BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY 2004

THE GOVERNOR'S CONCLUDING REMARKS

Ladies and Gentlemen,

The Bank of Italy has proceeded in its drive to make the organizational and technical innovations that will improve the performance of its duties at national and local level and the carrying out of its increasing tasks in international fora.

Within the European System of Central Banks the Bank has contributed to the creation of the new institutional and organizational framework for the conduct of a common monetary policy in the enlarged EU.

The purpose of the work undertaken by the Economic Research Department, in collaboration with other departments and the branches of the Bank, is to study in ever greater depth the cyclical and structural aspects of our economy within the context of the European and world economies.

The Bank of Italy's supervision of the banking and payment systems was found to be of high quality in the assessment carried out worldwide by the International Monetary Fund. The report highlighted the professionalism and integrity of the Bank's officers, the pillar on which the independence of this function rests.

Within the Eurosystem we are working alongside the Deutsche Bundesbank and the Banque de France to build the shared platform for the new European gross settlement system. Known as Target 2, the new system will use the most advanced components of the German, Italian and French procedures; it will be based on our technical infrastructure.

We have undertaken to provide the European Central Bank with the operational support of the Donato Menichella Centre should it prove necessary. In the field of banknote production, the Bank of Italy is cooperating in every way to improve the quality and security of notes.

Meetings to exchange experiences and arrangements for technical assistance with countries in Eastern Europe and around the Mediterranean are constantly increasing. In Naples in January we organized, jointly with the European Central Bank, the first seminar of Eurosystem and Mediterranean countries.

With the agreement of the Ministry for the Economy and Finance and the participation of the banking system we are completing the far-reaching programme to modernize the Treasury Payment and Collection Service.

The Bank's financial statements for 2003 show a profit. The falls in the book values of the Eurosystem central banks' foreign currency reserves as a consequence of the appreciation of the euro do not constitute a loss. In the context of long-term plans, efforts are constantly directed at improving operational efficiency and reducing costs.

The Bank has always made public the reasons for its decisions. It systematically accounts for its findings and actions through the distribution of reports and studies and in testimony before Parliament.

On behalf of the Board of Directors and the Directorate I wish to thank all the staff who have worked with skill and self-sacrifice in the service of the Bank and the country.

The world economy

The monetary expansion

In 2003, as in the previous four years, the expansionary policies of the central banks of the United States, Europe and Japan boosted the growth of money above that of GDP at current prices. Official rates were cut during the year to 1 per cent in the United States and 2 per cent in the euro area, while in Japan they have long been close to nil.

The money supply in the seven main industrial countries rose from 67 per cent of GDP in 1998 to 75 per cent at the end of 2003. The interbank accounts of institutions in different monetary areas are growing fast, as are the deposits of non-resident private-sector clients. The money supply is also expanding rapidly in China and the other Asian countries.

Reflecting the growth in the money supply, average yields on long-term securities in the main industrial countries, adjusted for inflation, fell from 5 to around 2 per cent between 1995 and 2003. Real short-term interest rates dropped from 3.4 per cent to close to nil.

The decline in interest rates spread to all markets. In 2003 the margins between yields on government securities in the emerging and the advanced countries narrowed.

Stock market capitalization in the main industrial countries, which had risen to 130 per cent of GDP in 1999, fell to 70 per cent in 2002, largely owing to the crisis in the high-tech sector. Partly in response to the increase in liquidity, it returned to 93 per cent at the end of 2003.

Towards the end of the 1990s and in the first years of the new century it became possible to gear monetary policies to sustaining demand after price stability had been restored in the advanced economies and inflation curbed in the emerging ones. Inflation expectations had been quelled by tight monetary policies that were maintained throughout most of the 1990s.

Prices of internationally traded manufactures followed a downward trend. Non-oil raw material prices decreased up to the end of the last decade, partly owing to the strong dollar, while those of oil and other energy sources contracted slightly until 1998 and then jumped in the following two years as the world economy rapidly gained momentum.

In the United States the long period of economic growth and expansion of investment in high-tech sectors came to an end in the autumn of 2000. The sharp slowdown in economic activity spread to Europe, the other industrial countries and the emerging economies.

Monetary policy in the United States and Europe has been markedly expansionary since 2001. From the end of that year the Bank of Japan has been increasing the monetary base at annual rates of between 10 and 30 per cent.

In 2001 industrial production declined by 5 per cent in the United States, 14 per cent in Japan, 4 per cent in the euro area and 6 per cent in Italy. The September terrorist attacks, the international tensions that followed and the stock market crisis aggravated the cyclical downturn.

The expansion of world trade, which had grown at a rate of 12 per cent in 2000, came to a halt.

The growth of the world economy in 2002, driven by the US expansion, was interrupted in the second half of the year by the mounting international political tensions and subsequently held back by the war in Iraq and the terrorist attacks in Europe and the Middle East.

The recovery

The Keynesian-style policy adopted by the United States in 2001 revived domestic demand for consumer goods and investment. Economic growth resumed at a rate of 2.2 per cent in 2002 and 3.1 per cent in 2003.

The federal budget moved from a surplus of 2.4 per cent of GDP in 2000 to a deficit of 3.5 per cent in 2003. Correspondingly, in relation to GDP the financial balance of firms and households gained more than 4 percentage points.

The Federal Reserve cut interest rates on short-term funds by 5.5 percentage points between 2001 and the middle of 2003, putting them at 1 per cent, the lowest level since the Second World War.

Consumption, fostered by the rise in disposable income, increased by 9 per cent in the three years. Investment in residential building, encouraged by exceptionally low long-term interest rates, rose by 4.9 per cent in 2002 and 7.5 per cent in 2003.

Investment in plant, machinery and transport equipment diminished; that in the IT sector increased sharply.

Thanks to labour market flexibility and the massive technology investments of the previous decade, productivity in manufacturing continued to rise rapidly even in periods when production stagnated. Unit labour costs in manufacturing fell by 2.5 per cent in the three years.

Imports remained stationary in the first half of 2003 but rose by nearly 7 per cent in the second. The cyclical upturn spread to all the other economies.

Japan’s gross domestic product grew by 4.1 per cent in the second half of 2003 and by 2.5 per cent in the year as a whole. In the United Kingdom the figures were 3.2 and 2.2 per cent respectively.

GDP growth in the emerging and transition economies was greater than in the previous year and particularly strong in China and India. The Latin American economies began to expand again after stagnating in 2002.

