in banks' capitalization in the 1990s was encouraged by the Basel Capital Accord of 1988. The proposed revision of the Accord is intended to introduce more sophisticated and diversified methods of risk assessment. The capital charge against loans will be based on the assessment of the debtors made by credit rating agencies or by the banks themselves. A charge against operational risk will be introduced. In October the Basel Committee, at the behest of the Bank of Italy among others, revised the proposal in order to ensure that the new requirements would not have adverse effects on the availability and cost of credit, especially for small and medium-sized enterprises.

The EU Council of Finance Ministers has undertaken a series of initiatives to speed up the preparation of Community legislation on banking and finance and its transposition into national law. The Council has reaffirmed the national dimension of banking supervision, which is effective insofar as it is performed in proximity to the institutions supervised.

The International Monetary Fund is urging emerging countries to reinforce their supervisory structures and to adopt appropriate standards and codes of conduct in various areas of economic policy.

4. Finance and the world economy

Economic integration and technological progress offer new opportunities but also raise new challenges for firms and economic policy.

Economic and financial globalization has opened up prospects of profitable investment of savings in the emerging countries as well. However, the returns vary considerably. These countries' financial systems have displayed shortcomings in assessing the quality of investment projects; their regulations and supervisory arrangements have sometimes proved inadequate.

The profit opportunities offered by the new economy are accompanied by increased risks. Many firms active in innovative industries have made high profits, but not a few have been forced out of the market. Investors have become aware of the uncertain nature of results.

The development of markets, increased liquidity and innovation permit greater diversification than in the past of sources of funding for borrowers and greater diversification of risks for creditors.

Financial systems are well prepared to operate in this new and more complex environment.

The restructuring carried out in the United States and Europe in the 1990s improved the soundness of their banking systems.

The spread of risk in the various components of the financial system requires considerable professionalism on the part of operators, greater attention to the needs of savers and ethical rigour in conduct.

Supervision and international cooperation have been strengthened.

A vigorous expansion of the world economy remains necessary.

In recent years monetary policy in the industrial countries has ensured abundant liquidity, in connection with the recurrent strains in international markets. The ratio of money supply to gross domestic product in the seven largest industrial countries rose from 68 per cent at the end of 1994 to 74 per cent at the end of last year, while real short-term interest rates fell over the same period from 3.2 per cent to practically naught. The creation of liquidity and the low level of interest rates kept crises from becoming systemic and helped to support economic activity in the industrial countries and the still hesitant upturn of 2002.

Major opportunities for growth have been created by the integration of markets and technological innovation. The joint effect of these factors can produce synergies capable of increasing the rate of growth worldwide.

The fundamentals of the US economy remain good. Its strength lies in the ability to raise productivity very rapidly, spurring output and employment. So far new production methods have involved only a limited part of the economy. The process is bound to continue.

In the other industrial countries the new economy is struggling to take hold.

In Europe there is still a fundamental need to start on far-reaching structural reforms of public finances and the labour market, in order to enhance the flexibility of the economy, which is an essential condition for making effective use of new technology and increasing competitiveness and the potential growth rate. In the medium term the opening towards the countries of Central and Eastern Europe can provide support for the Union’s economic growth.

The Japanese economy also continues to be beset by rigidities and inefficiencies.

Both Europe and Japan are faced with the problem of an aging population. Demographic growth rates are falling; in some areas they have reached zero or turned negative.

This has important implications for the composition of aggregate demand and the outlook for the profitability of investments.

In the emerging Asian economies, marked by low production costs and great flexibility, GDP is expected to grow strongly in 2003. In India and China it is continuing to expand rapidly.

In Latin America economic activity should recover from the downturn of 2002 to increase by between 2 and 3 per cent in 2003. In Brazil the reduction in political and institutional uncertainty has already had positive effects on the exchange rate and long-term interest rates. The prospect of the central bank being made fully independent of the government is a contributory factor.

In Mexico output has begun to grow again following the recession in the fourth quarter of 2001 and the first quarter of 2002.

