Mr. Fazio discusses Italy and Europe in a world of global finance Address by the Governor of the Bank of Italy, Dott. Antonio Fazio, at a conference jointly organised by AIOTE - ASSOBAT - ATIC - FOREX - AIAF and held in Naples on 24/1/98.

The expansion of trade and the globalization of markets have maintained the rate of growth of the world economy at a high level in the last ten years. The pace has been particularly rapid in the countries where labour is most abundant and least costly and in the industrial countries whose economies are marked by a high degree of flexibility and rising productivity.

The liberalization of trade in goods and services, the improvement in communications and the reduction in transport costs increase the efficiency of the allocation of resources in the world. The gains from trade, the new wealth created are unequally divided among the countries involved; they also result in a redistribution of productive capacity and an increase in specialization and concentration.

The globalization of finance allows saving to be allocated and managed more efficiently at world level; it has made a significant contribution to sustaining productive investment in the fastest growing economies.

In the six leading industrial countries the volume of financial assets rose between 1982 and 1995 from $30 trillion to $124 trillion and from four to six times their annual GDP at current prices. In the industrial countries the huge rise in public debt contributed to the increase in the supply of financial instruments. Stock markets have grown very rapidly in recent years, especially in the emerging countries. The activity of non-bank intermediaries operating on a global scale and investing primarily in shares and bonds and other widely traded assets has developed, rapidly reaching a very substantial volume.

Financial intermediaries, including banks, tend to behave according to operating models that are based on the same theoretical paradigms; sometimes, however, by reacting uniformly to important new information or to changes in expectations concerning individual economies, they shift funds very rapidly from one economy to another; they can take positions with very-short time horizons in foreign exchange or securities of a size that heavily influences countries with less solid financial structures.

1. The Asian crisis

Foreign investment in the emerging markets by banks and institutional and private investors rose from $50 billion in 1990 to $240 billion in 1996.

In mid-1997 the foreign debts of eight emerging Asian economies, including Hong Kong, Singapore and China, amounted to $900 billion or about 40 per cent of the area's GDP; some two thirds of the total was due to mature within one year.

The crisis, which has affected five countries in particular -- Thailand, Indonesia, Malaysia, the Philippines and South Korea -- is basically the result of the persistence of large external current account deficits ranging from 3 to 6 per cent of GDP and the consequent rapid accumulation of foreign debt.

These countries' budgets are generally close to balance and their public debt is limited. The disequilibria are attributable to an excess of private and public sector investment in relation to the albeit high rate of saving. The returns on investment projects have not always been adequate in terms of profitability and exports, partly owing to inefficiencies in the allocation of credit. Competitiveness was eroded by the 40 per cent devaluation of the Chinese currency in 1994.

Firms’ growing dependence on foreign loans, denominated mostly in dollars, the preponderantly short-term nature of the debt and shortcomings in the supervision of financial intermediaries made financial systems more fragile. The uncertain performance of the Japanese economy and financial system exerted a negative influence.

The crisis started and spread when market participants came to recognize the difficulty of sustaining exchange rates in the face of the sharp and continuing appreciation of the dollar and expectations of increases in interest rates in the United States. The possibility emerged of heavy losses by firms; growth prospects were scaled back, with further adverse effects on stock markets.

It is surprising, in this crisis as well, how fast the climate of opinion changed among investors; it suggests a formation of expectations based on the performance of the macro-economic variables only in the short run and on the attitudes of other market participants. The extrapolative nature of expectations compounds fluctuations in exchange rates and securities prices.

Once again there was a failure to make a thorough analysis of the underlying conditions of each economy. To be sure, the shortness of the average maturity of the debt indicated uncertainty among investors regarding long-term growth prospects; nonetheless, until mid-1997 the flow of capital to the area remained substantial.

Notwithstanding the interventions organized by the IMF, the crisis deepened in December and the early days of this year. The falls in share prices and exchange rates against the dollar in the five countries mentioned since early 1997 have reached respectively 40 and 50 per cent on average; expressed in dollars, share prices have fallen to less than one third of the initial level. The markets, and especially the stock markets, of Singapore, Taiwan and Hong Kong have been caught up in the crisis.

Events in the markets and the poorer prospects for the economies of the countries hit by the crisis have adversely affected the already delicate balance of Japan’s capital market and the quality of its banking system’s assets.

The Chinese economy has not been drawn into the crisis, owing to its initially strong competitive position, relatively underdeveloped financial system and the preference given to direct inward investment over portfolio investment.

The volume of financing mobilized by the IMF, other international organizations and the nations working to cope with the crisis is without precedent. The World Bank and the Asian Development Bank have been called upon to contribute to objectives beyond the scope of their respective institutional mandates. Total disbursements of around $110 billion have either been made or are envisaged.

Banks will have to help in containing the effects of the crisis by rolling over existing loans.

