BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 30 MAY, 1987

THE GOVERNOR'S CONCLUDING REMARKS

BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 30 MAY 1987

THE GOVERNOR'S CONCLUDING REMARKS

THE GOVERNOR'S CONCLUDING REMARKS

I prefaced my remarks to last year's General Meeting by recalling the breadth and intensity of the transformation taking place in both the Italian and international economy and by inviting the credit system and the Bank of Italy to re-examine their functions and review their methods of performing them.

Innovation and change continued to stir up the financial markets in 1986; the financial system's awareness of the problems increased, as did its determination to face and resolve them. Action has now been set in motion to strengthen the existing financial structures and to define and create new ones in what will have to be a long-term programme aimed at achieving objectives that reach beyond the present decade.

Logical time and chronological time do not always coincide. This lack of synchronism conjures up the year 2000, not because it can be expected to produce extraordinary events but because there is a discrepancy between the real world and the institutions in our field too and because we recognize it is up to us to eliminate this discrepancy by modifying institutions and their environment.

Such divergences are part of the evolutionary process, with everyday reality continually influencing institutions and vice versa; however, if one phase in the sequence is delayed, there is a danger that the whole process of advancement will come to a halt. The banks, which are still the linchpin of financial intermediation, are called upon to make a decisive contribution to the development of new instruments, institutions and markets. At the same time, they must grow stronger and reorganize to face the pressures of competition, which are being accentuated by financial innovation and European integration.

The Bank of Italy and the banking system are not alone in facing this challenge. Interest in the problems of finance has never been keener among academics, businessmen, the public and members of Parliament. The debate has been frank and thorough. More than ever before, the central bank has been called upon to explain and argue its views on the structure of the credit system and monetary management and to reconsider its position even when this is based on many years of analysis and experience.

In its own organization, the Bank of Italy is taking action that should increase the effectiveness of monetary and exchange rate policy, make its interventions in the credit system more incisive, raise the standard and reliability of banking services offered to the public, especially in the payments system and securities trading, and exploit the benefits of greater integration between the Bank's central and regional offices.

New operational arrangements, the more widespread use of high-technology equipment, the coordination of decentralized data processing projects and steps to diversify and enhance the experience of the staff are the main internal objectives the Bank is seeking to achieve.

The ability of managers at head office and in the branches, the professional competence of the staff and their sense of commitment and dedication assure success in this endeavour.

The world economy

Economic activity in the industrial countries

The rate of economic growth in the industrial countries slowed down from 3 per cent in 1985 to 2.4 per cent last year and continued to diminish in the first few months of 1987. The main impact of the fall in oil prices was on the rate of inflation, which declined by around three percentage points last year. Those who had believed that the slowdown in inflation and the decline in interest rates on their own could restore sustained growth were disappointed. Domestic demand proved insufficiently strong and the worsening of the trade balance with developing countries in volume terms offset the expansionary effect of the improvement in the terms of trade.

The acceleration in private consumption contrasted with a slowdown in public consumption and investment, especially the latter, which has been discouraged by the prospect of a weak expansion in demand and by the existence of idle capacity, despite the corporate sector's improved profitability. Uncertainty about the future behaviour of exchange rates and fears that protectionism might block access to important markets had a further dampening effect. These factors and the continuing high level of real interest rates have raised the yield threshold for new investment.

Even though growth was slower than expected, the stance of fiscal policy in the industrial countries as a whole was restrictive in 1986.

Steps to bring about the necessary reduction in the US budget deficit have not been matched so far by adequate reflationary measures in the other major countries, where concern prevails about the potential dangers of expanding demand more vigorously by boosting public expenditure; they doubt whether budgetary measures can be used to stimulate activity without causing an irreversible increase in the budget deficit.

At a time when domestic demand in the United States and the developing countries is being depressed by balance-of-payments constraints, the inability of Europe and Japan to boost world trade is heightening the risk of stagnation in the world economy.

More than 30 million people are without work in the industrial countries. Unemployment has decreased in North America, but in Europe it remains at rates of around Il per cent and in Japan it is rising, though still at a low level.

In the United States the deficit on the current account of the balance of payments reached $141 billion last year. The terms of trade improved, since the depreciation of the dollar was more than offset by the fall in the price of oil and other imported raw materials. The worsening of the deficit occurred in the real trade balance and was due to stagnation in the volume of exports at a time when imports were increasing rapidly. Signs of an improvement appeared in the autumn, but since the depreciation of the dollar is now feeding through to the terms of trade, the deficit is expected to narrow only marginally in value terms in 1987.

The exchange rate of the dollar has changed substantially over the last two years. Yesterday it was quoted at 144 yen and DM 1.82, whereas in February 1985 it had touched peaks of 263 yen and DM 3.47. The exchange rate movements have had only a limited impact on American competitiveness; exporters in other industrial countries have defended their shares of the US market by paring profit margins, and some countries in South-East Asia and Latin America have maintained or even improved their competitive position by tying their currencies to the dollar or by letting them depreciate. For their part, American companies initially concentrated on restoring their profit margins in export markets.

Changes in the cyclical position of the US economy in relation to those of the other industrial countries are proving slow to materialize; after increasing by 18 per cent in the United States and by only 7 per cent in the other OECD countries between 1982 and 1985, domestic demand expanded at an annual rate of 3.5 per cent in both areas in 1986 and the early months of this year.

The US current account deficit stands in contrast to the surpluses of Japan and the Federal Republic of Germany, which came to $86 and 36 billion respectively in 1986, in both cases equivalent to about 4 per cent of national product. Medium-term scenarios indicate that at current exchange rates and with unchanged economic policies the disequilibria between the three major countries will reduce only slightly before the end of the decade.

Such large imbalances between the current accounts of the major countries and the associated massive accumulation of net external financial assets and liabilities are a serious obstacle to the restoration of exchange rate stability and a return to a satisfactory growth path at world level. Even the maintenance of an open trading system is in jeopardy.

In the absence of more expansionary economic policies, the slowness of the adjustment in the external accounts of the major countries is accentuating the downward pressure on the dollar, thus posing a new threat to international financial stability, fueling inflation in the United States and curbing growth in countries with appreciating currencies.

As long ago as last September, when the decline in the US currency began to gather pace, these considerations formed the basis of the dollar support agreements reached at Gleneagles by the central banks of the European Community, which were the forerunner of the broader agreements concluded at the annual meeting of the International Monetary Fund. When the dollar came under renewed pressure, further meetings were held in October and again in February and April of this year at which commitments were made to coordinate policy and exchange market intervention among the leading industrial countries.

The depreciation of the dollar was held in check at the cost of massive intervention by the European countries and by Japan, especially the latter; it was only recently that the United States contributed to this effort. In the first four months of 1987 the United States' balance-of-payments deficit on current account was financed entirely by the increase in liabilities towards foreign monetary authorities.

Intervention alone cannot stabilize exchange rates, however. A greater willingness to cooperate has become evident, but if pronouncements are to be credible and effective they must be translated into corresponding domestic economic measures.

External debt and international cooperation

In 1986 the situation of the developing countries was affected both by the pronounced worsening of their terms of trade and by the slowdown in growth in the industrialized world. Whereas the effect of the deterioration in their terms of trade may be estimated at $100 billion assuming constant trade volumes, the increase in the current account deficit of these countries was only $24 billion, thus indicating the scale of their adjustment efforts. The condition of economies that rely mainly on exports of oil and other raw materials worsened considerably. With 1980 equal to 100, the ratio of the prices of non-oil commodities to those of manufactures fell from a peak of 128 in 1974 to an average of 72 in 1986; over the last year the decline amounted to 14 points. Signs of a recovery in raw material prices only began to emerge in the early months of 1987.

