BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY 2005

THE GOVERNOR'S CONCLUDING REMARKS

Ladies and Gentlemen,

The city of Rome was recently at the centre of world attention as heads of state and government, representatives of the world's religions and millions of men and women gathered to honour the Pontiff, a man who left an indelible mark on history.

They did so in acknowledgement of their shared ideal of mutual understanding and their aspiration to live together in fellowship and peace.

To his successor, a man of eminent learning, a son of the humanism ingrained in Europe, let us convey our best wishes that he may continue to work for a fuller collaboration among the peoples and nations of the world, fostering universal human and civil progress.

The Bank of Italy and its employees again worked with dedication in the service of the nation and its regional and local communities.

Cooperation with the other central banks in the European system and worldwide has continued to be intense and demanding, both in technical matters and in developing guidelines and policy measures to the benefit of the financial community and the international economy.

Supervision is performed through central and local units to safeguard financial stability and competition and the efficiency of intermediaries' services to the productive economy.

In the payment sector, with the entry into service of the new BI-REL system, which now also embraces Poland, efforts focused on the development of the single shared platform for the euro-area payment system together with the central banks of France and Germany.

The new information system supporting the operations of public entities will permit analytical, real-time observation of central and local government outlays and receipts. It is an essential source of knowledge in an institutional context in which decentralized activity is increasingly important.

The Bank's departments and branches are actively engaged in systematic data collection, analysis and research. The findings are placed at the disposal of government, the business and financial community and citizens.

International recognition of the professionalism, rigour and quality of the Bank's activity is unanimous and well-established.

For their great efforts, our gratitude goes to the economists and officers of the Economic Research Department, the Supervision Department and the other departments involved in preparing the Annual Report, a valuable source of analysis and information on the economy and finance.

On behalf of the Board of Directors and the Directorate, and personally, I wish to thank the entire staff, who, identifying with the action and objectives of the Bank, contributed their professional skill and diligence to the work of the Head Office and the branches.

The world economy

In 2004 the liquidity of the world economy continued to increase, albeit at a slower pace than in the past few years. The money supply in the seven leading industrial countries, which had stood at 66 per cent of GDP in 1998, rose to 75 per cent last year.

Short-term interest rates, adjusted for consumer price inflation, were about 3 per cent in 1998. They then declined rapidly, turning negative by half a percentage point in 2003 before returning close to zero in the second half of 2004.

Real long-term yields fell to around 1 per cent.

The robust expansion of the money supply fueled world economic growth.

The recession in the United States in 2001, the terrorist attacks in September of that year and the subsequent armed conflicts in the Middle East had triggered a sharp slowdown in economic activity in the industrial countries.

The turnaround was due to the stimulus from fiscal policy in the United States. The exceptionally low level of interest rates revived investment in construction and fostered demand for consumer durables. In the course of 2003 business investment in capital equipment also resumed.

Risk premiums fell. Flows of capital and investment to the emerging economies began to increase again.

World output expanded by 4 per cent in 2004 in real terms. Weighting national GDP figures according to purchasing power parity, growth came to 5.1 per cent, the highest figure in more than two decades.

The monetary expansion did not have any appreciable inflationary effect. In 2004 consumer prices rose by an average of 2 per cent in the leading industrial countries and by 2.7 per cent in the United States. The protracted deflation in Japan was attenuated. In the euro area prices rose by 2.1 per cent.

In recent years productivity gains in the industrial economies have more than offset increases in employee compensation. Within Europe, Spain and Italy are exceptions in this respect.

The growth in world demand has nevertheless generated strains in the prices of raw materials, especially energy. Oil prices have more than doubled in real terms from their average in the 1990s. This has affected producer prices in the advanced economies, despite the reduction in unit labour costs.

In the emerging economies inflation remains higher on average than in the industrial countries. It has subsided markedly from its level in earlier years.

In the United States the threat of an increase in inflationary pressures prompted the Federal Reserve to raise interest rates gradually beginning in mid-2004. So far the Fed has increased rates by a total of 2 percentage points, to 3 per cent. In the euro area, the cyclical slowdown over the course of the year and expectations of lower inflation led the monetary authorities to leave the official reference rate unchanged at 2 per cent.

In a number of countries the expansion of liquidity has been reflected in property values. In the United States house prices rose by 37 per cent between 2000 and 2004. In the United Kingdom the rise was particularly rapid until 2003; since the end of that year it has been countered by a more restrictive monetary policy stance, although prices still rose by 85 per cent between 2000 and 2004. In Italy house prices increased by 46 per cent over the period, in Spain by 86 per cent.

In Germany the downward trend in property prices, caused by over-investment in the early 1990s, came to a halt. In Japan property values continued to decline, albeit less steeply than in the past.

Between the spring of 2003 and the early months of this year, equity prices rose by between 40 and 50 per cent in all the main markets. They were sustained by the decline in interest rates and the substantial increase in corporate earnings. Greater liquidity and low yields spurred investors to take riskier positions. The volatility of prices fell sharply.

Yields on 10-year government securities in the US and European markets rose in the first half of 2004 but then fell to very low levels. In the first few months of 2005, price volatility increased, as did risk premiums on corporate bonds and the issues of the emerging countries. Yields on government bonds rose temporarily.

Yields on long-term government securities remain low. The yield on 10-year bonds is 4.1 per cent in the United States and 3.3 per cent in the euro area. These rates signal expectations of moderate inflation, but also slow growth, in the coming years. The yield on indexed securities is 1.6 per cent in the United States and 1 per cent in the euro area.

Short-term developments

In the United States gross domestic product grew by 4.4 per cent in 2004, up from 3 per cent the previous year.

The expansion in domestic demand under way since 2002 had been triggered by the increase in government spending and the reduction of the tax burden of households and firms over a period of years.

