

ACRI

Association of Italian Savings Banks

2003 World Savings Day

Address by the Governor of the Bank of Italy

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Rome, 31 October 2003

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1. The international economy

After the stagnation that had lasted from the autumn of 2002 until the spring of this year in connection with the war in Iraq, the world economy entered a new phase of expansion in the summer. From March onwards, as the uncertainty caused by the conflict began to diminish, share indices began to climb and financial indicators to improve.

In the second quarter economic activity gradually picked up in the United States and Asia. US gross domestic product increased by 7.2 per cent on an annual basis in the third quarter and is expected to rise by more than 4 per cent in the fourth. Year on year, growth will be around 3 per cent.

In Japan GDP grew in the second quarter at an annual rate of 3.9 per cent.

In Europe, the stagnation of the first two quarters gave way to still timid signs of recovery in Germany and France, both of which have large industrial sectors.

The dollar appreciated in the summer, reflecting the increased strength of the US economy; the exchange rate climbed back from the low point of 1.19 dollars to the euro at the end of May to 1.08 at the beginning of September. Subsequently, the US currency began to depreciate again and yesterday was close to 1.16 to the euro. Since the middle of September it has also fallen against the yen. Dollar depreciation has adverse effects on the price competitiveness and cyclical performance of European industry.

In the United States labour productivity continues to grow at a rapid pace. The trend has withstood the cyclical slowdown under way since the middle of 2000, testifying to the efficiency of the US productive system.

Consumption accelerated in the third quarter, growing at an annual rate of 6.6 per cent; it benefited from the tax relief measures introduced in May. Private fixed capital investment increased by 14 per cent, making a substantial contribution to the growth in output of over 2 percentage points, which was similar to the figure before the slowdown. Investment in IT, which had been picking up for some time, rose by a further 15.4 per cent. Exports expanded by 9 per cent. The contribution of public spending was virtually nil.

The growth in corporate profits and the sounder financial situation of firms underpin the assumption that a lasting recovery will take place in capital formation.

In Japan economic activity was mainly buoyed by the substantial rise in exports to other Asian countries and the acceleration of investment; the growth in demand attenuated the deflationary trend. The central bank continued to pursue a policy of monetary base expansion and purchased dollars on a massive scale to counter the appreciation of the yen. The improvement in corporate profitability, which also benefited from financial and productive reorganization, suggests that the investment cycle will gather strength in the future.

China's rate of economic growth in the first nine months of the year exceeded 8 per cent in comparison with the same period of the previous year. Imports increased by more than 40 per cent in value and exports by 32 per cent.

The country's exports, more than half of which went to other emerging Asian countries at the beginning of the 1990s, have gradually shifted towards the United States

and the European Union, where they have gained market shares. China's economic expansion has boosted the development of other emerging countries in the area and, indirectly, the growth of the world economy; imports from Japan and other industrial economies have also increased.

In Argentina the economic recovery that began last year continued through the first half of 2003. In September the government reached an agreement with the International Monetary Fund on a three-year financial aid programme of \$12.5 billion, thus avoiding the need to declare the country insolvent vis-à-vis international institutions.

In Brazil the improvement in the climate of confidence and financial conditions is laying the foundations for a strengthening of production in the last part of the year.

A lasting recovery in international trade, the factor that provided crucial stimulus to the development of the international economy in the 1990s, could be jeopardized by the unsuccessful outcome of the Fifth Meeting of Ministers of the World Trade Organization in Cancún last September. It is necessary to overcome this setback and continue the process of multilateral liberalization begun at Doha in 2001 to the benefit of the poorest countries and the whole international economy.

2. The euro area and Italy

During the first half of 2003 the euro-area economy stagnated.

Gross domestic product, which was stationary in the first quarter, declined by 0.2 per cent on an annual basis in the second. The cyclical weakness extended to all the main countries, although not to the same degree. The decline in output in Germany in

the first six months was equal to 0.6 per cent on an annual basis, the largest of the last ten years. In France it was 0.4 per cent. In Italy growth came to a standstill.

In the area as a whole as well as in the main countries the weakness of the economy was linked to the poor performance of exports. With imports showing virtually no change, the fall in exports subtracted 1.6 percentage points from growth in the area.

The increase in domestic demand was buoyed principally by private consumption, which accelerated slightly with respect to the previous six months. Spending on capital goods, which had been falling since the first half of 2001, continued to reflect the large margins of idle capacity and the uncertainty about the timing and strength of the economic recovery.

