BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1988

THE GOVERNOR'S CONCLUDING REMARKS

BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1988

THE GOVERNOR'S CONCLUDING REMARKS

THE GOVERNOR'S CONCLUDING REMARKS

In the past year the credit system has intensified its efforts to consolidate and develop its structures, organization and operational efficiency, in the knowledge that it must contend with keener competition not only at home but also in the international arena.

The Bank of Italy has supported this endeavour by taking specific measures with regard to the system and within the Bank itself in order to encourage the process of change in the financial sector. The progress that has been achieved and the very nature of the problems with which this Report deals confirm the validity of the Bank's strategy and its reliance on the entrepreneurial responses of market operators.

In the financial sphere, the opposite extremes of dirigisme and laissez faire are both subject to severe limitations. Recent events, and particularly those that shook the capital markets in late 1987, demonstrate the soundness of an approach that is based on experience and seeks the most effective combination of public intervention and market forces.

Not infrequently the pendulum is in danger of swinging too far in one direction. The lesson to be learnt from this is that deregulation should not mean removing fixed points of reference and renouncing all rules; by the same token, rejecting its excesses should not imply returning with a vengeance to restrictions and controls.

In the fields for which we have responsibility, namely money and credit, instruments for providing guidance are indispensable to ensure that freedom of choice in the production and distribution of goods and services both inside and outside Italy creates lasting economic and social progress and does not degenerate into instability and inflation. Both of these jeopardize the delicate balance of experience, aspirations and expectations that encourage citizens to save and enterprises to invest. Article 47 of the Constitution recognizes the value of savings, as something worthy of protection and as the basis of development; it depicts credit and money as targeted and controlled variables: if they are to act as an anchor, they must themselves be firmly anchored.

It is in this spirit that the Bank of Italy as an institution, and its staff at Head Office and in the branches, interpret their tasks, which they again strove to perform conscientiously last year, in preparing analyses and proposals in the context of an intense debate on economic and legal issues, in active daily participation in the increasingly broad and lively securities, foreign exchange, money and credit markets, in supervising an ever more varied array of financial intermediaries, in raising the efficiency of the Bank and in exploiting its human resources to the full.

The results achieved vindicate the policies chosen; however, it is on the problems facing us that attention should be focused.

The world economy

The slow adjustment of external disequilibria and the stock market crisis

Events in the world economy in 1987 were dominated by recurrent exchange rate pressures, uncertainty in financial markets and the stock market crash of October. The most severe strains emerged at precisely the time when the real economic situation of the industrial countries was improving.

The Wall Street crash came at the end of a prolonged rise in the stock market. Share prices had increased particularly rapidly in the preceding months; at the beginning of October they were more than 30 per cent higher than in December 1986. An increasingly large differential had developed between rising bond yields and falling returns on shares. The stock markets, no less than the foreign exchange markets, confirmed that under the pressure of speculation they are subject to wide fluctuations in prices and that price corrections are likely to be slow in coming, and hence traumatic.

The October crisis occurred against the background of the difficulties encountered in reducing the current account disequilibria of the three leading industrial countries. The strategy outlined in the Louvre Accord of February 1987 had been designed to stabilize exchange rates, initially by means of concerted intervention, in order to allow time for the substantial depreciation of the dollar to begin to eliminate the imbalance in trade in goods and services. Appropriate economic policies were to be adopted to consolidate the achievements in this regard and create favourable conditions for growth; they were to promote different rates of expansion in domestic demand in the various countries in order to reinforce the effects of the changes in exchange rates. During the summer, when short-term interest rates everywhere began to rise from an already high level, the market perceived a cooling of the climate of cooperation essential to the success of this strategy. The collapse in share prices in New York spread rapidly to other financial centres owing to market integration and psychological reactions.

In order to safeguard the stability of the financial system and prevent the stock market decline from affecting economic activity, the monetary authorities in the United States, in particular, reacted to the situation by injecting liquidity, thereby encouraging a fall in interest rates. A further depreciation of the dollar was accepted, and the US currency declined by about 8 per cent against the major currencies between the end of October and the end of December. The operations to stabilize exchange rates were resumed in the last few days of the year in the context of restored cooperation within the Group of Seven; their effectiveness was enhanced by the fact that the market judged the new nominal effective exchange rate of the dollar to be more appropriate.

Share prices recovered in the first three months of 1988; the performance of the various markets differed from April onwards, with some showing substantial fluctuations. By the end of last week the New York Stock Exchange index had recouped about a quarter of the losses sustained in October; the Tokyo index was close to the levels recorded before the crisis. Economic activity has remained strong in the industrial countries; the growth in consumption has been accompanied by an equally large expansion in investment, high capacity utilization rates, good profitability and favourable growth prospects.

Fears of a resurgence of inflation have not been allayed, despite the fact that oil prices have again fallen after recovering in the first half of last year. Raw material prices have continued to rise; expressed in SDRs, they are now 20 per cent above the low point of March 1987. International liquidity has continued to expand rapidly. In the United States, where the unemployment rate has fallen to its lowest level since 1974, operating rates are close to their upper limits in several sectors.

The events that culminated in the stock market decline were a reminder that investors should not ignore underlying profitability and capital adequacy when making their portfolio choices. They also revealed the limits of the support that can be given to exchange rates using monetary instruments alone when economic fundamentals are divergent and the contribution from fiscal policy is small.

It became clear that increasingly close links exist between the various financial markets and between the money and capital markets, fostered by international portfolio diversification, the freedom of movement of capital even at short term and growing recourse to techniques for spreading and covering risks. The increasing use of negotiable credit instruments and the blurring of the operational boundaries between the various types of intermediary confirmed the need to establish forms of prudential control for intermediaries and markets that are not subject to supervision. The disadvantages of having different operational practices and rules in highly inter-dependent markets became apparent.

In 1987 the imbalances in the current accounts of the three leading industrial countries increased further in dollar terms; the US deficit came to $161 billion and the surpluses of Japan and the Federal Republic of Germany amounted to $87 and 44 billion respectively.

These figures conceal the beginnings of the process of adjustment. Tangible signs of a reduction in the external disequilibria of the United States and Japan have begun to emerge for the first time since 1983; the growth in domestic demand in the United States was around one and a half percentage points slower than the rate of 4 per cent recorded in the rest of the industrial area. The greatest stimulus to growth came from Canada, Italy, the United Kingdom and above all Japan. The Japanese economy exhibited a remarkable ability to switch to a model of growth led by domestic demand. Greater progress towards correcting the disequilibria would have been achieved if the savings ratio of US households had not continued to fall, declining to a historic low of 3.7 per cent of disposable income.

Price competitiveness moved in a direction favourable to adjustment. At the end of 1987 the real effective exchange rate of the dollar was 12 per cent lower than it had been at the beginning of the decade; that of the yen rose by 35 per cent over the same period and the Deutschemark showed a less pronounced appreciation of 4 per cent.

Exporters of manufactured goods to the US market had initially absorbed the exchange rate changes by cutting their profit margins, which had widened substantially during the period of dollar appreciation. At the end of last year, however, exchange rate developments began to be reflected more fully in prices.

