BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY, 1989

THE GOVERNOR'S CONCLUDING REMARKS

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In performing its increasingly intensive activity, the Bank is looking to the future: to the needs of a country advancing to a higher level of development, to the pressing and unfinished task of restoring sound public finances, to our demanding European commitments. The management and the entire staff of the Bank are aware how delicate are the technical and public duties entrusted to them; I should like to express my gratitude to them all.

Last year the Bank of Italy improved its operational efficiency by taking advantage of the changes increasingly made possible by the spread of automation. Work began on updating the technical facilities of the branches and adapting their organizational structure in order to enhance their effectiveness in the areas of administration, banking supervision and economic analysis. Projects were also completed or launched with regard to the revision of internal regulations, cost accounting, internal auditing and the automatic handling of securities, data and documentation. The Bank maintains an active presence in research, in relations with other central banks and in international fora engaged in the coordination and formulation of decisions.

The signing of labour agreements covering the Bank's personnel for the period 1988-1990, in which a more advanced system of industrial relations plays an important role, was one of the positive achievements of last year.

The measures to enhance the Bank's own efficiency go hand in hand with those aimed at improving the quality of services provided jointly by the central bank and the credit sector. The new method of clearing out-of-town cheques has shortened settlement times, to the benefit of both banks and customers. Arrangements were made to permit the direct crediting and debiting of centralized accounts with the Bank of Italy, and the procedure for the daily settlement of securities transactions was streamlined. These are the first fruits of the reform of the payment system, which the Bank has promoted and is in the course of implementing. The revised system for reporting banking supervision and foreign exchange statistics was completed and put into operation.

These objectives, which the Bank of Italy has been pursuing for many years, stem from the Bank's vision of the integrated conduct of monetary policy, banking supervision and activities relating to payment services.

In my report to this meeting last year I concentrated on European integration, the restoration of Italy's economic health and the credit system's quest for ways of achieving greater efficiency in a supranational market. The events of the intervening months prompt me to return to these themes today in order to review developments, chart the progress that has been made and indicate where action has been slow. The events in question have occurred during an expansionary phase of the economic cycle. In reviewing them, one's thoughts turn inevitably to the present situation, to the interaction between imbalances in the public finances and retrograde trends in prices and foreign trade; the analysis that follows also deals with the structural problems that seem most pertinent to today's concerns.

The remarks I am about to make complement the main body of the Report, which contains analytical material and more detailed information; together, they are the means whereby every year the Bank duly accounts to the country for its actions.

The world economy

Problems in the development of the world economy

In 1988 the industrial countries achieved better economic results than had been expected. The rate of increase in gross domestic product rose to 4 per cent, one of the highest rates of the decade ; fixed investment was the most dynamic component of total demand. Though slower than in Japan and the United States, the growth in output and employment was also brisk in Europe; however, Europe's unemployment rate remained at 10 per cent. World trade grew rapidly, increasing by more than 9 per cent in real terms.

On an annual average basis, consumer prices increased by 3.2 per cent in 1988, a slightly higher rate than that recorded the preceding year; inflation accelerated as the year proceeded, and by the first quarter of 1989 it was running at more than 4 per cent.

The adjustment of current account imbalances was unsatisfactory. The growth in external demand and the improvement in competitiveness as a result of the depreciation of the dollar over the previous three years contributed to the contraction in the United States' deficit from $154 to 135 billion. Japan's surplus decreased by only $7 billion to $80 billion and Germany's rose from $45 to 49 billion; the aggregate current account surplus of the European Community nevertheless fell from $38 to 18 billion. The deficits of other member countries actually worsened; the fact of having maintained exchange rate stability does not reduce the need for greater commitment to policies that will lead to balanced growth.

The results achieved last year demonstrate that the stock market crisis in the autumn of 1987, though acute, was confined to the financial markets. The prompt reaction of the central banks of the major countries contained it and ensured that it did not jeopardize the economic growth that has been under way since 1983.

One of the main features of this phase of economic expansion, which has few precedents in terms of longevity, has been the strength of investment. The ratio of fixed capital formation to gross product, which had been declining for a decade, rose by more than 3 percentage points between 1983 and 1988 to exceed the peak recorded before the 1974 oil crisis. The policies introduced in the early eighties to restore economic and financial equilibrium and curb inflation created the conditions for the growth in investment, which was subsequently boosted by the recovery in corporate profitability, itself enhanced by wage restraint and, after 1986, by the improvement in the terms of trade of the oil-importing countries. Cooperation within the Group of Seven helped achieve more appropriate exchange rates between the major currencies, and world trade transmitted and amplified the stimuli to growth.

The appearance of renewed inflationary pressures and the fear that they would strengthen and spread prompted the monetary authorities of the major countries to tighten their policies from the spring of last year onwards, in the conviction that a resurgence of inflation would seriously jeopardize the prospects for medium-term growth. Short-term interest rates increased by several percentage points; long-term rates rose more moderately.

The analysis of economic developments and policies conducted at the international meetings in Washington in April of this year recognized the need for a restrictive monetary stance in order to counter inflationary pressures and acknowledged the undesirability of movements in the dollar exchange rate that were incompatible with reducing payments imbalances; above all, it underlined the need for a different combination of economic policies. In particular, the United States, Italy and Canada were called upon to reduce their budget deficits in order to regain better control over domestic demand. Greater budgetary flexibility would permit a less stringent monetary stance and foster a decline in interest rates. All countries were urged to reinforce their structural policies with regard to matters such as taxation, public sector efficiency, the labour market and competition rules and to encourage saving on a sufficient scale to ensure an adequate rate of long-term economic growth.

The events we have witnessed in recent weeks illustrate the difficulty of implementing these recommendations. The slowness with which fiscal policies are being directed towards the regulation of overall demand is overburdening monetary policies, is making it both more important and more difficult to coordinate them and is being reflected in exchange rate movements that are incompatible with the restoration of balance-of-payments equilibrium.

Since the beginning of this year the dollar has risen by about 14 per cent against both the Deutschemark and the yen. Without any further impetus from interest rate differentials, its appreciation has accelerated recently owing to a demand for the United States currency that has seemed to feed on itself and which on occasion has drawn strength from the very fact of breaking through barriers the market considered significant. The agreed combination of economic policies should be implemented in order to prevent the present exchange rate movement from developing into a trend. Although we are aware of the limitations of exchange rate intervention if it is not supported by appropriate policies, the central banks need to maintain their presence in the foreign exchange markets, on the basis of the flexible and pragmatic arrangements agreed between them, thereby ensuring that market operators remain acutely conscious of exchange rate risks.

In the broader world context, the current attempt by the Soviet Union and other Eastern European countries to open their doors to the rest of the world and to introduce market forces into their economies is worthy of note. It is a courageous decision, with objectives that are by no means easy, nor achievable in the short term; substantial monetary and fiscal imbalances must be rectified. In the new order, prices are to become the indicator of efficiency and to create the link with market economies via realistic exchange rates.

Countries in Asia, especially the newly industrializing economies, also achieved positive results last year in terms of growth and price stability. Although the newly industrializing economies reduced their trade surpluses only slightly, they are increasing the role of domestic demand in the development process and relaxing the restrictions on imports, including those of manufactured goods.

