Antonio Fazio: Finance and recovery in the world economy

Address by the Mr Antonio Fazio, Governor of the Bank of Italy, at the AIAF – ASSIOM – ATIC – ACIFOREX, Trieste, 3 February 2001.

*   *   *

Globally, the growth in the money supply and the value of financial assets reached a peak last spring. The NASDAQ index has subsequently fallen by one half; the S&P 500 index first stopped rising and then, in September, began to decline. The performance of technology shares in Europe has been similar to that of the US market.

All the European stock exchange indexes peaked towards the middle of 2000; they have followed a downward trend since the last few months of last year.

At the beginning of 2000 equities in all the main industrial countries except Japan appeared substantially overvalued in relation to the expected growth in earnings and the risk premium implicit in valuations. A year ago we called for a "virtuous" realignment of the financial market's valuation of firms with the performance of the real economy, to be achieved through robust economic growth.

The increasing divergence in the second half of the nineties between stock market prices and the actual and expected expansion in output was due to the world money supply having grown faster than the economy and to the rise in the velocity of circulation of liquid balances owing to the rapid increase in financial derivatives.

One of the features of the second half of the nineties was the pace of productivity gains in the United States deriving from the spread of new technologies; producer prices and world commodity prices remained stable.

The monetary policies of the leading central banks and the interventions of the international institutions had to cope with the succession of financial crises in Mexico, Asia, Russia and Latin America. The spread of these crises was averted; the worst effects of exchange rate instability and bank failures were kept within limits.

Monetary policies and the expansion in the assets of the financial intermediaries active in international markets brought a steady decline in bond yields; the excess of liquidity was reflected primarily in the rise in share prices.

The abundance of funds and the ensuing large fall in the cost of capital fueled the prolonged expansion in US domestic demand and fostered the recovery in 1999 in output and investment in Asia, Europe and Latin America.

The recovery increased the demand for oil and energy products. From the middle of 2000 onwards the ensuing rise in the oil price caused consumption to slow down in the industrial and oil-importing emerging countries.

We had drawn attention to the danger of not taking advantage of the opportunity offered by the improvement in economic conditions to press ahead, in Italy and in Europe, with structural reforms so as to transform the cyclical recovery into a new phase of sustained growth.

Recent economic developments

In the United States economic activity accelerated in the second half of 1999; the expansion continued in the first half of 2000 at a pace well in excess of the economy's potential growth rate.

Inflation picked up significantly. The tightening of monetary conditions begun in June 1999 was intensified during 2000. The federal funds target rate was raised by 1.75 percentage points between the middle of 1999 and the middle of 2000.

As in the other industrial countries, economic activity slackened in the second half of 2000. In the first half the economy's growth rate was nearly 6 per cent; in the third quarter it fell to 2.2 per cent. The rate of expansion in private investment has fallen from 13 per cent in the first half of last year to 3 per cent. For the first time since the end of 1998 pre-tax corporate earnings have declined.

In the last quarter of 2000 there was a further slowdown in economic growth: GDP growth on an annual basis dropped to 1.4 per cent, reflecting the slowdown in consumption and a contraction of nearly 2 per cent in investment.

The economic recovery in Japan, which had been fueled in part by the expansion of public expenditure, proved uncertain. The positive performance of private investment, which expanded by 4.5 per cent in the first nine months of 2000 after contracting in 1999, contrasted with stagnant consumption. In the third quarter net foreign demand's contribution to growth turned negative as a consequence of the sharp slowdown in exports; sales of capital goods to emerging markets in the region contracted.

There continue to be deflationary pressures on both consumer and producer prices.

In the other Asian countries, and especially those most dependent on the international cycle, the rate of growth declined in the second half of 2000, although it remained relatively high.

In Latin America the economies of the countries with the closest trade links with the United States performed well. Output in Mexico increased by 7 per cent in 2000, as against 3.7 per cent in 1999. Brazil recorded an increase of 4 per cent last year, up from 0.8 per cent the year before.

In Argentina, by contrast, the economic situation deteriorated last summer; the appreciation of the dollar, to which the peso is rigidly pegged, resulted in a further loss of competitiveness in 2000, of about 5 per cent.

In Europe the growth in exports, investment and sales of consumer durables had brought a sharp acceleration in production and job creation in the middle of 1999.

The expansion, which was still strong in the first half of 2000, weakened over the summer. The upturn in inflation diminished households' disposable income.

