

Antonio Fazio: Overview of global economic and financial developments in first half 2004

Address by Mr Antonio Fazio, Governor of the Bank of Italy, to the ACRI (Association of Italian Savings Banks), Rome, 5 November 2004.

* * *

1. The international economy

The recovery in economic activity, which began in the spring of 2003 in the United States and was sustained by the growth of the Asian economies, has gradually spread to Europe and Latin America.

In the first half of 2004 the world economy continued to expand rapidly; in the second half the pace moderated, partly as a consequence of the rise in the price of oil.

In the United States economic activity slowed in the second quarter, after expanding strongly in the first; the growth in household spending slowed to 1.6 per cent, but that in investment accelerated to 13.9 per cent. In the third quarter GDP grew by 3.7 per cent, fueled by a pick-up in consumption and the continuation of the expansionary phase of the investment cycle, which has now spread from IT products to include traditional capital goods.

Payroll employment rose, at a monthly rate of 300,000 from March to May and of 100,000 from June to September.

The economic expansion will remain strong in the last few months of this year and will carry over into next year.

Core inflation, measured by the deflator of consumption excluding energy and fresh food products, has held steady since March at around 1.5 per cent on a twelve-month basis. In view of the progressive reduction in unutilized capacity, the Federal Reserve began to raise the federal funds rate at a measured pace, so that it now stands at 1.75 per cent.

The budget deficit, after worsening progressively for three years, has stabilized in 2004, thanks to the growth of the economy. According to the estimates put out by the Congressional Budget Office, the federal deficit, including the social security balances, was 3.6 per cent of GDP in fiscal 2004, virtually unchanged compared with the previous fiscal year and 0.5 percentage points less than estimated in the spring.

The deficit on the external current account was equal to 5.4 per cent of GDP in the first half of 2004. From March to September the dollar fluctuated between 1.20 and 1.24 against the euro; since the middle of October a further weakening of the US currency has taken it to 1.28 against the euro. Since February 2002, when the prolonged decline of the dollar began, US competitiveness - measured by the fall in the real effective exchange rate, that is with account taken of inflation differentials - has improved by 13 per cent.

In Japan, exports continued to expand very fast in the first half of the year, at an annualized rate of nearly 19 per cent in real terms, despite the slowdown in those to Asia. Productive investment increased by 12 percent. The slowdown in GDP growth from 6.4 per cent in the first quarter to 1.3 percent in the second was partly due to the fall in public investment. The latent data available indicate that economic activity is likely to have remained weak in the third quarter.

Growth continued at a rapid pace in China, India and the other emerging Asian economics. The recovery has spread to the countries of Latin America.

In the last few weeks the persistence of international tensions has aggravated the threats to the continuation of the strong phase of global expansion. In real terms the price of oil has risen to 50 percent of the peak recorded during the upswing at the end of the 1970s; the latest figures available suggest that the rising trend may have come to a halt.

2. The state of the financial markets

The yields on US government bonds rose between mid-March and mid-May, primarily in response to the faster-than-expected growth in economic activity, by 1.2 percentage points to 4.9 percent; they subsequently came down and are about 4 per cent today.

In the euro area the yields on ten-year government bonds have also come down and are about 4 percent; in Japan they are about 1.5 per cent.

The abundant liquidity of the financial markets is helping to keep interest rates down and at the same time to reduce the volatility of the prices of shares and bonds.

The risk premiums on US corporate bonds have remained virtually unchanged, at a historically low level. Stock market indices have remained near the highs reached at the end of 2003; the price/earnings ratio has returned close to its long-term average value.

The volatility of stock and bond prices has been extremely low. In an environment marked by abundant liquidity and low interest rates, major international intermediaries have reacted to the weakness of the demand for credit by increasing the share of investments in high-yield instruments, in order to improve the return on capital. They have increased the supply of derivative instruments that provide protection against possible variations in the value of financial assets and assumed the related risks. The increased supply is deemed to have caused a fall in the price, and hence in the volatility, of options, which has spread to the cash markets. In such a situation, a return to normal levels of volatility could bring substantial losses.

In the emerging countries, after the rise in risk premiums that occurred in the spring as a consequence of expectations of an imminent increase in US interest rates, financial conditions have become easier everywhere; the recovery in exports has been a contributory factor. The low cost of financing has encouraged numerous emerging countries to bring forward bond issues and increase their amount. In the first half of 2004 the value of the gross issues of the emerging countries as a group was two thirds of the historically high value of nearly \$100 billion recorded in the whole of 2003.