The increase in households' disposable income, which was associated with the expansion in the budget deficit, was rapidly translated into a stimulus to consumption; the saving rate fell to an extremely low level, presumably to some extent reflecting confidence in the continuation of favourable economic conditions.

The recovery was sustained by the markedly expansionary stance of monetary policy. Purchases of durable goods increased by 7.4 per cent in 2003 and 6.7 per cent in 2004; investment in housing rose by 8.8 per cent in 2003 and 9.7 per cent last year.

Since 2003 investment by firms has also risen substantially. Expenditure on capital equipment and software grew by 13.6 per cent in 2004 at constant prices; of this, investment in computers and electronic equipment jumped by 33 per cent in 2003 and a further 27 per cent in 2004. Investment in transport equipment, which had fallen steadily between 2000 and 2003, accelerated briskly, growing by 12.5 per cent in real terms.

Exports of goods and services expanded by 8.6 per cent in volume.

Corporate profits rose thanks to the increase in output and productivity gains, which had continued during the recession. The recovery in employment that began in mid-2003 lent additional support to households' disposable income and consumption.

The pronounced acceleration in investment during 2004 reflected the sound financial situation of firms, tax incentives and, more fundamentally, the outlook for economic growth.

Investment has continued to expand this year, although at a more moderate pace.

In the first quarter of 2005 GDP increased by 3.5 per cent on an annualized basis. Productivity and employment continued to grow. The increases in the target rate decided by the Federal Reserve have been perceived by the market as aimed at stabilizing inflation expectations in the medium term.

At current exchange rates the leading industrial countries account for 65 per cent of world GDP. The United States produces just under half of the output of these economies and 30 per cent of the world total.

In 2003 and 2004 economic activity in the industrial countries and the emerging economies was sustained by consumption and investment demand in the United States. Imports from the rest of the world increased by 4.4 per cent in 2003 and 9.9 per cent in 2004.

World trade in goods and services expanded in volume terms by 4.9 per cent in 2003 and 9.9 per cent last year. China's contribution to the increase was equal to 1.5 percentage points in 2004.

Japan's exports of goods and services rose by 9.1 per cent in 2003 and 14.4 per cent last year. In Germany, they expanded by 1.8 and 9 per cent respectively. In France and especially Italy the increases were much smaller.

As in previous years, a significant contribution to world economic growth came from the emerging and developing economies. In China GDP expanded by 9.5 per cent, in India by 7.1 per cent. In the newly industrialized Asian economies growth came to 5.6 per cent.

In Japan productive investment rose by about 6 per cent both in 2003 and 2004, buoyed by foreign demand. Investment in residential building began to grow again after three years of decline. GDP increased by 2.7 per cent in 2004; this year growth will be slower.

Output in the euro area rose by 2.1 per cent.

Structural imbalances

The budgetary policy adopted in 2001 has produced a significant deterioration in the public finances in the United States. The expansion of the economy, which exceeded its potential growth rate last year, made it possible to stabilize the federal budget deficit at 3.6 per cent of GDP. The amount of federal debt held by the public rose to 37 per cent of GDP at the end of 2004.

The US Administration has pledged to reduce the deficit by 2010.

Over a longer time horizon the US economy will be burdened by the upward trend in pension expenditure and, above all, in that on health care, where costs are rising exceptionally fast.

The deterioration in the external accounts and low interest rates are at the root of the weakening of the dollar since 2002.

Since the middle of the 1990s external liabilities have grown sharply; at the end of 2003 they amounted to $10.5 trillion, half of which was accounted for by foreign portfolio investment and a quarter by direct investment in the United States.

External assets amounted to about $8 trillion at the end of 2003, a third of which consisted of direct investment abroad by multinational companies and another 30 per cent of portfolio investment.

The net debtor position of the United States, which had been equal to 5 per cent of GDP in 1996, rose to 25 per cent at the end of 2004.

The portion of the external deficit on current account that is not financed by inflows of direct investment or a reduction in US residents' non-dollar financial assets denominated in foreign currencies translates into an increase in dollar-denominated monetary assets, bonds and equities held by the rest of the world. The expansion in dollar assets held by non-residents is also the counterpart to US direct and portfolio investment in the rest of the world.

Between 1999 and 2004 the volume of deposits and private- and public-sector bonds denominated in dollars increased by 50 per cent, from $24 trillion to $35.9 trillion.

Over the same period, money and securities in euros expanded by 51 per cent, from €11.9 trillion to €18 trillion. Yen-denominated assets rose by 27 per cent.

The performance of the exchange rate of the dollar has major implications for global economic and financial equilibrium.

The comparative figures above do not reveal a growing imbalance between the volume of financial assets denominated in dollars and that of assets denominated in euros.

Owing to Japan's large current account surpluses, the quantity of financial instruments denominated in yen is much smaller than those denominated in the other two major currencies. Short-term yields close to nil have prevented an excessive appreciation of the yen.

The dollar stopped weakening in the first few months of this year, partly owing to the increase in official rates. Since mid-March it has appreciated by 8 per cent against the euro and by 3 per cent in effective terms.

The external deficit of the United States and the expanding supply of dollars fundamentally reflect America's faster growth by comparison with the other industrial countries. Between 1994 and 2004 consumption and investment demand increased by 45 per cent in real terms, while output, thanks in part to rapid productivity gains, rose by 38 per cent.

In Europe and the other industrial countries domestic demand and output both rose by 24 per cent during the decade.

In 2004 net national saving in the United States amounted to 2 per cent of GDP. In recent years the reduction in private-sector saving and the widening government deficit have prompted ever greater recourse to the savings of Europe, Japan and the emerging countries.

About three quarters of the US external current account deficit is matched by the persistent, substantial surpluses of Japan, the oil-producing countries, China and the other emerging countries of Asia. These countries cannot, or at any rate do not, invest all their saving in their own economies. The difference goes where investment is safer and where current and expected returns are adequate.