In the United States the slowdown in the volume of imports and the acceleration in that of exports were not sufficient to offset the movements in the terms of trade. In value terms, US exports are equivalent to 60 per cent of the country's imports, so that a rate of increase in exports that is two thirds higher than the growth in imports is barely sufficient to keep the trade balance unchanged. More than 40 per cent of the deficit stems from trade with developing and newly industrializing countries, the latter often having aggressive foreign exchange policies and restrictive trading practices. Finally, the United States' accumulated net foreign financial liabilities, mounting to more than $400 billion at the end of last year, entail interest payments that are a heavy burden on the current account.

The adjustment required in the volume of traded goods is substantial and affects the entire configuration of world trade. The projections made by international organizations indicate the danger that may arise over the medium term if progress in correcting the imbalances is too slow: the resulting financial instability and exchange rate volatility could trigger a recession.

This consideration emphasizes the need to strengthen cooperation among the major countries, as reaffirmed at the meetings of the Group of Seven and the Group of Ten in April. The United States must persevere with measures to curb its budget deficit. Fiscal stimulus to domestic demand in Japan and especially in Germany must be accompanied by structural policies aimed at encouraging growth and imports. The newly industrializing countries in South-East Asia, whose current account surpluses exceeded $30 billion in 1987, should also contribute to correcting the imbalances.

In view of the time needed for the forces of adjustment to develop their full impact on the underlying disequilibria, the commitment to curbing exchange rate instability between the leading currencies must be maintained.

One way of reinforcing economic policy coordination and enhancing its effectiveness would be to adopt a dynamic system of 'target zones between the main currency areas; in the case of Europe, this should be based on the ECU.

The international debt problem remains serious. The recovery in world trade and the revival in raw material prices have eased the financial difficulties of the most heavily indebted developing countries. Nevertheless, many of them have encountered obstacles that have prevented them from adhering to their stabilization programmes; inflation has begun to accelerate again.

During the eighties the real trade balance of the most heavily indebted economies has improved by the equivalent of around 8 per cent of their 1980 national income, but much of this has been offset by the deterioration in their terms of trade. The external constraint is depressing growth and investment, making absorption of the debt more difficult in the long run. This has adverse consequences for world trade as a whole.

The strategy pursued hitherto with regard to the debt problem remains valid in its case-by-case approach, its emphasis on appropriate domestic policies and its encouragement of cooperation between debtors, creditors and international institutions ; however, greater efforts are needed to sustain growth and ensure adequate flows of foreign finance. New market lending was inadequate in 1987. On the other hand, the volume of official debts restructured was double the figure for the previous year. The recent decision to carry out a substantial increase in the capital of the World Bank is a significant development. In order that financial support from the International Monetary Fund can also rise, the proposals for a considerable increase in quotas and lending in conjunction with appropriate structural adjustment programmes should be approved.

Towards the single European market

The European Community has achieved important successes in the eighties in curbing inflation and stabilizing exchange rates within the EMS. It has been less successful on the growth and employment fronts. National product has grown more slowly than in the other industrial areas over this period. New jobs have not been created; the unemployment rate has far exceeded the OECD average, and has been especially high among the young.

Quite apart from cyclical developments, the countries of the Community exhibit marked differences in national income and wealth, both among themselves and within their own borders. At one extreme is the group of countries with high per capita incomes, typically with a stationary or declining population, which have defeated inflation but seem to be content with rates of growth of less than 2 per cent. Labour costs are relatively high; much of investment is geared to reducing manpower, despite the already high level of capital intensity. Expectations that demand will expand only moderately are a factor depressing investment and potential growth. Unprecedentedly high unemployment is prevailing alongside high capacity utilization rates.

At the other extreme, countries with lower national income, less developed economic structures and a still large agricultural sector are showing greater vigour, drawing stimulus from their peoples' aspirations for a higher standard of living. However, deficiencies in their infrastructures and other external diseconomies are an obstacle to the inflow of capital from more advanced areas and to an increase in employment.

Italy is among the major industrial economies in terms of national product, the diversity of its industrial sector and the level of consumption. It displays dynamism, a capacity for initiative and an ability to adapt to changing external conditions; on the other hand, it continues to be afflicted by unresolved regional disparities, high unemployment, inadequacies in its infrastructure and public services and a large budget deficit. More than any other country, it shares the aspirations and problems of the two extremes represented in Europe, owing to its characteristics and its geographic situation.

The completion of a vast internal market by 1992, a commitment incorporated into the national legislation of the EEC countries through the ratification of the Single European Act, presents a historic opportunity to give fresh impetus to growth, tackle the problem of unemployment and strengthen the Community's ability to contribute to the formulation of economic policy at world level. The single market implies eliminating frontiers, passport and customs controls and all divisions between member countries. It also means removing the technical barriers and tax differences that fragment markets and prevent individuals and firms from freely choosing where to base their activities, sell their products and supply their services.

In an integrated Europe, which will be less susceptible to external buffeting and constraints, it will be possible not only to enjoy new "trade creation" benefits but also to achieve increases in efficiency thanks to larger production units and more competitive markets. The European Community will be able to offer itself as a focal point for the development of neighbouring areas with much lower national income and very different demographic prospects.

It would be a serious mistake, however, to suppose that the benefits will accrue automatically as a result of the operation of the invisible hand of the market.

Integration between economies at different stages of development is both an opportunity and a test. The savings capacity and technological resources of the more prosperous regions complement the abundant labour supply and desire for improved living standards of others where external diseconomies limit productivity but the growth potential is greater.

Europe will not fail the test if appropriate policies are followed. From the cyclical point of view, policy must be directed in some countries towards reducing excessive current account surpluses by transferring resources to domestic uses, and in others towards restoring sound public finances. The phase of disinflation can be considered to be at an end; the objective to be pursued is that of ensuring sustained growth while continuing to maintain price stability. From the structural point of view, financial and employment policies must be implemented that favour the flow of capital to regions with higher growth potential, maintain a strict link between wage increases and productivity gains and promote the reduction of subsidies and rigidities.

The Directive that will bring forward the implementation of full capital mobility, probably to 1990, is due to be approved shortly; it will increase the freedom of choice for savers and enterprises and contribute to a more efficient use of resources. However, if policies are not coordinated between member countries the potential exchange rate pressures will increase; the entire system will face a heightened risk of realignments that are not justified by economic fundamentals and competitive positions. The exchange rate's function as a disciplinary force on macroeconomic policies and on industry's behaviour in determining costs and setting prices might be jeopardized.

Hence there is an urgent need to strengthen the coordination of the stance and instruments of monetary policy. In the phase now beginning, the construction of Europe requires that monetary and credit objectives be set in concert, and not decided in effect by just one country and accepted by the others via the exchange rate constraint. While remaining flexible and pragmatic, monetary management must pay greater heed to exchange rate stability by allowing variations in the external component of monetary base to have a swift impact on interest rates.

Liberalization increases the probability and potential size of temporary shifts in investors' portfolio preferences between the currencies of the European Monetary System in response to expectations of changes in central rates. We have proposed the creation of a joint refinancing mechanism in order to provide a better defence against such shifts. The very existence of this instrument would discourage speculative attacks; its use would help prevent undesired effects on exchange rates and domestic monetary conditions.