The repercussions of the rise in the price of oil were more severe in Italy than elsewhere. The impact on production of the slowdown in consumption was partly offset by an acceleration in investment and a build-up of stocks of finished products. The cyclical indicators for the fourth quarter of 2000 confirm the slowdown in growth in Europe and Italy compared with the first half of the year.

The year-on-year increase in GIDP of the euro-area countries in 2000 is estimated to have been 3.4 per cent, one percentage point more than in 1999. The acceleration was due to the strong growth in world trade and a recovery in market shares. The growth in Italian exports continues to lag behind that in world trade.

Inflation in the euro area averaged 2.3 per cent in 2000. The core rate, excluding energy and food products, was 1.3 per cent. In Italy the overall rate was 2.6 per cent and the core rate 2 per cent.

The net outflow of private capital from Italy and Europe for direct and portfolio investment continued; it was greatest during the summer months. The capital exports of euro-area residents went primarily to the United States, thus helping to finance its substantial external current account deficit.

Banking systems and financial markets

With today's institutional arrangements, the currencies of the leading countries provide the basis for the multiplication of credit in international markets. The stock of money and liquid assets is difficult to control at world level; its expansion is limited only by the risks and the occurrence of instability in intermediaries or financial systems.

In a crisis the costs imposed by the destruction of savings and the contraction of credit, with the economies directly involved bearing the brunt, are much greater than the benefits reaped in the expansionary phase.

The use of derivatives has increased the scope for hedging, but it has also multiplied the volume of speculative positions.

The increase over the last ten years in the size of intermediaries and their internationalization are a response to the increasingly keen competition in domestic and international markets. Advanced methods are required to manage the risks inherent in organizations which have become more complex and are operating in more open and unstable markets.

Recent studies conducted under the aegis of the finance ministers and central bank governors of the Group of Ten indicate that a further increase in the size of intermediaries as a result of mergers and acquisitions would not necessarily enhance stability. Moreover, in domestic markets concentrations involving large banks may pose problems for competition, with adverse repercussions especially for individuals and small businesses.

In the United States rapid economic growth, the development of the capital markets and extensive activity in foreign markets providing high returns have enabled banks to make substantial profits in recent years.

Lending to all categories of borrowers has increased rapidly. Bankers appear to have shared the optimism prevailing in equity markets, leading in some cases to not entirely realistic estimates of customers' creditworthiness.

Corporate indebtedness, the level of share prices and the sizable exposure to emerging countries may aggravate the difficulties of the economy. Banks have adopted more prudent credit policies in parallel with the slowdown in the United States and the international economy.

The Federal Reserve's recent survey of leading banks has revealed a larger-than-expected deterioration in credit quality. The more selective approach to lending primarily concerns medium-sized and large firms and finance for mergers and acquisitions. The banks reported that they were also being more cautious in granting lines of credit to new customers.

The fall in the prices of shares in high-tech. sectors has dried up a major source of fee income for intermediaries.

The economic slowdown has also had repercussions on the bond market. The risk premium for bonds issued by firms with a high credit rating widened by about one percentage point in 2000 to 1.3 points; that for bonds with a low rating nearly doubled to 4.3 points.

The premiums have narrowed following the reduction in official rates in January.

Within the euro area, private enterprises intensified their borrowings on the international capital market in 2000. Corporate bond issues exceeded 350 billion euros; syndicated loans to the private sector increased to 230 billion euros. Recourse to the market was led by telecommunications companies.

The growth of the bond market was accompanied by an appreciable widening of yield spreads with respect to government securities. For bonds issued by telecommunications companies, the risk premium had risen to 164 basis points at the end of 2000.

In the Asian emerging countries, where technology companies account for a high proportion of market capitalization, share prices have fallen sharply since March 2000, by 40 per cent in Indonesia and Taiwan, 30 per cent in Korea and Malaysia, and 20 per cent in Thailand.

The increase in corporate indebtedness and greater financial fragility of these countries have undermined the confidence of international investors. This has led to a substantial widening of the yield differentials between dollar-denominated bonds issued by these countries and US Treasuries.

Equity markets have also declined sharply in Latin America, with falls of 20 per cent in Mexico and 30 per cent in Argentina. Financial market tensions in the latter heightened in the last two months of 2000. The yield differential between dollar-denominated Argentine government securities and US Treasuries has widened.