The performance of the other developing countries was unsatisfactory. In many Latin American and African countries the rate of economic growth was slower than the increase in the population, leading to a further decline in per capita income. Inflation soared again, becoming uncontrollable in some Latin American countries. In the oil-exporting countries the fall in the price of crude oil curbed growth by reducing their import capacity.

The problem of foreign debt continues to pose a serious danger, and not only an economic one, despite progress towards finding a solution. To meet their obligations, the heavily indebted countries need to transfer an enormous volume of resources abroad, but policies consistent with this objective conflict with the need to increase investment and improve the standard of living of broad sections of the population.

The strategy pursued until now in tackling the debt problem was re-examined in several fora last year. The US Treasury Secretary recently outlined a plan centred on a recognition of the need for a reduction in debt and debt servicing; relief would be granted to those countries that undertook programmes of economic adjustment and restructuring agreed with the International Monetary Fund and the World Bank.

Considerable difficulties — for the banks, the international institutions and the supervisory authorities — must be overcome before the plan can be implemented. High expectations have been aroused; we must begin to respond to them quickly by agreeing individual adjustment programmes with the countries concerned. A range of options for reducing the debt burden could be considered, such as reductions of principal, the capitalization of interest or a lowering of interest rates. Action on the interest front has the advantage of bringing a greater immediate reduction in the flow of payments for the same volume of resources and maintaining a close link between debtors, banks and international organizations during the implementation of the recovery plans.

The free movement of goods, services and capital

There is a high risk of an intensification of trade conflicts in the world market in goods and services. The United States will have to increase its exports in the next few years in order to reduce its trade deficit. Many developed countries and newly industrializing economies depend heavily on foreign markets to generate growth. The developing countries will have to find adequate outlets in the rest of the world for their primary products and, even more important, for their manufactured goods. The economies of Eastern Europe see full participation in world trade as an important prerequisite for growth and the very symbol of the success of their planned change of course.

In this complex and shifting context, protectionist pressures are latent and are often emerging in new forms. The GATT negotiations aimed at achieving further progress towards free trade in sensitive sectors, such as agriculture and services, are proceeding amidst considerable difficulty. The Trade Act approved in the United States in 1988 has aroused fears on account of the wider powers it grants the Administration to restrict trade. Bilateral agreements to control trade in particular products have become numerous and widespread.

The regionalization of trade that is taking place as a result of agreements among groups of countries is a positive development in that it leads to closer integration between neighbouring economies ; it produces a higher and more secure degree of trade liberalization than has been achieved so far in the wider context of the GATT. The erection of protective barriers against other countries would be a betrayal of the spirit that has inspired this process.

Free trade in goods and services should be defended and strengthened, as it is fundamental to efficient production and to greater welfare for consumers.

Capital movements are becoming an increasingly prominent feature of the balance of payments. The world foreign exchange market has expanded enormously and financial transactions are exerting a greater influence on the level and variability of exchange rates.

The freedom of movement of capital, as proclaimed in national legislation and international agreements, is a precondition for improving resource allocation and exploiting the full potential of investment opportunities. On account of their size and volatility, however, capital movements, and in particular those of a short-term nature, can produce exchange rates that are inconsistent with the fundamentals of the economies concerned, delay the restoration of balanced trade in goods and services and jeopardize free trade itself. In the present phase of the cycle, the scale of international liquidity and the speed with which the international capital market finances current account disequilibria increase the obligation for economic policymakers to act promptly to prevent pressures building up and having explosive effects on the economy.

The opening-up of economies has led to greater interdependence; the corollary to this must be a coordination of policies that also ensures stable exchange rate relationships. Only if this condition is met can free trade and the freedom of movement of capital coexist and foster balanced growth in the world.

Monetary cooperation within the Community has made significant progress in the ten years since the inception of the European Monetary System. The EMS is now a cornerstone of stability in economic relations within the EEC. The exchange rate mechanism has been the instrument for achieving more uniform economic conditions in participating countries; it has stood the test of prolonged and substantial movements in the dollar's exchange rate and the removal of exchange controls. The convergence of the economies involved has reduced the frequency of exchange rate realignments; the last occurred more than two years ago.

The Single European Act of 1986, which reinforced and extended the Treaty of Rome, marked a turning-point in efforts to ensure that the physical, technical and fiscal barriers still dividing member countries are dismantled before 1992.

The liberalization of financial transactions will be concluded by the middle of next year, when the Directive on short-term capital movements comes into force; it will be an important step towards the completion of the internal market.

However, it would be hazardous to take this step without adequate progress in harmonizing the tax treatment of investment income. The wide disparities between member countries with regard to the taxation of financial assets would cause distortions in savings flows and exchange rates, make the conduct of monetary policy more difficult and create strains within banking systems and financial markets.

When they approved the Directive last June, member countries made a political commitment to promote a tax regime that would ensure an orderly liberalization of capital movements. Uncertainty still surrounds the arrangement that will be applied, heightened by Germany's recent decision to abolish the withholding tax introduced at the beginning of the year. The principle of the mutual recognition of laws cannot be carried to the point where convergence towards a new equilibrium is left to competition between national tax regimes, as some governments propose. Broad neutrality as to where savings are held implies either establishing a system for assessing taxpayers' foreign income so that it can be taxed at the rate applied in their country of residence, or taxing investment income at source at harmonized rates. In the absence of one or other of these solutions, investment income would end up not being taxed in the country of residence of the recipient and in many cases would be exempt from withholding tax in the country in which it was earned.

These problems characterize the transition to a new order, but they are not the only ones; with broadly stable exchange rates and complete freedom of capital movements, the autonomy of national monetary policies in fact tends to diminish. The response lies in extending the process of integration to monetary policy itself.

Awareness of these links led the European Council to reaffirm the objective of economic and monetary union at its meeting in Hanover in June 1988 and to establish a Committee under the Chairmanship of the President of the Commission of the European Communities and composed of the governors of the central banks and a number of experts to draw up a final blueprint and propose concrete stages leading towards such union.

The Report presented in April, which was unanimously approved by the Committee, contains a clear and reasoned exposition of the feasibility and benefits of economic and monetary union. It is a landmark that cannot be ignored. The implementation of the union, which the Report divides into three stages, presupposes institutional changes that require the approval of a new Treaty.

In the final stage of the plan a single monetary area will be created with irrevocably locked exchange rates and a common monetary policy directed towards price stability. The most important institutional innovation will be the creation of a European System of Central Banks. With regard to fiscal policy, the union will entail stringent constraints on budget deficits and the method of financing them and establish powers to define and pursue a common macroeconomic policy. By achieving economic and monetary union, the Community will attain an objective that transcends the economic sphere; it will complete the design envisaged and desired by its founders.

Even now, as a first step towards union but also as a necessary complement to the liberalization of monetary and capital movements, monetary policy coordination must be made more effective by strengthening the role and structure of the Committee of Governors of the Community; moreover, member countries should honour their commitment to speed up economic convergence.

The transition from the coordination of national policies to the formulation of a common monetary policy would occur as early as the second stage, during which the European System of Central Banks would begin to operate, establishing operational mechanisms and procedures for collective decision-making to guide money creation by individual central banks.

The principles that have always inspired our convinced participation in the construction of Europe mean that integration within the Community should go hand in hand with a commitment to free trade with the rest of the world. If that condition is met, the institutional and economic experience of the Community will help foster growth and prosperity in the world economy as a whole.