The formation of a single decision-making body, through the creation of a European central bank, would set the seal on the process of integration. Tangible measures can already be taken to achieve that objective, which we believe is now more widely shared. The tasks and responsibilities of the EEC Committee of Governors could be enhanced with regard to the formulation of joint monetary objectives and the coordination of exchange rate policies vis-à-vis third countries; they could be extended to cover the activation and operation of the proposed refinancing mechanism aimed at offsetting destabilizing capital movements. At the same time, more active support for the development of the ECU in the markets and the establishment of direct links between the private and official markets could bring the creation of a common currency closer.

Domestic economic management, today and tomorrow

Developments during 1987

In the scenario I have sketched of a broader and more cohesive European Economic Community, Italy still suffers from long-standing weaknesses, but it has also regained some strengths that need to be consolidated. That the achievements of recent years must be constantly repeated has been confirmed by the economic events of the year that has elapsed since I last addressed you.

The objectives of expanding output and curbing inflation have been successfully reconciled with the need for external payments equilibrium and relative exchange rate stability, but economic policy has had a hard task regulating the economy. The difficulties stemming from Europe's slow growth have been accompanied by the impact that the budget deficit and the public debt have had on demand, financial flows and short-term capital movements. Adverse pressures quickly become acute whenever political or economic events in the domestic or world arena cloud expectations and shorten the time frame of corporate and household decision-making. In such circumstances monetary policy in particular must respond promptly, using all the instruments at its command in actions whose success can never be taken for granted.

Last year interest rates had to be adjusted repeatedly. It was also necessary to combine tax measures to contain consumer spending with the temporary reintroduction of credit and foreign exchange controls. The Treasury borrowing requirement exceeded the planned limit for 1987 by 14 trillion lire. The growth of credit to the non-state sector and that of the money supply were kept broadly in line with the objectives.

The fragility of the situation in which these regulatory measures were taken is evidenced by the size of interventions in both directions in the foreign exchange market. Between the EMS realignment in January and the end of April the Bank of Italy made purchases equivalent to more than $4 billion. From then until the first ten days of September support for the lira required sales totaling nearly $10 billion, and in the rest of the year the Bank purchased foreign exchange worth some $8 billion.

In the spring of 1987, against a background of accelerating domestic demand and a slowdown in world economic growth, the budget deficit did not appear to be developing in line with the target for the year. The external accounts were deteriorating, liquidity preferences were strengthening and the demand for government securities, especially at medium term, was flagging.

The Bank of Italy tightened control of the monetary base. From April onwards bank liquidity contracted and money market rates tended upwards.

Inflation showed signs of reviving during the summer; the annual rate of increase in consumer prices rose from 4.5 per cent in June to 5.5 per cent in October.

The issue yields on government securities were raised by about one point in July. Only subscriptions of short-term paper were affected. Uncertainty spread to the foreign exchange market, where operators mistakenly attributed the deterioration in the trade balance to poor competitiveness rather than to the growth differential between Italy and the other economies.

In August exchange rate expectations gave rise to heavy downward pressure on the lira, fueled by the expansion in lira credit, which Italian banks, especially the larger ones, were granting to their best customers at interest rates below the rising cost of liquidity. Determined market intervention in defence of the lira, tax measures to curb consumer spending and the raising of the discount rate to 12 per cent failed to dispel expectations of a decline in the exchange rate.

In mid-September it was necessary once again to impose restrictions on foreign exchange movements and on bank lending in lire. There could be no more convincing evidence of the linkage that expectations create between domestic disequilibria and exchange rate instability, in conditions of high capital mobility and in an economy in which budget deficits encourage total financial assets to expand much faster than national income. The speed with which bank lending subsided when the administrative controls were announced confirms that the demand for credit for financial transactions may become very substantial indeed.

The measures enacted in August and September ended the exchange crisis and curbed the growth of domestic demand. They did not halt the decline in the prices of government securities in the secondary market, despite the inflow of liquidity from abroad. The difficulties were compounded by the approach adopted in the Finance Bill for 1988, which initially centred on increases in indirect taxation at a time when prices were already rising. The doubling of the tax on interest from government securities further weakened demand, despite having been introduced earlier than planned by inclusion in the August package of measures in order to reduce uncertainty.

It was essential to prevent the temporary acceleration in prices in the summer from becoming a permanent escalation in inflation. The Finance Bill had to be revised, both to make it more rigorous and to eliminate the increase in VAT rates. In November the Government submitted the necessary amendments to Parliament.

The fall in share prices, which accelerated in the second half of October in the wake of the worldwide stock market crash, did not have repercussions on the real economy. In the financial sphere, the continued shift in investor preference towards more liquid assets had to be accepted. The investment funds, hard-pressed by redemptions, continued to sell government securities. It became more difficult to place new issues, despite a further half-point rise in yields on twelve-month Treasury bills and on Treasury credit certificates. The Bank of Italy took steps to underpin the prices of medium-term securities, purchasing 3.7 trillion lire worth between September and December. At the same time, it sold Treasury bills from its portfolio in order to maintain monetary control.

All in all, the performance of the economy last year was satisfactory. Real GDP continued to grow, expanding by 3.1 per cent. The volume of investment in plant and machinery expanded by 12.1 per cent. Inflation was held in check. In December the twelve-month rate of increase in consumer prices came back down to 5.2 per cent, and the average for the year worked out at 4.7 per cent, the lowest rate since 1969. Nevertheless, inflation in Italy is still more than twice as fast as in the other two leading participants in the EMS exchange rate mechanism, France and Germany. The balance of payments on current account was close to equilibrium. Portfolio diversification, for which there was more scope after the liberalization in May, generated foreign exchange outflows of about 3.5 trillion lire. These occurred mainly in the months preceding the stock market crisis and were more than offset by inflows of foreign capital, largely in the form of government borrowing.

The efforts to reduce inflation were assisted by a further slight decline in import prices as a result of the depreciation of the dollar. In manufacturing, wage increases were not large enough to generate cost pressures, thanks to a substantial rise in productivity, which improved by 6 per cent, thus keeping the increase in unit labour costs down to 1.8 per cent, while per capita labour costs rose by 7.8 per cent. In the economy as a whole the latter rose by 8.9 per cent and productivity by 2.9 per cent, so that unit labour costs went up by 5.9 per cent.

The improvement in the terms of trade that had begun in 1986 continued in 1987, concealing a deterioration in the real trade balance. The volume of imports of goods and services expanded by 10 per cent and that of exports by 3.6 per cent. All of the gain in exports came in the second half of the year, after stagnation during the first six months.

In the labour market, there was less recourse to the Wage Supplementation Fund; the number of hours worked per employee rose, but not the number of persons employed. Unemployment rose to 12 per cent of the labour force and regional disparities intensified; the rate held steady at 8 per cent in the Centre-North while rising by three percentage points in the South to 19 per cent.

In the cyclical management of the economy, the foreign exchange, credit and fiscal measures taken during the summer were intended to lead into a fiscal stance for 1988 that would damp down consumer demand, leave more room for exports and investment and give impetus to the improvement in the public finances.

In late 1987 and early 1988 the demand for floating rate securities improved. In January the authorities took advantage of the relaxation of tension in the exchange market to lift the foreign exchange restrictions ahead of schedule. The strong demand for Treasury bills drove yields at issue down by more than one percentage point; the issue yield curve now acquired an upward slope, in line with that of the market.