In the euro area, where growth was modest in 2002 and close to nil in the first half of 2003, the acceleration was less marked. The year closed with an increase in GDP of 0.4 per cent.

The expansion of liquidity, the availability of finance at low interest rates and the reduced cost of capital fueled demand for investment, especially in the economies with the most efficient markets for factors of production.

In the United States, private-sector fixed investment rose by 4.4 per cent in 2003, after falling sharply in the two previous years. Low interest rates also buoyed demand for consumer durables.

In the United Kingdom the cyclical upswing was investment-led. In Japan demand was sustained by exports and in 2003 by investment.

The growth of the Chinese economy was driven by a 27 per cent increase in investment at current prices, partly in relation to substantial inflows of foreign capital.

In the euro area low interest rates continued to boost home purchases; capital spending on machinery and equipment declined, as in 2002.

Above all it is uncertain whether the euro area will participate in the recovery of international trade. Exports were hampered in 2003 by the appreciation of the common currency and will be again in 2004.

Outlook. Productivity and competitiveness

In the short term world economic activity is driven by the level of demand.

The present expansion of consumption and investment and the performance of international trade suggest that the growth of the world economy in the second half of 2003 is likely to continue this year.

In the United States GDP is expected to grow by around 4.5 per cent in 2004. In Japan growth might be as much as 4 per cent; in the first quarter it amounted to 5.6 per cent, which was more than expected. In the emerging Asian economies GDP should grow by about 7 per cent, driven by the robust expansion in China and India.

In the euro area no contribution came from either business investment or exports in 2002 or 2003. GDP growth this year should exceed 1.5 per cent.

According to the International Monetary Fund, world economic growth will be around 4.5 per cent in 2004.

The strength of the recovery is vulnerable to uncertainties stemming from heightened international political tensions and the rise in oil prices.

The participation of each economy in the expansion now taking shape at the global level will depend on its competitiveness.

In the United States manufacturing output per employee rose by 4.3 per cent a year between 1996 and 2003.

The average annual increase in total factor productivity more than doubled by comparison with the previous two decades under the impulse of the introduction of new technologies and improvements in the organization of production.

The rise in productivity is accompanied by population growth stemming from the positive balance between birth and death rates, which has declined from 7 to 5.4 per mille in the last ten years, and from flows of immigrants attracted by the country's competitiveness and favourable prospects.

The increase in population stimulates consumption and simultaneously adds to the labour force. The age structure of the population shows a markedly lower proportion of elderly persons than in Europe and Japan both now and in the future. A young population with a long life expectancy is the basis for investment in human capital.

In the euro area investment in new technologies is lower and productivity growth much slower than in the United States. The natural rate of population growth is around 1 per mille; any increase comes almost exclusively from immigration. The population is aging rapidly.

Improvements in the industrial structure are still held back by constrictions and rigidities in factor markets.

In Japan the population is aging faster than in Europe, but exports are growing more rapidly than world trade and twice as fast as imports.

The far-reaching restructuring carried out by large manufacturers in the final years of the last decade reduced employment by 600,000 but boosted productivity and profits. Since 2000 employment has fallen by more than 1,300,000 at small and medium-sized manufacturing firms as a result of crises and reorganizations. The return to relatively rapid economic growth in 2003 has had a positive impact on these companies as well.

Investment accelerated sharply last year. Initially focused on introducing innovation and advanced technologies, it subsequently spread to the more traditional components. Direct investment by Japanese firms in the emerging Asian economies continues.

The potential growth rates of the emerging economies remain very high. Their gradual shift towards medium and even high-tech goods and services and their low labour costs pose a competitive challenge for the advanced economies.

An increasing share of world industrial capacity is coming to be located in the emerging economies.

The sustainability of the recovery

In the United States the lowering of interest rates, tax cuts and higher public spending appear to have triggered a new phase of rapid growth.

Gross federal government debt amounted to 58 per cent of GDP at the end of 2000; it rose to 62 per cent at the end of 2003. The portion held by the market is equal to just 36 per cent of GDP.

Economic growth will have a beneficial effect on tax revenues. The Administration has committed itself to reducing the federal budget deficit from the 4.5 per cent of GDP forecast this year to 1.6 per cent in 2009 by curbing discretionary spending. The decrease in the deficit will slow the rise in the ratio of debt to GDP and cause it to decline from 2008 onwards.

The financial position of firms has benefited not only from the growth in demand but also from lower interest expense and tax relief. The ratio of debt to equity has decreased.

The household saving rate rose back to 2 per cent in 2003. The value of property holdings reached 185 per cent of disposable income and the proportion of households that own their home rose to 68 per cent. However, household debt increased to 108 per cent of disposable income.

In the opinion of most analysts, house prices do not constitute a speculative bubble. Share prices are not out of line with current and expected dividends and interest rates.

With the disappearance of all signs of deflation, official interest rates are expected to return to normal levels before long.

The repercussions on the economy and whether they are positive or negative will depend on how markets and economic agents perceive the significance of the increase and on its effect on expectations.

The recovery in employment is helping to sustain consumption.

The rise in investment in information technology, the increase in productivity and the good financial position of firms should ensure the continuation of rapid growth despite the expected rise in interest rates.

One factor of risk is the state of the external accounts. The current account deficit is of the order of 5 per cent of GDP; two thirds of it is due to the difference between the rate of growth in domestic demand in the United States and in the rest of the world. Net foreign debt is now more than 25 per cent of GDP.

Until now the external deficit has been financed by substantial inflows of capital in the form of direct and portfolio investment. In the last two years Asian countries have increased their purchases of US Treasury securities. American multinationals are still investing heavily in the emerging economies in order to take advantage of lower labour costs. The volume of short-term dollar-denominated assets held by the rest of the world has risen continuously.

The dollar has depreciated by 11 per cent since February 2002; the competitiveness of the US economy has improved in equal measure. Massive purchases of dollars by Asian central banks have slowed the depreciation. The increase in US net foreign debt in dollars has been curbed in the last two years by the weakening of the currency. Given the elasticities with respect to prices, the reduction in the current account deficit that will result from the lower level of the dollar does not appear to be decisive; over two years it can be estimated at around 1 percentage point of GDP.

Since the spring of 2002 the effective exchange rate of the yen has risen by 6 per cent; competitiveness has remained broadly unchanged. The euro has appreciated more sharply; the euro area's competitiveness has fallen by 17 per cent in two years.