The difficulties faced by the most heavily indebted countries grew still more acute. Despite the fall in interest rates and the depreciation of the dollar, debt servicing began to rise again in relation to export earnings. The US initiative of October 1985 made a resumption of economic growth the centrepiece of the programmes of restructuring in the most heavily indebted countries, and assumed the availability of increased finance and a favourable international environment. It has taken longer than expected to reach agreement with the Plan's intended beneficiaries, adjustment programmes have run into difficulties and world demand has grown more slowly than predicted. The deterioration in the terms of trade of the largest debtors was one factor in the swing in their current account from balance in 1985 to a deficit of $12 billion last year. Brazil has suspended the servicing of its medium and long-term bank loans. Following the debt agreements reached a few months ago with Mexico and Nigeria, only those with Argentina and the Philippines are now nearing conclusion.

In 1986 the World Bank essentially achieved the lending objectives set under the Plan, but the contribution from private sources was inadequate, with bank lending to the fifteen most heavily indebted countries increasing by only $4 billion. The initiatives to make the terms on which bank loans are renegotiated more flexible and thus less costly and to encourage the conversion of loans into bonds or other securities should be viewed favourably.

The difficulty of ensuring that the volume of lending from private sources is as large as originally planned and the increase in borrowing requirements mean that lending via official bilateral and multilateral channels must be increased. Despite the agreements to reschedule substantial amounts of debt under the auspices of the Paris Club, the need for significant increases in the resources of the World Bank and the regional development banks and for an expansion in subsidized loans and aid to the poorest countries is becoming urgent.

The Bretton Woods institutions remain the natural forum for strengthening the procedures for international economic coordination, promoting an adjustment in balance-of-payments disequilibria, fostering growth in the world economy and tackling the problem of the developing countries' foreign debt; they have the technical expertise and independence to win acceptance for their appraisals even from the major countries and to promote the establishment of a system in which the costs of adjustment are distributed more evenly.

As to the means of achieving these ends, the route indicated in the report of the Group of Ten on the functioning of the international monetary system published almost two years ago appears to be more valid than ever. Its recommendations are beginning to be implemented both in the activities of the Fund and within the Group of Seven; the multilateral surveillance of member countries' economic policies should lead to operational prescriptions and subsequent checks on their implementation. The ground was prepared by establishing a system of targets and indicators, which reinforces the pool of shared information and gives continuity and objectivity to assessments and subsequent verifications, thus helping foster a recognition of the constraints imposed on the policies of sovereign countries by the interdependence of their economies.

The European countries and the Community

Inflation rates in the European countries continued to converge towards a lower level against the background of a strengthening of the structure of their economies and an improvement in their financial situation. The rate of growth remains unsatisfactory, especially after years of near stagnation; in 1986 it matched the average for the other industrial countries, the expected acceleration having failed to materialize.

The performance of the German economy continues to be weak; activity expanded by one point less than expected last year and the slowdown has accentuated to the point where growth in 1987 is now forecast at around 1.5 per cent. The trend decline in the supply of labour owing to demographic factors is fostering a reluctance to exploit the economy's potential more fully; the unemployment rate has fallen to 8 per cent in Germany, the only one of the four major European countries in which unemployment has declined.

In other countries, some of which still have to make further progress in containing inflation and budget deficits and to consolidate their achievements in these fields, the scope for more sustained expansion is limited by the weakness of growth in the major economies.

The European Monetary System, which has proved its resilience in the face of instability in the world economy in recent years, is entering a new phase. In its first few years it derived cohesion from both external and internal factors, in the shape of the strength of the dollar and the priority all member countries gave to monetary stability. The countries with higher inflation accepted a real appreciation of their currencies in order to curb the rise in prices and domestic costs; currency realignments and even restrictions on capital movements enabled them to overcome the tensions that inevitably developed during the gradual convergence of inflation rates.

The picture is now changing, partly as a result of the system's very success. The slowdown in inflation now allows countries to assign greater importance to expanding employment. The substantial progress made in liberalizing capital movements and opening up Europe's financial markets is limiting the scope for independent monetary policies and may give rise to destabilizing movements of funds. In addition, the decline in the dollar is tending to weaken cohesion among the European currencies.

The exchange market interventions that preceded the realignment of January 1987 were the heaviest since the creation of the EMS. The realignment itself was largely in response to factors unconnected with the behaviour of the fundamental economic variables.

These developments confirm that in addition to the primary need to bring about a convergence of member countries' economies there is a need to strengthen the EMS and adapt its mechanisms to the new conditions.

The completion of a market without barriers to the movement of goods and factors of production requires the Community to resolve the underlying inconsistency between the free circulation of capital, exchange rate stability and autonomy of monetary policy. To seek a solution by relaxing the discipline of the exchange rate agreements would mean sacrificing the contribution that the EMS has made for more than eight years to the stabilization of prices and to orderly trade relations.

Increased capital mobility and the ability to make instantaneous changes in the composition of financial portfolios mean that a number of essential prerequisites must be met; first, a more flexible and coordinated use of monetary instruments in times of tension, with rapid changes in short-term interest rate differentials, secondly closer cooperation in exchange market intervention and acceptance of their monetary impact and thirdly more active management of exchange rates within the permitted band of fluctuation.

Furthermore, the potential increase in destabilizing capital movements necessitates an expansion in Community credit lines and a review of the circumstances in which they may be used; such action would enhance the credibility of the EMS. Financial integration must continue to advance, but it would be advisable to maintain a capability to regulate financial flows through the exceptional and temporary use of restrictions on speculative capital movements, as foreseen in the Treaty establishing the EEC.

The drive to liberalize the financial markets coincided with the enlargement of the Community and the launch of an ambitious programme to integrate and open up markets, which was given concrete form in the Single European Act. To guarantee attainment of these objectives by the deadline of 1992, the capacity for Community policy intervention should be strengthened, whereas in fact it has been weakened by the increased cost of agricultural support and the hardening of defensive attitudes in industry. Integration will not advance unless economic growth assumes equal importance alongside monetary stability in the overall framework of economic policy.

The Italian economy

The last year

In 1986 the fruits of resolute action and favourable external trends combined in a way that had not occurred since the time of the first oil crisis, which had combined with internal disequilibria to lock the Italian economy in the vice of inflation and sap its potential for growth. Last year the tangled skein of problems that had marked the last fifteen years was unraveled.

The growth in output and especially in domestic demand accelerated to 2.7 and 3.2 per cent respectively. The improvement in the terms of trade reduced the trade deficit by 18 trillion lire and brought the balance of payments on current account back into surplus by 6 trillion lire.

Italian firms achieved substantial profits and their investment in plant and equipment was large, higher in relation to GDP than was the case in the other leading European economies. They competed successfully in world markets in which prices were falling. The major Italian groups were also very active in the financial markets and made substantial acquisitions abroad.

The state sector borrowing requirement was held below the 110 trillion lire recorded in 1985. Net of interest payments and settlements of past debts, it was reduced from 47 to 36 trillion lire.

Most important of all, inflation was brought down to an average of 5.9 per cent for the year and 4.2 per cent over the twelve months to December. The present pace of consumer price inflation is the slowest since 1968. The inflation differential between Italy and the other leading industrial countries, which had been nine percentage points at the start of the eighties, has now narrowed to two points.