Thus there was partial implementation of the plan for the management of the public debt, which the Treasury and the Bank of Italy had agreed in the autumn on the assumption that the proposed fiscal policy for 1988 would be applied in full. The plan had a threefold objective: to lengthen the average maturity of the debt, to increase the proportion of fixed rate securities, and to offer savers a greater variety of instruments. It was also proposed to standardize the financial characteristics of new issues of the main types of security in order to make comparisons easier and thus facilitate secondary market trading. Furthermore, the plan called for more regular, though still limited, issues of Treasury certificates and bills in ECUs and for borrowing on the international market during the delicate initial period of foreign exchange liberalization.

The difficult parliamentary passage of the Finance Bill eventually produced a law entailing a borrowing requirement of over 120 trillion lire for 1988, 20 trillion lire above the original target.

Adjusted for the number of working days, industrial production in the first quarter of 1988 was 6 per cent greater than in the corresponding period of 1987. Imports were 9.4 per cent higher in value, a rate of growth nearly three times that of exports. The trade deficit amounted to 6.5 trillion lire, more than half as large as that for the whole of 1987.

The external accounts reflect and confirm the buoyancy of domestic demand. Investment is continuing to grow, stimulated by the high rate of capacity utilization and by high profits; part of it is being directed to plant expansion. The increase in disposable income and in financial wealth has fueled purchases of durable and non-durable consumer goods; a continuation of this tendency would jeopardize current account equilibrium, which assumes even greater importance at a time of financial market liberalization and integration.

Creeping inflation, which we have not yet managed to eradicate, has been fluctuating at around 5 per cent for consumer prices and 4 per cent for wholesale prices. If the kind of cost and demand pressures implicit in some recent public sector wage claims were to materialize and corrective budget measures were not taken, inflation would begin to accelerate once more.

After the hesitant recovery in January and February, the demand for government securities weakened once again. The decline was most pronounced at the longer end of the market, notably for Treasury credit certificates. The problem lay less with demand from the public than with that from the banks, which were concentrating on meeting strong loan demand in the face of stagnant deposits. The Bank of Italy resumed purchases of medium-term government securities until the end of April. In the last two months the Treasury has raised interest rates on twelve-month bills, increased the spread on credit certificates and improved the yields on four-year bonds.

The public finance rehabilitation plan approved in the last few days by the Government aims to achieve a budget surplus net of interest payments in 1992 by reducing expenditure and increasing revenue. Immediate budget measures have also been announced to reduce the borrowing requirement for 1988 to 115 trillion lire, decreasing the Treasury's resort to market borrowing by 7 trillion lire. The demand-damping effect is smaller, in that the direct impact of the measures on income and consumption is equivalent to about half that amount.

The current phase of buoyant economic expansion signaled by all the indicators permits and requires countercyclical measures to be implemented almost simultaneously with the start of the progressive rehabilitation programme implicit in the Government's plan; this will enhance the credibility of the plan itself and strengthen market confidence.

The credit and money supply targets for 1988 are unchanged from those set by the Interministerial Committee for Credit and Savings last autumn. They constitute a disciplining force for the entire economy. The banks have been invited to slow down their lending, and not just that connected with financial transactions. For its part, the Bank of Italy is carefully regulating bank liquidity; it is curbing the creation of monetary base in order to slow down the growth in credit, which had shown signs of accelerating even before the lifting of the lending ceiling.

Economic policy and control of the money supply in an internationally integrated economy

Given the prospect of freedom from foreign exchange controls and the full integration of Italian financial markets with the rest of Europe, the events I have just described demonstrate the crucial importance of being able to make full use of fundamental instruments such as fiscal policy and incomes policy for purposes of economic management. Only in this way will it be possible to achieve the complementarity between these instruments and monetary policy that is necessary if each is to be correctly and effectively applied to its proper objectives.

For monetary policy, European economic and financial unification will further complicate the task of safeguarding external payments balance, in that it will require consistency between capital movements and exchange rate stability. In the past it was frequently possible to use monetary means to reconcile conflicting objectives, such as internal and external equilibrium or stability and growth, albeit at not inconsiderable cost; the scope for such action will inevitably tend to be narrower in future. Greater reliance will have to be placed on fiscal and incomes policy to curb cost pressures and free the resources needed for investment and for exports.

For countercyclical and other purposes, economic policymakers must regain full control over the budget as soon as possible. The fiscal measures concerning the allocation of resources as well as the volume and composition of aggregate demand must also be consistent with the guidelines the European Community elects to follow.

In Italy more than in the other industrial countries, the labour market continues to be hampered by rigidities that are scarcely reconcilable with the need to reduce the country's high unemployment. They are to be found in legislation and labour agreements and in the rate of increase in both aggregate wages and wage differentials. They have an adverse effect on price stability, employment and efforts to reduce regional disparities, as well as causing strained labour relations. As regards wage determination in both the public and private sectors, employment policy must ensure that efficiency and competence are suitably rewarded while reconciling increases in productivity and nominal incomes in specific sectors with the overall objectives of economic policy.

The commitment to improving institutional and market arrangements extends to monetary policy. Financial integration and the removal of foreign exchange restrictions make it more essential than ever that interest rates, especially short-term rates, be free to respond promptly to pressures in the foreign exchange market, and that interest rates at issue and secondary market yields be consistent.

Efforts to woo investors back to fixed rate securities, both public and private, must be based on a maturity diversification that reconciles the liquidity and yield requirements. Longer-term investors ought to be paid a premium to compensate them for the risk of interest rate variations and the reduced liquidity of their assets. As a rule, this will produce a rising yield curve; far from reflecting or signaling inflationary expectations, such an arrangement will help to redirect savings towards longer maturities.

Strengthening the fixed rate segment will permit greater mobility in short-term interest rates and deepen the secondary market in government securities. The recently initiated reform of this market is intended to improve its working and enhance its transparency, so that prices better reflect the state of supply and demand.

An efficient money market is a prerequisite for the smooth functioning of the secondary market in government securities and the prompt transmission of monetary policy impulses. In the interbank market the range of maturities has widened in the competitive segment for very short-term deposits, but the segment remains small and operates alongside others that are highly unresponsive. Variations in liquidity cause very sharp swings in interest rates in this segment, but these are transmitted only partially and with delay to the rest of the money market.

The rationalization of the payment system and of financial transactions will make a major contribution to a more functional interbank market. Broadening the market will reduce the volatility of the overnight rate, strengthening its role as an indicator of monetary conditions, and will induce the banks to respond more promptly to changes in liquidity.

A further contribution could come from changes in compulsory reserve requirements. The Treasury and the Bank of Italy are now examining a system that would allow banks to mobilize the funds committed for this purpose, provided that the requirement were met on average over the monthly maintenance period. Each bank's free and compulsory reserves would be amalgamated into a single deposit with the Bank of Italy. Within specified limits, the banks would have the option of using these deposits rather than resorting to interbank borrowing or central bank financing. The control of monetary base and the punitive terms of lending of last resort would ensure that banks did not overuse this new facility while relying on central bank refinancing to comply with the monthly average reserve requirement.