3. Economic developments in the euro area and Italy

The upturn in economic activity in the euro area has not been as buoyant as in the rest of the world. In the first half of this year GDP expanded at an annual rate of 2.3 per cent. Between the first and second quarters there was a slight slowdown.

Growth was sustained chiefly by household spending. Consumption expanded substantially in France; in Germany it continued to contract.

Investment continued at a modest level, growing at an annual rate of 0.7 per cent. A pronounced acceleration in France contrasted with continuing contraction in Germany, once again determined by investment in construction.

The area's exports accelerated to an annual growth rate of 7 per cent in the first six months of the year, fueled by the powerful expansion of world trade and the stabilization of the effective exchange rate of the euro. This result reflects the good performance of German exports, which are highly competitive even at current exchange rates. The stimulus to economic activity was blunted by the substantial increase in imports.

The contribution of net exports to GDP growth was negative in both France and Italy.

Italian economic growth picked up slightly in the first half but remained significantly below the area average. Italian GDP growth followed the area-wide trend in decelerating between the first and second quarters.

The main impediment to Italian economic growth is weak export performance. After diminishing in the first quarter, foreign sales increased appreciably in the second; growth apparently continued in the third quarter, albeit at a slower pace. For the year, export growth is projected to be much less than the growth in world trade; Italy's share of the world market is expected to decrease further.

Italian export penetration has met with difficulties both in the euro area and in the rest of the world. The loss of market shares began to intensify in 2002.

With deteriorating competitiveness and the unfavourable trend in exports, industrial production recorded no increase between the second quarter of 2003 and the third quarter of 2004; in the euro area as a whole it grew by 2.8 per cent. Compared with the average for 2000, in September industrial production was down in Italy by 2.8 per cent; in the euro area, it showed an increase of 2.5 per cent.

In the first half of this year Italian investment recouped the decline registered in 2003. The most substantial increase was in investment in machinery, equipment and transport equipment. Household expenditure increased at an annual rate of 1.6 per cent. This gain came entirely in the first quarter; in the second consumption showed a marginal decline, due to spending on services. Purchases of durable goods continued to grow strongly, in connection with easy credit terms and a modest recovery in households' confidence.

In the second quarter the twelve-month rate of consumer price inflation in Italy was around 2.3 per cent. In the last few months it has fallen below the average for the other euro-area countries. The effects of higher oil prices on electricity and gas prices have yet to be felt.

According to national accounts data, in the first half of the year the number of persons employed in Italy rose by 0.6 per cent on an annual basis. For the euro area as a whole the increase was scarcely 0.2 per cent. In recent years the increase in the number of persons employed, despite the stagnation of economic activity, has been driven by the greater flexibility of the labour market and the moderation of real wage growth.

Nevertheless, in the first half of the year unit labour costs in the service sector grew more than two percentage points faster on an annual basis than the average for the main euro-area countries. In industry excluding construction the gap exceeded four points. The main factor was labour productivity, which evolved less favourably in Italy than in the other countries.

The unemployment rate has continued to fall, but geographical disparities remain extremely great.

4. Looking ahead

The expansion in the world economy in 2005 will not match the exceptional rate of growth estimated for the current year, of the order of 5 per cent.

In September the International Monetary Fund forecast growth of 4.3 per cent next year. It may be lower than that in view of the uncertainties stemming from international political tensions and the rise in oil prices, although this appears to have run its course.

In the United States output is expected to grow by 3 to 4 per cent, in line with its potential; in Asia growth should be between 6 and 7 per cent, and in Japan, between 2 and 2.5 per cent.

The rapid expansion in world trade is expected to continue, although not as fast as this year.

The euro-area economy will continue to grow in the last part of the year and in 2005.

In view of recent trends, the expansion of the Italian economy appears uncertain.

Industrial production has not yet shown any sign of recovery. Preliminary estimates indicate that in October the level was no higher than at the end of 2003. Gross domestic product rose by 0.5 per cent in the first quarter and 0.3 per cent in the second; the increase is expected to remain about the same in the third quarter. For the year as a whole the estimated increase is 1.2 per cent, which is well below the average for the other European countries.

Household consumption is increasing in line with GDP. The sharp upturn in world trade concerns Italy's exports as well; if the recovery observed in the second quarter continues, they may increase by as much as 5 per cent in volume in 2004.

After falling sharply in 2003, investment is showing signs of recovery.

According to a survey conducted by the Bank of Italy's branches between 17 September and 7 October on 4,157 firms, including 3,094 in industry excluding construction and 1,063 providing non-financial services, capital spending in 2004 will be only slightly below the amount initially planned; the recovery in investment is expected to continue in 2005, both in the service sector and in industry.