The recovery of the world economy and the rapid growth of the Asian countries have put increasing pressure on commodity markets.

Although the rises in metal prices are not out of line with their behaviour in previous expansionary phases, in real terms oil prices have returned to the high levels they reached at the end of 2000, when the last expansion peaked. Prices are affected by the political tensions in the Middle East.

The lower energy intensity of output compared with previous decades and the growth in activities and investment of an intangible nature will help contain the impact of rising energy prices on inflation and growth in the industrial countries. The effects could be greater in the emerging economies.

The "Millennium Development Goals" and poverty reduction

Achieving rapid and sustained world economic expansion requires faster growth in Europe and, above all, progress extending to the backward economies.

For the poor countries, integration into the world trade system is essential.

Value added in these countries is formed primarily in the agricultural sector. Restrictions on trade in agricultural products and farm subsidies in the more advanced regions are equivalent to imposing tariffs of the order of 25 per cent on imports from the backward countries.

Fresh impetus must be given to the resumption of the multilateral negotiations begun at Doha in 2001. The European Union's proposal to abolish export subsidies for agricultural products could help break the deadlock.

By April 2004 thirteen countries had completed the procedures for reducing their foreign debt as part of the initiative in favour of heavily indebted poor countries. Another eleven countries have not yet satisfied the conditions to be eligible for relief. Efforts are under way to extend the deadline, which is currently set for December this year.

Following the Monterrey Conference in 2002, the developed countries pledged to increase the amount of official development assistance to the backward economies from $58 billion to $77 billion a year, or 0.29 per cent of the donor countries' GDP, by 2006. To achieve the objectives set by the United Nations in 2001, official aid would have to increase to more than €100 billion a year.

A Bank of Italy study shows that reducing inequality in developing countries tends to be associated with faster income growth.

The goal of halving the percentage of persons living on less than $1 a day by 2015 is unlikely to be achieved. Improvements have occurred in China and India, but the number of poor people in sub-Saharan Africa increased by a third in the 1990s.

The gravest situation concerns the health of the population. Epidemic diseases have large social costs, afflicting people who could otherwise contribute to economic activity. The insufficient development of human capital hinders the use and spread of new production techniques.

Initiatives such as that aimed at ensuring elementary education for all children in the economically backward countries are highly commendable.

Recent meetings of the Development Committee of the World Bank have underscored the need to broaden the focus of international efforts from institutional issues to encompass basic education and the supply of medicines at accessible prices.

The inclusion in the growth process of countries that have not benefited from trade liberalization or whose backwardness has prevented them from taking advantage of globalization will help defuse tensions. It is a necessary condition for the sustained growth of the world economy.

The Italian economy

The euro area

Euro-area GDP increased by 0.4 per cent in 2003. Investment declined further despite interest rates remaining at historically low levels.

Household consumption increased by 1 per cent. Exports were unchanged on the previous year, while imports of goods and services rose by 1.8 per cent.

Despite the sharp upturn in the world economy, economic activity struggled to revive in the three largest economies, which account for 70 per cent of the area's output.

In Germany gross domestic product contracted in 2003.

The sluggishness of Europe's largest economy dates back some years now. Between 1998 and 2003 output increased by just over 1 per cent a year, half the average for the rest of the euro area. The slow growth is an indicator of structural difficulties in an economy endowed with high-quality and competitive industrial capacity.

Exports continued to grow, gaining market share in the dynamic economies of South-East Asia as well as in the euro area. Between 1998 and 2003 the volume of exports of goods and services rose by 33 per cent, compared with an increase of 29 per cent in world trade. Market share rose from 10.7 to 11.3 per cent in 2003.

Industrial production rose by 6.4 per cent over the five years.

Domestic demand failed to contribute to growth in the last three years.

Between 2001 and 2003 investment fell by 12 per cent. After performing well in 1999, consumption progressively lost momentum and has contracted in the last two years. The number of unemployed, which fell until 2000, rose to 3.8 million at the end of last year, equal to 9.7 per cent of the labour force; in addition, more than 1 million workers were on retraining courses.

The propensity to save has risen, reflecting the uncertainty of households about the performance of the economy and the reform of Germany's very generous public welfare and pension system.

In France economic growth between 1998 and 2003 was slightly higher than the euro-area average; it was nearly double that in Germany.

Gross domestic product increased by 0.5 per cent in 2003. Industrial production rose by 6.3 per cent over the last five years.

Investment declined in 2002 and again in 2003, although it picked up during the year. Household consumption continued to increase even in the last two years of economic weakness in the euro area.

Since the mid-1990s exports have risen in line with world demand; they declined last year. As in other euro-area countries, the penetration of the domestic market by foreign products is making rapid gains.

The Italian economy, like Germany's, has grown at a pace well below the European average over the past five years, expanding at an annual rate of 1.4 per cent.

Consumption growth was weak but not out of line with that in the other euro-area countries.

Since 1999 investment in construction, especially residential building, has recovered in connection with low interest rates. In the last five years bank lending for house purchases has more than doubled. The rise in property prices, while substantial, has still been less than in other European countries and North America, thanks in part to the response of supply.

The loss of competitiveness with respect to the developed countries and, even more, the emerging economies remains the greatest weakness of the Italian economy.

Industrial production has risen by only 0.9 per cent over the last five years.

Investment in machinery, equipment and transport equipment has slowed since 2001; in the last two years it has decreased by more than 5 per cent.

Exports of goods and services declined in volume by 3.4 per cent in 2002 and by a further 3.9 per cent in 2003; in five years they grew by just 3.6 per cent. Italy's share of world trade at constant prices fell from 4.5 per cent in 1995 to 3.9 per cent in 1998 and 3 per cent in 2003; at current prices the decline was smaller. As the euro has strengthened, firms have kept their prices unchanged, but at the cost of reduced export volumes.

Italian exports are concentrated in traditional and luxury sectors, where they owe their success to quality and style. Italian sales of leather products and footwear and of furniture account for about 14 per cent of the world total. Italy's share of the market for non-metallic mineral products is about 12 per cent, while that of textiles and clothing is 7 per cent. All are mature sectors that taken together account for just over one tenth of world trade.

Italy produces few technologically advanced products, for which world demand is growing more rapidly than the average.