Competing in Europe

Italy needs to develop its economy rapidly, in qualitative as well as quantitative terms, and it has the potential to do so. Substantial private and community needs remain to be satisfied. The nation has a skilled work force, considerable private savings and small and large entrepreneurs of initiative.

Membership of the increasingly integrated European Community will offer new opportunities and present new challenges. We are nonetheless obliged to remove the obstacles to growth, which are mainly endogenous.

Unresolved structural problems and systemic weaknesses are undermining the real and financial stability of our economy. By far the most serious and alarming are the direct and indirect consequences of the shortcomings and disequilibria of the public sector. If our awareness of the problems and our determination to resolve them ultimately proved inadequate, we would be in danger of undoing the progress Italy has achieved in past years.

Problems and weak points remain in the labour market and the energy sector as well as in branches of production such as agriculture. Above all they affect the quality and efficiency of the services provided to households and businesses by the tertiary sector and by government. They are even to be found in industrial firms, notwithstanding the restructuring that has taken place.

In the single European market labour and capital costs will tend to equalize, or will be forced to, under the spur of competition, which will be accentuated by decreased exchange rate flexibility. Awareness of this is spreading among the managers of firms and among the work force.

In the late fifties and sixties the Italian economy was able to draw greater advantage than others from the first stage of European economic integration and the resulting surge in trade, moving as it was from a high initial level of protection.

The current second stage, which will complete European economic integration, will lead to a further expansion of trade in areas where it is already intense, as in manufactured goods, but it will have its greatest effects on services. Equating service activities with products that cannot be traded internationally will become even less realistic. The ease of communication and the freedom of movement of persons will give European consumers and enterprises access to a vast range of services beyond their national frontiers, and not only those financial services with which I shall deal below.

Only a substantial improvement in the efficiency and competitiveness of the entire Italian economy can enable us to seize the opportunities for growth that this process is creating, to turn to advantage the potential inherent in our large labour force and to begin at once to tackle the problem of unemployment, which will not disappear even when the effects of the slowdown in the birth rate make themselves felt.

The productive economy

In an open economy, it would be a mistake to attempt to solve the employment problem by blocking the application of new techniques and productivity gains or confining them to defined sectors.

Since 1980 employment in Italy has increased by 350,000 persons and its composition has changed radically. The growth has not been enough, however, to keep pace with the rapid expansion in the labour force and to prevent a steady rise in the unemployment rate. The number of persons employed in industry has decreased by a million. Public and private services have created over two million jobs, more than offsetting the decline in industry and agriculture. Employment has risen faster in services used directly in the production of other goods than in services for final consumption.

Given that the reduction in manpower in manufacturing industry is coming to an end, now that restructuring has been substantially completed, and that the outflow of labour from farming is also tending to slow down, strong and sustained economic growth will mean that the jobs created by the services sector can raise the overall level of employment.

The expansion of this sector has taken different forms, depending on the region. In the Centre-North it has occurred primarily in services to business, while in the South it has involved mainly government services and commerce.

Even the statistical data now show that the Southern question and the unemployment problem coincide. Economic progress cannot be achieved in the South unless manufacturing industry and advanced services are strengthened by means of initiatives designed to take advantage of the abundance of labour in that region, given the prospect of a labour shortage in the rest of the country. It is equally important, however, to exploit other activities capable of stimulating trade with other regions, such as those connected with agriculture and tourism.

Progress on both these fronts can be assisted by improving the infrastructure, which remains poor by European or Northern Italian standards, raising the efficiency of government departments and public services and encouraging the emergence of new entrepreneurs. Measures in favour of industrial and other firms need to concentrate on the South, where even enterprises with growth potential find their costs and profitability affected by external diseconomies.

With regard to the energy question, Italy is the only major industrial country not to have achieved any reduction in its import dependency since 1980; it still imports 83 per cent of its requirement, as against a European Community average of 44 per cent. Italy also stands out for its heavy reliance on hydrocarbons, which meet 80 per cent of the country's energy needs, compared with 63 per cent for the Community as a whole.

It has now been decided to call a halt to the nuclear energy programme, given the current state of technology. A strategy must be adopted that is consistent with this decision. In view of the acknowledged need for a greater measure of environmental protection than in the past, priority must be given to resolute policies of energy conservation and diversification as regards both the sources of energy and their suppliers. Prices, utility charges and tax measures need to be used actively to contain and steer energy consumption. The ability to adjust indirect taxes is essential in this regard. The situation of Italy with regard to energy resources is such that it should continue to be free to use this instrument even after the complete integration of markets within the European Community.

In a growing economy, the rationalization of energy sources and energy conservation alone will restrain but not halt the increase in the demand for energy, which is a fundamental factor for every type of productive activity. Even if energy is considered as equivalent to any other good traded freely in international markets, higher imports will be a burden on the balance of payments; this must be offset by efforts to produce at more competitive prices in order to export a larger volume of other goods and services.

As it prepares to face competition in more fully integrated markets, Italian industry is still composed of a large number of small and medium-sized companies and a few large groups, both public and private. The proportion of small firms has tended to grow, owing in part to decentralization by the largest companies. Firms with fewer than 100 employees accounted for 23 per cent of sales by manufacturing firms with 20 or more employees in 1973, 26 per cent in 1980 and 30 per cent in 1985.

During the eighties small businesses have advanced steadily in terms of output, exports, investment and jobs, but their productivity has risen less rapidly than that of large firms. They retain the advantage of greater flexibility in the use of resources and lower labour costs per employee. They need to invest more in new technology, enhance their expertise, strengthen their marketing and their financial and cash management and increase personnel training.

All the statistical sources indicate a dramatic improvement in the economic and financial condition of large private firms. They have cut overall unit costs, economized on labour and reduced their borrowing.

In public enterprises, which have also made significant progress in this regard, the improvement in profitability has been less pronounced. In the last few years the decline in interest rates and the decrease in borrowing have reduced interest charges for them too; the restructuring process should now be completed. This will be particularly arduous in the industries that are still struggling to overcome a worldwide crisis.

Investment policies geared towards rationalization, careful management of stocks and the return to profitability have enabled both private and public enterprises, and especially the largest firms, to make a drastic reduction in recourse to external financing. The net borrowing of the entire corporate sector decreased from 7.5 per cent of GDP in 1980 to 2.9 per cent in 1987, despite the expansion of corporate investment.

This trend, in combination with the limited growth of output, the reduction in employment and the modest expansion in plant capacity, has given rise to fears that preoccupation with financial matters might distract attention from the production of goods and services. Whenever financial management has been effectively integrated with productive activity, this risk has been averted and the return to profitability has been accelerated.

Between 1983 and 1986 the gross operating profit, net of debt servicing, of a group of 400 leading industrial firms in both the public and private sectors rose from 8 to 21 per cent of value added. This recovery in the yield on real capital illustrates the positive results of the reorganization of production, and tends to alter the balance of relative advantage between real and financial investment in favour of the former. Combined with good demand expectations, the improvement in profits in 1987 led to renewed investment aimed at expanding plant capacity.