In Italy in the first half of 2003 the negative contribution of trade to growth was equal to 2.3 percentage points. Domestic demand was sustained largely by inventory rebuilding.

Household consumption performed better than in the rest of the euro area but purchases of durables contracted. Investment in capital equipment declined by 15.2 per cent on an annual basis, partly due to low level of plant utilization and the uncertain outlook for demand.

Expectations for 2004 do not point to an upturn in investment in either industry or services.

According to the business survey conducted in September by the branches of the Bank of Italy among a sample of manufacturing and service companies, expenditure on fixed investment in 2003 will be even less than budgeted at the end of last year, which was already down by about 10 per cent.

Activity in the public works sector is expected to contract slightly again in 2003. Following the rise in the value of works put up for tender at the beginning of the year, there are widespread expectations of an upturn in the first half of 2004.

Exports declined in the first half of the year by 11.4 per cent on an annual basis, considerably more than in Germany or France, where they decreased by respectively 2.7 and 5.5 per cent.

In the first nine months of this year the harmonized consumer price index rose on average by 2.1 per cent in the euro area and 2.9 per cent in Italy.

The rise in the prices of services and costs in industry was largest in Italy. The rate of increase in unit labour costs continues to be higher than that of our European partners. Since wage pressures are limited at present, the rise must be ascribed to the slowdown in productivity.

In the first six months of the year the number of full-time equivalent workers in employment rose by 1.1 per cent from the year-earlier period, compared with an increase of 0.8 per cent in value added.

The decline in per capita output reflects the reduced contribution of technical advances compared with the past, which is evident from the persistent downturn in total factor productivity. It also reflects the expansion in labour intensive and low productivity activities, especially among services provided to businesses and households.

Employment rose by 4.8 per cent in the construction industry and by 2 per cent in private services but remained virtually stationary in the rest of industry and declined again, for structural reasons, in agriculture. The growth in employment during a period

of persistently slack economic activity was sustained by the continued moderation of wage demands. The performance in the first half of the year reflected the slow progression of wages fixed in national labour contracts; they are expected to accelerate in the second half of 2003.

Unemployment decreased, in contrast with the tendency in the main European economies. In July the seasonally adjusted unemployment rate was 8.7 per cent in Italy and 8.8 per cent in the euro area. The decrease was concentrated in the South, where unemployment is nonetheless more than three times greater than in the rest of the country.

According to preliminary estimates, industrial production rose in the third quarter by around half a percentage point compared with the second quarter, thus reversing the downward trend under way since last autumn.

However, the upturn is not borne out by estimates for September and October, which point to a fall of over 1.5 per cent with respect to the previous two-month period.

The growth in gross domestic product in 2003 is expected to be less than 0.5 per cent. Since the recovery is still weak at the European level as well, it appears unlikely that a rate of growth of 1.9 per cent can be achieved in 2004.

3. The structure of industry and competitiveness

In the first eight months of the year the performance of Italian exports was negative in all the main markets. Exports to the United States contracted by 13 per cent compared with the same period of 2002, and those to China slowed sharply. Sales to the euro area diminished by 3.1 per cent.

Between the fourth quarter of 2000 and the same quarter of 2002 Italian firms suffered a loss in price competitiveness of 7.5 per cent, which was more than in the other major European countries. Along with the nominal effective appreciation of the euro, a contributory factor was the rise of around 2.5 per cent in the prices charged by Italian exporters compared with those of competitors. The relative prices of German exports remained basically unchanged, while those of French exports diminished slightly.

In the first eight months of this year price competitiveness deteriorated further by 3 per cent. In the same period mechanical engineering was the only sector of Italy's model of specialization to show an increase in the volume of sales.

The modest results achieved of late by Italy's exporting firms are in line with a long-term trend.

Italy's share of world exports at constant prices declined from 4.5 per cent in 1995 to 3.6 per cent in 2002, a proportion similar to that of the mid-1960s. The rapid rise in Germany's sales abroad from 1995 onwards led to an increase in its share of the world market of more than 1 percentage point, to 11.3 per cent in 2002. France's share was stable at around 5.6 per cent.

Italy, which ranked sixth in world trade in the mid-1990s, now ranks eighth, having been overtaken by China and Canada.

Losses of market share have also occurred in the domestic market. However, the differential between the growth in imports and the growth in GDP in Italy is not significantly different from that in the other main European economies.