The Italian economy

The results for 1988

The Italian economy also performed strongly last year. Rapid growth and moderate inflation, despite the reappearance of some tensions, coincided with the full implementation of foreign exchange liberalization, which was achieved against the background of broad balance-of-payments equilibrium. These favourable economic conditions would have allowed a breakthrough to be made towards the adjustment of the public finances, but the measures adopted have failed to correct the tendency for the budget deficit to increase.

Spurred by investment and export demand, gross domestic product expanded by 3.9 per cent and industrial output by nearly 6 per cent. Capacity utilization exceeded the peaks recorded at the beginning of the decade and firms in some industries developed a more flexible response to variations in the volume and composition of demand. Employment increased significantly in terms of both the total man-hours worked and the number of persons employed, which rose by some 300,000; the improvement also extended to industry, after seven years of falling employment. The prolonged rise of the unemployment rate halted at about 12 per cent, despite the continued growth in the labour force. Regional disparities worsened, however; unemployment remained stable in the Centre and declined in the North, which is approaching full employment, but it increased further in the South.

The expansion in investment, which has been under way since 1983, continued at a vigorous pace. In the last two years expenditure on machinery, equipment and transport equipment has increased by 21 per cent at constant prices. Stimulated by the outlook for demand and facilitated by good corporate profitability, part of capital accumulation is now being directed towards expanding capacity, and non-residential construction is also picking up after years of stagnation.

Private consumption expanded by 3.8 per cent. The main stimulus continued to be provided by households' disposable income, which was augmented not only by the growth in employment but also by the rise in real per capita earnings.

In manufacturing industry, strong domestic demand was accompanied by a more rapid increase in costs. The prices of intermediate goods rose by an average of 5.1 per cent. Labour costs per employee increased by 8 per cent; substantial productivity gains, albeit smaller than those achieved in 1987, held the rise in unit labour costs to 3.6 per cent. The increase in producer prices kept pace with costs, accelerating from 2.3 to 4 per cent. Average profit margins remained at a historically high level that appears, however, to be in line with those in the other leading industrial economies.

Consumer price inflation averaged 5 per cent in 1988, half a percentage point above the target. The twelve-month rate remained steady until the late autumn, but rose to 5.4 per cent in December and continued to rise in the early part of this year.

The upturn in inflation rates is a global phenomenon that has been more pronounced in some countries than in Italy. The inflation differential between Italy and the rest of the European economies continued to narrow, albeit modestly. However, the swiftness of the acceleration at the end of the year reinforced the concern that had been felt since the spring. When economic activity is expanding rapidly everywhere, competitive constraints tend to slacken, even without a depreciation of the currency, thus weakening resistance to cost increases and allowing demand pressures free rein. Where foreign competition is less direct and domestic market segmentation more pronounced, as in much of the services sector, it is easier for businesses to increase their relative prices.

The balance of payments was the other focus of constant attention last year. The new exchange control legislation, which embodies the principle of freedom to engage in all external transactions, came into effect on 1 October. Preventing current account disequilibria and ensuring that the increase in capital flows occurred in an orderly manner was essential.

The increase of almost 6 per cent in the volume of exports last year was not sufficient to prevent a fall in Italy's share of world markets ; this occurred despite both a slight improvement in competitiveness, with profit margins in manufacturing industry remaining unchanged, and the fact that domestic demand was growing at about the same rate as in the other leading countries. The loss of market share was due chiefly to the sectoral composition of world trade, with expansion being fueled by demand for high technology capital goods. Italian industry still specializes mainly in traditional goods, although the international success of some innovatory Italian products indicates that the situation is changing. The persistence of these structural characteristics, which has been studied in previous Annual Reports, also helps to explain the behaviour of imports. The growth in the volume of imports other than energy products touched 10 per cent and occurred mainly in capital goods.

The trade deficit worsened by 1.7 trillion lire, a figure which conceals a deterioration of 5 trillion lire in non-energy products, despite stable terms of trade. The energy balance improved as a result of a decline in import prices and a reduction in stocks. The transience of the market conditions underlying this improvement has been confirmed by the recent rise in oil prices. Italy's dependence on imported energy continues to limit the economy's potential for growth. The easing of this constraint requires a policy aimed at energy conservation and the development of domestic energy resources. The National Energy Plan sets forth policy guidelines that have still to be put into practice.

The deficit on trade in services is worsening. The surplus on tourism contracted by 16 per cent in a single year and will probably diminish further; it is now less than the net outflow due to investment income. The other items, most notably unrequited transfers, have recorded growing deficits for some time. The deterioration in the current account amounted to nearly 5 trillion lire; the deficit was 6.8 trillion lire, equivalent to only 0.6 per cent of gross domestic product.

The successful management of the delicate phase of exchange control liberalization was facilitated by interest rate differentials in favour of the lira; the exchange rate was allowed to fluctuate around the level considered appropriate to the condition of the economy. From mid-year onwards, the supply of foreign exchange exceeded the demand, at times substantially. More than half of the increase of 10.9 trillion lire in the foreign exchange reserves last year was recorded in the fourth quarter, despite the fact that the lira had been allowed to rise towards the narrow fluctuation band. On an annual average basis, the nominal effective exchange rate of the lira declined by 3.1 per cent.

Between the beginning of the seventies and the first half of the eighties external financial assets declined from 9 to 5 per cent of residents' portfolios as a result of exchange controls. Once the non-interest-bearing deposit on investment abroad had been abolished, the proportion quickly rose to over 6 per cent. However, non-residents increased their investment in Italy even more substantially; net of disinvestment, there was a capital inflow of 16 trillion lire. The international financial markets have responded positively to Italy's decision to liberalize capital movements, interpreting it as a pledge of both price and exchange rate stability.

Domestic economic management

Strong measures to reduce the budget deficit would have been consistent with the requirements of cyclical economic management; they would have enhanced the prospects for sustained economic growth, not undermined them. By curbing consumption, they would have eased the pressure on prices and the deterioration in the balance of payments on current account. By laying the basis for stronger investor confidence, they would have made it possible to keep the market in government securities in equilibrium at lower interest rates. The benefit to the budget would thus have been twofold: they would have reduced the primary deficit and also eased the debt service burden.

This did not happen. The corrective measures adopted, which concentrated more on increasing revenue than on curbing expenditure, were substantial but they could not prevent the state sector borrowing requirement from rising to 124.6 trillion lire, or 11.6 per cent of GDP, about the same ratio as in 1987. The relative size of the primary deficit, which had begun to decline in 1984, continued to contract, but the improvement was smaller than had been planned; this component of the state sector borrowing requirement decreased from 3.8 to 3.4 per cent of GDP, compared with the target of 2.8 per cent.

The task of restricting demand again fell largely on monetary policy. In August and again this March official interest rates had to be raised from their already high levels, and the entire interest rate structure shifted upwards. In the last quarter of 1988 the effects of this policy were reinforced by the appreciation of the lira.

As early as the spring of last year the rapid growth of imports and bank lending was signaling a strengthening of aggregate demand. The Bank of Italy tightened liquidity conditions, causing the rates on open market repurchase operations to rise. Nevertheless, under the pressure of exceptionally keen competition in the credit market, the banks' average lending rate continued to decline after the removal of the lending ceiling; by the end of May it was down to 13.2 per cent, one point lower than the peak reached the previous October. Financed in part by sales of securities, the expansion in bank lending exceeded 25 per cent in the second quarter on a seasonally adjusted annual basis.