Equity investment at home and abroad also represents a path to corporate expansion. Firms are moving towards flexible forms of organization, especially companies operating internationally. They are acquiring subsidiaries to gain access to technology and markets. They view internationalization as a valid objective for its own sake. It is the responsibility of senior management to avoid losing sight of a coherent strategy for pursuing profitability through a policy of functional complementarity that enhances the efficiency of each unit.

In view of the vitality of entrepreneurial initiative, the legal framework in which business is conducted also needs to be adapted, and this is a task for government. The changes required concern the joint stock company as a market institution at the centre of a network of relations with shareholders, creditors, consumers, employees and the state. It is not only the relationships between these interests that depend on the legislative framework, but also the very ability of firms to compete effectively. The time has come to introduce anti-trust legislation in strict accordance with Community directives to provide consumer protection, ensure free access to markets for large and small firms alike and to prevent behaviour that distorts the workings of the market. It is particularly important to establish a legal and regulatory framework for holding companies and takeover bids that safeguards the rights of minority shareholders while not stifling initiatives to modify or strengthen the structure of controlling interests.

Government services and public finances

A large services sector is a characteristic feature of modern industrial economies. It supplies a significant and growing share of the factors of production used by industry. Accordingly, the prices of manufactures are increasingly dependent on the cost of services.

Italy has been the odd man out as regards productivity trends in the services sector: between 1980 and 1986 output per worker in market services rose on average by 13 per cent in the United Kingdom, Germany and France, while in Italy it fell by 4 per cent.

The productivity and competitiveness of the economy are determined primarily by the condition of the public sector. Input-output tables show that public sector market services are used, directly or indirectly, by every branch of production. Services supplied for final consumption by households constitute the greater part of government services. Public dissatisfaction with their shortcomings ultimately generates upward pressure on earnings.

The far-reaching changes and rapid rise in the demand for services in connection with the growth of the economy, social and geographical shifts and the aging of the population have made the task of the public sector more difficult. Its response to these changes in terms of the organization and use of resources has been inadequate. Not infrequently, the private sector has had to make good the shortcomings by duplicating the activities of public providers; no plans have been drawn up for transferring the production of some services to the corporate sector.

Insufficient progress has been made in improving rules, procedures and methods. The narrowing of wage and salary differentials has weakened the link between earnings and the standard and quantity of work. The areas and sectors in which the demand for services has increased most do not correspond to those in which the rise in government employment has been greatest. The inadequate levels of capital and investment in technology have restricted the productivity of important sectors. The separation between responsibility for spending decisions and responsibility for the financing of expenditure has led to slack management.

Closer comparison with the other European countries will heighten the contrast between the requirements of citizens and firms and the ability of the public sector to meet them. Delay in acting would increase the calls for the indiscriminate dismantling of the pillars of the welfare state. On the contrary, these need to be safeguarded as achievements that a civilized society cannot renounce. If these services are to be preserved, benefits will have to be managed in accordance with principles of efficiency and restricted to those who are genuinely entitled to receive them.

It is now increasingly recognized that the major obstacle to the stable growth of the Italian economy is the state of the public sector. Every alarm has been sounded, every metaphor employed. If the present condition were to persist, Italy would be unable to play its rightful role in the economic order towards which Europe is moving. It would be prevented from doing so not only by the shortcomings in public services but also by the imbalances building up in the public finances.

A borrowing requirement that for the last two years has represented a double-digit percentage of gross domestic product and the consequent accumulation of debt act in several ways to curb economic progress.

During the seventies and early eighties the budget deficit and the public debt increased in relation to GDP in nearly every industrial country, thereby attenuating the recessionary effects of the deterioration in their terms of trade and in some cases helping to ease social conflicts that would otherwise have been difficult to overcome. However, as the eighties progressed these countries radically improved the state of their public finances: Germany and Belgium halved the ratio of their budget deficits to GDP, the United Kingdom is close to balancing its budget, while Denmark and Sweden have swung from a large deficit to a surplus. In Italy the borrowing requirement decreased from 14.3 per cent of GDP in 1983 to 11.6 per cent in 1987, when the average for the rest of the Community was 3 per cent. The persistence of large deficits pushed Italy's public debt up to more than 90 per cent of national income last year, whereas in the rest of the EEC the average was 52 per cent.

This constitutes a burdensome legacy. High real interest rates are the channel through which its effects are transmitted. If interest rates were brought down, and hence faster monetary expansion accepted, the tax explicitly levied on present and future generations would be replaced by an inflation tax.

Closer integration in the European Community can only marginally reduce the pressure the Treasury exerts on domestic interest rates. It is true, of course, that integration will give creditworthy firms greater scope for raising funds abroad and may make it easier for the Treasury to place a part of its debt in international markets, though not even the state can ignore the exchange risk. However, it would be an illusion to believe that the burden of adjustment could be avoided in this way.

The analyses underlying the Government's plan for 1988-92 confirm that the debt would spiral upwards in relation to national income in the absence of corrective action. It is indispensable that the budget deficit net of interest payments be eliminated through expenditure and revenue measures, changes in budget procedures and a revision of the structure of the finance law. Partly because it would help to restore confidence, eliminating this component of the budget deficit is the only course that will permit a parallel decrease in interest rates, ultimately removing the difference between the cost of the debt and the growth rate of the economy. At that point the public debt will stop rising in relation to GDP and start to decline. It is essential that the trend be reversed and the virtuous circle set in motion by market means, the only ones that are feasible.

Banking and finance in evolution

Community legislation

The efforts within the Community to strike a balance between the principles of mutual recognition of national banking regulations and harmonization of their key features are expressed in the proposal for the Second Coordination Directive. This supplements the definition of a credit institution by identifying the activities to be covered by mutual recognition, ensures a degree of flexibility by making provision for secondary legislation, confirms the autonomy of banks and recognizes basic elements of group structures. The Directive is based on awareness that the integration process would rapidly come to a halt or entail serious risks if the stability of financial systems were not protected by uniform prudential rules, especially as regards minimum initial capital, solvency ratios, identification of qualified shareholders, large exposures, investments and confidentiality.

The supervision of the foreign branches of a credit institution will be entrusted to the home country authorities. Their task will be complicated by the size of the market and the persistence of differences between national regulations. The opening of banking frontiers creates the need for a Community forum to tackle problems of interpretation, coordinate interventions and formulate guidelines for secondary legislation; such a forum already exists in embryo in the Banking Advisory Committee.

European financial integration will be achieved through the liberalization of both short-term capital movements, scheduled to take place during 1990, and the supply of banking and financial services, to be completed by the end of 1992. By giving everyone in the Community the right to invest and borrow in any member country, the first part of this programme acts on the demand side and is concerned with instruments. By allowing the credit institutions of every member country to operate throughout the Community, the second part acts on the supply side and is mainly concerned with institutions. In view of the substantial overlap between these two processes, it will be necessary for monetary policy and banking supervision to give consideration to the problems that the timing difference may cause. There will also have to be minimal harmonization of the various types of contract and financial product, most of which are governed by national regulations.

The action of the credit authorities

During the last ten years the Italian credit authorities have sought to create the conditions that would permit the money and financial markets to become broader, more diversified and more efficient. New categories of intermediaries have developed. Competition has intensified.