The statistical picture of 1986 is one of both light and shade, however. The continued rapid rise of 8 per cent in the GDP price deflator indicates the persistence of domestic inflationary factors. Although the trade balance improved substantially at current prices, valued at constant 1985 prices it deteriorated by 7 trillion lire. The budget deficit remains very large, and last year's success in containing it was due not only to action to correct the underlying trends but also to favourable cyclical factors and temporary measures. Though regaining their profitability and credit standing both at home and abroad, Italian firms have not so far shown a renewed inclination to make large-scale investment in additional capacity. The expansion in economic activity created 120,000 jobs last year, but it was not enough to reduce the unemployment rate, which rose further to 11.1 per cent.

The progress made in 1986 was certainly due in part to the depreciation of the dollar and even more to the fall in oil prices, but ultimately it was the result of economic policy measures to tackle the domestic causes of inflation and halt the drift in prices and supply conditions that had occurred at the beginning of the decade.

In retrospect, 1986 was the culmination of a long period of disinflation. The Italian economy has been saved from irreparable harm, but significant problems remain. Unemployment, which is unresolved nationwide and extremely serious in the South, remains a crucial issue; it is the point of reference underlying our analysis of disinflation, corporate recovery, the problem of the public finances, and the external constraint.

Disinflation

In 1980 inflation in Italy was running at 22 per cent. World oil and commodity prices had been rising at an explosive pace of over 30 per cent per year since the beginning of 1979. The rise in the prices of primary products was followed by the sharp appreciation of the US dollar against other major currencies between the autumn of 1980 and the spring of 1985. A large number of Italians feared that inflation would spiral into hyperinflation. Many doubted that it could be curbed, and were even more sceptical that this could be done without stifling the nation's industry.

At the beginning of the decade monetary policy and exchange rate policy were harnessed in a steadfast effort to combat the renewed outbreak of inflation.

The rigorous approach to exchange rate management, which used the discipline inherent in the EMS exchange rate mechanism to good advantage, curbed imported inflation but also necessitated a permanent reduction in domestic production costs. The exchange rate policy could not have been applied, however, if external equilibrium had not been maintained by keeping interest rates high.

The "divorce" between the Treasury and the central bank was the institutional act that consolidated this monetary stance. Its practical effect is summed up in the change from negative to positive real interest rates. Given the widening gap between government revenue and expenditure and the escalating public debt, higher interest rates first eliminated excess demand and then prevented its recurring.

The need to limit the repercussions of monetary stabilization on output and employment and to restore equilibrium without disrupting capital formation meant that the change of course and the implementation of the new policy approach had to be gradual. The momentum of wage and price increases, the limitations of fiscal policy and the imperfections of the market made it impossible to disinflate by means of monetary shock treatment without incurring very heavy real costs.

Attenuated though they were by the gradualness of the process, the costs of the new monetary and exchange rate policies themselves stimulated a growing awareness of the damage caused by inflation and of the need for stronger commitment in the community at large. The changes in the wage indexation system introduced by agreement between labour and management in 1983 and by government decree in 1984, together with easier industrial relations, brought the rise in labour costs back down to levels not incompatible with a return to stability; the expansion in the budget deficit was resisted and policy on public service charges and administered prices sought to reconcile allocative and distributive requirements with the need to avoid fueling inflation.

Although oil prices remained at their peak and the rapid appreciation of the dollar continued, the convergence of the various components of economic policy brought inflation down to single figures by the autumn of 1984. After a pause due chiefly to the restoration of profit margins, inflation declined to its present level during 1986, aided by the favourable global environment and the expectations engendered by a succession of economic achievements.

This protracted battle against inflation did not prevent employment from continuing to rise, in contrast to developments in the rest of Europe. The problem of unemployment nevertheless grew more acute, mainly owing to the growth of the labour force.

Between 1980 and 1986 the demand for labour increased by 1.8 per cent, but the labour supply expanded by 5.8 per cent, propelled by population growth and a rise in the participation rate among women. The demand for labour was depressed by slow economic growth and by the fact that this period saw the industrial restructuring made necessary in the first half of the seventies by changes in international and domestic income distribution and relative prices. The rise in the unemployment rate amounted to 3.5 percentage points, two points less than the average for the major European countries.

Employment contracted by 1 million in industry and by 500,000 in agriculture, but the services sector, both public and private, created 1.7 million jobs, more than a third of them in services to enterprises. The faster growth in the labour force in the South caused the unemployment rate there to rise by five points to 16.5 per cent. In the Centre and North it rose by three points to 8.5 per cent.

A renewed strong commitment to the development of Southern Italy is indispensable to any lasting reduction in unemployment. Forecasts for the coming decade have long made it clear that whereas in the Centre and North the contraction of the population of working age will reduce the excess supply of labour, in the South unemployment rates will continue to rise. Substantial resources have been appropriated for the South. If they are not to be wasted, the institutions laid down in the long-range plan must be fully operational, entrepreneurs must have scope for initiative and there must be continuous and careful checks to ensure that government action is consistent with the objectives.

The improved health of the business sector

The phase of disinflation largely coincided with the recuperation of the business sector. In fact, the two processes have some causes in common and have reinforced one another.

Ten years ago it seemed that if entrepreneurship was to survive in Italy small firms had no option but to use semi-legal labour nor large ones any alternative but to accumulate debt that would be eroded by negative real interest rates.

At the beginning of the eighties the new orientation of monetary and exchange rate policy led some observers to fear the impoverishment of Italian industry, despite the expansion in profits and investment it had enjoyed from 1978 to 1980.

The spectre of deindustrialization did not materialize, however. The strict stance on exchange rates and real interest rates maintained during the eighties has forced large firms to adapt to the changed pattern of prices and costs and it has not deterred smaller businesses, where adjustment was already under way. The process was greatly assisted by the re-emergence of wage restraint and the development of an industrial relations climate more favourable to the pursuit of improved productivity. Both of these factors helped curb the rise in unit labour costs, and substantial transfers of public resources relieved firms of the cost of overmanning and helped offset corporate losses.

The recovery of the business sector was an important element in the fight against inflation. Productivity growth, which curbed prices as well as unit costs, was generated by new investment, new technology, new combinations of resources and product innovation; the fact that the expansion in economic activity, though slow, was faster than that achieved in other European countries was a further contributory factor. The decline in inflation, in turn, enabled firms to plan ahead with greater certainty.

Despite stronger stimulus and the improved economic climate, the recuperation of the corporate sector would not have been possible if management and workers had not shown an ability to resolve the problems of the seventies. That ability has been proven.

The response differed in kind and in timing between small and large firms and, among large ones, between the private and public sectors.

The available data on the eighties show that small and medium-sized firms grew steadily, unaffected by cyclical variations. From 1981 to 1984 the output of industrial units with between 20 and 100 employees grew by 5 per cent per year and was higher than the national average, employment rose by 1.5 per cent annually and investment continued to grow at a pace not far short of that of the 1978-80 expansion. In 1984 their gross profit margin rose to 38 per cent of value added. Their borrowing was heavier than the average for enterprises as a whole, but the cost was covered by their operating profits.

In large firms, the modernization of plant and the reorganization of production began when it became clear that competitiveness could no longer be fully recouped by devaluation nor would debt be eroded by negative real interest rates. Between 1981 and 1984 large private and public sector industrial firms raised productivity by 9 per cent per year; labour inputs were reduced at an annual rate of 7 per cent. Companies also reorganized their finances; in relation to value added, debt declined by 16 percentage points and gross interest charges by 6, while financial income doubled.

The overhaul of production and organizational arrangements in the large public sector companies was hampered by the fact that they are heavily represented in the most severely troubled industries. Initially it was also delayed by the persistence of the view that they should contribute directly to the maintenance of output and employment. The process of change was eventually set in motion by the trend towards reducing the state's role in the production of non-strategic goods, which took hold in Italy and elsewhere.