The ability of the international markets to finance the sometimes large disequilibria between saving and investment in the leading economies has increased in the last few years.

Up to now the United States has had no trouble in financing its external deficit on current account, thanks to foreign capital inflows attracted by high productivity and high investment yields as well as by a secure and stable economic and institutional environment.

The dollar assets held by the authorities of Asian countries amount to some $2 trillion. Some of these countries have net external debtor positions, which suggests a further accumulation of foreign exchange reserves, including dollars. The exchange rate of the dollar is bolstered by the progressive raising of US official interest rates.

A fall in the value of the dollar would harm the orderly working of the international financial system.

Looking ahead, a reduction in these imbalances is essential. An increase in US national saving and faster economic growth in the other industrial countries and worldwide are needed to help adjust the US deficit on current account.

Prerequisites for achieving sustainable development, for fully exploiting the opportunities for world economic growth, are closer economic and financial integration of the backward economies into the world trading system and a reduction in poverty, which remains deep-seated in vast areas of the globe.

The international community is pursuing these objectives.

The strategy is based on opening the markets of the developed countries to the goods produced by the poor countries, on official development assistance, on the cancellation of the foreign debt of heavily indebted countries and on institutional reform in beneficiary countries.

We look forward confidently to the meeting of the ministers of the World Trade Organization in Hong Kong in December, which is a crucial passage towards completing the Doha agenda for trade liberalization by the end of 2006. Aid must be made more effective. Innovative mechanisms and instruments of finance to increase the volume of resources, now smaller than planned, are under study. The Heavily Indebted Poor Countries initiative has made some progress, but there are still many countries with highly unstable internal conditions unable to benefit from debt reduction.

Broader participation in the use of resources and in the benefits of globalization lays the basis for economic and social advance under conditions of international harmony.

The Italian economy

Gross domestic product in the twelve countries of the euro area expanded by 5.1 per cent between 2000 and 2004.

In France economic activity was sustained by household spending. GDP grew by 6.6 per cent in the four years and exports by 5.4 per cent, or a quarter of the rate of expansion in world demand. Productive investment, after two years of contraction, returned to growth in 2004.

In Germany GDP expanded by 3 per cent over the four years, or by 0.7 per cent per year. Growth was led by exports; these increased by 23 per cent in volume, with gains in world market share. Consumption slowed sharply by comparison with the previous decade, reflecting households' uncertainty in connection with social security reform and employment trends.

German investment in capital goods diminished in 2001 and 2002; it recovered somewhat in the second and third quarters of 2004 but fell again in the last part of the year. The transfer of production to the countries of Central and Eastern Europe continues apace. Since 2000 construction investment has fallen by 4 per cent per year; in residential building, the contraction of activity has proceeded in parallel with the decline in prices.

The German economy is weighed down by the limited progress made in modernizing industry in the eastern regions; despite massive transfers from the federal government and lower labour costs, this is still not sufficiently competitive.

In Italy too the expansion of output has been unsatisfactory. Since 2000 the average annual growth rate has been less than 1 per cent. The increase in consumption, despite employment growth and budgetary stimulus, has been of the same order of magnitude.

Economic activity has been sustained by investment in residential building, favoured by low interest rates on mortgage loans and tax benefits for home renovation.

Business investment in capital goods contracted in 2003. A recovery in the first half of 2004 was followed by renewed decline in the third and fourth quarters.

The greatest weakness of the Italian economy continues to be its inadequate international competitiveness.

Between 2000 and 2004 world demand for goods increased by 20 per cent in real terms.

Italian exports were less in 2004 than in 2000. At constant prices, Italy's share of the world market fell from 4.6 per cent in 1995 to 3.5 per cent in 2000 and 2.9 per cent in 2004.

At the start of the decade the Italian economy, like the others of the euro area, was affected by the world cyclical slowdown. In the last two years it has not managed to take advantage of the sharp acceleration in economic activity in North America, Asia and Latin America.

Industry

The competitive difficulties of Italian industry first became manifest in the second half of the 1990s.

Between 1995 and 2000 there was virtually no gain in total factor productivity in manufacturing. Labour productivity rose by 1 per cent per year, against 3.2 per cent in Germany, 4.3 per cent in France and 3.9 per cent in the United States. In the five years the index of industrial production rose by 8 per cent, compared with 14 per cent in Germany and France.

These divergent trends have continued in the last few years.

Between 2000 and 2004 industrial production increased by 1.2 per cent in France and 2.6 per cent in Germany, while in Italy it contracted by 3.8 per cent. Essentially because of the failure to increase productivity, unit labour costs in Italian manufacturing rose by 12.6 per cent; over the same period they fell by 2.8 per cent in Germany and rose by 2.6 per cent in France.

The decline in industrial activity can be ascribed mainly to the machinery and electrical and electronic equipment sectors, whose output fell by 26 per cent between 2000 and 2004, and transport equipment, where the reduction came to 17 per cent. The contraction in these medium-high technology sectors explains 3.6 percentage points of the decrease in the overall index.

The performance of the textile and leather industries, those most directly affected by the competition of the emerging Asian economies, accounts for 1.9 points of the overall decline. Activity expanded, by contrast, in food processing, paper, metal and wood products, which like textiles and leather can be classified as low technology.

Areas of excellence and success stories, present in practically every branch of Italian industry, are founded upon innovative capacity and product quality. But in view of their limited scale, they are not enough to revive the entire industrial sector.

It is essential that these outstanding producers remain rooted in Italy. They can and must transmit the stimulus to improve quality and production to other enterprises.

Firms and technology

In the 1980s the expansion of Italian firms abroad aimed at acquiring interests in or control of European and non-European firms whose products were similar or complementary.

In those years foreign investment was mainly the preserve of Italian firms in medium-high technology industries with significant economies of scale that were seeking market outlets. In the mid-1980s such firms employed three quarters of Italian manufacturing's 260,000 workers abroad. Another 10 per cent worked for high-technology firms interested in exploiting synergies for the development of new products and advanced production techniques. Most of these foreign workers were employed in Western Europe and North America.