In the banking field this aim has been pursued in several ways : the shift from a system of supervision based primarily on the authorization of individual operations to one relying principally on general rules, the easing of restrictions on operations and the segmentation of the institutional categories of intermediary, the reaffirmation of the entrepreneurial concept of banking in contrast with others that curtailed banks' autonomy, the introduction of forms of supervision on a consolidated basis, the application of new regulations for bank branches, the permission for public banks to raise private capital, and the indication of the diversified financial group as the preferred form of organization for credit activities. These measures mean that the acceleration in the unification of the Community has not caught Italy unprepared. It is now time to quicken the pace.

The application of company law to the credit sector has been extended in recent years by legislation approved by the Community and the Italian Parliament as well as by court decisions and regulations issued by the credit authorities, whose supervisory practices have often anticipated the shape of such legislation. Enhancing banks' entrepreneurial role does not reduce the importance of public regulation to protect savings: market forces on their own do not guarantee that financial structures will be both stable and efficient.

The Bank of Italy has studied the legal framework for public sector credit institutions, which account for around two thirds of the banking system, and formulated proposals that elaborate on earlier indications. Establishment in the form of a limited company allows public sector banks to take advantage of the greater scope provided by company law and promotes equality of competition. The solution preferred by the Bank of Italy would involve the public entity in transferring the banking business to a limited company, of which it would own the controlling interest, while maintaining the special features rooted in its own history.

The group model enables both private and public sector credit institutions to supply a wider range of services without losing the advantages of specialization. It is an organizational solution whose validity is independent of the specific requirements of the Italian banking system. Law 114 of 1986 has given both the supervisory authority and banks' governing bodies access to the information needed to monitor the performance of the subsidiary companies of a group headed by a credit institution. There is also the alternative configuration in which a non-bank financial company heads the group. In both cases the group would be operating within the ambit of the Second Community Directive and would have to be subject to supervision and prudential controls on a consolidated basis.

The separate incorporation of banking businesses in the public sector and the group model of organization provide credit institutions with new scope for rationalizing, supplementing and diversifying their activities and for creating the structures that best fit their strategies.

Recent events in international financial markets have confirmed the need to strengthen the safeguards to limit the potential instability of the financial sector and prevent it from transmitting harmful impulses to the real economy.

The control of financial intermediaries includes interventions both to promote stability and to enhance transparency; their complementarity does not nullify the difference between their purposes. The conceptual and operational separateness of the two types of control explains why they have been entrusted to different authorities.

Banks will remain at the centre of the financial system. They are the principal channel for the transmission of monetary policy, they influence investment and output through the supply of credit and they play a key role in the complex payments mechanism. The fact that their balance sheets include assets that are not easily negotiable and monetary liabilities makes them unique. They are subject to special controls and have the privilege of access to central bank credit, which produces its effects in the economy through them, and all the more rapidly the less the market is segmented.

Non-bank intermediaries that are empowered by savers to decide how their wealth is to be invested perform an activity that involves a relationship of trust, in the same way as banking. These intermediaries need to be set within a regulatory framework that, by protecting the trust element in the relationship, will also defend the stability of this important sector of the financial system. In view of the common features and the need for equal competitive conditions, the prudential control of these operators should be analogous to that of banks, albeit less severe and arranged differently. The legislation governing investment funds was based on this principle. The blurring of the traditional boundaries between both markets and intermediaries requires that stability-oriented regulation and control should be comprehensive and undivided.

The situation is different for operators instructed to carry out transactions for savers who have made their own investment choices. Such operators are links in the complex impersonal mechanism for fixing the prices of financial instruments that constitutes the stock market in the broadest sense of the term. As part of the measures designed to increase its efficiency, the primary requirement for these operators, and any others that have direct access to the market, will be to respect a code of conduct serving to prevent conflicts of interest and make adequate information available to investors.

The strategy of the credit institutions

Italian credit institutions, both individually and collectively, must formulate strategies to strengthen and upgrade their position in both domestic and international markets. We firmly believe that they can cope successfully with Community competition, just as industrial firms did when customs tariffs were abolished thirty years ago.

Comparison with the regulatory frameworks governing the operations of the credit institutions of the other main EEC countries shows that Italian banks are not disadvantaged. Unlike the legislation in some other countries, the 1936 Banking Law allows them to place securities with their customers, to belong to share underwriting and placement syndicates and to assist the flotation of companies in this way. Recently, the scope for banks to lend beyond the short term has been increased and standardized, while opportunities have been created for medium-term fund-raising. The Interministerial Committee for Credit and Savings has gradually eased the restrictions on equity investments and can be expected to move further in this direction.

Acquiring the trappings of an overseas presence does not signify preparing to meet international competition. In expanding abroad, banks need to be selective but at the same time to take an overall view, preferring to establish a branch here, to purchase a subsidiary there or to negotiate an agreement with foreign banks, depending on which method will most enhance the bank's ability to meet the financial needs of borrowers and investors in international markets.

The experience of banking systems that are already operating in conditions of complete freedom from exchange controls and freedom of establishment abroad shows that only a small number of banks have acquired multinational status. Even then, their main source of income has remained the business they do in their home countries, primarily in retail banking.

Community integration will bring the larger Italian banks into more direct competition with those of other countries. There will be even greater pressure on them to strengthen their structures and capital bases, to cut their costs, to make better use of their human resources and to focus on the most profitable sectors of the market. With a view to ensuring an active role for themselves in a larger and more diversified market, the leading banks and special credit institutions must assess the adequacy of their organization, range of operating and professional specializations and size. Mergers, even on a large scale, may prove desirable.

For Italian banks the outcome of the 1992 challenge will be decided first and foremost in Italy. It will be won by defending traditional markets and customers through improvements in the quality of supply in the three basic areas of corporate finance, payment services and the management of households' savings, rather than by entering new markets and fields of activity, which can often prove costly.

The profits of banks and special credit institutions were lower on average in 1987 than in the previous two years, with considerable differences between the results of individual institutions. The adverse effect of their rigid cost structures on profitability is becoming more pronounced as a result of the disappearance of special factors that had boosted profits in recent years, some of them related to the performance of the securities market.

The banking system's awareness of the need to give higher priority to reducing costs and raising profitability is increasing, owing partly to the pressure exerted by the compulsory minimum capital ratios. Translating this awareness into action is not proving easy; the improvements in efficiency achieved by the less profitable institutions are still inadequate.

As regards corporate finance, excessive and technically indistinguishable lines of credit entail the risk of sudden large fluctuations in the amount of credit actually used. More active monitoring at each stage of the various types of loan is conducive to more balanced management of a bank's resources and a stable customer base. A close link between lending policy and conditions in the money market improves banks' situation as well as making for more efficient transmission of monetary policy stimuli generated by indirect instruments.

Similarly, on the liabilities side banks' operations can be made more effective by diversifying both fund-raising instruments and offering differentiated returns. Banks' balance sheets and profit and loss accounts would immediately benefit from the introduction of a rational set of prices and yields that distinguished between payment services and those involving the investment of savings. The development of fund-raising through the issue of certificates of deposit is a first step in this direction. Such a distinction would also facilitate the conduct of monetary policy.