Turning from past accomplishments to the present and the prospects for the future, we see that some of the problems facing the business sector are unique to one or other of the three types of enterprise; they can be tackled by exploiting the complementary features of the different kinds of firm.

Large private sector companies have channeled increased resources into financial investments and the acquisition of equity in other firms, both at home and abroad. Investment in equity participations has been prompted to some extent by the discrepancy between the underlying economic value and the stock market valuation of many firms. Above all, given the slow expansion of world demand, in certain industries the acquisition of subsidiaries is not only less costly but also less risky than the construction of new plant and is undertaken for specific purposes, such as better access to markets and to technology, more efficient links between different stages of production, and risk diversification. Traditional economies of scale are becoming less important, whereas greater significance is being attached to scope economies and to the integration of information technology and services into the production process.

Large Italian industrial groups have laid new stress on the international dimension of their business. In 1986 net direct investment abroad was the equivalent of two thirds of Italy's current account surplus and involved a number of very large transactions. The Bank of Italy ensured that the foreign exchange flows associated with these transactions and with a substantial disinvestment in Italy by non-residents were orderly.

The strategic consistency and profitability of foreign investments depend on the sound judgement of senior management. The availability of liquid assets gives firms greater freedom to implement their policies, but at the same time it increases the danger that the pursuit of short-term capital gains may distract them from the ultimate goal of producing goods and services.

Macroeconomically, the benefit that may derive from foreign subsidiaries comes via the balance of payments. The soundness of major firms' investment decisions will determine the scale of their contribution to easing the external constraint, and thus creating employment, in ways that will complement their traditional contribution as exporters of goods and services. The Italian economy is not yet sufficiently mature to become a permanent net exporter of capital. Balanced resource allocation requires that the capacity of firms to employ labour and to overcome the remaining manifestations of economic backwardness be strengthened.

The action that remains to be taken to complete the rehabilitation of public sector enterprises will be able both to exploit and to help consolidate the improved economic situation of the country. Public sector enterprises can make a substantial contribution to improving the infrastructure essential to the overall efficiency of the economy. Transportation and telecommunications are particularly important in this regard; the productive potential made possible by information technology cannot be developed fully without extending and modernizing the nation's telecommunications network.

Notwithstanding the advances that have made small and medium-sized firms a strong component in the Italian economy, firms of this size are encountering difficulties, and not only in expanding. Innovation continues to be spread thinly; moreover, the replication of the North-South divide among small firms on a number of fronts such as productivity, business start-ups and profitability is a further cause for concern. The financial weakness of small businesses is exacerbated in the South, as can be seen in their greater recourse to bank loans and their lower debt servicing capacity. Now and in the foreseeable future, the continued creation of jobs depends principally on the vitality of small and medium-sized firms, but an adequate growth in employment cannot be achieved if large firms do not play their part.

The problem of the public finances

The glaring productivity gap between the public and the private sectors affects the ability to compete, to produce and to create jobs in an economy that is increasingly integrated with the rest of the world. A growing volume of private resources is being spent to make up for the shortcomings of the government sector. The citizens of this country realize the urgent need for a vast improvement in the efficiency of public services as a means of enhancing the functionality and cohesion of a civilized society.

Regulations and procedures must be streamlined. Conformity with the precepts of good management and impartiality, which Article 97 of the Constitution establishes as the standard in the administration of public offices, must be assured by rules for monitoring performance and by a closer correspondence between performance and earnings. First and foremost, better services presuppose new patterns of organization.

The central government budget must be restored to its proper role as the indispensable instrument of government: the guarantor of the provision of public goods essential to society, a flexible tool for the regulation of the economic cycle and a reliable point of reference for balanced economic growth. The revitalization of the public sector presupposes not only reform of the structure and operations of the public administration but also a thorough revision of budget procedures and action to moderate expenditure trends and sustain the growth in revenue.

In the spring of 1986 the Budget Committees of the two houses of Parliament supported experimental changes to streamline the budget's passage through Parliament and deepen the involvement of the executive branch in decisions regarding budgetary policy. The aim of the modifications is to bring forward decisions on medium-term planning objectives, to ensure that the framing of such objectives takes account of actual trends in public finances, to make achievement of the desired results more certain and to restore the original function of the budget as an integrated instrument of macroeconomic policy by excluding measures for specific sectors, such as health, social security and local government finances.

The short time available for drafting the economic and financial planning document and the Cabinet crisis of July 1986 made it impossible to apply the new procedure in full for the 1987 financial year. When it is fully implemented in future years it should be complemented by an assessment of the trend in the public finances and the cost of bills entailing expenditure, a task that should be entrusted to a technical body.

Despite the progress made in 1986, the persistence of factors that give rise to serious concern about the public finances in both the short and the long run confirm the urgent need to limit the budget deficit.

We are not blind to the difficulties that must be overcome by the Government's budget proposals, which hinge on achieving a balanced budget net of interest payments. Above all else, an awareness of the problems involved should reinforce the Government's resolve to keep the expansion of current expenditure down to the rate of inflation.

The effects of long-term social, economic and demographic pressures need to be resisted or offset. In the pensions field, the provision of welfare assistance should be made more strictly conditional upon effective need, the criteria for eligibility should be reviewed in order to increase the redistributive effect of expenditure on pensions and the retirement rules should be amended to reflect changes in society. In the health service, efficiency must be improved in order to reduce costs and raise the standard of service. Grants to industry must be directed more specifically to raising productivity and expanding the productive base, and their size must take account of the recovery in corporate profitability.

The need to increase tax revenue as a share of GDP as one of the ways of restoring budget balance is demonstrated by the persistence of tax avoidance, tax evasion and erosion of the tax base. The scale of these phenomena has been made more evident by the recent revision of national income.

Merely maintaining the incidence of tax at its present level will require prompt action, since certain sources of extraordinary revenue will soon dry up. Above all, progress must be made in tax reform, designed not only to produce a permanent rise in revenue but also to eliminate distributive inequalities and distortions in the use of resources, to lower some tax rates (partly in order to reduce the incentive for evasion), to adjust the balance between direct and indirect taxation and to extend automatic collection procedures. To stabilize local finances, charges for certain services should be linked more closely to the cost of provision. The unification of the European market will itself necessitate a review of existing tax systems, primarily with a view to standardizing the basis and rates of indirect taxation.

The balance-of-payments constraint

The failure to restore the public finances to equilibrium is eroding the competitiveness of the entire economy and the availability of saving. It is exacerbating the constraints imposed by the balance of payments on growth and employment.

The turnabout in the terms of trade in 1986 made good about half the deterioration that had taken place in the period covering the first and second oil crises. However, there is inherent instability in the relationship between world prices of manufactures and those of primary products. Competition has been accentuated by the slowdown in the growth of world trade. The position of Italian industry is not without its weak points, at a time when the manufacturing sector, on which Italy relies to balance its external accounts, is being called upon to offset a deterioration in the other main items of the balance of payments on current account.

Net foreign exchange earnings from tourism, which were already making a far smaller relative contribution to the current balance than they had until the early sixties, have been affected in recent years by a loss of competitiveness compared with other Mediterranean countries and the rising propensity of Italians for foreign travel.

Net receipts from private transfers have declined perceptibly. Net outflows on account of public transfers are increasing, owing to Italy's position in the international community and its increased commitment to international cooperation and development assistance.

The financing of the external payments deficits of the eighties has generated a net external debtor position whose interest costs amount to 4 per cent of current foreign exchange earnings.