The country's share of the market for machinery and mechanical equipment has remained stable at around 10 per cent; for transport equipment it fell from 3.7 per cent in 1998 to 3.3 per cent in 2003.

The outlook for growth

In the United States both potential and actual output increased at a markedly higher rate in the second half of the 1990s than in the preceding decades. Annual labour productivity growth in services and industry rose from the previous average of 1.5 per cent to 3 per cent between 1995 and 2003. Inflationary pressures were limited; real wages and employment increased.

The flexibility of the labour market, the allocative efficiency of the financial markets, the laws governing economic activity and the solidity of the institutional framework can continue, as in the past decade, to foster an expansion and composition of investment capable of coping with rising consumer demand and growing competition in international markets.

The economy's productivity and the central role of the dollar in the international monetary system have demonstrated their ability to attract savings from the rest of the world.

On the basis of the favourable underlying economic and demographic conditions, the US economy is estimated to be capable of annual growth of around 3.5 per cent over the medium term.

In the euro area both potential and actual growth are lower.

According to the European Commission, the euro area's potential output increased at an average annual rate of 2.3 per cent in the 1980s and 2.1 per cent in the 1990s; in the three years from 2001 to 2003 there was a further slowdown.

The low growth and progressive aging of the population limit the medium-to-long-term expansion of expected demand, especially for the products of industry.

Persistently weak investment in new technologies, rigidities in factor markets, the modest scale of public and private research, and legislative and administrative constraints act as a brake on productivity. In the euro area the annual growth rate of labour productivity across the whole economy was 0.9 per cent between 1995 and 2003, compared with 1.9 per cent in the four preceding years.

The trend of production costs and the composition of supply are reflected in losses of international competitiveness and world market shares.

The deceleration of potential growth is evident in the three largest economies. In Germany, the annual rate of increase in potential output fell from 2.5 per cent in the first half of the 1990s to 1.5 per cent in the second and to 1.2 per cent in the period from 2001 to 2003. In France, the expansion of capacity remained close to 2 per cent.

Italy

In Italy, the average annual increase in potential GDP, estimated at 2.4 per cent for the ten years from 1981 to 1990, fell to 1.6 per cent between 1991 and 2003. Weak business investment will tend to impose a further limit on supply growth in the coming years.

The expansion of expected demand is curbed by the loss of competitiveness caused by meagre productivity gains and rising production costs. In the last two years the appreciation of the euro has also played a role.

The social legislation in force in Italy and other European countries was enacted in the late 1960s and early 1970s, at the end of two decades of strong growth; it was designed on the assumption of continued rapid expansion of the economy.

In the 1970s slower growth and the crisis of important branches of industry led to radical restructurings of production, but action to remove the legislative rigidities and improper costs burdening firms was insufficient.

The imbalances had repercussions on the public finances; they worsened as the population aged and employment growth slowed. The increase in the public debt weighed on the structure of the financial markets and on the interest expense of both the State and firms.

The repeated realignments of the exchange rate from the mid-1970s onwards brought out the ability of small and medium-sized enterprises to react and their role as an engine of employment and growth. With their more streamlined, flexible organization, these firms were also able to establish a presence in international markets.

In the 1990s economic policy tackled the adjustment of the enormous budget deficit. The reforms of the pension system, health care and local authority finances cut into the imbalances, but not deeply enough; they must be completed. The public debt continued to rise, albeit more slowly. Tax revenue had to be increased.

The rigorous monetary policy initiated in August 1994 subdued inflationary expectations and fostered a decline in long-term interest rates, with benefits for the public finances and for firms.

Italy's return to the exchange rate mechanism in November 1996 and its subsequent participation in monetary union allowed interest rates to be lowered further and contributed to the stability of the financial system. These developments ended the possibility of adjusting the exchange rate in order to compensate for the inefficiencies and competitive difficulties of the domestic economy.

The share of off-the-books employment remains large. The tendency of firm size to shrink, under way since the end of the 1970s, has intensified; the gap vis-à-vis the other main industrial countries has widened.

According to 2001 census data, the average number of workers in Italian firms is less than 4. Excluding the 2.4 million firms with a single worker, the average workforce numbers around 8, compared with 13 in France and Germany and 15 in the United Kingdom.

The fragmentation of the economic structure limits productivity gains, research, the development of innovative, technologically advanced products, and the conquest of new markets.

Against a background of wage moderation, in the late 1990s reforms aimed at increasing flexibility in the use of labour produced immediate effects, with a rise in the number of persons in work and a reduction in unemployment. Thanks also to the fall in the cost of money, corporate profitability remained generally satisfactory.

The banking system underwent a radical restructuring.

But competitiveness continued to weaken, especially in industry. Productivity gains lagged behind those achieved in the other major industrial countries in the 1990s, most notably in the second half of the decade.

Labour productivity in the economy as a whole rose by 0.7 per cent per year between 1995 and 2003; in the last two years it diminished. Total factor productivity increased by 0.9 per cent per year between 1991 and 1995. In the second half of the decade, this slowed to 0.5 per cent. In the last three years there was a decrease of 0.7 per cent per year.

Econometric analysis of the data on the major branches of the economy shows that gains in total factor productivity depend on the intensity of investment in new technologies and the extent of exposure to international competition. These characteristics in turn are correlated with firm size.

Low growth and loss of competitiveness are causing difficulties in an increasing number of companies, including some larger ones. In the last three years a significant number of firms operating in traditional sectors have had recourse to wage supplementation or mobility benefits for their workers, or have gone out of business. In 2001 the number of hours covered by wage supplementation was equivalent to the work of 90,000 full-time employees; in 2003 this figure rose to 130,000.

It is necessary to reverse the trend, to return to a path of rapid growth.

Building on widely distributed and lively entrepreneurial abilities, on restored cooperation with the banking system, industry must regain its propulsive role and contribute to the creation of a new model of development.

Italy's economy has long been distinguished by industrial districts, which have attenuated the disadvantages of smallness.

A profitable, competitive core of some 3,700 medium-sized firms, with between 50 and 500 workers each and employing a total of almost 500,000, achieved above-average sales growth and helped to sustain exports in the second half of the 1990s.

Most of these firms are family-controlled, well-capitalized and operate in traditional sectors and market niches.

An increase in their size, more investment in research, expansion into adjacent segments of activity and greater penetration of foreign markets could significantly improve the Italian economy's growth prospects.