Financing the Treasury became increasingly difficult. Yields on Treasury paper were first raised in April. Partly in order to smooth the launch of the secondary market in government bonds, the Bank of Italy intervened to support prices, especially those of Treasury credit certificates, and made offsetting sales of Treasury bills. Despite the set of measures enacted by the Government in May with the aim of reducing the Treasury's market borrowing by 7 trillion lire, a further across-the-board increase in rates on new government issues became necessary in July. The floor price for auctions of 3-month Treasury bills was eliminated. Improved market conditions enabled the Treasury to fund its borrowing requirement, but only at the cost of a shortening of maturities.

From the beginning of the summer onwards the Bank of Italy again began to urge fiscal measures that would bolster investor confidence in government paper while at the same time curbing consumer demand.

Economic and financial conditions necessitated raising official interest rates by half a point to 12.50 per cent at the end of August, at the same time as similar action was being taken in almost all European countries following the increase in US rates.

In presenting its Finance Bill in September, the Government reaffirmed its commitment to redressing the public finances. In accordance with the three-year financial plan, the budget measures were designed to reduce the deficit by 20 trillion lire on a current programmes basis in 1989, to 117.35 trillion lire. A key element was the control of spending on an accruals basis. The abolition of secret parliamentary voting on expenditure bills helped foster confidence in the success of the adjustment plan. Financial intermediaries and savers responded positively: fixed rate securities were heavily subscribed at declining yields and with maturities lengthened to five years ; uniform price auctions were introduced for issues of this kind.

At the end of November expectations began to deteriorate again. The borrowing requirement for the year was overshooting the preliminary estimate published in September; by the end of the year the difference amounted to about 7 trillion lire. The implementation of the budget measures announced for 1989 was becoming increasingly difficult. The demand for government securities again flagged and there was a further acceleration in bank lending, both in lire and in foreign currencies. The Bank of Italy took up only part of the net supply of foreign exchange, thus letting the lira appreciate in order to curb imported inflation and damp down domestic pressures on prices. Monetary policy in the other leading industrial countries was also orientated more decisively towards combating inflation, with official interest rates being raised in many European countries and in the United States between December and February.

I reported to Parliament on the seriousness of the situation in a statement I made in early February. On that occasion I reiterated the urgent need for fiscal adjustment measures.

In issue after issue in January and even more markedly in February, investors expressed their increasingly strong preference for shorter-term securities, a preference that was further accentuated by unfounded rumours concerning the public debt. Of necessity, the borrowing requirement was thus financed preponderantly through issues of Treasury bills. Economic indicators reflected the rekindling of inflation and the deterioration in the trade balance.

In February and March a number of monetary measures were enacted to link up with the expected fiscal package. They consisted of three main elements: the reintroduction of a reserve requirement on banks' net new foreign currency liabilities, a one-point rise in the official discount rate to 13.50 per cent, and the abolition of the floor price on 6-month and 12-month Treasury bills to allow the market to fix equilibrium yields without constraints or fear of outside influence. Yields on bills at all three maturities rose by about one point in the first auction in March and those on Treasury bonds and credit certificates were also increased substantially.

The Government approved the package of budgetary measures on 23 March. It acknowledged that the excessive borrowing requirement in 1988, the resurgence of inflation, the rise in interest rates and the watering-down of the measures contained in the Finance Law had progressively altered the situation, so that the target of 117.35 trillion lire for the 1989 deficit had been superseded. The new package aims to reduce the state sector borrowing requirement by 12 trillion lire to 130 trillion by cutting expenditure, raising additional revenue and modifying cash management procedures. This would bring the overall requirement down to 11 per cent of GDP and reduce the primary deficit by nearly one and a half percentage points to about 2 per cent of GDP, in line with the target set in the medium-term plan.

To allow time for the monetary and fiscal package to take effect, the Bank of Italy covered the Treasury's residual borrowing requirement for March and supported the prices of medium-term government securities in the secondary market. It made net purchases totaling 8.4 trillion lire, of which 6.8 trillion were securities at issue, whereas in January and February the Bank's portfolio had contracted by 1.6 trillion lire. In April and May the entire supply of government securities was again taken up in the market. Bank liquidity, which was high at the end of March, was brought down to more normal levels in the first half of April by means of repurchase agreements. Outright operations in May mopped up 2.2 trillion lire; more liquidity will be absorbed in June, when the Treasury will benefit from the bringing forward of income tax payments.

This flexible short-term monetary policy accords with a discretionary interpretation of the relationship between the central bank and the Treasury as it has been defined since 1981, when the Bank was relieved of the obligation to subscribe government securities at issue. This arrangement is fundamental to the operational distinction between management of the public debt and the conduct of monetary policy. It strengthens the independence of the central bank but in no way undermines the cooperation between the two institutions, to which the Bank is all the more committed when there is full agreement on the analysis of the situation and the ways to deal with it. In March this flexibility averted the risk of a financial crisis ; it will not jeopardize the achievement of the annual target for the creation of monetary base.

The cost of living is now rising at an annual rate of nearly 7 per cent, more than 2 points above last year's low, recorded in October. The acceleration has been due partly to the increase in indirect taxes, the appreciation of the dollar and the rise in world raw material prices, but it is the persistent strength of demand that enables these factors to have their full impact on final prices, generates direct inflationary pressure in its own right and affects the trade account. Exports have expanded strongly but imports have grown even more rapidly, so that in the first four months of this year the trade deficit increased to over 11 trillion lire, a deterioration of 4 trillion in comparison with the same period of 1988. The increase in imports involved not only raw materials, both for current production and for stockbuilding, but also manufactures.

The Bank of Italy has combated the resurgence of inflation mainly by allowing the lira to appreciate. Since last September the effective exchange rate has risen by 1.3 per cent. This action entails a cost, in the sense that if it is protracted owing to the inadequacy of fiscal adjustment it will exacerbate the trade deficit. It is essential to avoid any cyclical misalignment between Italy and the world economy, which is slowing down. Fiscal policy should aim to curb consumer demand for the remainder of 1989. Bringing forward part of the first instalment of income tax payments from November to May could prove insufficient. Nominal per capita earnings must not rise faster than in 1988. The growth in GDP is expected to slow down, but still to exceed 3 per cent in real terms, thanks to exports and investment.

The objective of the restrictive monetary stance is to reverse the acceleration in inflation by this summer. Monetary base management will seek to keep the growth in the M2 money supply within the 6-9 per cent target range announced in September, when forecasts of the nominal growth in GDP and the size of the public sector borrowing requirement were lower. Rigorous control of the borrowing requirement to prevent it from overshooting the target is fundamental to maintaining stable expectations.

The growth in credit, and especially that in bank lending, will have to decline. After slowing down in March, the expansion in bank lending accelerated again in April. Given not only the sustained growth in fixed investment but also the economic policy approach I have just outlined and the banks' ability to continue to finance loans by selling securities, financing to the non-state sector is expected to grow by about 13 per cent this year.

