

ACRI
Association of Italian Savings Banks

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Address by the Governor of the Bank of Italy
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1. The international economy

The tone of the world cyclical situation is basically determined by the performance of the economy in North America on the one hand and in the emerging Asian countries on the other.

In the United States GDP grew by 3.6 per cent on an annual basis in first half of the year; in the third quarter it expanded by 3.8 per cent, notwithstanding the natural disasters that hit the Gulf of Mexico.

Business investment continued to expand at a rapid pace, particularly on information technology. The growth in private consumption also remained strong; the dampening effects of the rise in energy prices were offset by the favourable impact of increased employment and higher wages and salaries. Spending also continued to be sustained by a further increase in the value of real estate. The household savings rate turned slightly negative in the summer.

Overall, the natural disasters had limited repercussions on growth. It is estimated that GDP will grow by at least 3.5 per cent this year, compared with 4.2 per cent in 2004.

Reconstruction, for which Congress has already approved appropriations totalling \$62 billion, equal to 0.5 per cent of GDP, will provide a stimulus for economic activity next year.

The rise in energy prices has lead to a significant increase in inflation, which reached 4.7 per cent in September.

During 2005 the Federal Reserve has raised the federal funds target rate on six occasions for a total of 1.5 percentage points, bringing it to 3.75 per cent. The monetary authorities plan to pay very close attention to price and cost developments to prevent inflationary impulses from spreading through the economy and undermining expectations. Unit labour costs have been accelerating since the middle of last year.

An important positive development, due to higher-than-expected fiscal revenues, is the reduction in the federal deficit; in the fiscal year ending in September the deficit amounted to 2.6 per cent of GDP, compared with 3.6 per cent in 2004. In 2006 it is expected to remain close to this year's level.

The imbalance on the external current account continued to grow; inflows of private capital accelerated, however, making it easier to finance the deficit.

The dollar has appreciated with respect to the end of 2004. The euro has depreciated by 11 per cent against the dollar and by 5.7 per cent in nominal terms.

China's economy has continued to expand rapidly, growing by over 9 per cent. In India, GDP growth is forecast at 7.1 per cent in 2005. In the other emerging economies of the Far East and Southwest Asia as a whole growth is expected to be around 4.5 per cent this year.

In Japan GDP returned to significant growth in the first half of 2005, mainly under the impetus of the strong recovery in domestic demand; employment increased. The industrial system has regained efficiency as a result of the extensive restructuring under way since the end of the 1990s. The deflationary phase is expected to come to an end during 2006.

The good economic performance of the US economy influences the economies of Canada and Latin America; all the major countries in the area will record rapid growth again this year.

The International Monetary Fund estimates that world GDP, calculated on the basis of purchasing power parities, will grow by 4.3 per cent in 2005.

Compared with the crisis of the 1970s, the negative effect on economic activity of the rise in the price of oil has been generally limited, as all the major economies have become less energy intensive. Since 2000 the price of crude oil has risen by 70 per cent in real terms, mainly owing to the rapid expansion in economic activity. A reasonable degree of certainty about the trend of prices in the medium term is essential for investment intended to increase supply.

2. The euro area and the Italian economy

In the euro area output continued to grow at a modest pace in the first six months of 2005, expanding by just over 1 per cent on an annual basis. Economic activity was sustained by domestic demand, in particular consumption. Foreign trade made a negligible contribution, despite benefiting from the depreciation of the euro; export growth, which was confined almost exclusively to Germany, was offset by the expansion in imports. Euro-area competitiveness in the world market and the internal market remains a serious problem.

In the first half of the year the pace of growth slowed slightly. In France and Germany an acceleration in the first quarter was followed by stagnation in the second.

In 2005 euro-area output is expected to grow by 1.2 per cent, compared with 2.1 per cent last year. In October twelve-month inflation was 2.5 per cent, driven by the rise in the prices of oil and other raw materials; it reached 2.4 per cent in France in September and 2.6 per cent in Germany in October.

In Italy economic activity, which had already fallen sharply in the last part of 2004, continued to decline in the first quarter of 2005 as a result of the further large contraction in exports. In the second quarter GDP returned to growth, increasing by 0.7 per cent; the reversal of trend was caused mainly by exports, which increased in real terms by 5.5 per cent with respect to the previous quarter, after contracting by almost 5 per cent in the fourth quarter of 2004 and again in the first quarter of 2005.

The improvement in the economic situation in the second quarter was largely due to the contribution of domestic demand. Household consumption rose by 0.6 per cent, mainly reflecting purchases of durable goods.

Gross fixed investment turned positive, growing by 1.5 per cent after a series of declines beginning in the second half of 2004.

The investment recovery was especially strong in the construction sector, particularly residential building. By contrast, investment in public works has tended to decline by comparison with 2004.

The upturn in economic activity in spring was accompanied by an increase in employment of 0.3 per cent with respect to the previous quarter. A significant part of the large rise in employment since 2003, amounting to 3 per cent overall, is due to the reporting of previously undeclared work by non-EC immigrants following regularization measures. National accounts data, which contain an estimate of undeclared labour, indicate a smaller increase.