Regardless of cyclical variations, the energy question remains the crucial factor in Italy's external constraint. Since 1970 the ratio of overall energy requirements to GDP has diminished by 16 per cent, less than in other countries. The proportion of energy demand met by domestic production did not change significantly after either the first or the second oil crisis; it remains below 20 per cent. A selection of domestic and international scenarios for the next decade show that growth rates of the order of 3 per cent a year, which would barely be sufficient to avoid aggravating the difficulties of the Italian labour market, would entail a steady rise in the deficit on the energy account to about 3.5 per cent of GDP by the end of the period, as against 2.2 per cent in 1986.

Major and unavoidable policy choices must be made urgently in the energy field. If they do not lead either to energy savings or to the production of energy at lower import cost, the increased energy imports connected with economic expansion will have to be offset by a corresponding increase in Italy's foreign exchange earnings from trade in other products. This implies forgoing increased consumption of consumer goods and presupposes an ability to raise competitiveness in order to win a larger share of world trade.

Italy's deficit on trade in foodstuffs and food products is substantial and rising even at constant prices; in 1986 it reached 12 trillion lire.

The slowdown in the expansion of demand from the OPEC countries, followed by the depreciation of the dollar and more recently by the erection of barriers to penetration of the markets of the Far East have prompted Italian manufacturers to strengthen their presence in European markets, which are highly competitive and already account for more than half of Italian exports. The stance adopted by large Italian firms towards Community-wide operations is a response to this challenge, as is the recovery in productivity and profitability achieved by the industries that are the most prominent in world markets.

Italian society needs rapid as well as stable economic growth, and it has the resource potential to achieve it. Action to encourage exports must certainly include measures targeted at individual sectors, but more important it must create favourable general conditions. Inflation has been curbed, though not conquered, and the industrial fabric has been revitalized; these are now realities. The same cannot be said of reform of the public administration and the restoration of a sound budget, on which the overall efficiency of the economy is crucially dependent. If the constraints on the expansion of output and employment are to be eased, it is essential that resolute action be taken in these areas and that business and labour do not abandon their commitment to price stability and the consolidation of the corporate recovery.

The outlook for 1987

In these first few months of 1987 the world economic outlook has turned gloomier. World trade is slowing down. The downward trend in the dollar prices of major raw materials is being reversed. The price of crude oil has risen to the level of February 1986.

In Italy the gap between the rate of expansion of domestic demand and that of GDP that emerged in 1986 is widening. In March the capacity utilization rate in industry came close to the high levels achieved in early 1980. New labour contracts have further boosted households' disposable income; the acceleration in consumer spending, which is still benefiting from last year's improvement in the terms of trade, is threatening to crowd out investment by firms, which is expanding rapidly.

It is uncertain whether the planned reduction of 10 trillion lire in the public sector borrowing requirement by comparison with 1986 can be achieved. Far from declining in line with the annual target, the requirement for the first few months of 1987 was similar in absolute terms to the figure for the same period of last year. Expenditure will rise during the remainder of 1987 as the full effects of new labour contracts with public employees make themselves felt.

Domestic demand seems to be expanding more quickly than in the other leading industrial countries. The trade balance shows a widening gap between expanding imports and stagnating exports. In the first four months of the year the surplus on trade in non-energy products was 3 trillion lire less than in the same period of 1986. The oil deficit has worsened month by month. Last year's balance-of-payments gains are being eroded more rapidly than had been expected.

The twelve-month rate of consumer price inflation has stabilized at around 4.2 per cent; wholesale prices have begun to rise once more.

The trend in the prices of manufactures must be brought permanently into line with those in Italy's main competitors. In an international environment in which the forces of stagnation are threatening to prevail over those of expansion, it is essential to maintain competitiveness. Now that the nationwide labour contracts have been concluded, it is up to individual firms to defend their competitiveness, chiefly by seeking to improve productivity and, where necessary, holding down their profit margins.

During these four months, the action of the Bank of Italy has been directed first and foremost to moderating the growth of credit to the private sector. After an acceleration early in the year, bank lending in lire and in foreign currency slowed down in March and April, bringing the annual rate of expansion in the first four months back down to 10 per cent. Over the same period, credit to the non-state sector expanded by 11 per cent. Partly as a result of weak demand for government securities, deposits have been growing at a faster pace since March, thus threatening to obstruct the slowdown in bank lending.

Firm monetary and exchange rate policy will be required to keep the Italian economy on a stable growth path that is not jeopardized by renewed balance-of-payments deficits or resurgent inflation.

Money and finance

Like its counterparts in other industrial countries, the Italian financial system is going through a period of rapid change involving markets, intermediaries, savers and enterprises.

In the strategy adopted by the Bank of Italy, the measures affecting the structure of the financial system and the conduct of monetary policy have both been directed towards the goal of reducing inflation. The success achieved does not terminate our commitment to stability, but rather spurs us to speed up the modernization of the financial system and enables us to proceed with the liberalization of exchange controls.

The need to advance on these three fronts makes it even more urgent to ease the constraints placed on monetary policy by the large public sector deficits and the high level of government debt. The progress already made with the refinement of monetary policy instruments is evident in our day-to-day operations; this continues to be an important activity, but it cannot take the place of the more rigorous measures required to correct the imbalance in public finances that is impeding the development of the Italian economy.

The development of the financial system

Direct financing of the public sector by private investors has intensified in line with the protracted decline in bank deposits as a proportion of financial assets.

The changes in corporate financing are of more recent date, but they have occurred very rapidly; the stock market has been revitalized by the improvement in the condition of the business sector and by the inflow of resources via investment funds and portfolio management services. In 1986, 19 per cent of the flow of resources to the productive sector, the bulk of which went to the major industrial groups, was raised through share issues, compared with an average of 6 per cent in the ten preceding years.

Large firms have devised new forms of financial operation and are occasionally acting as financial intermediaries. They are combining their increased profitability with a willingness to manipulate items on both sides of the balance sheet; financial assets are viewed both as cash management instruments and as a means of attack or defence, while liabilities are taken up not only for productive purposes or to finance investment but also to make financial acquisitions, sometimes in the context of takeover battles.

Compared with the situation in the mid-seventies, the Italian system of financial intermediation now offers a far wider range of instruments and institutions, more in keeping with the level of economic development the country has achieved and better able to cope with complex processes of resource allocation. As it has evolved, however, it has developed mechanisms, weaknesses and potential abnormalities that make it necessary to reconsider the current arrangements for protecting savings and regulating the currency.

Macroeconomic control requires a coherent view of the process whereby savings are transferred from surplus to deficit sectors. Supervision aimed at protecting savings and ensuring the stability of financial intermediaries, to which I shall return later, is necessarily more thorough in regard to credit institutions and to instruments that are close substitutes for bank credit and money.

The monetary policy implication of the greater diversity of the credit system is that the link between the action of the central bank and the public's expenditure decisions tends to depend more crucially than in the past on interest rates and less on the availability of credit. With a greater variety of financial instruments, it is more difficult for one monetary or credit aggregate alone to reflect the state of the economy and serve as a basis for policy. The method adopted by the Bank of Italy, which involves establishing and announcing several objectives within a coherent flow-of-funds framework, suits this new reality. The use of the econometric model enhances the consistency of monetary policy action and underlines the role assigned to the final objectives.

Developments in the monetary and credit aggregates in 1986 and early 1987 reflect and confirm these considerations. Last year the M2 money supply expanded at a rate of 9.4 per cent, thus remaining close to the middle of the target range; the rate of change in the money supply net of certificates of deposit and in monetary base was more modest, 8.2 per cent in both cases. Credit to the private sector expanded by 11.5 per cent, however, significantly faster than the target of 7 per cent, owing to an acceleration from the autumn onwards.