Plans for more effective action to redress the public finances now focus on the adjustment measures for 1990. The Economic and Financial Planning Document presented by the Government to Parliament under the new budget procedure postulates a reduction of 16 trillion lire in the primary borrowing requirement on a current programmes basis. The drafting of the necessary measures to achieve this reduction is the most urgent and delicate task facing the Government and the public administration in the preparation of the Finance Bill. This process will also affect the financial market in the next few months; experience has shown that investors' readiness to subscribe government securities is closely related to credible action to redress the public finances.

For fully effective economic policy

International capital mobility and financial innovation complicate the linkage between financial aggregates and real economic variables and make it essential to provide the conditions in which all the instruments of economic policy can operate effectively.

Intermediate monetary targets, even in the form of broad target ranges, have not lost their usefulness. The announcement of such targets encourages market behaviour that is consistent with the monetary guidelines and they give the central bank a yardstick for assessing the divergence of the economy from its planned course.

In setting such targets, as in the whole conduct of monetary policy, an overall view of financial flows is increasingly necessary in order to take account of the differing impact that financial innovation and unexpected cyclical impulses have on the various aggregates. With investment far higher than forecast, credit expanded much faster than the money supply in a number of countries last year. If the public debt is large and increasing, primarily at short term and still held to a considerable extent by the banks, as is the case in Italy, expansionary conditions may well make it especially difficult to set intermediate targets and achieve them simultaneously and on schedule.

In Italy, the rapid growth in output and investment gave rise to strong demand for bank loans. The policy decisions of the banks themselves also contributed to the growth in lending; their slowness to adjust lending and deposit rates to market conditions facilitated control of the money supply but did not assist the action to curb lending. Monetary policy has been more successful in governing the rate of growth of aggregate bank credit, comprising both lending and securities, than in influencing its composition. The banks speeded up the replacement of securities by loans, which has been under way since 1984; in a year of modest deposit growth, they thus financed an increase of 52 trillion lire in lending by reducing their securities portfolios by 14 trillion lire, mainly through sales of Treasury credit certificates and special credit institution bonds, as well as by increasing their own external borrowing by 10 trillion lire. The growth in lending to the non-state sector was equal to 15.7 per cent at the end of the year, compared with the target of 10 per cent. By contrast, the growth in the M2 money supply worked out at 8.5 per cent, within the 6-9 per cent target range.

Monetary policy is more effective when it can operate through well-developed financial markets. In Italy, significant improvements in efficiency were made or initiated in 1988 with regard to the payment system, reserve requirements and the secondary market in government securities. The imminent launch of a screen-based market in interbank funds operated by the banks themselves is in keeping with the innovations that are under way. These developments, together with the elimination of the floor price in Treasury bill auctions, will make it easier for the central bank to shift its focus from primary to secondary market operations.

Within a framework of increasingly stable exchange rates, more effective monetary policy must be supplemented by flexible, countercyclical fiscal policy. Given such backing, monetary policy can concentrate more on preserving external balance.

This situation does not obtain in the Italian economy, however. For extended periods over the past eighteen months the Bank of Italy has had to create conditions in which the budget deficit could be covered via market sales of securities ; it has had to curb demand at a time of very substantial capital inflows, which were accentuated by the restrictive monetary stance. A degree of exchange rate flexibility, the extension of reserve requirements to the banks' net fund-raising in foreign currencies and moral suasion only attenuated this contradiction, but could not resolve it.

A fiscal policy directed towards domestic balance is all the more necessary now that complete freedom from exchange controls within the European Community is approaching. Imbalances between domestic money creation and the demand for money and credit will lead even more swiftly to balance-of-payments disequilibria. Monetary aggregates will need to be regulated with reference to targets for the entire Community. The rate of growth of credit in each country will have to be consistent with these targets and its monetary counterpart compatible with exchange rate stability. As we move towards this new arrangement, the scope for national monetary policy to reconcile conflicting objectives will narrow.

Countries that lack fiscal flexibility will find it difficult to keep pace with European integration. Among the member countries that have yet to redress their public finances, Belgium and especially Ireland have made significant progress in the last two years. With the prospect of the lira joining the narrow fluctuation band of the EMS, Italy cannot postpone making equally substantial progress.

Saving

The need for action appears all the more urgent in the light of the emerging trends in domestic saving.

Gross saving, which fluctuated between 25 and 28 per cent of national income from the mid-sixties onwards, has fallen during the eighties, so that last year it stood at 20.9 per cent. The decline is due mainly to the public sector. The negative saving of general government, that is to say its current deficit, rose from an average of 3.8 per cent of national income in the seventies to 6.1 per cent this decade. Adjusted for inflation, the deterioration in public saving has been more pronounced in recent years, shifting from saving of almost 3 per cent of national income in the early eighties to negative saving of around 2 per cent in the last three years.

The private sector's propensity to save also declined between the two decades, although less sharply. Gross private saving, adjusted for inflation, averaged 21.6 per cent of national income from 1981 to 1988, almost a full percentage point lower than in the seventies but still higher than the average of 19 per cent for the other major OECD countries. During the eighties the savings ratio has recovered only partially from the fall that occurred when the acceleration in inflation in the wake of the second oil shock eroded the financial wealth of households without curbing their consumption. The recovery, which has been aided by the improvement in corporate profitability, has not been strong enough to offset the simultaneous growth in the budget deficit and has come to a halt in the past two years.

The need to reflect on the prospects for saving in Italy is indicated by a variety of factors, which the experience of other countries suggests might undermine households' propensity to save.

In the next few years the propensity to save might be reduced by changes taking place in the structure and organization of households themselves, such as the decline in the average size of family and the spread of one-person households, which reduce economies of scale in consumer spending. In the longer run, the aging of the population, due mainly to the fall in the birth rate, will also operate in the same direction.

Developments that are otherwise positive may also tend to increase consumption more than income. The paradox is only apparent, however. The precautionary motive in the broad sense remains one of the fundamental determinants of saving. Economic and social progress that augments individual prosperity, enhances future security and increases efficiency can blunt that motivation and lead to a fall in the propensity to save.

The increasing availability of personal credit offers an example of this effect in the financial sphere. By easing liquidity constraints, personal loans improve a household's ability to alter the timing of its consumption and thus raise its level. In economies where personal credit has partly replaced intra-family financial transfers, households' indebtedness has increased substantially, to the detriment of the propensity to save.

The response to this change must come first and foremost from economic policy. It is doubtful, however, whether the propensity to save can be bolstered by paying higher remuneration on savings. The high real interest rates of the past decade in a number of countries have not impeded a rise in the propensity to consume, although in some cases, as in Italy, they have given households a strong incentive to invest their savings in financial assets. In the last few years the real return on saving has been distinctly higher than the secular trend, so that there appears to be little likelihood of an appreciable and lasting rise. High yields can safeguard existing saving, but not raise it significantly.

Fiscal policy in the broad sense can do much by encouraging thrift and discouraging consumption. The public sector can and must do more, by generating saving within the sector itself.

In the leading industrial countries the last few years have witnessed increasing public saving, which has once again become marginally positive, even before adjustment for inflation. Italy, however, is dramatically out of line with the average. The plan for the rehabilitation of the public finances announced last year and confirmed in the Economic and Financial Planning Document aims to stabilize the public debt as a proportion of national income by 1992 and to reduce it gradually thereafter. Net of interest payments, the budget deficit should be replaced by a surplus of 0.6 per cent of GDP in 1992.