Starting in the 1990s, in order to recoup competitiveness that had been undermined by a deterioration in their price-quality balance, textile, clothing, leather and footwear manufacturers, including many small firms, began to shift some of their production to countries where labour was cheaper.

By January 2004 the number of workers of foreign companies controlled by Italian firms had risen to 870,000, equal to 18 per cent of total manufacturing employment in Italy. A third of these workers were located in Eastern Europe and Asia.

According to the data on foreign direct investment gathered by the nascent company register kept by the Italian Foreign Exchange Office, Italian firms with significant activity in other countries number 1,450; of these, 390 head international enterprises. The expansion is concentrated in high- and medium-high technology sectors and located above all in France, Spain and the United States. Investment in Romania, Poland, Croatia and the Czech Republic is mostly by firms in low-technology industries.

Scant is the presence abroad of medium-low technology companies, which account for a substantial portion of Italian manufacturing.

Bank of Italy surveys have found that, on average, firms with production abroad produce 9 per cent more value added per worker than other Italian firms. Their investment per worker is higher too. In medium-technology sectors, the outward relocation of production does not appear to affect employment in Italy or actually has a positive impact. In traditional industries, shifting part of production abroad is a defensive move; it reduces employment but enables the company to bear up under international competition.

Italian manufacturing industry employs some 5 million workers; in Germany the figure is twice as high, in France 20 per cent lower.

Most workers in Italy are employed in low-tech industries. The share of workers in textiles, leather products and footwear fell from 18.6 per cent in 2001 to 16.6 per cent in 2004. In France and in Germany the shares in 2001 were 6.5 and 3.1 per cent respectively. For Italy, the competitive pressure from the emerging economies is greater. It is essential to step up the response by improving the quality of output and increasing its creative content.

Medium-high technology products, including automobiles, account for 26 per cent of industrial employment in Italy, compared with 30 per cent in France and 42 per cent in Germany.

This is the sector that is the key to Germany's strong export growth.

Food processing, paper and printing and wood products account for 27 per cent of industrial employment in France, 22 per cent in Germany and 19 per cent in Italy. In Italy these industries have enjoyed productivity gains thanks to reorganization and restructuring, which have also improved product quality. Demand is chiefly domestic.

High-technology sectors account for 7 per cent of Italian industrial employment and 10 per cent of value added. In France the employment share is 11 per cent, in Germany 9 per cent, in the United States and Japan around 15 per cent.

International demand for technologically advanced products is growing much faster than for other goods. Given the quality and specific nature of these products, the elasticity of demand with respect to price is lower, and firms can obtain prices that permit adequate remuneration of the productive factors.

The slowness in modernizing the productive apparatus in medium-high technology sectors and the underdevelopment of high-tech industries are responsible for the slower growth in Italian productivity and competitiveness compared with industry abroad.

In March 2002 the European Council set an objective for R&D spending to reach 3 per cent of GDP by 2010.

Comparison with other countries shows that Italy is lagging behind.

The quality of some scientific research in Italy is very high by international standards.

Direct public-sector spending on R&D in the form of activities carried on in universities and research institutes is less than 0.6 per cent of GDP. In France and Germany it is about 0.8 per cent.

The comparison is even more unfavourable for the private sector.

In Italy private entities allocate 0.5 per cent of GDP to R&D; in France and Germany 1.4 and 1.7 per cent respectively.

Total spending on R&D amounts to 1.1 per cent of GDP in Italy, 2.5 per cent in Germany and 2.2 per cent in France. In the United States it is equal to 2.7 per cent and in Japan to 3.1 per cent.

The effectiveness of research in terms of the fallout for economic activity depends on the volume of expenditure; it is greatest in the largest firms and economies.

It is essential that synergies be created within the European Economic Area in order to give effect to the guidelines laid down by the Lisbon European Council.

The fragmentation of industry weighs upon the Italian economy, restricting its capacity for growth. Limited size is an obstacle to investment in research; it increases the difficulty of strategies to expand abroad and gain significant positions in international markets.

Even without counting sole proprietorships, 99 per cent of firms have fewer than 50 workers. Numerous newly created companies operate in high or medium-high technology sectors.

Drawing also on the experience of other major European countries such as France, Germany and Spain, action must be taken to reinforce the policies in favour of high-tech firms, in particular through public-sector contributions to start-up capital, the creation of consortiums, and incentives for technology transfers from public-sector research centres to productive activities. Productivity gains can be achieved by making greater use of intranet connections between firms within Italy and abroad.

The various tax incentives and other measures to improve competitiveness that have already been enacted, and the planned reduction in the regional tax on productive activities, can be of great assistance.

The banking system should support the most dynamic firms and promote the merger and consolidation of others by exploiting the information in its possession.

It is crucial that firms themselves should take steps in this direction.

Broader recourse to forms of venture capital is needed in order to foster initiatives in innovative sectors, in which the expected return is high, but also the attendant risk.

Employment

Between 2000 and 2004 GDP grew by 3.7 per cent; thanks to wage moderation and the introduction of new forms of flexibility, the number of people in work rose by 5.9 per cent.

In the absence of robust expansion in economic activity, less stable and less well-paid forms of employment have developed. The past decade has seen an increase in the number of fixed-term contracts. There are now 400,000 people working under coordinated and continuous collaboration contracts, equivalent to 2.4 per cent of total payroll employment; the Biagi Law makes provision for the transformation of such contracts into less precarious forms of employment. The number of part-time workers has increased, partly in response to the demands of the workforce itself; compared with the other major European economies, the proportion of such workers is still small.

The gap between entry wages and average pay has widened. The proportion of low-paid workers is estimated to be 18 per cent, with full-time employees accounting for 11 per cent and part-time workers for 7 per cent.