The heightened competition among the banks for the business of major firms manifested itself in a sharp expansion in the volume of credit granted, which was more than seven percentage points higher than the growth in credit actually used. Developments such as this give rise to fears that in their pursuit of business the banks sometimes go beyond the limits dictated by the optimization of operating profits and resource allocation. On the demand side, the need for funds to finance investment and production was augmented by demand associated with companies' financial operations carried out at home and abroad. In 1986 firms acquired almost 17 trillion lire more in financial assets than in 1985, mainly on account of increases of 8.5 trillion lire in shares, 4 trillion lire in trade credit and foreign loans and 2.5 trillion lire in liquid assets. The fact that a considerable proportion of bank lending was used for financial purposes is also apparent from the volume of bank loans granted to financial companies and the large groups that are most active in the share market.

Although the behaviour of the exchange rate, inflation and output was in line with the targets, steps were taken to counteract excess lending to the non-state sector; liquidity could have flooded out of the financial sector into the real economy, causing uncontrollable short-term disequilibria. In the last quarter of 1986 money market intervention kept the banks' gross liquidity at around the normal level and reduced their net liquidity from 3 trillion lire to a negative figure of 4.5 trillion; the average rates on securities repurchase agreements rose by four percentage points. Inflows of foreign exchange following the EMS realignment in the middle of January 1987 exceeded the outflows that had occurred in the preceding weeks.

The authorities also responded to the excessive growth in lending through closer concertation with the major banks. The reduction in the discount rate on 13 March and the introduction of the reserve requirement on increases in the banks' net foreign currency liabilities made conditions less attractive for inflows of foreign capital. The second of these measures not only serves the cyclical objective of curbing the banks' fund-raising abroad but also strengthens the system for regulating banks' liabilities.

Recent experience has confirmed both the success achieved in developing indirect monetary control instruments and the need for further progress. The Bank stepped up its repurchase agreements in government securities in order to increase the effectiveness of its actions; in 1986 it carried out 65 such operations involving a total of 137 trillion lire, compared with 51 transactions amounting to 66 trillion in 1985. The turnover of the interbank market and the number of participants have increased, but greater variety in the types and maturities of contracts and in trading mechanisms would be desirable. As regards measures to improve the payments system, the overhaul of the procedures for accessing centralized accounts and effecting clearing operations will enable the interbank market to operate throughout the day and access settlements in their accounts at the central bank in real time from anywhere in Italy.

The new regulations concerning certificates of deposit are designed to improve the transmission of monetary policy stimuli. The banking system has responded positively; between the end of August 1986 and April 1987 the volume of certificates in circulation almost doubled to 30 trillion lire. Crediting interest on deposits more frequently, as is the custom in other countries, would ease the seasonal fluctuations in the money market now caused by the practice of crediting interest only once a year.

The authorities influence the composition of financial portfolios not only by means of monetary instruments and measures to protect savings but also through taxation.

As a result of the 1974 tax reform, taxation has been extended to all financial assets and all forms of income, tax rates have been standardized, distinctions between different categories of issuer have been eliminated and the taxation of dividends and income from investment fund units has been simplified. Further important steps remain to be taken before the system may be considered coherent; there are still areas in which the tax base is being eroded, in particular with regard to capital gains on shares. It is difficult to see any logical uniformity in the plethora of indirect taxes on financial transactions, with the result that the working of the financial market is distorted. Businesses are moving away from heavily taxed instruments such as bills of exchange and making greater use of others, such as "bankers' receipts", that are less well protected legally but preferable from the point of view of tax; the duration of loan contracts and even the distribution of flows among intermediaries are being influenced by taxes that ultimately yield little revenue.

Financial integration and the liberalization of exchange controls

The integration of Italy's national financial market into the international system first entailed removing the administrative constraints imposed on foreign transactions from the early seventies onwards. The gradual dismantling of these restrictions over the last few years proceeded in line with the improvement in the general state of the economy and was concluded by the measures taken three weeks ago.

Further progress will be made with the introduction of the decrees for which Law 599 of 26 September 1986 provides. The Bank of Italy's own contribution to the formulation of the decrees is based on a broad interpretation of the freedom to engage in foreign transactions within the limitations set by the Law; the legislation confirmed, inter alfa, the

Foreign Exchange Office's monopoly of foreign exchange operations and the criminal nature of foreign exchange offences, provisions that have no counterpart in the other countries of the Community. We are firmly of the opinion that the complete integration of Italian firms into the world market in goods, capital and financial services cannot be postponed, even if the disequilibria that halted the liberalization of exchange controls begun so courageously in the fifties and continued in the sixties have not been completely eliminated.

Operating in an environment of increased capital mobility will require Italian monetary policy to be oriented even more strongly towards stability and to pay greater attention to monetary conditions in other countries. It will mean facing the repercussions of an adjustment in residents' portfolios on a scale that is difficult to estimate after a long period of rigid control. Even after the transitional period, larger and more frequent changes in interest rates may be necessary, since the lack of exchange controls will make capital movements more sensitive to exchange rate expectations.

The decision to advance along the road of liberalization stems from a deeply-held conviction of the social and economic needs of a modern industrial country. This in no way lessens the challenge it entails. The Bank of Italy has taken care to strengthen the foreign exchange reserves, which constitute the first line of defence. Appropriate action must now follow at both domestic and international level to complete the revitalization of the economy and to ensure that the international community cooperates in the way required by closer international interdependence.

Monetary control and Treasury financing

In the light of the new configuration of the Italian financial system and its integration with the rest of the world, the question of the linkage between the behaviour of the public sector and monetary management arises with renewed urgency. Although the trend increase in the public sector borrowing requirement that had lasted since 1979 was broken last year, government debt still grew by 17 per cent, a rate six points faster than the growth in national income.

A more vigorous policy to restore sound government finances would allow a less rigid monetary policy, which in turn would reduce the burden of public debt since lower interest rates would help boost economic growth and cut government expenditure. It is in this way that monetary policy can ease the burden of the public finances. The ratio of the borrowing requirement to the annual expansion in monetary base, which is currently around ten to one, shows how illusory it would be to believe that the financing of the public sector can be facilitated by expanding the money supply without running the risk of rekindling inflation.

Short-term or floating rate securities still make up 83 per cent of outstanding government debt; in 1986 net issues of medium-term fixed rate securities accounted for more than 30 per cent of the borrowing requirement, the highest percentage for many years. At a time of renewed confidence in the purchasing power of the lira, the willingness of savers to invest at fixed rates for periods of several years was also fostered by the structure of interest rates. The demand for fixed rate securities has weakened in recent months.

The impact that the financial behaviour of the state sector has on monetary policy also stems from the pronounced short-term volatility of the borrowing requirement. The practice of setting a ceiling on tender rates close to the market rate and the mechanism of the Treasury overdraft facility with the central bank mean that imbalance between the demand for government securities and the supply affects banks' reserves, despite the "divorce" between the Treasury and the Bank of Italy. Since it is impossible to achieve market equilibrium by determining in advance both the interest rate on securities and the issue volume, it would seem advisable to fix the quantity of paper offered and let demand determine the price in the case of short-term borrowing, and to do the opposite for medium and long-term securities. In accordance with this approach, the recent decision to issue medium and long-term government securities on pre-arranged terms and to leave open the quantity on offer avoids inflated applications made solely to gain an advantage in the allocation of securities and creates more orderly market conditions. Likewise, with regard to Treasury bill issues the cessation of the present practice of setting floor prices would allow the auction method to operate properly again and give more effective control over liquidity. The liberalization of exchange controls has made it even more necessary to have operational arrangements that give interest rates the complete flexibility required for management of the currency.