An opening to the capital market and more efficient corporate governance structures are necessary.

These companies can act as reference points and poles of attraction for smaller firms.

The role of the credit system will be decisive. Banks have made an important contribution to the reorganization of large industrial groups, of which Italy has relatively few. Large companies are essential to augmenting Italian industry's capacity for innovation.

The privatization and liberalization begun in the 1990s must be carried through to completion. Action must be taken to improve the low tenor of competition in the service sector, particularly in business services.

In agriculture and food-processing, more stress on quality products and an increase in the average size of production units can enable Italian firms to succeed in foreign markets. In tourism, action to protect the environment and to improve tourist services and facilities can, indeed must raise Italy's market shares to a level consistent with the country's wealth of cultural and natural resources.

To achieve widespread application of information technologies, the commitment of producers, possibly joined in consortia of small and medium-sized firms, and cooperation with the high-level scientific research centres that exist in Italian universities are indispensable.

Basic research, reorganized according to the needs of an advanced nation, and, in a shorter-term perspective, more intensive and pervasive use of the new technologies are crucial for the growth of the Italian economy and for Italy to be a player in an ever-more competitive world arena.

Competitiveness is weighed down by energy costs that are more sensitive in Italy than elsewhere to oil price fluctuations. Italy is in the forefront in experimenting with renewable, clean, competitive energy sources. Public support and private-sector interest must ensure we maintain the comparative advantage we now enjoy even with respect to the most advanced economies.

Productivity depends significantly on the external economies generated by public infrastructure.

Projects for the creation of Community infrastructure networks, with the contribution of private capital, were defined during Italy's presidency of the European Union. With the public works enabling law, Italy launched a programme to close its infrastructure endowment gap vis-à-vis the other EU countries; execution of the programme must be accelerated.

The cyclical situation

Public works spending turned upwards in 2003. Most of the growth in activity occurred in the northern regions; in the South, the value of the works executed fell slightly.

The works carried out in 2003 were largely the continuation or completion of projects begun in previous years, only in part new projects. The obstacles to carrying out the programmes derive from the small volume of resources available and administrative difficulties. In the northern regions, labour shortages are also a problem.

Considering the good progress of contract tenders, activity can be expected to pick up over the next two years, giving impetus to domestic demand.

The divergence between the downward trend of industrial production in Italy and the expansion in the other European countries has become more evident since the middle of 2002. In the first quarter of this year industrial production rose again in Germany and France. In Italy it fell by 0.5 per cent and according to preliminary estimates the decline continued in April and May.

GDP did not expand in the final part of 2003; despite a progressive reduction in industrial output, it did increase in the first quarter of this year.

According to the Bank of Italy's survey of the investment plans of companies with at least 20 employees, after contracting last year investment in the manufacturing sector is likely to stage a moderate recovery in 2004. Large firms above all are expected to step up their investment; planned capital spending by companies with fewer than 200 employees is set to be cut once more.

The growth of international trade in 2004 is forecast to be of the order of 7 per cent. Italian exports are rising again, albeit more slowly than world demand.

The impulse imparted by exports, together with the upturn in business investment and the recovery in public works, should boost overall demand and lead to an increase in output of the order of 1 per cent. The growth in output would remain below potential.

In a favourable international context, national output growth could rise to 2 per cent in 2005. Employment could expand faster.

The financial markets and banking

The worldwide abundance of liquidity contributed to further expansion of activity in the financial markets in 2003. The volume of funds raised by firms and governments increased and bank lending continued to grow.

The financing of the economy

In Italy total finance to all sectors of the economy in the form of bank loans, bond and equity issues and other instruments was equal to €255 billion last year; of this amount €65 billion flowed directly from abroad to non-bank sectors.

The corporate sector, including finance companies, received €108 billion, households €32 billion. Counting the assets and liabilities of Cassa Depositi e Prestiti in the public sector, the latter registered inflows of €36 billion. A total of €79 billion flowed abroad, partly for asset purchases by investment funds.

The share of total saving absorbed by the public sector has diminished gradually since the mid-1990s, while that going to firms has increased. In eight years credit to households, mainly for the purchase of housing and consumer durables, has risen from 8 to 13 per cent of the total flow.

The funding of firms in 2003 comprised €29 billion of equity, €34 billion of bond issues and €45 billion of bank loans. In 2002 corporate bond issues had amounted to €38 billion. In the mid-1990s, firms' recourse to the bond market had been negligible.

The efficient operation of the capital market presupposes that issuers disclose complete and correct information on their profits and losses and balance-sheet situation, so as to enable intermediaries and investors to make a well-founded evaluation of the risk and expected return on their securities.

Companies' internal control systems, enjoying the necessary independence, must ensure reliable operations and correct reporting to top management. Companies' governing bodies are liable for the truthfulness of the data made public, first and foremost in their financial statements, which guide financial analysts' evaluations and investors' decisions.

For listed firms and others that raise funds on the market, the law assigns auditing firms the task of certifying that the accounts are properly prepared and transactions exactly recorded, and that the financial statements correspond to the company's books.

The reforms enacted in the United States following the corporate scandals of recent years have reinforced the controls that corporate bodies and outside auditors must exercise over companies' operations and the information that must be made public. More severe sanctions have been enacted for directors and auditors for incomplete or false disclosure in financial statements. The controls of the Securities and Exchange Commission have been stepped up. A new agency under the SEC has been formed to oversee auditing firms.

In the light of the conduct that marked the recent corporate crises in Italy, internal and external controls need to be reinforced here too, thus strengthening the market's capacity to gauge the real performance of companies and their directors.

The resources allocated to the authority charged with supervising companies and markets must be increased so that by examining periodic filings and carrying out inspections it can promptly and systematically verify the correctness of operating procedures and the quality of the data made available to the market.

Investor protection also requires full disclosure and proper conduct on the part of the intermediaries that place or trade securities.

We welcome measures aimed, in part through closer international cooperation, at preventing the use of complicated corporate structures with ramifications in off-shore centres whose sole purpose is to evade the rules on transparent financial reporting.

Banks and credit risk

In the United States the economic recovery has had positive effects on the accounts of the banking system. Commercial and industrial loans diminished again in 2003, but credit supply conditions are easing. The quality of loan assets improved, and writedowns were less than in 2002. Income continued to increase rapidly, owing in part to large-scale securitization of credit claims and relending of the proceeds. In connection with the modest rise in operating costs, the return on equity amounted to 15 per cent. Non-interest income accounted for 45 per cent of revenues.