This is an important intermediate objective. Progress will then have to be made towards eliminating the public sector's current deficit, which the planning document estimates at around 30 trillion lire in 1992. The aim should be a system of public finances that creates saving rather than destroying it, in order to augment the economy's capital stock, ease the balance-of-payments constraint and regain the use of the budget as a countercyclical instrument.

Financial institutions and the market

Markets, operators, financial instruments and even the regulations governing financial intermediation are changing at an accelerating pace. The problem of the relationship between financial institutions and the market is re-emerging, sometimes in new forms, in Italy, in the European Community and in the world at large.

In Italy, legislation on the securities market is required all the more urgently because of the shortcomings of the stock exchange and the need for comprehensive regulation of the new activities and operators in this market. The bills before Parliament contain provisions that would significantly broaden and strengthen the market. The main principles on which the proposed legislation on securities firms is based are that all operators engaging in securities business should be governed by the same regulations, trading concentrated on the stock exchange and rules formulated to prevent conflicts of interest between intermediaries and customers. The bill reaffirms the view of competition and transparency as public goods that are complementary to stability. As the bill stands, some of the ways envisaged for concentrating trading on the stock exchange do not appear consistent with the foregoing principles or with an efficient capital market; they restrict the activity of dealers, especially banks, and create obstacles to the search for the best execution of customers' orders.

In the European Community the foundations are being laid for an integrated financial market: the Second Directive on the coordination of banking legislation, which could be approved this year, was flanked at the end of 1988 by the proposed "Securities" Directive. The Community approach recognizes that securities business is one of the banks' activities, that participants in the securities market need to be governed by special regulations, that these must guarantee equal treatment to bank and non-bank intermediaries performing the same operations and that the control of stability must be graduated in accordance with the type of activity undertaken.

Under the system that is emerging, the UK model, in which securities business is mainly conducted by non-bank institutions, will coexist with the continental model, in which credit institutions play a major role on the securities market. A pronounced bias in favour of one or other of these models would be a simplification running counter both to the situation in many member countries and to developments in the leading financial centres. The far-reaching changes in corporate finance, the spread of securitization, the growth of a global securities market and the standardization of instruments have blurred the frontiers between loans and securities and between deposit banking and investment banking. On the other hand, heightened awareness of conflicts of interest and the need for investor protection is leading to the regulation of firms' internal organization and conduct of business with customers. Accordingly, the separation between banking and securities activities that some countries instituted between the two world wars is disappearing. There is a general movement towards a new equilibrium between the role of the market and the centrality of banks, whose dual function of granting loans and creating money remains unique and irreplaceable.

Between 1980 and 1988 the proportion of the financial assets of households and enterprises that was intermediated by financial institutions fell in Italy from 59 to 46 per cent. This reflected the reduction in the share of bank liabilities from 57 to 40 per cent, which was only offset to a limited extent by the increase in those of non-bank intermediaries, especially investment funds. This major change was determined by the growing supply of government securities, which have taken their place alongside bank deposits in investors' portfolios. In 1980 households held 30 per cent of the government securities in circulation; last year they held 56 per cent. Italy is no longer among the countries with only a small proportion of saving invested directly in the market.

Non-bank finance has developed through the spread of services such as the collective investment of savings, portfolio management, leasing, factoring and merchant banking. The range of intermediaries has widened, strengthening the links between traditional banking and the capital market. Banks have taken part in these developments, responding flexibly to the emergence of new products and markets; in many cases they have operated indirectly through specialized subsidiaries in the banking-related sector.

Banks, credit institutions' non-bank affiliates and other operators that are frequently owned by institutions in other countries or by industrial and commercial groups are now all present in one and the same market, in which they provide closely comparable forms of finance and assistance to investors. Legislation is needed to supplement that proposed on securities intermediaries and complete the regulation of the new forms of non-bank fund-raising and lending. Rules will have to be introduced requiring intermediaries' own funds to be commensurate with the overall riskiness of their activities. As for conflicts of interest, the regulations will have to guarantee that all participants performing the same activity are treated equally.

The changes that are under way are directed towards applying prudential criteria to all intermediaries and simplifying supervisory procedures.

Even though non-bank intermediation has expanded considerably in recent years, with investment funds to the fore, Italy still has fewer types of operator than other countries at a comparable level of development, and some markets, such as those for insurance and pensions, are growing less rapidly. At the end of 1987 technical reserves and private pension entitlements amounted to 11 per cent of households' financial assets, a much smaller share than in most of the other industrial countries.

The limited recourse to contractual savings and pension plans in Italy reflects the scale of the state pension system. In years to come, the financial situation of this system, in which pensions are financed out of current contributions, will be adversely affected by the demographic trends that have already been established. The sharp rise in the number of old people entitled to benefits in relation to the working population that pays the contributions calls for corrective action to prevent the system from becoming increasingly unbalanced.

Principles of sound finance and the arrangements in force in other countries suggest that funded personal and company pension schemes should be developed in Italy to supplement the compulsory state system. In view of the nature of their liabilities, supplementary pension funds generate a stable and long-term demand for financial assets. In addition to restoring the equilibrium of the state pension system, the development of pension funds would improve the composition of financial assets in terms of instruments and maturities and broaden the capital base of the corporate sector.

The credit system

The profitability of a bank, as of any other enterprise, is an indicator of its efficiency and a guarantee of its independence. Profits provide the means of strengthening a bank's capital base and increasing its market share.

Last year's large shift in the composition of banks' balance sheets in favour of loans enabled them to improve their net income, which rose to an average of 1.62 per cent of total resources, thus offsetting part of the fall recorded in 1987. One factor that contributed to this positive result was the start made on curbing operating costs, especially by some large banks.

Retained profits plus the fresh capital raised by some institutions were not sufficient to maintain the upward trend of the ratio of capital and reserves to risk-weighted assets, a direct consequence of the large increase in loans. In order to operate in the single European market, banks will have to have adequate capital, defined in the proposed Community Directive as a solvency ratio of 8 per cent, the level set in Italy two years ago. One quarter of the banks operating in the Community fail to meet this standard at present, while fewer than one fifth of Italian banks are below the mark. The fact that the capital ratio for the credit system as a whole is above the compulsory minimum does not mean that the system possesses all the funds it will need to continue growing in the coming years. Banks, especially the large ones, will have to invest to reinforce their positions in the domestic and international markets and to make the best use of technology.

The development of credit institutions is likely to be more efficient and better balanced if it is based on a diversified pattern of ownership, involving all the main categories of economic agents: enterprises, households, foreign operators and the public sector.

I have already expressed a favourable opinion on insurance companies acquiring shareholdings in banks, even controlling interests, provided operational independence is safeguarded on both sides; the same applies to banks acquiring interests in insurance companies.

Capital must also be able to flow into the credit sector from industrial and commercial companies. Provision is made for this in the bill on competition and the market; the aim of the proposed legislation is to prevent a single non-financial company or group from exercising control over a credit institution or group. The extensive discussion of this aspect has not revealed differences of principle. It is generally accepted that the potential conflict between the interests of depositors and those of shareholder-borrowers is a threat to stability and the efficient allocation of resources that the law cannot ignore. In the face of these risks, the first line of defence must be at the level of ownership.