The cost of labour per employee has been kept down, but the entry of new workers in marginal activities has depressed productivity growth.

The incidence of the underground economy remains high, especially in the South.

As a result of greater female participation, 57.5 per cent of the working-age population is in employment, compared with 62.8 per cent in France, 64.3 per cent in Germany and 71.2 per cent in the United States.

The increase in employment has been concentrated in the Centre and the North.

In the South, compared with the mid-1990s there has been a resumption of migration of people with higher educational qualifications towards the central and northern regions. The drop in the unemployment rate in the last two years has been due to a contraction of the labour force; the difficult situation has discouraged young people and women from entering the labour market.

Between 1995 and 2004 employment rose by 17.8 per cent in the service sector, compared with 11.4 per cent in the economy as a whole. The increase in private services was 24.9 per cent; employment in industry remained virtually unchanged.

Starting from a lower level, public and private services in Italy are expanding at the same pace as in other advanced economies; the service sector is still not as developed as in France, the United Kingdom or the United States.

Business services continue to be relatively undeveloped in terms of employment, quality and productivity. Efficiency gains are possible in retailing. The fragmentation of supply and regulatory constraints affecting costs and employment weigh on the service sector as well.

In terms of value added, the sector's growth slowed after 2000 compared with the previous decade. The decline in industry's contribution to GDP growth was not offset in Italy by an adequate increase in that of services.

The growth rate of the Italian economy continues to be one of the lowest of all the advanced economies.

The public finances

The modest growth of the economy has weighed on the public finances in recent years.

In the period 1980-1993 primary current expenditure increased by 4.2 per cent per year in real terms; between 1994 and 2000 repeated interventions made it possible to keep the annual growth below 1.2 per cent.

In the last four years primary current expenditure increased by 2.4 per cent per year in real terms.

The growth in this aggregate continued to reflect long-term trends caused by legislation that was enacted in more favourable macroeconomic and demographic conditions.

Support was increased for several categories of citizens in difficult circumstances. Measures were also adopted to boost public investment and increase the role of private capital in infrastructure development. General government investment expenditure rose from 2.5 per cent of GDP in 2000 to 2.9 per cent in 2004.

The combined ratio to GDP of primary current expenditure and investment expenditure rose by 2.2 percentage points, partly in connection with the economic slowdown. The ratio of revenues to GDP fell by 0.6 points; excluding the effect of one-off measures, the fall was almost 2 points; the trend reflects the tax reliefs and concessions granted to firms and households in 2001-2004, for an annual average of €5 billion.

The situation with regard to the public finances remains difficult. The imbalances are of a structural nature and long-standing; they reflect negatively on the economy's potential for growth.

The substantial improvements recorded in the public finances in the 1990s were due to an increase in the taxation of firms and households and to the decline in interest payments associated with disinflation and participation in the monetary union. The containment of expenditure made a significant contribution; however, it also affected public investment.

Net borrowing in 2001, initially estimated at 1.4 per cent of GDP, is now calculated to have been 3.2 per cent.

Since 2002 the stagnation of the economy has aggravated the deterioration in the underlying state of the public finances; in 2004, with the help of one-off measures, net borrowing amounted to 3.2 per cent of GDP.

At the end of 2004 the ratio of debt to GDP was 106.6 per cent.

The premise for all effective action to restore more balanced public finances is a careful assessment of the state of the accounts, of the risks associated with the cost of the debt, of the consequent limits for stabilization policies, and of the difficulty of coping with the burden arising from the aging of the population.

High taxation, the uncertainty connected with the increase in the budget deficit and the insufficiency of infrastructure are a brake on investment and growth.

Corrective action must be based on structural reforms. Expenditure must continue to increase at the rate set in the last Finance Law. There is a need for measures to adjust the level and composition of revenue, progress in managing services, and the creation of a growth-oriented legal framework.

Structural reforms improve expectations, help to create a climate of confidence, increase the economy's potential for growth.

Banking

Last year was a good one for the banking sector in the leading countries.

In the United States bank revenues benefited from the further substantial increase in lending to households, the upturn in lending to firms, and higher commissions on services. Provisions for loan losses diminished. The return on equity was 13.3 per cent.

In the United Kingdom the return on equity of the leading banks was around 20 per cent. As in the United States, their profitability is boosted by large volumes of trading on the financial markets. The large increase in commissions on securities placement and asset management services was accompanied by a smaller rise in interest income.

In Japan the banking system is engaged in strengthening its capital base. The proportion of bad debts decreased, particularly among the large banks.

The euro-area banking sector also achieved good results. Lending grew by 6.3 per cent, one point more than in 2003. Profitability continued to improve among the leading banks as a result of reductions in operating costs and provisions for loan losses. The satisfactory results of the French and Spanish banking systems were accompanied by an improvement in those of the main German banks, which had performed poorly in previous years.

In Italy the return on equity of the banking system rose by 4 percentage points to 10.7 per cent.

The financing of the economy

The new financing provided to all the domestic sectors in Italy, in the form of bank loans, bond and share issues and other instruments, amounted to €163 billion in 2004. The public sector absorbed €51 billion, households €45 billion. The funds raised by firms, including finance companies, totaled €67 billion.

The hesitant growth of investment since 2001 has limited the demand for financing. Bank lending to firms rose by 3.5 per cent in 2004.

Loans to smaller firms continued to grow briskly; lending to production units with fewer than 20 workers, which account for about half the employment in industry and services, increased by 5.7 per cent.

Credit to firms based in the South of Italy expanded by 7.8 per cent.

The economy's growth difficulties were not reflected in a deterioration in loan quality. On average, between 2001 and 2004 new bad debts were equal to 1 per cent of loans outstanding at the beginning of each year. The ratio was about 4 per cent in the recession of the early 1990s and remained above 2 per cent until 1996.