The disappointing results in both international and domestic markets are attributable to three factors: the composition of output, which in Italy is still heavily biased towards scantily innovative sectors; the unfavourable dynamic of domestic costs and productivity; and the entry into the international market of firms operating in Italy's sectors of specialization and located in developing countries, where production costs are lower, productivity is rapidly rising and the quality of products steadily improving.

Over the last seven years industrial production grew by a total of 4.9 per cent in Italy, compared with 16.4 per cent in France and 16.5 per cent in Germany. In the euro area excluding Italy industrial production expanded by 20 per cent. Only the United Kingdom, where output is oriented towards internationally traded services, recorded a smaller increase in industrial production: 2.5 per cent.

Signs are emerging that Italy is lagging behind the most advanced countries in the shift to a primarily service-based economy. Services' share of total value added has remained virtually unchanged from the end of the last decade, standing at 68.4 per cent in 2002.

By contrast, the service sector's share has continued to grow in the other leading European countries. In Germany and the United Kingdom it rose by seven percentage points between 1990 and 2002, to respectively 71 and 72 per cent. In France it stabilized at around 71 per cent in the second half of the 1990s.

The composition of international demand has shifted towards higher-tech products; in the last ten years world demand for these goods has grown practically twice as fast as that for traditional goods. Between 1997 and 2002 world exports of chemical, electronic and IT products grew by 24 per cent, those of motor vehicles by 24 per cent and other transport equipment by 22 per cent. By contrast, world imports of textile products grew by only 1.3 per cent and those of leather and footwear by 0.9 per cent.

While in the other main European countries traditional branches of production are being abandoned in favour of more innovative ones, in Italy the output of high-tech sectors has contracted, albeit slightly.

In the manufacturing sector total factor productivity diminished by 0.2 percentage points a year between 1995 and 2001. The more intense contribution of capital and labour was not matched by an advance in techniques or organizational efficiency.

The scant growth in productivity is largely attributable to the fragmentation of Italy's productive system. The small average size of firms emerges from the results of all the industrial censuses, the average number of workers per firm has fallen uninterruptedly since 1971, to stand at 3.9 workers per local production unit in 2001.

Small firms are a vital strength of the Italian economy; their flexibility has enabled our country to overcome moments of great difficulty. In the present context, however, they are unable to expand their activity and to compete successfully in the advanced markets.

Competitiveness is affected by factors external to the firm, such as energy costs and the endowment of modern infrastructure. The efficiency of the legal and institutional system also considerably influences the functioning of a market economy. Company law has been reformed in Italy but shortcomings are still to be found, especially as regards bankruptcy law.

It is necessary to remove the obstacles to the growth of firms, first of all by favouring alliances, mergers and acquisitions between companies operating in similar or complementary branches of production. It is a field of activity in which Italian banks can play a role of prime importance.

At the same time it is necessary to establish the conditions for a wider application of the new technologies in industry and the service sector, by creating networks that can raise the productivity of individual firms and, above all, that of the economy as a whole.

Growth in the size of firms, greater investment in research, stimuli to the internationalization of the productive system, investment in infrastructure, and efficiency gains in public and private services are the key points of a strategy for the competitiveness of the productive system and for stronger growth.

4. Interest rates and credit

Short-term interest rates in euros came down by about 0.7 percentage points in the first half of the year, stabilizing at around 2.1 per cent. This is one of the lowest levels since the 1940s.

After falling to historic lows in the first two quarters of the year, long-term rates rose rapidly over the summer, reflecting above all the improvement in the prospects for world economic recovery; the rise was sharper in the United States, less pronounced in the euro area.

The Italian banking system has continued to satisfy the demand for financing for current production and investment. In the first nine months of the year the growth in lending to residents accelerated by comparison with the previous year, owing to the rapid expansion in the medium and long-term component. The increase amounted to 7.7 per cent in the twelve months ending in September, higher than the average in the euro area.

The credit expansion involved both non-financial firms and producer households; it was greatest for those in the service sector and the construction industry. Lending to manufacturing firms, which had contracted in 2002, showed a moderate increase on the order of 5 per cent.

There was a slowdown in lending to large companies but an acceleration in that to small and medium-sized firms with credit lines of up to €25 million.

Credit to consumer households has continued to expand rapidly, growing by 9.1 per cent in the twelve months ending in August, primarily in the form of mortgage loans for the purchase of housing.

The growth in credit has been broadly similar throughout Italy. Adjusted for the effects of bank consolidations, the average annual growth in lending in the South by banks based in the Centre and North amounted to 9.7 per cent between 1998 and 2002, around eight percentage points more than in the previous five years.