The acquisition of control of individual banks by a non-financial company or group has not been advocated as a matter of principle but as a means of meeting immediate needs, as a way of providing the credit sector with the capital, managers and organizational techniques it requires to overcome the challenges in store. The transfer of skills and resources between different sectors of the economy is beneficial and should be fostered. In the not so distant past the revival of industrial and commercial firms benefited from the contributions of the financial sector and the introduction of more efficient methods of financial management. This was achieved, however, without creating ties of ownership or control; in a market in which the factors of production are sufficiently mobile, transfers of managers and methods do not depend on the existence of such links.

The positive view we have taken of diversification in the pattern of ownership has led us to adopt an open stance with regard to the participation of sound foreign institutions in the capital of Italian credit institutions, within a framework of reciprocity.

In the longer term, however, the strengthening and broadening of banks' equity base will have to be achieved primarily by attracting households' savings, either directly or indirectly. The development of the role of long-term institutional investors, such as pension funds, would allow savings and pension plan resources to be invested in the capital of banks.

The declining importance of operational and geographical specialization and the opening of the domestic market to Community competition mean that it would be desirable for credit institutions to adopt a standard legal form. Outside the cooperative sector, the public limited company is the one most frequently adopted for collective enterprises, both in Italy and abroad. A common form enhances the mobility of equity interests ; in a competitive and rapidly changing industry, ownership itself must be laid open to the critical assessment of the market and the possibility of its changing hands is a necessary condition if credit institutions are to achieve their optimal size and configuration through growth or merger.

A year ago I described the problems concerning the legal status of public sector banks. If they were to become public limited companies in accordance with the procedures proposed in the bill presented by the Minister of the Treasury, they would be able to raise equity capital in the market and diversify their ownership.

The extent to which Italian credit institutions are in public hands is without parallel: banks belonging directly or indirectly to the public sector account for 65 per cent of total deposits. This situation has its roots far in the past. One contributory factor has been the capital that publicly owned banks, in the absence of other rescuers, have injected into banks in difficulty: in the last twenty years 42 banks with a total of 835 branches have passed into the public sector. A shift in the division between public and private in the credit system is feasible, given the degree to which the financial system has developed, the accumulation of savings by households and enterprises and the likely future configuration of the supplementary pension system. The frontier between public and private ownership must be crossable in both directions.

The drive to achieve a size that will allow Italian credit institutions to compete more effectively with foreign banks has gathered pace. Our urging has been heeded: important initiatives are taking shape, while others are running into obstacles that need to be removed in a far-sighted approach to the interests of both individual institutions and the credit system as a whole. The plans involve large banks and special credit institutions and are designed to create units of a size, diversification and capital strength that will allow them to play a significant role in European and world markets.

Mergers must seek to produce viable combinations of capital, managerial skills and networks, evaluated on the basis of a thorough analysis of costs and benefits. On its own, adding balance sheets and operating structures together neither guarantees economies of scale nor ensures greater potential for growth.

The skill of a banking entrepreneur is, of course, revealed by his ability to identify the potentialities of a merger, but perhaps even more after the decision has been taken, when the structures of the new institution have to be organized rapidly to translate these potentialities into profits.

Especially for large concerns, the multi-functional group serves to increase the scale of operations while conserving the advantages of specialization. The importance of the potential outcome and the need for certainty call for a regulatory framework such as that foreseen in the bill now before Parliament, which would make the banking and financial services group an entity that can be made directly subject to supervision, via the parent company. Having a pure holding company as the parent company rather than the credit institution may permit a better balance to be struck between group member companies in the formulation of strategy and may be more appropriate for public banks adopting the status of limited companies. The need to reorganize the banking system confirms that it would be desirable, as I have noted on other occasions, for company law to recognize and regulate corporate groups, with special reference to the unitary nature of their management and the protection of minority shareholders and creditors.

Lending to small and medium-sized businesses by local banks and their links with savers in their traditional areas of operation are characteristics worth defending and a source of competitive strength. But even for these banks the need to find new markets, diversify their risks, achieve economies of scale and cope with increasing competition is a reason for adopting appropriate forms of concentration, even if they control a large share of their local market. The need to improve and expand services and reduce their cost can also be met by creating consortia and concluding agreements among several banks, supported by their central institutions.

Concentration becomes not only desirable but necessary when a bank's financial position is precarious. In such cases decisions must take account of the speed with which a salvable situation may deteriorate.

The first intervention by the Interbank Deposit Protection Fund was made last year with ways and means that corresponded to the multiple interests involved. The Fund, which was set up on a voluntary basis, proved effective and flexible in operation; it can be further improved in the light of the experience gained. The banks' ability to exercise self-regulation was also demonstrated in other projects regarding the disclosure of company information, the publicizing of rates and conditions, the identification of customers, the payment system and automation. These forms of cooperation will enable them to improve the quality of banking services and strengthen their ability to compete in the market.

Banks have taken full advantage of the removal of the restrictions on the transfer of branches: in the first year of operation of the new regulations they decided to relocate 630 offices. In addition, since 1986 about 6,000 automated teller machines have been or are being installed and about 12,600 point-of-sale terminals.

The next step to be taken is to liberalize the opening of new branches. The Bank of Italy will be submitting a procedure based on tacit approval to the Interministerial Committee for Credit and Savings. Each bank's expansion plans will have to be consistent with its capital strength and profitability, the orderly development of its branch network and its technical and organizational structures. The introduction of the new regulations will mark the start of a delicate phase for the banking system; as other countries have found, there is a danger of overbranching, with a consequent increase in fixed costs. It will be up to each bank to assess the benefits and risks inherent in the opportunities opening up for itself and its competitors.

The new order will imply a new approach to branch networks. Branches will generally need to be streamlined and increasingly serve as points for maintaining contact with customers and for the sale of services, rather than their production. The latter can be relatively centralized in order to reduce fixed costs and permit the most efficient use of staff and technology.

Financial intermediation and the South of Italy

Although we are aware that financial factors on their own are not sufficient to bring about economic growth, the Bank of Italy pays particular attention to matters regarding financial intermediation in the South, and a special section of this year's Report is devoted to the subject.

The seriousness of the South's economic problems is well known. It is reflected in the area's trade deficit, which has varied between 15 and 25 per cent of its gross product in the period since 1951. In absolute terms the deficit in 1987 was of the order of 50 trillion lire. Most of the deficit is financed by transfer payments to the southern regions. This flow, part of which returns to the Centre-North in the form of demand, enables the South to maintain a higher level of investment per unit of output than the rest of Italy and to narrow the difference in consumption compared with the rest of the country.

The fact that the higher rate of investment is not matched by faster growth in output, as sectoral surveys confirm, indicates that the problem does not lie only in the volume of resources but also in the efficiency of production processes. In the last few years the productivity gap in industry has widened, not narrowed: value added per employee in the South of Italy is now nearly twenty per cent below that of the Centre-North. The charging of social security contributions to the budget offsets part of the effect on competitiveness, but highlights the need for a closer link between earnings and companies' productivity performance.

These summary considerations call for a review of the mechanisms for allocating resources and the functioning of markets and financial intermediaries in the South of Italy. The efficiency with which the transferred resources are used could be enhanced by further increasing the proportion of capital investment, entrusting their allocation to the market rather than to the budgets of government entities and focusing public intervention on major infrastructure projects.