In the first nine months of the year, the majority of firms saw their turnover increase in nominal terms with respect to the year-earlier period; during the third quarter orders showed some improvement with

respect to June; a large percentage of firms in industry and services expect demand to pick up further in the next six months.

In view of the favourable performance of international trade, it is expected that output will be sustained by exports. Poor competitiveness on the domestic market will entail a sharp rise in imports; GDP growth will be faster than this year; however, on the basis of current trends, it will amount to less than 2 per cent.

Estimates made with the Bank of Italy's econometric model indicate that investment in machinery, equipment, and means of transport could expand by 3 to 4 per cent in real terms.

5. Economic policy

The twelve-month inflation rate fell to 2 per cent in October, according to preliminary data.

On a seasonally adjusted basis, the consumer price index registered a slight decrease with respect to September. This is a development whose interpretation is multifaceted. Undoubtedly, the weakness of demand played a part in the decrease. After the criticisms and discussion of the behaviour of the distributive trades on the occasion of the changeover to the euro, the sector needs to regain consumers' confidence. A broadly shared determination to act in this direction can bring benefits for the level of economic activity and for the distributive sector itself.

In a cyclical phase that remains uncertain but is showing signs of improving, it is crucial to launch policies designed to create the conditions for faster economic growth.

It is indispensable to proceed with the adjustment of the public finances. Curbing the rate of growth of current expenditure is part of this strategy; the recoupment of tax bases is necessary in order to reduce the benefits accruing to tax evasion and avoidance.

There is ample scope for increasing the efficiency of the public sector. Major advantages can come from further administrative simplification and a drastic reduction in authorization procedures.

Structural measures can contain the rise in expenditure on health care, without affecting the quality and availability of services.

In the medium term, the size and certainty of the expenditure savings connected with the changes in the pension system will have to be verified in depth.

The process of decentralization of government powers must necessarily involve a transfer of personnel and administrative units.

In a context of deficient infrastructural endowment, even in such essential services such as transport, water supply and the provision of energy at moderate costs, spending on public works in 2004 remained at the previous year's levels in real terms. Extraordinary measures and adequate financing can accelerate the transition from the phase of decision-making to that of project execution. Arrangements to prevent or resolve conflicts of authority, together with innovative mechanisms of cooperation with the banking system, can help to get the projects effectively under way. Private enterprise can take on an important share of the cost of the investments, when these regard the provision of services remunerated by user charges.

The intensification of activity in this sector enhances the competitiveness of the economy; it will yield immediate results in term of an increase in domestic demand.

The policies of liberalization, of stimulating competition, must be strengthened. Tax reduction will have a positive effect on expectations and growth if it does not lead to an increase in the public sector's deficit and debt.

If, in other words, it is perceived as sustainable.

It is necessary to move to lighten the fiscal burden for firms as well. Measures aimed at facilitating their expansion in size and encouraging technological innovation are indispensable in order to operate well in a system increasingly exposed to international competition.

The situation of firms in the last three years has been affected by the uncertainty of the cyclical situation. Banks have continued to provide support in this difficult phase. In the context of the new collaborative relationships, they are committed to making it still easier for small firms and innovative enterprises to obtain access to credit, in part by offering a wider range of services.

There can be no delay in an organic reform of bankruptcy law. Although the conditions for a complete overhaul in the near future may be lacking, some institutes can be reformed and new ones introduced. Legislation must be adopted to provide for timely management of corporate crises, outside the framework of bankruptcy procedures or before recourse to them becomes necessary. Reform of the law on revocations in bankruptcy is needed to ensure certainty in relationships between the company and its creditors, especially suppliers and banks, and to avoid the sudden interruption of financing to the firm, due in the first place to the legal aspects involving penal responsibility.

We are in a difficult moment for our economy.

In a situation of less-than-full employment of productive factors and low growth, the formation of saving in the economy and the amount of savings at households' disposal depend on increasing investment and accelerating growth.

The defence of savings, above all through the stability of intermediaries, and the allocation of these resources by the banking system to the benefit of the most valid and innovative firms through efficient disbursement are indispensable in order to raise the economy's potential growth rate.

Consistent action on the part of politicians, the social partners and firms themselves must strengthen the signs of recovery.

The perception by firms and households of a will to proceed in this direction by making up the shortcomings and encouraging productivity and competitiveness can dispel pessimism, foster a more solid recovery of economic activity and investment and put our economy back on the track of growth.