Turkey has experienced serious episodes of financial instability in conjunction with the crisis of its banking system; there have been adverse repercussions on equity prices, interest rates and the exchange rate. The crisis was sparked when international banks cut back their lines of credit to Turkish banks, which were highly exposed to exchange rate risk.

The turbulence in Argentina and Turkey subsided following support interventions coordinated by the International Monetary Fund and marked by the significant participation of the private sector.

The Italian banking system has undergone a wave of mergers and far-reaching restructuring in the last ten years that, starting from a situation marked by low concentration and mainly small banks, has permitted the creation of groups better equipped to face international competition. The liberalization of banking activity and privatizations have helped to increase competition in domestic markets.

The groups that have emerged have improved their profitability by expanding asset management business and reducing staff.

It is now necessary for the leading groups to strengthen their organizational structures and make the improvements competition demands.

They will need to simplify their group and productive structures, rationalize their distribution networks, integrate their information and riskmanagement systems, and expand their innovative lines of business, especially in services.

In the last three years banks' profitability has already benefited from action to contain labour costs, the reduction in bad debts and higher revenues from asset management services. In the first half of 2000 banks' return on equity was 12.4 per cent on an annual basis. Figures for the first three quarters and preliminary data for the fourth confirm the promising outlook for the year as a whole.

Lending continued to expand rapidly in 2000. Exposure to companies operating in high-tech sectors, at interest rates below the average for nonfinancial firms, more than doubled. Including banks' holdings of bonds and shares and the guarantees they have issued, the total exposure to these sectors is on the order of 83 trillion lire. The loans granted by the Italian banks that have financed such companies are equal to 30 per cent of their consolidated capital.

The average solvency ratio for the Italian banking system in June 2000 was 10.5 per cent, basically unchanged compared with twelve months earlier. In December 1999 the average value of the ratio for internationally active Italian groups was 9.6 per cent, compared with 12 per cent for competitors in the Group of Ten countries.

The introduction, with the 1988 Basle Capital Accord, of capital requirements related to risk assets fostered a strengthening of banks' capital bases.

Although the Accord was initially aimed at internationally active banks, the simplicity of its rules has led to its adoption in more than 100 countries.

Extensive revision of the original Accord by the supervisory authorities of the leading countries culminated on 16 January 2001 in the publication of a new capital framework for banks that will come into force in 2004.

The new rules provide for new valuation methods and a more diversified classification of the risks assumed by banks. The capital requirement for credit risk will be based on the assessments of borrowers made by rating agencies or those produced by banks themselves on the basis of their own information. It will take greater account of banks' use of credit risk mitigation techniques. A new charge will be introduced for operational risk.

Supervisors will ensure that banks have systems for managing and monitoring capital adequacy that are appropriate to their overall risk profile; this action will be complemented by market scrutiny on the basis of more extensive disclosure requirements for banks.

The importance of large banks for the stability of the financial system means that they must set aside more capital than the minimum requirements under prudential rules. Especially for intermediaries that borrow in the international markets, high levels of capital strengthen market confidence, *inter alia* with beneficial effects on the cost of funds.

The outlook for the world economy

According to the IMF, the world economy's rate of growth could decline to 3.5 per cent this year, from 4.8 per cent in 2000.

Current forecasts are considerably lower than those published last September.

The very nature of the recovery that began in 1999 and the persistence of deep structural imbalances in some areas had suggested that the rapid pace of world economic expansion would probably not be sustainable.

The plentiful supply of international liquidity made it possible to continue to finance the external imbalances of the United States and the Latin American countries while also fueling the growth of the world economy. However, the rapid increase in demand eventually pushed up energy prices, thereby contributing to the economic slowdown in the United States, Europe and several emerging countries.

In Europe the recovery has been driven by exports. It is necessary to create conditions that will allow domestic demand to grow vigorously.

The return towards more realistic share prices and the adoption of greater prudence in lending by the banking systems most exposed to the emerging countries heighten the need to make the adjustments whose urgency was not recognized in full owing to the cyclical upswing.

In the world's leading economy the spread of innovation is still in progress. The potential growth in output remains high in the long term.

After rising to 5 per cent in 2000, growth in GDP this year may not reach 2.5 per cent. In December the business confidence index fell for the third consecutive month; in January there was also a significant erosion of household confidence.

Both the timing and the extent of the easing of monetary conditions at the beginning of January took the market by surprise; it has presumably served to avoid a collapse in share prices in the United States.