Japan's banks are also benefiting from the economic recovery and higher share prices. There was a further reduction in the volume of bad debts, primarily among the largest banks.

In the euro area there was a modest acceleration in bank lending in 2003. The fastest-growing component was household credit. In Germany lending to firms diminished and banks' profitability remained very low, especially for the largest groups, which undertook reorganization and substantial staff downsizing. Lending to firms decreased in France as well, although banks' income and profits increased.

In recent years swings in the stock markets and exchange rates, the world business cycle and severe political and military tensions have subjected the international financial system to heavy pressures. It has absorbed the fluctuations better than in the past; there have been no significant cases of instability.

The soundness of financial systems has benefited from the development of the markets and derivative instruments, which have helped redistribute risks among the institutions prepared to assume and manage them.

The international derivatives market registered particularly rapid growth last year. These instruments enhance intermediaries' operational possibilities; resort to them modifies banks' *modus operandi*; the reallocation of credit, exchange rate and interest rate risk has contributed to the stability of banking systems.

The supervisory authorities are carefully monitoring the phenomenon, individually and in the fora for international cooperation.

The Bank of Italy issued prudential regulations on credit derivatives some years ago, together with rules for the presentation of derivatives in banks' accounts. Regulations on the organizational structures of intermediaries that do business in these instruments are being finalized.

Bank lending to firms rose by 6.3 per cent in Italy last year, 3 points above the growth rate of nominal GDP and also 3 points more than the average rise in the euro area.

The cost of credit to firms is very low in both real and nominal terms, owing in part to more intense competition. Rates on both short-term and medium and long-term loans came down over the year by 0.8 percentage points, to 5 and 4 per cent respectively. These rates are in line with the rest of the euro area, even though the average Italian borrower is smaller.

Credit supply conditions remained expansive; undrawn margins on current account overdrafts are ample for all categories of customer.

As in 2002, lending to small firms grew more rapidly than that to larger firms, with increases of 7.6 and 6.1 per cent respectively.

Southern firms in particular benefited from easy access to credit. The increase in lending has been significantly greater than for firms in the Centre and North of Italy. Adjusting for the different size and sectoral distribution of firms in the two parts of the country, the gap in short-term lending rates has remained equal to 1.2 percentage points, reflecting the higher credit risk in the South.

Continuing a trend that began in the second half of the 1990s, lending to households rose substantially. Demand was fueled by low interest rates; not only home mortgages but also consumer credit expanded rapidly.

The annual percentage rate of charge on new home mortgage loans decreased by 1 percentage point in Italy last year to 3.9 per cent. More than three quarters of the loans were at variable rates. The advantage of small initial instalments comes at the cost of a possible rise in interest rates, and borrowers must be aware of this.

Credit quality suffered from the Cirio and Parmalat defaults. Exposures equal to 1.2 per cent of loans outstanding at the start of the year were classified as bad debts during the year, compared with 1 per cent in 2002.

Credit risk remains generally low by comparison with the period following the cyclical downturn of the early 1990s. From 1994 to 1996 new bad debts averaged 2.5 per cent of outstanding loans each year. The evolution of loan portfolio risk depends on the prospects of the economy returning to a path of sustained, rapid growth.

Between 1999 and 2003 banks transferred loans amounting to €71.9 billion to the market through securitizations, including €26.4 billion of bad debts. Securitizations of bad debts essentially came to an end in 2002.

The risk on the securitized credits was virtually all taken up by Italian or foreign institutional investors. In the case of securitizations of bad debts, the originator banks not only charged the writedowns to income but also took up the riskiest securities.

To protect themselves against the possible deterioration of their portfolios, banks took out credit derivative contracts for a notional value of €46 billion. In turn, they provided hedges for €42 billion.

The new Capital Accord now nearing completion at the Basel Committee for Banking Supervision adopts risk management techniques consistent with international best practice.

The new Accord introduces procedures of varying complexity for calculating capital requirements. It leaves it to banks themselves to choose the method that best suits their loan portfolio and their risk measurement and management techniques. The new Accord is expected to take effect in 2006 or 2007. On the basis of statistical analyses conducted in 2003 by the Bank of Italy, trade associations and Italian and foreign research centres, adverse consequences are not expected for the financing of firms, especially small and medium-sized ones.

Profitability and capital

In recent years the Italian banking system has carried out a restructuring and a reallocation of ownership comparable in breadth – albeit in a different context – to that of the 1930s. The Bank of Italy made sure that consolidations did not undermine competition.

The experience of a number of countries indicates that for larger banks an increase in the scale of business does not necessarily improve stability or efficiency, owing to the difficulty of integrating and managing complex structures.

In Italy the banking groups arising out of consolidations between banks with dissimilar operational characteristics are engaged in restructuring their organizations in order to enhance efficiency and profitability.

A simplification of corporate structures is under way, in order to improve group governance. Operating and IT procedures for risk control are being standardized. On-line banking channels, networks of financial salesmen and branch networks are being rationalized.

Strategies to expand abroad require a major effort. With a view to EU enlargement and in support of Italian firms' business operations, Italian banks have moved into Central and Eastern Europe. In four countries they now have significant shares of the local banking market.

The total assets of Italian banks were 31.7 per cent higher in 2003 than in 1996 at constant prices and net revenues 18.3 per cent higher. Over the same period the number of employees decreased by 3.5 per cent.

Operating expenses held broadly stable last year, while consolidated gross income rose by 2.7 per cent to €65.8 billion.

The ratio of operating expenses to gross income is low by comparison with other European banking systems. The share of staff costs in operating expenses is higher.

Return on equity improved by 0.3 percentage points to 6.7 per cent. The profitability of the system was affected by the writing down of exposures to the Cirio and Parmalat groups.

Self-financing amounted to €3.3 billion and equity issues to €2.5 billion.

The banking system's consolidated capital rose to €139.8 billion. The solvency ratio improved slightly to 11.4 per cent, which is still about one point below the average for EU banks in 2002.

The Bank of Italy regularly reviews the capital adequacy of the banking system using statistical procedures that simulate highly unfavourable market conditions. These analyses indicate that the banks have sufficient capital to cope with sudden changes in interest rates or even with the extreme contingency of a deterioration in the financial position of firms and a fall in real estate values comparable to that of the recession of the early 1990s.