The improvement in loan selection techniques has helped to contain credit risks. Prospectively, however, the quality of bank assets depends on the economy's returning to rapid and sustained growth.

Bank lending to households increased by 15.8 per cent, which was almost 5 percentage points more than in 2003 and twice the increase for the euro area. Demand for home mortgage loans was strong; consumer credit continued to expand at a high rate.

The growth in lending to households in recent years is ascribable to the low level of interest rates, developments on the supply side and fiercer competition. At the end of 2004 the annual percentage rate of charge on new home mortgage loans was 3.8 per cent, in line with the conditions prevailing in the euro area.

Household debt rose from 32 per cent of disposable income at the end of the last decade to 36 per cent in 2003. The ratio remains low by international standards; it is 61 per cent in France, 92 per cent in Spain, 104 per cent in Germany, 107 per cent in the United States and 129 per cent in the United Kingdom.

The expansion of financial assistance to households offers the banking system opportunities for growth. The ample possibility of obtaining credit requires households to be fully aware of the effects of interest rate movements on the obligations they assume.

The Italian banking industry

A stable, efficient, competitive financial system bestows security and value on the savings entrusted to it. It increases the country's growth potential.

The share of total value added attributable to financial intermediation services is equal to 5.5 per cent, in line with the figure for the euro area. The sector gives work to almost 600,000 persons, or 3.2 per cent of all payroll employees; some 340,000 are employed in the banking industry.

The fundamental role of the banking system is to meet the needs of the productive sector, to support it during cyclical downturns and accompany it during phases of expansion and growth.

Since the middle of the 1990s the Italian banking industry has carried out far-reaching consolidation; profitability has increased in connection with the expansion of the range of products and services, the lowering of operating costs, the containment of risks, and entry into fast-growing markets.

Significant productivity gains have been achieved. Between 1995 and 2004 total assets and value added per employee grew respectively by 4.6 and 2.4 per cent per year at constant prices.

At the end of 1994 there were 994 banks. The five largest groups accounted for 33 per cent of total assets.

Encouraged by the Bank of Italy and under the growing pressure of competition, the process of consolidation through mergers and acquisitions has been particularly intense in the last ten years, also by comparison with the other member states of the European Union and all the leading industrial countries. Mergers and acquisitions numbered more than 450 and involved target banks with 42 per cent of the system's total assets. During the decade 231 new intermediaries began to engage in banking.

At the end of last year there were 778 banks. The market share of the top five groups had risen to 51 per cent, in line with the European average.

There are 60 branches and 15 subsidiaries of foreign financial institutions established in Italy, accounting for about 8 per cent of the banking system's total assets. They hold much larger market shares in interbank transactions, securities trading on the wholesale markets, securities portfolio management and corporate financial services. Foreign intermediaries hold approximately one quarter of the consumer credit market.

Between 2000 and 2004 foreign banks handled more than 70 per cent of the value of the 212 Euromarket issues by Italian non-financial corporations.

The Italian banking system has increased its presence beyond the nation's borders. Twenty-five groups are established abroad, with 150 branches and subsidiaries. The expansion is significant in countries that recently joined the European Union and in those that are candidates to become members soon; in some countries, substantial market shares have been acquired in competition with other important European banks.

The reorganization of the system has gone hand in hand with a considerable increase in competition.

Econometric studies by the Bank of Italy indicate that the efficiency gains achieved by banks following concentrations have largely translated into more favourable interest rates for households and firms.

The geographical diffusion of banks has been increasing in both the Centre and North and the South; customers can choose from a wide range of suppliers.

Since the entry into force of the Antitrust Law in 1990, the Bank of Italy has examined about 750 transactions involving reorganization and consolidation; in 23 cases investigations were conducted, many of them ending with the imposition of measures to prevent the creation of positions harmful to competition. In addition, 28 potentially anti-competitive agreements were investigated and 5 cases of abuse of dominant position.

Agreements regarding prices, the division of markets, the exchange of information and uniform model contracts have been examined. A major effort is devoted to analysis of the supply conditions of payment services.

All the decisions have been adopted taking account of the prescribed opinions and in constant, fruitful cooperation with the Antitrust Authority.

The progress made by the Italian banking system in terms of efficiency and capital adequacy has been recognized by the main international organizations. The most recent revisions of the credit ratings assigned by the rating agencies to the leading banking groups have been upgrades.

In the three years 2002-2004 there was an improvement in the supervisory ratings assigned by the Bank of Italy on the basis of banks' financial reports. In the same period full inspections were carried out at 541 banks representing 52 per cent of the system's total assets, a share similar to that of the 518 banks inspected in the previous three years. Unfavourable evaluations declined from

23 to 16 per cent of the total and regarded intermediaries with 1.5 per cent of the system's total assets. In the three years 2002-2004 inspections were also made of specific operational areas in another 16 banks with 10 per cent of total assets. Unfavourable findings were reported in 5 of these cases.

In the first half of the 1980s banks had assisted the shift in the composition of households' financial wealth from deposits to government securities. In recent years, while firms' recourse to direct financing in the markets was growing, banks extended their activity in securities placement and trading, in part to satisfy customers' demand for relatively high-yielding securities.

In several cases banks' procedures for identifying and handling conflicts of interest and their compliance with the disclosure and transparency requirements of the legislation on investment services proved inadequate.

Banks must inform savers correctly and advise them prudently; they must evaluate the suitability of the products offered in the light of investors' declared needs and financial means. It is up to the customer to choose the most appropriate combination of risk and return on investments.

Further determined steps need to be taken by banks to improve the quality of the services they supply and to keep down the costs of retail services and the fees charged.

In cooperation with the Antitrust Authority, the Bank of Italy has initiated an investigation of the costs of closing bank accounts, with the aim of assessing whether the conduct of intermediaries limits customer mobility.