The risk of recession has determined the decidedly expansionary stance of monetary policy. The additional half-point cut in official rates just a few days ago, the possibility of further reductions and especially the clearer intention of using fiscal policy are capable of reviving positive expectations and thus creating the conditions for an upturn.

The sustained expansion in economic activity in the nineties helped to generate the budget surplus and reduce the public debt. In the 2000 fiscal year the federal budget surplus was equal to 2.4 per cent of GDP.

There remains the need to ensure the orderly financing of America's external imbalance. Net inflows of foreign direct investment - more than $250 billion in the three-year period 1998-2000 - make a sudden massive outflow of capital unlikely and attenuate the risk of sharp fluctuations in the value of the dollar.

A rapid recovery of the US economy is essential for the stability of the world's financial markets and the expansion of the global economy.

In Japan the restructuring under way in the major industrial groups, aimed at cutting excess capacity, has permitted their return to profitability and a revival of investment, but it has failed to put the economy back on a path of rapid growth.

Business confidence, which had been recovering strongly, worsened again in December. The high levels reached by the public debt and the budget deficit in 2000 leave little leeway for the use of budgetary policy to boost the economy. The scope for monetary policy support remains limited.

GDP growth is likely to remain close to last year's low figure of 1.6 per cent. Measures to safeguard the stability of the banking system and improve the outlook for growth appear necessary and are under study.

In the euro area the rate of GDP growth in 2001 is expected to be more than half a percentage point lower than in 2000. The outcome will depend on international cyclical developments.

Domestic demand is becoming the crucial factor in sustaining growth. The budgetary measures adopted in several countries with a view to reducing the tax burden on a permanent basis are a step in the right direction only if they are accompanied by a curbing of current expenditure and a strengthening of capital expenditure. Budgetary balance and debt reduction, where appropriate, must be assured.

Taking a broader view, an additional stimulus to growth in European countries will come, under appropriate conditions, from the enlargement of the Union to include central and eastern Europe and some Mediterranean countries.

Over 100 million people would be involved, about one quarter of the area's present population. Average per capita income in the twelve candidate countries is very low, approximately 40 per cent of the average for the Union. Standards of living in these countries vary widely: whereas per capita income is between 20 and 30 per cent of the EU average in Bulgaria, Romania, Latvia and Lithuania, it is close to 70 per cent in Slovenia and is 80 per cent in Cyprus.

All the candidate countries made progress during the nineties in bringing down inflation, which fell from the very high values of the beginning of the decade to 12 per cent in 2000.

Commercial and financial ties with the EU countries have strengthened considerably. In 1999 the exports to the European Union of the twelve countries in question accounted for about 70 per cent of their total exports and consisted mostly of labour-intensive manufactures. In the same year net direct investment in these countries, mostly by EU countries, was equal to almost 5 per cent of their GIDP. Foreign investment has fostered the European Union's exports of technologically advanced products and services; at the same time it has helped the beneficiary countries to modernize their capital stock, introduce new technologies and develop management skills.

The entry of these countries into the European Union will intensify the flows of immigrants. The failing birth rates in the countries currently making up the Union call for the entry of additional labour in the medium term. With the support of adequate integration policies, workers coming from the candidate countries, who are relatively well qualified, can be fully inserted into the productive structure and help to sustain growth.

Structural reforms in Italy and other EU countries to increase technological innovation and shift production towards more advanced sectors will prevent "crowding out" and make it possible to reconcile the integration of the new members with increased prosperity throughout the Community.

Conclusions

The price-earnings ratio of the companies of the S&P 500 was 31 at the end of 1999; it declined to 25 in 2000. The expected real rate of return on investment in shares rose from 3.3 to 4 per cent.

In Germany and France the price-earnings ratio dropped from 26 and 25 respectively in 1999 to 21 and 19 in 2000.

In Italy the ratio dropped in the same period from 29 to 23.

In all four markets the price-earnings ratios remain higher than the long-term values that prevailed up to 1995. They may reflect a reduction in the risk premium associated with equity investment.

Other conditions being equal, the greater liquidity of share markets tends to attenuate the fluctuations in the value of individual shares and of portfolios. Savers can diversify their investments widely by using the services of professional asset managers. The depth and resiliency of the markets reduce the risk of loss on the sudden liquidation of portfolios.

Recourse to professionals lowers the costs of investment selection and reassures savers. It is always necessary to correspond to this trust in terms of professional conduct and disclosure to investors.