Improvement of the mechanisms that make up the payment system in Italy is a precondition for customers to be supplied with rapid and reliable transfer services as well as prompt and complete information, for banks themselves to have the data they need for their treasury management, and for the efficiency of the interbank market to be increased. The Bank of Italy has already begun to implement the plans that were drawn up and published in April of this year in a follow-up document to the 1987 White Paper on the payment system. Far-reaching changes will be made to the architecture of the system through the widespread application of telematic procedures. Substantial improvements will stem from the exchange and settlement of out-of-town cheques in the clearing house, the direct debiting and crediting of accounts with the central bank and the creation of a single computerized interbank clearing system. The banks, both individually and collectively, must act promptly to develop the operating and data processing procedures needed to exploit the full potential of the new system.

As regards branches, the possibility of interbank sales, the elimination of the distinctions between the different categories and, most recently, the liberalization of the regulations on relocations give banks new freedom to exercise their entrepreneurial autonomy and reorganize their networks. Branches provide the foundation for customer relationships and are one of the most effective instruments for meeting competition, but they also generate costs and become a source of weakness if made to serve as an ostentatious symbol of a bank's rank. Streamlined branch offices with resources, products and delivery times that match the requirements of the area served are the key to rationalization, the necessary prerequisite for the future growth of the bank's network.

The more intense competition that is now a feature of banking markets must not impede the cooperation required to solve problems that concern the whole system. In some fields, such as the review of fund-raising techniques, a cooperative phase may be necessary if competition is to develop effectively. The bodies representing the banking system, and in particular the Italian Bankers' Association, provide the natural fora in which to discuss these matters, identify solutions to infrastructure problems and specify technical requirements.

Ladies and Gentlemen,

My remarks today have been concerned with action on two broad economic policy fronts: the action to be taken in Europe to create a genuine, united Community that can stand alongside the United States and Japan as a point of reference in the world economy, and the action required in Italy to achieve an efficient public sector that promotes growth and stability and does not squander resources.

The objectives towards which Europe is moving are those of a Community that appears to be reviving the ambitions of its founding fathers, namely the removal of all internal frontiers and the curbing of member countries' powers of veto. The objective of a true monetary union and the establishment of a European central bank is taking shape. The major disputes about minor issues appear to have subsided; though the road ahead is still arduous, the way is now clear for progress towards the completion of economic union, which will prepare the ground for political union and make it essential. The agenda is a demanding one, owing to the complexity of the problems to be resolved and the importance of the interests at stake. It will be a laborious process, never free of the risk of setbacks, but for the civilization to which we belong it is the only way to avoid losing the thread that was broken by two world wars and retied by those with the vision to imagine Europe as a community.

If this vision is to become reality, the European Community must adopt the correct approach to the fundamental choices it now faces. It must reconcile capital mobility with exchange rate stability by intensifying monetary cooperation to the point of establishing a common policy. It must recognize that the need for economic progress in vast backward regions of the Community is so great that individual countries will be able to enjoy soundly based monetary stability only if economic growth is achieved throughout the area. It must participate in international cooperation with unity of purpose and powers of action of its own. It must be the Europe of true equality, in which all member countries contribute to the formulation and implementation of policy.

Italy's commitment to this vision is profound and its contribution is essential. Both have their roots in the tradition of the Risorgimento and in a long-standing inclination towards a universal society. The more our country builds on its strengths and corrects its weaknesses, the more it can contribute to the construction of a solid common edifice, and the better it will be able to participate and progress within Europe. Being a part of Europe means accepting clearly defined obligations regarding the action to be taken.

Substantial progress towards the restoration of monetary stability has been achieved in the decade that is now drawing to a close. This major accomplishment, which some considered impossible only a few years ago, has been attained by determined, resolute action. Yet it is an incomplete success, vulnerable precisely for this reason and constantly jeopardized by pressures from competing corporatistic claims that must be resisted in the public interest.

The state of the public sector well illustrates the precariousness of our achievement. The disequilibria in the sector have grown worse owing to the inadequacy of the measures to redress the situation; they are obstructing the economy's productive forces and sapping their vitality.

There is a close link between the construction of a unified Europe, which is now under way and in which we wish to be active participants, and the righting of our public finances, so that decisions regarding these two spheres must be taken and implemented in tandem. Italy generates 19 per cent of the Community's total GDP but accounts for 29 per cent of its public debt. The quality of some of our basic public services is below that of an advanced society. The shortcomings of the public sector penalize the entire economy, because economic legislation, administrative efficiency, transportation, telecommunications, urban organization, education and scientific research are major factors in overall competitiveness.

With the advent of complete capital mobility, a large and growing public debt makes the task of monetary management more arduous. The state's continuous massive borrowing imposes an economic cost and a financial constraint that impede not only economic growth but also the resolution of Italy's fundamental problems, namely unemployment and the South.

For a country with Italy's resources and powers of initiative, the damage implicit in an inefficient public sector and seriously unbalanced public finances is not so much the danger of sudden explosions, or of economic and social crises, but rather the day-to-day reality of constant waste, unrealized development potential and the threat of a resurgence of inflation, which has not been entirely defeated.

When the inflationary spiral was carrying Italy away from the rest of Europe, we set out the conditions and institutional changes required to restore stability. We believed that this could be achieved if the arrangements and attitudes most directly barring the way were altered. At the same time we warned against the illusion that dramatic crises could produce miraculous cathartic effects. Without trauma, some established mechanisms and patterns of behaviour have been changed substantially, to the benefit of all.

The same resolution and commitment are required today.

A chronic budget deficit and a level of public debt that is a burden on this and future generations point to unresolved problems transcending economics and finance. They concern the foundations of our institutions, the rules of civilized society; they affect the relationship between individual risk and social solidarity; they impinge on both the linkage between economic life and public administration and the consistency between policy choices and resource constraints.

In its procedures for authorizing and financing expenditure and monitoring the quality of public services, Italy follows rules and practices that are incompatible with sound finances. Each of these aspects has been analyzed in a number of fora, and each of them has been the subject of concrete proposals that have been successfully tested in other countries. All of these proposals accord with the Constitution and many of them reinforce and apply its principles.

Procedural reform must be accompanied by measures to improve the balance between expenditure and revenue: an incomes policy that respects general economic constraints and rewards skill and productivity, a closer link between welfare expenditure and real need, greater efficiency in the health service to reduce costs and raise standards, a system of corporate subsidies aimed more directly at overcoming regional disparities, and a more rigorous and equitable tax system, especially as regards tax evasion and avoidance.

It is not true that this means dismantling institutions of genuine social solidarity; on the contrary, sound public finances, in which consistency has been restored between resources and expenditure, will actually be more responsive to society's expectations, and more just. It is not true that the action to be taken is beyond our capability. Nor does the state of the economy prevent an immediate start being made; indeed, the present phase of growth, which is particularly vigorous in all the components of domestic demand, calls for action to curb an expansion that is already beginning to conflict with the balance-of-payments constraint.

The Government's financial rehabilitation plan is based on a sound diagnosis and it sets forth the guidelines for action. The sectoral measures that will give practical force to the plan need to be taken with urgency. A sharp reversal of the trend in Italy's public finances is a sine qua non for remaining on a truly equal footing in the European Community. It is essential if the progress made hitherto is to be consolidated and translated into economic growth on the scale the nation's resources permit and its needs demand.