The protection of savings and the structure of the credit system

The growth of intermediation outside the credit system and the advisability of regulating and controlling such business were widely discussed last year and were the subject of several studies, some initiated by the authorities. The analysis of the causes of this development and of its nature, scale and implications for the protection of savings and the effectiveness of monetary policy confirmed the need, which proved to be universally accepted, for all forms of financial intermediation to be appropriately regulated, in line with the tendency in most of the other industrial countries.

Asked to give Parliament the benefit of the Bank's experience and judgement, I recommended that suitably graduated supervision should be introduced for the forms of financial intermediation that are now exempt, with the aim of promoting stability as well as transparency and proper practices. Prudential controls should not be restricted to banking and banking-related activities. On the other hand, the aim of forestalling instability and protecting savings can and must be pursued in conjunction with those of streamlining operations, improving intermediaries' efficiency and enhancing competition between them. As regards the assignment of supervisory duties, arrangements will have to be developed that avoid a dispersion of responsibility for the controls designed to defend stability. These need to embrace the totality of banks and financial intermediaries and require a systemic view of the problems involved, coupled with scope for rapid operational intervention.

Pressure for change, both in the banking and financial system and in the regulatory and supervisory framework, is also being generated by the international integration under way in this field. In the EEC the aim is to establish a single market by the end of 1992, with complete freedom of establishment for intermediaries and freedom to provide financial services under uniform rules. This objective is to be achieved through harmonization of the basic rules by means of Community Directives, which now only require majority approval, and leaving other national features to be dealt with by mutual recognition.

In the last twelve months the Interministerial Committee for Credit and Savings and the Bank of Italy have given strong impetus to change in the structure of the credit system by completing the implementation of several elements of a design for a new configuration of the credit system. In addition to the provisions regarding mandatory capital ratios, relationships between banking and commerce, and banks' branch networks, which I shall discuss later, decisions were taken on banks' operations beyond the short term and their investments abroad, merchant banking activities, the Interbank Deposit Protection Fund, supervision on a consolidated basis, and the abolition of all geographical restrictions on the operations of foreign banks' branches.

Bank capital

Bank capital, which represents the resources provided by investors, is of special importance in view of the amount of savings entrusted to banks by third parties and the risk inherent in loans to customers.

In recent years the Italian banking system has shown a good capacity for building up its capital base, the strength of which now compares favourably with that of other banking systems, though the aggregate figure hides considerable differences between individual banks. The ratio of capital and reserves to total customer deposits has risen over the last five years from 7 to 11.6 per cent. Share issues by large banks made a substantial contribution to the 3.6 trillion lira increase in own funds in 1986: public-law banks raised 800 billion lire and the banks of national interest 1 trillion. Since then, the latter have made additional issues totaling 2 trillion.

The recent measure introducing mandatory minimum capital ratios for banks is in response to the need to buttress stability in a phase of growing competition. It became possible to adopt these provisions, which give binding force to indicators that were already in use, after a period devoted to building up banks' capital and reserves, developing the share market and making the changes required to enable public sector banks to have access to it. Similar rules to those applied to banks should be introduced both for special credit institutions and for other types of financial intermediary, thereby helping to make competitive conditions more uniform.

The capital adequacy requirements will intensify the stimulus for banks to improve their efficiency and enhance their entrepreneurial skills. The determination of different capital ratios according to the theoretical riskiness of the various categories of assets confirms the neutrality of the supervisory authorities with respect to banks' operating choices and is consistent with the easing of entry controls and restrictions on operations. Banks will thus be freer to adopt the strategy of their choice, but their plans for growth will depend much more on their ability to generate profits, and hence to create or attract the necessary capital. The link between earning capacity and volume of business, between the profit and loss account and the balance sheet, will become much closer.

Compliance with capital ratios is a necessary, but not a sufficient condition for sound operations. They complement but do not replace the supervisory authorities' assessments of the quality of banks' assets as a whole, of their balance sheet strength and profitability, and of the effectiveness of their internal organization and control procedures, which are appraised on the basis of prudential returns and inspections.

The new regulations imply that part of the Italian banking system will have to find additional capital. At the end of last year, 130 banks, or slightly more than one tenth of the total number, were below the minimum levels now required and will need to raise an estimated 4 trillion lire to make up for the deficiency. Taken together, the other banks had a surplus of 16 trillion.

One of the factors contributing to the need for capital and reserves is the increase in risk that has occurred recently. Over the last five years bad debts have risen from 4 to 6.7 per cent of total loans and are now equivalent to one third of own funds, including loss provisions. The general improvement in economic conditions has not prevented this development; small and medium-sized firms have come to account for a larger proportion of bank lending and their generally higher failure rate results in a greater incidence of bad debts.

For enterprises, and hence also for banks, the ability to generate profits is the primary guarantee of continued capital strength. The operating profit of the Italian banking system has risen over the last ten years from 1.2 to 1.8 per cent of its total assets. However, if the accounting figures are adjusted to give a reasonable return on the growing volume of own funds, profitability is found to have fluctuated slightly around a constant value. The flattering results achieved in 1986 were due in part to factors such as the temporary reintroduction of the ceiling on bank lending and the very large increase in income from securities business. Looking ahead, banks' profitability will depend on their ability to cope with fiercer competition; they will come under increasing pressure to rationalize operations by reducing costs, exploiting market opportunities and improving their organizational efficiency.

Many of the banks that do not meet the capital requirements at present are either small or medium-sized. The merger of structurally weak banks with stronger ones would be an appropriate response to the demands of minimum ratios, insofar as it would promote a better distribution of the capital resources of the banking system as a whole. Equity participation in Italian banks by foreign intermediaries could also serve to strengthen their capital bases and could bring about the exchange of operating know-how made necessary by European integration and international competition.

Households and firms also provide banks with capital. If these flows are to last and grow larger, banks will have to achieve results that will allow their securities to provide competitive yields.

The contribution that non-financial firms can make to banks' capital is restricted by the need to protect the autonomy of banking. The objectives of allocative efficiency and stability of the banking system have resulted in the separation between banking and commerce being adopted as one of the cornerstones of our banking legislation. Recent developments in industry and finance led the Interministerial Committee for Credit and Savings to reaffirm the principle of separation and to protect it by administrative means, giving the Bank of Italy responsibility for preventing the creation of credit institutions dominated by non-financial firms or groups, tightening the restrictions on connected lending, and encouraging intermediaries to add provisions to their Statutes to avoid preferential treatment being given to shareholders and associated companies.

The separation between banking and commerce regards the acquisition of controlling interests, but not minority interests. As I indicated to Parliament last autumn, minority interests are not only a source of capital but can also serve as a means of transferring the entrepreneurial expertise of industrial firms to banks.

The capital base of the special credit sector has also been strengthened. Own funds more than doubled over the last five years, with those of the industrial credit institutions rising from 11 to 15 per cent of their total borrowed funds and those of the other categories from 7 to 11 per cent. After the substantial recapitalizations charged to the budget in the wake of the crisis in the chemical industry, self-financing has been the main source of new capital, supported by steadily rising profits until 1984. In the last two years this improvement has come to a halt, while the tendency for lending risks to increase has persisted.

In the future, many special credit institutions will have to meet part of their capital needs by drawing on external sources, both by enlarging the shareholder base of those in public ownership and by issuing forms of equity in the capital markets.

The same economic logic that requires private sector credit institutions to remunerate the owners of their equity and to compete for the capital they need must also apply to the banks and special credit institutions in the public sector. Where it constitutes an obstacle, the regulatory framework will have to be changed, in conformity with the principle of competitive equality between credit institutions, defined by law as enterprises irrespective of their public or private status.