The intensity of the crisis and the fear of systemic repercussions have produced a disarray in the measures and decisions adopted that suggests the present arrangements for international cooperation are inadequate in the face of the challenges posed by the globalization of markets.

2. International monetary developments

The backdrop to the Asian crisis is the persistent problem of the uncertain performance of the Japanese economy and the excessive burden placed on monetary policy.

This situation is an inheritance from the Mexican crisis in the early months of 1995, which led initially to an abnormal appreciation of the yen and to fears of a prolonged decline of the dollar.

The lowering of interest rates in Japan to near zero led in the second half of 1995 to a fall on the order of 20 per cent in the effective exchange rate of the yen. The economy did not benefit sufficiently in terms of growth, while the imbalance associated with Japan's large external credit position was aggravated. The weakness of the exchange rate tended to depress share prices, thereby contributing to the contraction in domestic bank credit.

Fiscal policy, even after the recent announcement of a small reduction in taxation, continues to be directed towards the undeniably desirable objective of containing the public debt in the long term. A further reduction in the budget deficit is expected in 1998; there does not appear to be sufficient concern about the deflationary implications of this course in the short term.

The measures now before the Japanese Parliament provide for a limited stimulus to domestic demand based on tax reductions that should amount to around half a percentage point of GDP. The package also includes a plan for shoring up and rescuing the financial and banking system involving very substantial resources, some $240 billion or 6 per cent of GDP.

The long period of expansionary monetary policy in Japan, especially from the spring of 1995 onwards, has substantially increased the supply of yen and lowered the cost of yen financing. Japanese banks have considerably increased their supply of credit to international markets; their external liabilities have fallen substantially and they have become large net creditors.

The expansion in the credit provided by the Japanese banking system has occurred in a period which has been marked by a very large US current account deficit, at present on the order of $180 billion a year, coupled with a persistently high level of direct investment abroad by American firms. The relatively slack economic conditions in most of the industrial countries made it easier to finance the external deficits of the countries affected by the crisis.

In a context of low inflation, both actual and expected, the supply of money at very low interest rates has been reflected in long-term yields in Japan and the other leading markets. The yields on long-term Japanese securities fell to 2.1 per cent in 1997. Japanese overseas portfolio investment amounted to more than $80 billion in 1994 and 1995, twice the level of the preceding years; it rose further in 1996 and the early part of 1997; around one fifth of the outflow goes directly to the US market.

Foreign investment in US securities amounted to more than $300 billion in 1996, an increase of 50 per cent on 1994 and 1995; compared with three years earlier it more than doubled. Annual disinvestment is on the order of $100 billion. The yield on ten-year US securities fell from 6.4 per cent in 1996 to 5.8 per cent at the end of 1997.

The European financial system also received much larger portfolio investment inflows in 1996 and 1997 than in the preceding years. More than $200 billion flowed into Germany in 1996, compared with $125 billion in 1995 and $76 billion in 1994. In 1997 the yields on medium-term securities fell faster in Germany than in the United States, reaching 5.3 per cent.

In some respects the abundance of liquidity in the international market appears to be a replay of the situation in the early 1990s, up to the beginning of 1994, following the prolonged US monetary expansion. The Federal Reserve held short-term rates close to 3 per cent for nearly two years. In these circumstances the yields on medium and long-term securities in the leading markets declined steadily and substantially until the last few months of 1993. Those on ten-year US Treasury bonds fell from 7 per cent at the beginning of 1992 to just over 5 per cent in October 1993; the yields on German securities fell from 8 per cent to below 6 per cent at the end of 1993. The yields on ten-year Italian Treasury paper fell from over 14 per cent in the autumn of 1992 to below 9 per cent in the early months of 1994, after reaching 15 per cent during the EMS crisis.

From February 1994 onwards, in connection with the shift in the stance of US monetary policy, interest rates rose rapidly everywhere; securities prices fell to their level of two years earlier.

After the Mexican crisis, medium-term interest rates declined gradually again in all the main markets from the spring of 1995 onwards. Monetary policy was tightened moderately during 1997 in all the industrial countries except Italy and Spain. The upward pressures on interest rates are now being neutralized by the need to facilitate the solution of the Asian crisis and the expectations of slower growth in the United States.

The funds that have been withdrawn from the Asian economies have flowed to the financial markets of the industrial countries, above all that of the United States, providing support for share and bond prices and the exchange rate of the dollar.

The yen has been constantly weak, but in general outside Asia the pattern of exchange rates has remained orderly.

On several occasions during the 1990s the Japanese government announced plans for fiscal expansion. Although they were substantial, the composition of the measures, their temporary nature and incomplete implementation meant that they produced effects of limited size and duration. The Japanese economy appears to be dominated by negative expectations for the medium and long term connected with the prospective ageing of the population. The large fall in property and share prices at the beginning of the 1990s created difficulties for the banking system, which have now been aggravated by the crisis of South Korea and the countries of South-East Asia, which have close commercial, financial and entrepreneurial ties with Japan.