The unemployment rate, calculated on the basis of the new labour force survey, continued to fall, reaching 7.8 per cent on a seasonally adjusted basis in the second quarter. The decline in the labour market participation rate, particularly among women in southern Italy, was a contributory factor.

During the summer consumer price inflation, measured by the national index, increased owing to the surge in energy prices. In October the twelve-month rate of

increase in prices was 2.2 per cent. As regards unregulated prices, in September the twelve-month increase for non-food and non-energy products and services slowed slightly.

3. The financial markets, banks and firms

The increase in the external current account deficit of the United States and in the surpluses of the oil-exporting countries and China has been accompanied by an increase in the supply of dollars and an excess of saving with respect to investment capacity. The liquidity of the countries with structural surpluses has poured into the international financial markets, helping to reduce the level of interest rates.

In the euro area, where inflation expectations remain low, ten-year government bond yields have come down during the year. In the United States the yields on ten-year Treasury securities have fluctuated around historically low levels.

Real long-term interest rates, implicit in inflation-indexed securities, currently stand at around 1.3 per cent in the euro area and 2 per cent in the United States.

The profitability and improved balance sheet situation of firms have helped to support the prices of corporate bonds and equities both in the United States and in the euro area. Since the start of 2004 share indices in the United States have risen moderately, though with sharply differing sectoral performances. In the euro area they have scored sharp gains, benefiting from the fall in real long-term yields. In Japan too the stock market has risen appreciably.

In the banking sector, the positive trend recorded in all the main industrial countries last year has been confirmed in 2005.

In the euro area, lending to households has continued to expand at high rates, especially loans for house purchases. Credit demand from firms has also increased, in connection with the upturn in mergers and acquisitions involving non-financial corporations. The rapid growth in lending has sustained banks' income, albeit with marked differences among the leading countries.

In Italy, in the phase of recovery now beginning to take shape, lending conditions remain easy for all categories of customer.

In the first nine months of 2005 the growth in bank lending accelerated to 8.7 per cent, from 6.7 per cent in the year-earlier period. This was partly the result of loans to some large groups in connection with corporate restructuring. Bank lending to smaller firms also accelerated. The interest rates on loans fell marginally from their already very low levels.

Lending to manufacturing companies began to grow again in the branches where production was strongest. There was a substantial increase in lending to service and construction companies.

Continuing a trend under way since the end of the last decade, the increase in lending to businesses was concentrated in the medium and long-term component. At the end of September, 59 per cent of outstanding credit had an original maturity of more than one year, compared with 47 per cent in 1997.

In the South of Italy bank lending has continued to expand at a considerable pace this year. In September the twelve-month rate of growth in lending to firms was 9.9 per cent in the South, compared with 6.4 per cent in the rest of the country. The difference reflects the limited self-financing of southern firms; the decline in some forms of public transfers may also have been a factor.

Lending to households has shown very strong growth. In the twelve months ending in September it increased by 15 per cent, almost double the euro-area average.

Loan quality has not been affected by the long phase of sluggish economic growth. In the twelve months to September new bad debts amounted to 0.8 per cent of the total. In addition, loans worth 1.7 per cent of the total were classified as exposures to customers in temporary difficulty. These figures are in line with those recorded last year and are low by historical standards.

In the first half of 2005 Italian banks' return on equity, calculated on the basis of accounts not consolidated at group level, was equal to 10.8 per cent, compared with 9.9 per cent in the first half of last year and 9.5 per cent in 2004 as a whole. The improvement in profitability was accounted for by the decrease in net value adjustments to assets.

At the end of 2004 the Italian banking system's supervisory capital amounted to €149 billion on a consolidated basis, 7 per cent more than a year earlier. The solvency ratio had risen slightly to 11.6 per cent, from 11.4 per cent at the end of 2003.

An essential role is played by banking foundations, which hold 19 per cent of the capital of listed banks.

4. The outlook

The world economy is expected to maintain a high rate of expansion in 2006. According to the IMF, world trade will grow by around 7 per cent.

In the United States, growth is expected to be only slightly less than that estimated for 2005. In Japan, the increase in GDP is forecast to remain at this year's

level of about 2 per cent. In China, economic activity is expected to expand again by 8.2 per cent, and in the other emerging Asian countries as a group by nearly 6 per cent.

In the euro area too, since the summer economic conditions show signs of improving.

In August, euro-area industrial production rose by almost 1 per cent with respect to the previous month, reflecting the recovery in France, Spain and Italy. More recent survey data on the individual countries confirm the positive signals. In October business confidence strengthened, especially in Germany.

In Italy, the index of industrial production rose in August by 1.3 per cent with respect to July, and despite an estimated decline in September apparently gained around 1 per cent in the third quarter as a whole. GDP is estimated to have increased by about 0.5 per cent in the quarter.