Banking groups based in the Centre and North are allocating a growing portion of the funds they raise in the South to southern businesses; in June the percentage exceeded 90 per cent, compared with 60 per cent for the remaining intermediaries.

Bank lending rates have fallen, adjusting gradually to money market conditions, in line with the euro-area average. In the first nine months of the year the average rate on short-term loans to non-bank customers fell by 0.9 percentage points to 4.8 per cent. Taking account of the different composition of firms by size and sector, the differential between short-term bank lending rates for firms in the South and those in the Centre and North widened slightly to 1.1 points; the increase corresponded to a higher rate of growth in new bad debts in the South.

5. The growth of the corporate bond market

In a phase characterized by low real interest rates, an international bond market for euro-area firms has developed rapidly since the introduction of the single currency.

Between 1998 and 2002 the stock of bonds issued by banks and firms grew from 44 to 59 per cent of the area's GDP, a figure comparable to that prevailing in the United States if the securities of government agencies are excluded.

In the four years from 1999 to 2002 Italian non-financial corporations made an average of 43 bond issues a year, with an average issue value of €440 million. In the four previous years issues had numbered 11 per year, with an average value of €150 million per issue.

The transactions were carried out largely in Luxembourg, because of the speed and low costs of the procedures and lower taxation.

Since the spring of 2000 the slowdown of the world economy has brought an increase in the risk premium on corporate bonds in all the main countries. The deterioration in corporate situations has led to a growing number of defaults, first in the United States, then in Europe.

In 2002 there were 32 defaults on securities of European non-financial corporations. Half of the companies unable to honour their debts were British and a quarter were Dutch; three cases of default occurred in Germany and one case each in Italy, France, Belgium, Switzerland, Sweden and Norway.

The default in Italy concerned the bonds of a food products group that had made issues for a total of €1,125 million, or about 1.5 per cent of the bonds issued by Italian non-financial companies in Luxembourg between 1998 and June 2003.

As with most Euromarket bond issues, the securities were sold by the underwriting syndicates to banks and institutional investors. Some were subsequently bought by individuals in transactions with banks. Demand for the bonds was boosted by their high yields in comparison with those offered by issuers with the lowest investment grade ratings.

In Italy the number of individuals who bought these bonds by means of bilateral contracts with banks averaged about 4,000 per issue; the sale prices varied from bank to bank and moved in line with market conditions. Public offerings, which require the preparation of a prospectus, are aimed at a large number of anonymous investors and marked by a single price for the entire offering period.

In selling securities, banks are subject to the rules of conduct established for the solicitation of investors and the marketing of financial instruments.

The investigations undertaken by Consob and, at its request, by the Bank of Italy are at an advanced stage. They will make it possible to trace the paths taken by the bonds, from the time they were issued to the time they were acquired by customers, and to assess the actions of the individual intermediaries. If violations of the rules and regulations are found, the necessary steps will be taken in the competent fora.

The distinction between a bank deposit and a bond issued by a company or a public entity is fundamental and savers need to be reminded of it. Only in the former case is the bank under an obligation to redeem the principal. Over many decades, from the 1930s onwards, no Italian savers have ever incurred losses on their deposits.

The bonds issued by a company or a public entity, and sometimes even a sovereign state, normally offer a higher yield, to compensate for the risk implicit in such instruments.

This risk is primarily related to the financial situation of the issuer. As in the other advanced financial systems, the checks required by law do not include evaluations of the economic advantageousness of the securities that are being offered or of the solvency of the issuer.

It is up to the intermediaries that buy bond issues and then place them with institutional investors or individuals to evaluate the quality of the securities and the adequacy of the yield.

The intermediaries responsible for the marketing of securities must be fully aware of the nature of the risk and make it clear to investors, in accordance with the regulations established by Consob.

The preliminary findings with respect to a sample of transactions concluded by the intermediaries inspected by the Bank of Italy show that most of the bond sales examined were carried out in compliance with the provisions designed to ensure the necessary transparency in dealings with customers and to prevent the proposal of transactions unsuited to investors.

Where internal checks reveal cases in which the procedures prescribed by law were not complied with completely, the individual banks concerned will assess the desirability of taking steps to strengthen the confidence of investors and maintain their reputations.

6. Conclusions and prospects

Doubts about the efficiency and integrity of a part of Italy's financial system may be counterproductive for the development of the markets and ultimately for the business of firms, which are already having to cope with a weak economic cycle.