In Argentina the introduction of new institutional arrangements for the central bank can help to create a monetary equilibrium after the negative experience with a currency board. The sharp drop in capacity utilization has led, since the middle of last year, to a recovery in production with low inflation. The devaluation of the currency has restored international competitiveness. The new agreement with the IMF indicates that the most critical phase has been overcome.

In some other Latin American countries institutional and political arrangements remain not fully stabilized.

In the 1990s the main beneficiaries of the process of multilateral trade liberalization that culminated in the conclusion of the Uruguay Round were the countries able to produce medium and high-tech goods. The merchandise exports of the emerging countries, helped by low labour costs, grew over the decade at an average annual rate of nearly 9 per cent, compared with 6.5 per cent for the industrial countries. At the same time there was a large increase in foreign direct investment.

In the new decade it will be necessary to grasp the opportunities offered by a further vigorous expansion of international trade. The development agenda drawn up in 2001 at Doha, in Qatar, envisages the liberalization of direct investment and trade in agricultural products. It is a moral imperative for the leading industrial countries and the international organizations to increase the participation of the developing countries in global production and world trade, by eliminating tariffs and discriminatory practices. Subsidies to agriculture, which are especially large in Europe, Japan and the United States, must be reduced. The production of the advanced countries must be directed towards high-quality goods.

5. Prospects

Interpreting the economic situation has become difficult and complicated in the last few weeks.

The greater diversification and larger size of financial markets increase the scope for economies to grow, but as well as disseminating risk they affect investment and consumption, at the international level and within the leading countries, making them less predictable.

In the industrial countries the latest data point to persistent shortfalls in demand, which adversely affect investment. The situation appears to be dominated by the fear of military conflict and terrorist attacks.

In the United States the indicators have sent contradictory signals as to developments in the short term. In November orders for capital goods, excluding the most erratic items, declined by 2.6 per cent. In December retail sales rose by 1.2 per cent; the figures for large stores point to continuing uncertainty. The survey of manufacturing industry suggests an improvement, but industrial production showed a further small decline; investment in housing continues to grow.

If the geopolitical tensions abate, it is possible that global economic activity will accelerate in the first half of the year. In the United States private forecasters expect an increase in US output of around 2 per cent in the first quarter, possibly rising to 4 per cent in the fourth. There continue to be large disparities among forecasters regarding the strength of the recovery.

The Administration has announced a new multi-pronged fiscal stimulus: the bringing forward to 2003 of tax cuts and incentives enacted in May 2001; the abolition of personal income tax on dividends; tax deductions for small firms' capital expenditure; support for job seekers; and a lengthening of the duration of unemployment benefits.

The measures involve a total of $670 billion over ten years.

The programme is intended to sustain the economy's potential growth in the medium term; in order to absorb the impact on the public finances, there must be an acceleration in the actual rate of growth. The abolition of the tax on dividends avoids the double taxation of savings, thereby fostering the accumulation of capital.

The measures enacted in 2001 and 2002 and the highly expansionary stance of monetary policy have yet to produce their full effects on domestic demand. A substantial part of the new tax relief, corresponding to 1 per cent of GDP, will apply to this year's incomes.

The US economy accounts for 30 per cent of world GDP.

Signs of recovery were widespread in 2002: quite clear in Asia, excluding Japan, less certain in the industrial countries.

In Europe investment accelerated in the second half of the 1990s. It is necessary to proceed with structural reforms to increase the efficiency of the labour market and reduce the size of government budgets in relation to GDP.

The recovery in the world economy has suffered a setback in recent months. The dollar has depreciated further. Uncertainty has affected domestic demand in all the industrial economies.

At the end of December the US Administration’s declarations that war might be avoided had an immediate positive effect on prices on all the main stock markets. Subsequent developments in the situation and the positions announced, however, have again had repercussions on stock markets and the price of oil.

The consequences of an armed conflict cannot be easily calculated, for it would affect raw material and energy prices, upset financial and commercial relations that have been the basis for the rapid development of the world economy over the past decade, and aggravate the risk of further terrorist attacks.