The assessment of the International Monetary Fund

Supervisory activity is carried out within the legal framework established by the Consolidated Law on Banking and the Consolidated Law on Finance in accordance with European law and the principles agreed by the international financial community.

In 1997 the Basel Committee laid down the "Core Principles for Effective Banking Supervision".

Underlying Italy's legislation in this field is the concept of banking as an entrepreneurial activity, in line with the First Banking Directive. Supervision is performed without infringing on banks' operational autonomy in any way, as regards either corporate policies or individual decisions, especially the granting of loans.

The International Monetary Fund has been entrusted by its member governments with the task of making detailed assessments of the supervisory rules and practices adopted by both developed and emerging countries, with a view to verifying their compliance with international standards. At the end of last year 101 countries had been assessed, of which 7 belonged to the Group of Ten. The assessment of Italy was conducted in 2003.

The Fund's report, published in the last few weeks, judged the Italian system of banking supervision to be of high quality: with reference to the 30 Basel Core Principles, Italy was found to comply with 24 and to be largely compliant with 5; in only one case was it found to be non-compliant. The assessment is highly satisfactory, also when compared with those of other important countries. The non-compliance concerns the absence in the Italian legal system of rules protecting its supervisors against liability for measures adopted in good faith in carrying out their functions.

Appreciation was expressed for the independence with which supervisory activity is performed and the transparent way in which the Bank makes the principles and methods of supervision public; a positive judgement was passed on the collaboration with the supervisory authorities of the other sectors of the financial system.

The Fund deemed that the rules of prudential supervision in force in Italy conformed with the best practices recommended by international bodies. The analysis of supervisory data was judged to be systematic and thorough, thanks to the integration of the examination of statistical reports with on-site controls. It considered the Bank's interventions to be appropriately graduated according to the seriousness of banks' situations.

Households and the protection of savings

Wealth, both real and financial, is the result of the accumulation of savings over time and of the change in the value of its components. It is held by the public sector, households and the foreign sector. Ultimately, the value of industrial and financial businesses also belongs, directly or via intermediaries, to these sectors.

At the end of 2003 the gross wealth held by households was some €8,200 billion or more than 6 times GDP, a ratio that was in line with those of other economically and financially developed countries.

Of households' total wealth, €5,300 consisted of real estate and other real property, €2,900 of financial assets.

Households' holdings of cash, deposits, bonds and other bank fund-raising instruments amounted to €854 billion, or 29 per cent of their total financial wealth. Their holdings of postal deposits and public-sector securities amounted to €421 billion, or 15 per cent of the total, while shares and other equity interests were valued at €567 billion. The corporate bonds issued by Italians firms held directly by households amounted to €54 billion.

Italian households' purchases of the bonds issued, directly or through foreign subsidiaries, by the two companies that have collapsed amounted to about €3 billion.

The rest of households' financial wealth consisted of investment fund units totaling €326 billion, insurance companies' technical reserves, a small amount in respect of pension funds, and severance pay entitlements and foreign assets.

Compared with more financially developed countries, there is still a widespread tendency for savers to take their own investment decisions; these need to be based on detailed evaluations of financial instruments that differ considerably in terms of maturity, yield structure and issuer risk.

The provisions of the Consolidated Law on Finance concerning investment services and the implementing regulations issued by Consob require intermediaries to comply with transparency obligations and rules of conduct designed to put customers in a position to make informed investment choices. When trading securities, intermediaries are required to ensure counterparties are aware of the features of the financial instruments and to evaluate their suitability with respect to investors' risk propensity and wealth.

The corporate failures have highlighted the need for a financial system long oriented towards deposit-taking and the placement of government securities to adapt corporate conduct and structures to the rapid shift in investors' preferences towards assets with higher risks and yields. Intermediaries must thoroughly evaluate the riskiness of securities they trade and make it clear to investors.

The ability to promote customers' interests is the basis of intermediaries' reputation, the essential condition for maintaining and expanding profitable business dealings with households and firms.

This is the contribution of ethics and professionalism to customer relations that I have repeatedly called on all those operating in the securities market to make, banks first and foremost.

At the request of Consob, the Bank of Italy verified compliance with the rules on investment services at some banks. The formal acts required were found to have been performed for the bulk of the transactions examined.

There is a need for banks to improve the quality of their procedures for the provision of investment services. Their internal control systems must ensure appropriate conduct and the supply of adequate information to investors.

Attention must be paid to the training of the persons charged with assisting customers. Every investor must be aware that higher yields necessarily entail higher risks.

The economic and social importance of savings is enshrined in Article 47 of the Constitution.

The volume of savings generated in the economy is decisive for the welfare of households; by financing investment, savings provide the basis for the growth of economic activity and employment.

The protection of savings, founded in the Constitution, is entrusted, as far as the banking component is concerned, to the supervision of the Bank of Italy. The security of these savings depends on banks' stability. It follows that a unitary view of the savings entrusted to banks and their utilization in favour of investment and production is indispensable.

Ever since the adoption of the 1936 Banking Law, no depositor in Italy has ever lost any money. The total cost of public intervention in crises has been much less than in the other leading countries.

The stability of insurance companies and other institutional investors is also the key to the protection of the savings they are entrusted with.

In the case of funds raised by companies directly in the market, the possibility of losses is inherent in the riskiness of entrepreneurial activity; it is compensated, on average, by a higher yield.

The protection of savings is being debated in Parliament. The European Central Bank has issued an opinion on this matter in which it stresses, in the light of Community legislation: the specific nature of bank fund-raising and lending; the essential role of the central bank in fostering the soundness of financial institutions and the financial system as a whole; and the broad scope of prudential supervision in a necessary context of institutional independence.

As a direct response to the events that have revealed the need, steps must be taken to increase the effectiveness of the controls on activities which have seen situations arise that have harmed thousands of families and impinged on the orderly functioning of parts of the financial market.

At the Bank we are respectfully following the debate under way; we are convinced that Parliament's decisions will reinforce the confidence of savers.

We have invited banks to re-establish a relationship with their customers founded on trust in the cases in which, even if only on the basis of internal investigations, it was found that the needs of investors had not been looked after as well as possible. Several banks have taken steps in this direction.

The restoration of a favourable climate in the financial market and in attitudes towards intermediaries is essential for the continuity of support for production and investment, especially at a time of cyclical weakness and difficulties at some companies.