From a macroeconomic point of view, the defaults that have occurred in Italy have been on a smaller scale than those in the other leading industrial countries; the value of corporate bonds exposed to the risk of losses is less than 0.05 per cent of households' total financial assets.

A large share of the savings of firms and households consists of bank deposits. At present households' total financial assets comprise €480 billion of such deposits and €2,100 billion of other financial assets.

Bank deposits, together with government securities, are safe investments for savers; they consequently offer lower rates of return. Deposits tend to grow in line with gross domestic product; other financial instruments grow at a much faster pace.

In all the world's developed economies the activity of banks has spread during the last ten years or so to include the distribution to savers of financial instruments such as bonds and shares, thereby fostering the consolidation of firms' financial structures and the diversification of households' portfolios.

I reiterate what I have already stressed on other occasions. In this activity the professionalism of intermediaries must always be coupled with ethics, so that savers are directed towards investments that are consistent with their income, wealth and appetite for risk.

The organizational and operational structure of each intermediary must be capable of performing this task correctly.

The protection of savings is enshrined in the Constitution. The Bank of Italy is responsible for the stability of the banking system and for the protection of the savings this intermediates directly. History shows that this kind of investment has been fully guaranteed without interruption from the enactment of the 1936 Banking Law up to today.

A sound and efficient banking system is essential for the stability of the economy, especially when business activity is sluggish, as at present, and also an instrument for the support of productive investment and economic growth.

The stability of the financial system is based on the solidity of the economy and the profitability of firms.

Overcoming the problems the Italian economy faces today depends basically on economic policy measures capable of accelerating growth through a higher level of investment activity.

At a time when there is the prospect of an international recovery, it is up to economic policy to create the conditions for faster growth, but ultimately it is up to firms to take investment decisions, on the basis of their ability to foresee and plan the future, search for new markets, and introduce new technologies and products.

For nearly ten years now the Italian economy has been suffering from a steady loss of competitiveness that slows its growth and endangers less efficient and innovative firms.

Much has been done in terms of improving the efficiency of the money and financial markets, from the 1980s onwards, and restructuring the banking system, since the mid-1990s; there has been a considerable increase in competition. Credit and finance are necessary to arrive at a more efficient working of the economy, but they are not sufficient to ensure its growth.

In the past a very high proportion of savings was absorbed by the public sector. Budgetary equilibrium is a key prerequisite for the creation of a climate conducive to the expansion of investment; to achieve this goal, it is necessary to curb the growth of primary current expenditure through structural reforms in the main sectors.

The tax burden, which increased considerably between the second half of the 1980s and the second half of the 1990s in order to reduce the budget deficit, has had deleterious effects on competitiveness and the productive structure. General government net borrowing, which in 1999 had fallen to 1.7 per cent of GDP, has begun to rise again; the reduction in the public debt in relation to GDP has slowed.

Participation in the single currency has ensured that the financial system has enjoyed much more stable conditions than in the past. For growth to benefit, this step needed and needs to be accompanied by a complete and lasting adjustment of the public finances and an increase in the effectiveness and efficiency of government services. Important advances have been made in the organization of the labour market.

The convinced participation of the social partners is an essential prerequisite for a project that will enable Italy to return to growth.

One has the impression of a country, an economy that is not fully exploiting its potential.

A lessening of the tax burden requires a reduction in current public expenditure, not in absolute terms but in relation to GDP.

The endowment of infrastructure falls short of that necessary for competitiveness and growth, both in the more economically advanced regions and in those that are less developed.

The share of expenditure devoted to infrastructure contracted sharply during the 1990s; it remains small, especially in relation to the need to close the gap with respect to the other advanced economies.

In an international setting marked by the availability of abundant finance at low interest rates, public investment is not held back so much by a lack of funds as by delays in drawing up plans and administrative constraints that obstruct their implementation.

Considerable efforts are being made in this field, but they need to produce results as soon as possible.

We continue to take an optimistic view, based on objective data such as Italians' high propensity to save, of the scope for the economy to grow. Following the decision of the Constitutional Court, banking foundations can better undertake new initiatives and contribute to the development of our society. We must proceed resolutely to ensure dignified employment for the still excessively large number of those who could work but do not enter the labour market for want of job openings.

We must proceed in this direction in order to leave the next generation a country that is economically and socially more advanced, that can give effect to the dictate of the first article of the Constitution: "Italy is a democratic republic, founded on work".