The survey conducted by the Bank of Italy branches on a sample of firms in industry excluding construction and in services and the monthly ISAE survey of industrial firms in October show an improvement in the economic situation compared with the first half of the year. The index of household confidence also registered a healthy increase in October.

The growth in output in 2005 should be slightly positive with respect to last year. Exports are expected to be flat for the year as a whole, recouping the decline recorded late in 2004 and early in 2005. Given forecast growth of 7 per cent in world trade, Italy's market share is expected to decline further to 2.7 per cent, compared with 4.6 per cent ten years ago.

Households' propensity to save is likely to show a further increase, reflected also in their consumption decisions.

Action is necessary to ensure that pension funds take off in 2006 on the basis of the draft legislation, whose speedy approval would be opportune. Besides providing better protection of retirement savings, they will also sustain markets and investment.

In the second half of the year total gross fixed investment is expected to make up for the drop recorded in the first quarter and thus to be basically unchanged in 2005 as a whole. Investment in machinery and transport equipment is down, in connection with the persistence of ample spare capacity; while spending for construction, above all residential building, is up.

5. The structural problems

In the past decade high taxation, the backwardness of physical and intangible infrastructure and the inefficiency of public services have impeded the modernization of the production system. The fragmentation of the business sector into many small firms was accentuated. Technological innovation was slow. Product specialization failed to meet the challenges of the new international context.

In Italy the contribution to total value added from high-technology activities, essentially ICT and biotech, is small. Middle-technology industry is also in difficulty, suffering a 15 per cent fall in output since 2000.

The price competitiveness of Italian goods continues to be undermined by the unfavourable trend in unit labour costs due to inadequate productivity growth. Between 2000 and 2004 unit labour costs in Italy rose by 13 per cent, or 16 points more than in Germany and 9 points more than in France.

The modest expansion of economic activity and the sharpening of competition have affected firms' earnings. The decline in profits has been significant, especially in

manufacturing and among smaller firms. Since 2001 there has been steady increase in resort to the Wage Supplementation Fund.

The banking system has provided support to industry, financing substantial corporate restructuring, but the low rate of capacity utilization has impeded investment.

Public investment has lent significant stimulus to economic activity in recent years, expanding from 2.5 per cent of GDP in 2000 to 2.9 per cent in 2004. Investment by the State Railways, not counted as public investment, rose from 0.3 to 0.6 per cent of GDP over the same period.

According to the Bank of Italy's twice-yearly survey of a sample of 500 medium-sized and large firms, public works activity, which increased by 5.3 per cent in 2003, slowed its expansion in 2004. In 2005 it has contracted and is projected to decrease by 5 per cent for the year.

An adequate impulse to activity in this sector is essential in order to help sustain the business cycle in the next few quarters and to overcome the serious shortcomings of Italy's infrastructure.

Action, including extraordinary measures and procedures, is needed to accelerate the opening of public works projects that have been approved and in some cases to prevent projects already under way from being brought to a halt.

Industrial production, which had expanded during the summer months, weakened in September and again in October, according to preliminary estimates.

In the years to come, as well, despite the limited financial resources available, economic policy must provide for measures that can effectively improve productivity and competitiveness.

In my observations on the Finance Bill I noted the worth of the measures, though limited, to reduce the cost of labour. An interesting provision involves the possibility of revitalizing Italy's industrial districts by giving them independent legal and functional status. The Fund for Technological Innovation designed to further the Lisbon Agenda can help reinforce competitiveness.

Unflagging commitment is also necessary on the part of firms and agents outside industry, in such sectors as tourism, business services and the promotion of the cultural and environmental heritage.

Confidence has to be instilled. The budget policy embodied in the Finance Bill involves strict containment of the expenditures of central government and of transfers to local authorities. This should be accompanied by gains in efficiency in administration and in public services.

Excluding temporary measures, net borrowing has been running at 5 per cent of GDP for several years now and the borrowing requirement net of privatization receipts at about 6 per cent. Such levels are an obstacle to reducing the debt-to-GDP ratio, which turned back upwards in 2005. Achieving the net borrowing target for next year is essential. Adjustment of the public finances requires constant monitoring of trends in revenues and expenses.

An increase in confidence, which can be inspired by the economic policy approach adopted, can amplify the incipient recovery in investment. Growth in 2006 should exceed 1 per cent.

The banking system is in a position to supply the means for a more vigorous expansion of economic activity. In recent years it has been developing successfully. Progress is needed in the options offered to customers, in particular in services and in asset management, and in innovative investment support procedures such as project financing. We are following Parliament's work for the protection of savings with attention and respect.

In order to further the upturn in economic activity and the prospects for growth it is necessary to adapt product specialization while at the same time achieving a durable adjustment of the public accounts. Perceiving the signs of an improvement in the economy and successfully achieving higher growth is also a way of favouring debt reduction.

Cohesion among the social partners and the commitment of firms, the political system and institutions will help to overcome this difficult phase for our economy. A high rate of growth is within our reach. Our resources of saving, wealth and human capital can bring it within our grasp.