In Italy an excessively large share of savings has been absorbed by the public sector. Bringing the ratio of public debt to GDP down towards the values obtaining in the other industrial countries, especially those participating in the Monetary Union, will increase the resources available to the private sector.

The formation of savings and their amount depend on the growth of the economy. Economic policy, firms' activity and the behaviour of the social partners must be directed first and foremost at achieving growth.

Ladies and Gentlemen,

The primary task of economic policy in the present difficult context is to curb the quantity of resources absorbed by the public sector.

General government net borrowing on an accrual basis was equal to 2.4 per cent of GDP in 2003.

The figure forecast for this year is 2.9 per cent.

The state sector borrowing requirement on a cash basis was €43 billion in 2003. In the first five months of this year it is estimated to have been €48 billion, compared with €37 billion in the corresponding period in 2003. The Government does not rule out the possibility of measures to curb the imbalances in the public finances in the second half of the year.

In the absence of corrective measures net borrowing will exceed 3 per cent of GDP; it might rise to 3.5 per cent. As a consequence of the drying up of receipts from one-off measures, net borrowing in 2005 would be around 4 per cent of GDP.

The increase in the budget deficit in recent years has been influenced by the cyclical weakness of the economy. It also reflects the failure to correct the underlying trends that lead to a widening gap between the growth of current primary expenditure and that of taxes and social security contributions.

Expenditure on health care and social security outlays are rising in relation to GDP. The primary surplus was 5.2 per cent of GDP in 1998; it fell to 2.9 per cent in 2003 and is forecast by the Government to fall to 2.2 per cent this year.

The public debt remains very large. International monetary developments have permitted interest payments to be reduced; the return of interest rates to normal levels will affect the deficit.

The performance of the public finances and the volume of debt reduce the scope for budgetary policies to support domestic demand by increasing the deficit. The positive effect produced by an increase in the private sector's disposable income would be more than offset by the adverse effect deriving from the further increase in public debt.

A decrease in the tax burden must be the outcome of a reduction in current expenditure in relation to GDP; what is required is a rationalization of governmental activity and an increase in the efficiency of public services.

It is necessary to revive growth, starting with investment demand.

The contribution of expenditure on infrastructure has been less than expected. Now that the necessary legislative groundwork has been laid, it is important to proceed with the realization of projects, to support demand and give certainty to the prospects of the removal of the external diseconomies caused by the inadequate endowment of public capital.

The downward trend of industrial production is a threat to the stability of a growing number of marginal firms.

The banking system must be strong enough to provide production and investment with support in this difficult phase of the economic cycle; it can help reverse the trend. It must improve its ability to assist Italian firms in their expansion abroad.

A renewed collaborative relationship between the social partners makes it possible to focus on growth in a medium-term perspective again.

Italy needs an economic policy that is clear, certain and based on reliable data and well-defined and widely accepted measures set within a long-term strategy.

The restoration, in an appropriate number of years, of balanced public finances and a reduction in the weight of the debt are indispensable conditions for the return to macroeconomic stability.

Research must become a priority goal of investment.

The labour market reforms enacted have stimulated employment and ensured sufficient flexibility. For this not to turn into precariousness and lower productivity, a higher rate of growth is indispensable. To this end, it is necessary to maintain a degree of wage moderation that safeguards the link with productivity.

A stable economic policy framework can increase the interest of foreign businesses and investors. A South of Italy more closely integrated into the national and European economies offers a reserve of potential growth in view of the abundance of young people and the cultural and environmental resources on the basis of which to develop tourism and forms of production hinging on human capital, new technologies, especially information technology, and renewable energy sources.

Artisanal businesses play an important role in Italy's economic and social fabric. Firms that wish to grow in the domestic market and expand abroad must necessarily aim to rationalize and increase their scale of production, with the help of information technology and possibly through consortium arrangements.

There will have to be aggregations, reorganizations of ownership and financial structures. Cultural barriers and difficulties must be overcome.

Banks, their initiative and their ability to play a role in team efforts are essential for a new phase of growth.

The major banking groups, their increased efficiency and the spirit of enterprise of local banks can make an important contribution, thanks in part to their store of information, to the birth of new projects and to the modernization, enlargement and enhancement of the many, already highly profitable, medium-sized firms present in the Italian economy.

Further progress needs to be made in the reform of the law governing economic activity. Banks must be able to support firms in difficulty, restructure them and relaunch the viable parts, possibly under new owners.

There are signs of an upturn in investment by the largest industrial firms; public investment is set to accelerate; world demand for goods and services is expanding rapidly.

We must take part in the international recovery, with respect to which Europe and especially Italy have remained on the sidelines.

It is within our reach. The social partners and the banks need a clearly defined and agreed reference framework. The forthcoming Economic and Financial Planning Document must provide guidelines in this respect.

In harmony with Italy's civil traditions, economic growth and social development cannot be pursued independently of Europe.

We must learn from younger and more dynamic countries, worldwide, emulate the good things they have created in economic and public life. In developing Italy's political and cultural relations, we must look, in friendship, to the West but also to the East and the southern shore of the Mediterranean.

Economic growth is slow in Europe owing to the aging of the population and the stratification of legal and social structures put in place in an earlier age of faster growth. We must conserve the spirit of those structures. The demographic crisis needs to be tackled by an opening, carefully regulated, of our country to foreigners who come here to find better living conditions and to contribute to our economy. Above all there is a need to give renewed vigour to policies for taxation and public services and for measures to support families and create a climate of confidence for the education of young people. The ability to look ahead with optimism must not be lost.

On the first day of this month of May 2004 the European Union made a historic advance.

Ten new countries joined, bringing with them a variety of cultures, traditions and languages that cannot but enrich our patrimony of civil values; a substratum of common historical, cultural and religious roots is clearly intelligible.

The immediate problems facing the government of the new Union are considerable, as are those facing the economy.

But by enlarging the Union we have enlarged the market; in time this will prove beneficial. In many cases Italian firms and banks are already grasping the opportunities created.

The new Union is better placed to have its values accepted by the nations of the world and to contribute to peace, the indispensable condition for relations among peoples, for the advancement of trade and for the economy.

We are working to create a future that, in order to provide security, must be based on a harmonic set of moral values, laws and economic structures that will realize the expectations of all those, including many in our advanced societies, who await an improvement in their living conditions, and give confidence and hope to the new generations.