It is necessary to overcome the slowdown of the international economy and the risks of a worldwide recession. Adverse repercussions on the expected returns on investments must be avoided.

The potential for growth remains high in the largest industrial economy, on whose performance the international cycle depends crucially. It is estimated at around 4 per cent. The diffusion of new forms of organization of production, made possible by information technology and by new technologies, have involved only a part of the economic system; the process can continue in the years ahead.

The expansionary stance of monetary policy and the use of fiscal policy to support demand in the short term and foster investment in the longer run can restart the engine of growth.

For the economies of Latin America, the contribution of North American demand and financing remains fundamental.

In Japan, more resolute deregulation of the economy, the restructuring of production, a greater opening up to foreign businesses and trade with the new industrial economies of the region can increase productivity. Domestic demand, influenced by low demographic growth and the ageing of the population, needs to be supported.

Intermediaries and large banks that operate in international markets are seeking new configurations following the strong growth of the nineties. The banking systems of the countries of the European Union are solid; after the rapid expansion in lending in the past years, a re-examination of the criteria for measuring risk and of the structure and level of capital is necessary.

The potential growth rate of the European economy remains limited by the as yet scant application of new technologies and the slow progress of structural reforms. The expansion will continue, even if more slowly than in 2000, thereby contributing to the stability of the world economy.

An increase in domestic demand can also come from more intense infrastructure investment. It is necessary to press ahead with the steps already taken to remove the rigidities and imbalances that are still present in the labour market, the social security systems and the structure of government budgets. Scope for sustained growth can come from the integration of the economies of central and eastern Europe.

In Italy there is a wide gap between achievable and actual growth.

In 2000 GDP is estimated to have expanded by 2.7 per cent. From the middle of the year onwards consumption was held back by the increase in energy prices; this reduced private sector disposable income significantly, by more than 1 per cent of GDR Inflation was marginally higher than in the other European countries, but the latest data suggest that a gap could re-open.

Last year exports again expanded less than world trade and the exports of the other EU countries; the increase in sales within Europe was especially small. Non-price factors continue to influence Italy's export performance and to contribute to the rise in imports.

The increase in employment has been considerable thanks to the innovations in the labour market and the upturn in economic activity. The size of the underground economy has remained basically unchanged and abnormally large by international standards.

Further reform of Italy's labour laws and the agreements between employers and trade unions will have to permit a more flexible adjustment of costs to reflect productivity and individual companies' situations, with account also being taken of the sectors and geographical areas in which they operate.

The recent efforts to raise the volume of public works must be continued, both because of the contribution they make to domestic demand and employment and in order to reduce the infrastructure shortfall in large parts of the country and to increase the efficiency of the economy as a whole.

This raises the issue of the need to improve the functionality of local authorities, to enhance their project development and execution capabilities. Changes must be made to the legal system in order to eliminate regulations and divisions of responsibility that make it hard to bring public works to the starting gate and then through to the finish line. The action already taken to improve the efficiency of government must be followed up.

The improvement in the public finances was interrupted in 2000. The state sector borrowing requirement, net of settlements of past debts and privatization receipts, rose back to 2.2 per cent of GDP, from 1.5 per cent the year before. The overshoot with respect to the estimates included in the Economic and Financial Planning Document was equal to 1 per cent of GDP.

In December the Government presented the update of the Stability Programme for Italy to the European Council and Commission. The target for net borrowing of 0.8 per cent of GDP in 2001 was confirmed.

The results for the borrowing requirement for 2000 make that objective more difficult. Immediate and resolute action is necessary to ensure that it is achieved. The situation of the public finances must be checked month by month. Any overshoots must be corrected. Unfavourable trends in receipts will have to be offset with curbs on disbursements; careful controls on spending are essential in order to avoid having to introduce revenue-side measures.

The growth in GDP in 2001 could be on the order of 2.5 per cent.

The planned reduction in the tax burden will have beneficial effects on domestic demand and growth.

Adjustments in the pension system are necessary in order to ensure its equilibrium in the medium term. More stringent budgetary rules need to be introduced for local authorities.

The planned reduction in the tax burden over the coming years must be credible; it must become part of economic agents' expectations.

Certainty of a reduction in taxation encourages investment and consumption, reduces the disincentives to work and increases our economy's potential rate of growth.

We must put all the time available to us to good use; create the conditions for inserting the Italian economy into the world recovery; strengthen the country's economic and civil development and the prospects of wellbeing for the younger generations and for families.

*   *   *