Compliance with the rules on the transparency of banking services is checked at individual bank branches by the Bank of Italy's branches. In the three years 2002-2004 checks were made at 2,536 branches of 224 different banks; 109 banks were ordered to eliminate anomalies and 23 received sanctions.

It is essential that banks attach strategic value to improving customer relations. The strengthening of confidence in intermediaries' correct conduct contributes to the continuity of relationships, prevents disputes and limits reputational risk.

The new legislation on the protection of savings is now being finalized in Parliament after extensive debate.

Bank ownership

The share of total assets attributable to publicly owned credit institutions has fallen from 70 to 9 per cent since 1992.

A distinctive feature of the Italian banking system is its presence on the stock exchange: listed banks account for 77 per cent of the system's total assets; in the other main countries of continental Europe the figure is between 40 and 50 per cent.

The privatization process was completed in just a few years, despite the underdevelopment of institutional investors such as pension funds and, more in general, the shortage of resources available for strategic investments in bank equity. The banking foundations undertook to form stable core groups of shareholders. Compliance with the separation between banking and industry was ensured in placing the equity holdings.

The contribution of foreign financial intermediaries to the formation of controlling ownership arrangements has been considerable and has increased in the course of time. Foreign banks and other foreign investors today hold an average of 16 per cent of the capital of the four largest Italian banking groups. In Germany, France and Spain, the participation of foreign investors in the capital of the four leading national groups is equal to 7, 3 and 2.6 per cent respectively.

Institutional investors and insurance companies, which by their nature have long-term investment horizons, play a prominent role in the ownership structures of the main European banks. In Italy, the share of the capital of the top four banking groups held by Italian and foreign insurance companies is limited, amounting to 4.7 per cent; for the top ten groups it is 4.4 per cent.

The hoped-for growth of pension funds, in connection with the reform of public pension provision, is of great importance for the Italian financial system; it can also increase the resources allocated to strengthening the capital of banks. This will make a greater supply of credit available to the economy.

Control of a company can be acquired in different ways. Economic agents choose the most appropriate, in compliance with the procedures laid down by the legal system to protect the numerous public and private interests involved.

The Italian legal system, like others in Europe, specifies the cases in which exceeding a given threshold in the capital of listed companies triggers the obligation to make a public tender offer.

The decision shareholders take regarding acceptance of the offer may reflect the intention to realize short-term gains or instead the desire to share in formulating and evaluating the company's business strategies.

In view of the special nature of banking, the legal systems of the developed countries contain specific rules for the transfer of the ownership of banks.

In Italy, in conformity with the relevant Community directives, the law is designed to safeguard the sound and prudent management of credit institutions. Persons who intend to acquire control of banks or major holdings in their capital must comply with clearly-defined disclosure requirements and obtain the necessary authorizations.

The criteria and procedures used for supervisory evaluations take account of the proposed methods for making acquisitions. They are neutral with respect to the nationality of the interested parties.

If the entity intending to acquire the equity interest is an EU bank, Community law provides for prior consultation with the supervisory authorities of the country in which it has its registered office. When the applicable conditions are met, the transaction is subject to approval by the European Commission as regards the protection of competition.

The Bank of Italy's analysis of applications for authorization takes account of the situation of the applicant, the purpose of the acquisition and the state of the target company. If the buyer is an Italian bank, consideration is given to the adequacy and feasibility of the plans for obtaining the necessary capital resources, with a view to compliance with the prudential rules. The time required to grant authorizations depends in part on the size of the proposed investment and the availability of information on the applicant's assets and liabilities and financial position.

The Bank of Italy's independence in the performance of its supervisory functions and the transparency with which it discloses the principles and criteria of its controls have regularly been recognized by international institutions.

Information concerning supervisory matters is covered by professional secrecy. This can be waived in the cases which have been explicitly provided for.

The role of banks

The return on equity of the banking system was 10.7 per cent in 2004; profits amounted to €11 billion. Revenues remained basically unchanged compared with the previous year; there was a further reduction in operating costs and loan loss provisions diminished.

Preliminary data indicate that this year's results for the first quarter are in line with those recorded in 2004.

The improvement in profitability has helped to strengthen the banking system's capital base. Supervisory capital has risen to €149 billion; it is equal to 11.6 per cent of the system's risk-weighted assets, compared with 10.1 per cent in 2000. The gap with respect to the average of European banks has narrowed in the last few years and is now about 1 percentage point.

Bank credit continues to be of fundamental importance for Italy's economy, partly owing to the still limited development of the capital market. For small and medium-sized enterprises, which make up the bulk of Italian industry, bank credit accounts for approximately 70 per cent of their total external financing.

Some of the major banking groups have established banks dedicated to the financing of firms, especially small and medium-sized ones. The banks that operate at the provincial and regional levels have strengthened their positions.

In just a few years all the different types of investment funds provided for in the Consolidated Law on Finance have become operational. But demand for innovative corporate finance services is slow in emerging.

The Italian economy is contending with particularly intractable problems of growth. Industry's loss of competitiveness is essentially of a structural nature. Firms in difficulty risk being shut out of the market. Recourse to the Wage Supplementation Fund is increasing; employment is stagnant.

In this difficult transition of our economy the support of the banking industry is of fundamental importance. It is necessary to nurture new initiatives in high-tech sectors and investment in R&D.

The banking system must encourage the opening of firms' capital to investors able to increase and redirect productive capacity. It must foster the growth of firms and assist them in the necessary task of expanding abroad in order to defend and regain shares of the international market.

Ladies and Gentlemen,

In the United States GDP grew at an annualized rate of 3.5 per cent in the first quarter. Productivity and employment rose further.

Forecasts indicate growth in 2005 and 2006 in line with that of potential output, which is estimated to be of the order of 3.5 per cent per year.

The increase in interest rates that the Federal Reserve has embarked on will slow down the growth in the money stock; intended to curb inflation expectations, the rise has not had an adverse effect on medium and long-term interest rates, which remain at moderate levels in all the main markets, thus encouraging investment and consumption.