Reducing that risk would free the latent forces that can promote the further expansion of trade, the exploitation of comparative advantages, the dissemination of new technologies and the growth of world output.

The effort to prevent and combat terrorism must be strengthened and broadened at the international level.

Without guidance, globalization is a source of enrichment for some, less so for others; its allocation of benefits produces tensions and reactions by increasing inequalities. It needs to be governed.

It is the responsibility of the major countries and the emerging nations, aided by the international organizations, to promote more advanced forms of coordination based on political ideals and guidelines that take greater account of the needs of the poor countries.

The benefits of peaceful coexistence and constant striving for the international common good bring advantages to all: individuals, families, peoples.

In Italy economic growth recovered slowly in 2002.

Activity in the construction sector began to strengthen from the second quarter onwards. Productive investment increased substantially in the third quarter. Responding to the expansion in international trade, exports provided a strong stimulus to production from the second quarter onwards.

The changeover to the euro weighed on consumption.

In the twelve months to December 2002 Italian consumer prices rose by 2.8 per cent; rounding is estimated to have contributed a little over 0.5 percentage points. According to the official indices, the prices of some frequently purchased food products have risen by as much as 10 per cent; the prices of some consumer durables have decreased.

Empirical studies indicate that the inflation perceived by consumers has been much greater than that measured with rigorous, established methods by the National Institute of Statistics.

Now that the Finance Law has been passed, progress must continue with a firm economic policy. The labour market reforms rendered necessary by the new openness to international competition and the opportunities for broad and deep exploitation of new technology must be completed.

It is not in the interest of either firms or workers to extend the rigidities in labour relations. It would have serious implications for employment.

The social insurance system needs to be reformed so as to preserve this important conquest of the twentieth century for the protection of the weak in particular and to the benefit of the younger generations.

The reform, which must be comprehensive, is necessary in order to reduce the burden of the public debt; supplementary funded pension schemes will generate the resources to increase investment and employment.

Italy's forthcoming presidency of the European Union can offer the opportunity for coordinated action at the European level.

The ratio of current primary public expenditure to GDP, after remaining stable for several years, has begun to rise again. Lowering it will allow taxation to be reduced gradually over the medium to long term, which is a prerequisite for a more competitive economy.

In particular, the economy must benefit from an intensification of the effort already launched to provide more infrastructure. Spending on public works, both large and small, which declined during the 1990s causing large external diseconomies not only for the advanced regions but also for the South, will sustain domestic demand.

Expansion in the less favoured regions, investment in research, and the revival of major industrial groups are essential to prevent the economy from regressing and may offer opportunities for growth.

Sure and effective management of the economy, the modernization of the machinery of government, forms of decentralization that, within a framework of national unity and solidarity, capitalize on regional strengths and local initiatives do not impede — indeed require — institutional reforms, a new and more efficient configuration of important aspects of the legal order of the Republic as defined in the Constitution, a configuration better able to meet the need for representative local government and democratic legitimation.

The debate is under way, inevitably marked at the beginning by differences of opinion and different projects. We are following it carefully and with confidence, in view of the determination with which the question of reform has been posed by the highest authorities of the State, the Government, Parliament and the political parties.

A constitutional consensus can be sought and reached, in the tradition of the founding of the Republic.

Italy's Constitution, the fruit of the consensus reached after the war with a noble vision of the common good by men of different ideas and faiths, remains the foundation for national unity and development, for the effective participation of the whole population in the country's political, economic and social organization.

Article 1 lays down that the Republic is founded upon labour - the expression of the dignity of each citizen, the basis of popular sovereignty, the guarantee of everyone's full participation in organized civil life.

This objective, shared by all, is to be achieved through politics and the economy. These are different spheres, both of them essential: the first must safeguard the autonomous functioning of the second.

A fully-fledged democracy cannot do without either. It is a construction where work is always in progress. The rapidly changing world around us demands a greater commitment, to which everyone must make their contribution, for the good of Italy.