The transformation taking place in Italy's financial system will make the intermediation of saving more efficient, to the benefit of the South as well as the rest of the country. However, the financial structure of the Southern regions needs to be specially strengthened in terms of diversification, integration with domestic and foreign markets and competitiveness. Progress has been made in recent years. The geographical and sectoral segmentation of the credit market has been considerably attenuated by the reduction in the specialization of credit institutions, the increase in the area in which they can operate, mergers between banks in different parts of the country and a branch policy designed to foster competition. In 1977 the difference between banks' operating costs per unit of total resources in the two parts of the country, which is affected by factors such as population density and the average size of transactions, amounted to about 30 per cent; today it is less than 20 per cent. Nonetheless, the credit system in the South remains less exposed to competition, less profitable and less highly capitalized.

Banks operating in the South are undoubtedly faced with greater difficulties in assessing businessmen's creditworthiness, greater uncertainty about the outcome of plans, and a greater likelihood of projects encountering obstacles in the social and economic fabric and in external diseconomies. On the other hand, the Southern regions offer potential for development, and not only because of the underemployment of their human and material resources. There are opportunities for new industrial initiatives, for the modernization of agriculture and for the promotion of advanced services. This is confirmed by the renewed interest shown by both Italian and foreign groups. In recent years the South has itself produced entrepreneurs who have successfully coped with business risks and set in motion significant endogenous growth, albeit still on a small scale.

The contribution of banks lies in their independent selection of firms in the light of a broadly-based assessment of each investment project, which implies knowledge of the economic environment in the South and of market trends in Italy and abroad. In a phase devoted to making good a lag in development, it is essential for talented entrepreneurs to be able to go to banks that can recognize their potential and meet all the financing requirements of their companies. Nationwide banking groups with the experience and the diversified organization needed to provide a full range of financial services are best suited to these tasks. The presence of more banks of this kind in the South, alongside the major indigenous credit institutions, would foster the development of the area; they would not replace the smaller local banks, which would have an incentive to innovate and improve their efficiency. Increased competition and the fuller disclosure of rates and conditions are the means to achieve the desired narrowing of the interest rate differential between the South and the Centre-North.

Ladies and Gentlemen,

Saving, its formation and the ways in which it is intermediated are crucial in any economy; they have a decisive bearing on stability and growth, current and future prosperity and the very contribution that economic activity makes to the progress of society.

This ancient truth is still relevant, both to the present and to the future, to the world economy and to ours. After six years of uninterrupted growth in the industrialized countries, there is a danger that balance-of-payments disequilibria will be compounded by a savings shortfall as a result of households' rising propensity to consume and the difficulties in generating higher public saving; the warning signs are present in the insidious acceleration in inflation and in high real interest rates. In the less developed countries, in those with high external debt and in the centrally planned economies there is often an acute need both for more saving and investment and for a better balance between them.

The European Community is committed to creating an integrated area without internal barriers, open to external trade and capable of playing a full role in international relations alongside the other major economic powers. There is now full acknowledgement of the limits to which purely national monetary policies are subject in integrated markets and of the need for a close link between monetary and fiscal policy. On the basis of this recognition, the Committee set up by the Heads of State and Government at their meeting in Hanover has developed comprehensive proposals for achieving true economic and monetary union. Member states must now make a fundamental political decision. If they decide to move towards such a union, national monetary policies defined in accordance with common guidelines will become more effective from the very beginning of the first phase and discipline on budgetary policies will become more stringent.

The strength of the Italian economy stems from the high propensity of households and enterprises to save. Our present affluence and the social and demographic changes that are occurring preclude any further increase in the savings ratio, and indeed give cause to fear it will decline. The prospects for growth, for investment and for employment therefore depend on restoring the ability of the public sector to generate saving and provide services of the quality demanded by citizens and enterprises. Saving, capital accumulation and efficient services are the means of overcoming structural deficiencies in some sectors and areas of the country. In industry these deficiencies are reflected in the slowness with which Italy's specialization in world trade is developing; in the South of Italy they are evident in forms of underdevelopment, overlaid with a precarious situation in the civic sphere, neither of which can be tolerated any longer. The mere fact of being a part of the new constellation emerging in Europe demands that the difficult task of restoring sound public finances be completed as soon as possible.

We are now witnessing an acceleration in the transformation of the financial markets and the conditions in which the central bank operates. The new electronic technology dispenses with the paper documents that have been a cornerstone of the payment system based on token money. With the dismantling of national frontiers, the economic agents of one country have unimpeded access to the money created in others. The further development of financial markets and intermediaries in response to the requirements of economic growth and integration is both reshaping the demand for saving and its supply and modifying the methods of intermediation.

These changes open up the possibility of gains in efficiency and freedom. For this potential to be realized, the functions that legislation and tradition have allotted to central banks in the payment system, in the management of the currency and in the intermediation of savings must also be further refined. For its part, the Bank of Italy has responded by fostering the transformation and reviewing its own methods of operation.

Italy's commitment to the creation of better monetary and financial conditions at home and new institutional arrangements within the European Community is often overwhelmed, however, by day-to-day concerns. The public finances continue to send shockwaves through the financial market. Recently we have again had moments of difficulty maintaining the equilibrium of the securities market, which is burdened with a large and increasing volume of short-term public debt. We were able to overcome these difficulties, but we did not eradicate them; they are inherent in the state of the public accounts.

It is essential to make a breakthrough in tackling the imbalances in the public finances, the unresolved problem of the Italian economy. The public sector borrowing requirement will not contract without reforms that impinge upon the level and the quality of expenditure on the one hand and the determination of revenue on the other. The measures adopted by the Government and Parliament in recent years have been neither insignificant nor easy ; they have limited the effects of the underlying trends, but they have not eliminated the trends themselves.

The economic conditions for successful action are better today than at any time in the past. The need for corrective measures is universally proclaimed and the present economic upswing is a compelling reason to act swiftly.

In an economy undergoing a sustained expansion and showing clear signs of overheating, it is up to economic policy to dampen domestic demand, loosen the external constraint and create conditions in which growth can continue and reduce unemployment. These are tasks that every reasonable economic approach assigns to fiscal policy. In accordance with its statutory obligations, the Bank of Italy is committed to stifling the resurgence of inflation and preventing a repetition of the damage we suffered in years past. It will continue to exercise tight control over liquidity in order to reinforce the anti-inflationary effect of a stable exchange rate. The plan to reverse the acceleration in prices in the second half of the year must not miscarry.

Five years ago we indicated the elimination of the borrowing requirement net of interest payments as a first objective; it would have been a significant achievement had it come early enough to curb the rise in interest payments caused by the growth of the public debt. This goal remains to be fulfilled, but the ultimate objective must be to eliminate the budget deficit on current account. If the attack is not directed at the root causes of the deficit, all progress in curbing its effects will prove inadequate and appear tenuous to those who entrust their savings to the state.

The restoration of sound public finances is not beyond the capability of a country that has quadrupled its per capita income in forty years. Economies with less potential than ours have succeeded. Naturally, the steps to be taken imply modifying deeply entrenched habits and arrangements ; they will affect widespread positions of privilege and will require an ability to overcome prejudice and mistrust and to renounce the defence of special interests. Any delay increases the burden we and future generations will have to bear. An advanced society must be able to adopt rules and restrictions that are recognized to be in the general interest: this is the very essence of its existence. The vitality of the economy, the challenges surmounted in recent years and the evidence of the widespread benefits this has brought give grounds for confidence. The course is mapped out: there is no justification for not following it with determination.