The US expansion will have positive effects on the other advanced economies and on the emerging economies.

In Japan GDP is expected to grow by 1.5 per cent in 2005 and faster in 2006. The growth of the newly industrialized Asian countries continues at a rapid pace.

World trade in goods and services is set to expand by about 7 per cent this year.

The growth of the euro-area economy will be slower than in 2004; it will continue to be well below that of potential output, which is estimated to be 2 per cent.

Europe is faced with a slowdown in population growth. Aging affects the ability to innovate, reduces the growth in consumption and investment; it will cause the costs of health care, assistance for the elderly and pensions to rise.

Reforms to lengthen people's working lives and rationalize the organization of health services will have to be enacted.

Tax policies and services aimed at improving the conditions of less well-off households and encouraging births and schooling are indispensable in a medium-term perspective, to prevent a reversal of economic growth and social development. An increase in immigration is inevitable; policies are necessary both to regulate the flows and to promote integration.

Industrial production in Italy has fallen by more than 5 per cent since 2000; in the other euro-area countries it has risen by 4 per cent.

The divergence has been clearly visible since the middle of 2003; whereas industrial output recovered in France and Germany, in Italy it began a fall that became more pronounced in the second half of last year. In the first four months of this year industrial production was 2.7 per cent less than in the first four months of 2004.

Manufacturing industry is suffering from a progressive loss of competitiveness, primarily as a consequence of the lack of productivity growth. The fall in output also has implications for the service sector.

Despite the substantial expansion in world trade, Italy's exports in 2005 will be at the same level as in 2004. In the five years since 2000 they will have recorded no growth in volume terms.

The Bank's annual survey of the spending plans of industrial and service firms with 20 or more workers points to a reduction of 3.6 per cent in investment at constant prices in 2005. In the service sector the fall of 5 per cent in 2004 appears set to be followed by another contraction this year.

Investment in public works in the first few months of this year remained at the level of a year earlier. The expansion in activity expected as a result of legislative changes and the increase in tenders has not yet occurred; in addition to difficulties in the decision-making process, firms report delays in the disbursement of funds.

Consumption is expected to grow by about 1 per cent, in line with the preceding years.

The increase in employment is faltering.

The growth in gross domestic product in 2005 will be virtually nil.

A slight recovery in the second half of the year, fostered by economic policy measures, will permit a return to growth in 2006.

On the basis of current trends, general government net borrowing in 2005 will be of the order of 4 per cent of GDP, compared with the Forecasting and Planning Report figure of 2.7 per cent, based on the hypothesis of 2 per cent growth in GDP.

The Italian economy has weaknesses which, if not overcome, could compromise its growth in the medium term.

Correction of the trend of public current expenditure, reform of the taxation of business and labour, a crackdown on tax evasion, and a significant reduction in public debt in relation to GDP are the prerequisites for raising the potential growth rate of the economy.

Action is required by firms aimed at growth in size, technological innovation and the development of new products.

Business must be encouraged by the prospect of a macroeconomic environment of stability and growth and by specific measures at the sectoral level. An increase in competition within industry and services is necessary.

The participation of the social partners in reviving growth is indispensable.

Thanks in part to its recent strengthening, the banking industry will continue to provide the resources the economy needs.

There has been substantial growth in lending to small businesses, especially those located in the South; support has been provided to large firms in difficulty.

In Italy – as and more than in the United States, France and Germany – the extensive presence of small and medium-sized businesses calls for large banks to be flanked by others focused on the local economy while not neglecting the opportunities offered by globalization.

But finance cannot replace the entrepreneur in pursuing innovation, developing projects and raising productivity.

Italy's endowment of public capital remains small. In many economically advanced regions the basic transport infrastructure is inadequate; in the South the supply of electricity and the distribution of water are also insufficient.

It is necessary to make good the delay in implementing the major initiatives linked to the fast track for public works. With the completion of the legal framework for project financing, large-scale participation of private capital will be possible. The efforts of public entities, including regional and local authorities, can create the conditions for an increase in investment in 2006 and 2007.

Sufficient and modern infrastructure is indispensable for the growth of tourism, a sector in which Italy enjoys a comparative advantage thanks to its exceptional endowment of cultural and environmental assets. In the South the tourist industry is well below its potential.

Further liberalization and modernization in the service sector will contribute to raising productivity and employment. Advanced business services are relatively undeveloped in quantitative terms, partly owing to the lack of demand. It is necessary to proceed with the reorganization of public administration.

Thanks to low interest rates and a large volume of medium and long-term lending, domestic demand has been buoyed in the last four years by investment in construction.

The difficulty of exporting and the decline in productive investment hold back demand in the short run. The growth in gross domestic product remains far below the already modest increase in potential output.

It is necessary for planning and infrastructure investment in large cities to stimulate a rapid revival in demand. The measures to foster competitiveness may provide an incentive for private investment.

Italy has faced and overcome difficult periods in its history, recently as well, thanks to the efforts of governmental and institutional bodies, the initiatives of the business community and the convinced cooperation of society.

The poor performance of the economy has adverse effects on the population's attitude towards institutions, those who govern and their plans.

The recent political developments in important countries of the European Union must strengthen the commitment to achieving faster economic growth in the continent in which we feel integrated by common cultural and civil roots.

It is necessary to give the European institutions a basis of democratic legitimation and representativeness, apply in full the principle of subsidiarity which the founding fathers made a cornerstone of the Treaty of Rome. More than a redoubling of rules, it is necessary to capitalize within a unitary framework on the differences and capabilities of the individual countries and economies.

We must regain confidence. Politics, institutions, forward-looking entrepreneurs and the social partners must react, achieve consensus on realistic goals of general interest, strive to return, in an international economic context that remains basically favourable, to the path of economic growth and civil development.