The specialization of credit intermediaries

The criterion of specialization is one of the features that serves to distinguish the structure of a financial system. In the industrial countries the financial products and services supplied are basically the same, though their relative importance differs. The manner in which the supply of these products is divided among the various types of operator in each system defines its specialization boundaries. These vary both from one place to another and from one period to another, but some differentiation of operations between categories of intermediaries is always present because it reflects the advantages deriving from skill specialization, simplified management and the spreading of risks.

The categories of credit intermediaries currently to be found in the various financial systems were mostly established in the period following the banking crises of the thirties. Thus, in Italy we have the 1936 Banking Law with its emphasis on the distinction between banks and special credit institutions. As in other countries, the continuous, if irregular, development of new instruments and intermediaries has been coupled with an erosion of the boundaries of specialization. Both these tendencies have gathered pace in the last few years. The creation of a European financial market will involve a narrowing of the differences between financial categories and structures.

Rather than being a hindrance to Italian intermediaries' competitiveness, the rules governing our financial system can be arranged to provide an institutional and organizational framework permitting customers' diversified requirements to be satisfied as effectively as possible. Within a group that is managed in the light of one overall strategy, old and new elements can have not only specific functions but also separate legal identities and capital, as well as autonomous fund-raising capabilities.

The solution based on a group of diversified companies with centralized control will be suitable for only a small number of major organizations. Within this structure it will be possible to include the whole range of intermediaries that has been developed over the years, as well as other entities in which non-financial companies will be free to participate, provided they do not violate the separation between banking and commerce. The implementation of such a blueprint will require the creation of clear divisions between the operational spheres of the various parts making up the group.

Small and medium-sized credit institutions will continue to have a key role to play in the financing of the economy. In their case operational diversification and the search for the optimal size of activities may be achieved best not by adopting the centralized group model but by individual banks creating links and arranging other forms of cooperation.

The choice of a financial group's structure and functions lies with the governing body of each parent company. The instruments for exercising control and the whole regulatory framework will have to be extended and used to take account of such financial conglomerates. The supervisory authorities will cooperate in defining the content of the various specializations and the requirements for their mutual independence.

Branch policy

The granting of credit, the taking of deposits and the operation of the payments system all require close contact with customers, and hence a branch network. In view of its implications for efficiency, competition and stability, the configuration of the branch network forms part of supervisory policy. The authorities have made active use of their regulatory powers in this field.

Door-to-door methods of selling financial products involve relations with customers that contain an element of risk. The protection of savers requires that these methods should be regulated by forbidding the supply of banking products in the strict sense (a function reserved exclusively to bank branches) and limiting their use to the distribution of uniform and highly standardized products, such as investment fund units.

The authorization of more than 500 new branches in 1986 is the latest step in a rationalization programme that the supervisory authorities have implemented through successive branch network plans with the aim of fostering an orderly expansion of the banking system and triggering competition by breaking down the longstanding geographical segmentation of the banking market.

We have now entered the phase designed to allow banks to organize their own networks. They have already been authorized to transfer branches within specified areas without restrictions. Since September the installation of automated teller machines has been considerably liberalized. Pursuant to a recent resolution of the Interministerial Committee for Credit and Savings, the Bank of Italy will authorize the transfer of branches between banks and standardize the different categories of branches, thereby allowing those performing a limited range of operations to become full branches. A new simplified authorization procedure will increase the scope for relocating existing branches, with the Bank of Italy assessing only the acceptability of individual bank's technical and organizational structures. Looking ahead, it will be possible to adopt a similar procedure for the authorization of new branches.

Ladies and Gentlemen,

In these concluding remarks I have referred more than once to the phase of disinflation that has been under way since the start of this decade. In retracing the main developments of this process, my assessment and the very tone of my presentation today were bound to differ profoundly from the opinions expressed on this occasion in years not long past, when it was vital to call attention to the economic and other perils inherent in the inflation that has gripped Italy for a decade and a half.

These repeated warnings were always based on painstaking analysis of the phenomenon to identify its causes, both immediate and more remote, exogenous and structural. Hence we did not have to confine ourselves to diagnosing the ailment but were also able to prescribe remedies and outline adjustments in economic policy.

Our analysis gave us faith in Italy's ability to climb back up what many had considered an impossibly slippery slope and a conviction that the central bank's task was not merely to regulate the economic cycle but to tackle the root causes of inflation and by its example encourage others to do likewise. This faith and conviction sustained us in our day-to-day policy-making. Though well aware of the limited effectiveness of the Bank's actions when it was acting virtually alone, as was not infrequently the case, we never wavered in our pursuit of the restoration of stability, which we regarded as the key to balanced economic growth.

However, if anyone thinks that today's assessment of events betrays complacency about the present state of affairs, he is quite mistaken. Our unflagging commitment to research, whose fruits are reflected in the body of the Report and which have shaped these concluding remarks, enables and indeed obliges us, even as we record the progress made, to point out that the recovery is still incomplete, that longstanding problems have yet to be resolved and that fresh problems lie ahead.

We have sought to dispel the widely held opinion that disinflation and the revitalization of a large part of the economy are no more than the fortuitous product of external events by demonstrating that these accomplishments are due primarily to domestic policy measures and the response of market forces. At the same time, however, we have emphasized that Italy, of all the industrial economies, remains the most vulnerable to instability and that it has only limited scope for countermeasures.

One false step could put us back into the plight from which we have extricated ourselves. In a world economy that offers scant stimulus to growth and in which free trade itself is threatened, even a momentary lapse in the discipline dictated by our close interdependence with the rest of the world, a surrender to the illusion that we could evade the unresolved problems of our economy, would be enough to rekindle inflation, which has been damped down but not stamped out, tighten the external constraint, which has been relaxed but not eliminated, and shake confidence, which has been restored but not yet consolidated.

If we are to avert these dangers, we must all raise our sights to the more noble aspirations of society, and not allow ourselves to be lured into the shortsighted pursuit of self-interest.

We are within reach of a society that can provide employment for the younger generation, tackle the problems of the South with fresh resolve, make the choices necessary to accommodate the increasingly widespread desire for new lifestyles, be a full and respected member of the international community, and temper the risks of economic activity through monetary stability, collective solidarity and clear rules. Our achievements must spur us on to further effort.

The corrective action that the private sector expects of the public sphere requires rigorous control of expenditure and efficiency in the provision of public services. The institutions on which our nation has relied for the past two decades in pursuing the goals of social solidarity proper to an advanced society that is sensitive to economic inequalities have revealed built-in flaws that make their operation incompatible with the fundamental equilibria of the economy. Their elimination will require reform of the institutions themselves. Though difficult, such an undertaking is essential if we are to give social policy solid foundations and a guarantee of longevity and not jeopardize cylical and growth policies.

The newly-found vigour of the corporate sector should be harnessed to expand the productive base; the future pattern of earnings growth and industrial relations should be directed to the same end. In a free economy, in which it is government's responsibility to correct the shortcomings of the market, even very high profit levels are socially acceptable if at the same time enterprises demonstrate their ability to promote non-inflationary growth of the economy, create employment and develop products that reflect a changing society's values for the quality of life.

The Bank of Italy will continue to work for the realization of this design, contributing technical competence, impartiality and devotion to the public welfare. That is the spirit that infuses the Report which I submit to this meeting. The monetary and financial problems facing us are intertwined with the other fundamental problems of our economy. It is our duty to point out the need for complementary lines of action to resolve them and to take all necessary measures within our own sphere.