The way to overcome the impasse -- given the size of the Japanese economy and its actual and potential strength in terms of productive capacity and saving -- appears to be to provide an effective stimulus to domestic demand. Monetary policy, with interest rates close to zero, appears to have shot its bolt.

The plan now under discussion, if it is approved by Parliament in its entirety, appears to be on a sufficiently large scale as regards the rehabilitation of the financial system. By contrast, the stimulus for economic activity appears still to be small. More incisive budgetary measures, possibly with short time horizons, could improve the outlook for growth in Japan without having adverse long-term effects on its public finances.

The levels reached by share prices in the economies affected by the crisis, in conjunction with the stabilization plans drawn up for some of them with the support of the IMF, mean that there are likely to be profitable investment opportunities.

In the present phase the international economy is exposed to the risk of systemic instability, with consequent widespread deflationary effects. International portfolio investment flows have been of unprecedented size in the last few years; it is necessary at least to monitor them and to some extent to govern them.

A recovery in domestic demand and an improvement in the prospects for growth in Japan would also underpin the yen; they would bring direct benefits for the Asian countries and indirect benefits for the world economy. There is an increasingly urgent need for a new comprehensive approach to these problems conforming with the configuration of global markets and today's international financial system.

3. Europe in the global market

Europe's markets are increasingly integrated with the international market in finance.

The international opening of the Italian and French financial systems has proceeded apace in the 1990s. Germany had already been playing an important role in international markets; at the same time the share of finance coming from abroad has steadily grown and the large net external credit position built up above all in the 1980s is tending to diminish. The international openness of the United Kingdom remains pronounced, reflecting the presence of the world's leading financial centre.

The recent monetary developments have had a significant effect on all the markets of continental Europe. The last three years have seen substantial flows of portfolio investment into Germany, France and Italy as well as smaller countries. The fall in long-term yields, which occurred simultaneously everywhere, has reflected the stability of prices and the reduction in government deficits within Europe; more immediately it is the consequence of the large inflows of funds that have been a feature of all the European markets.

Policies must be designed to maintain in the European Union financial investments that tend to be of a temporary nature. The small inflow of direct investment into some continental European countries, coupled with growth in EU outward direct investment, is a cause for concern. There is a need to develop conditions of competitiveness and profitability in productive systems that will attract the funds of international investors on a permanent basis.

The competitiveness of the financial industry in continental Europe is relatively low. Costs are high; the quality of the services provided is still inadequate. Small markets and the chronic weakness of some currencies have been a brake on the development of a more modern financial industry able to compete in the global market.

In 1996 the current account of the European Union's balance of payments showed a surplus of $86 billion or 1 per cent of the area's GDP. From 1990 onwards the external accounts of the EU countries fluctuated between deficit and surplus against a background of rapid growth of the world economy and moderate growth of domestic demand within the area.

The limited increase in output, the steady decline in industrial employment and the rise in unemployment are indicators of insufficient competitiveness with respect to the rest of the world. The markets for goods and above all the market for labour are more rigid in continental Europe; unit labour costs in industry are comparable with those of the United States and Japan, but much higher than those of newly industrialized countries in Asia, Latin America and eastern Europe. The tax burden, and especially that relative to employee workers, is high.

Population ageing will profoundly alter the balance between the economically active and inactive members of society. The low level of economic growth depresses the propensity to invest.

The prospect of economic and monetary union has forced European countries to take determined action to put their public finances back on a sound footing. To a large extent the effort required to adjust budget deficits has been made. A high degree of monetary stability has been restored. In several cases however, the tax burden has increased further.

Monetary stability is the primary objective of the unification; it serves to create conditions conducive to investment and growth.

The parameters for government deficits and public debts are playing a key role in achieving monetary stability in the area; they were nonetheless conceived in a context in which the implications of the globalization of commerce and finance were still not sufficiently clear; it is also necessary to try and reduce the burden on the economy of some items of the public finances and the ratio of taxes and social security contributions to GDP.

To seek to enhance the Union's competitiveness through the exchange rate would be in contrast with the objective of monetary stability. Competitiveness is in the first place a reflection of the share of resources absorbed -- directly in the form of wages, indirectly via some items of public expenditure -- by labour. It must therefore be enhanced through a cost of labour, a flexibility in its use and a level of direct and indirect taxation that are compatible with today's greater international openness of the markets for goods, services and especially finance.

Increasing the size and diversification of the capital market can make a decisive contribution to monetary stability and ultimately to the prosperity of the economy.

Europe as a whole is a net creditor with respect to the rest of the world. The creation of a single financial market that is no longer segmented by different currencies, in a context of price stability and greater competitiveness, will offer considerable scope for growth in the issue and trading of corporate bonds and shares, and for the development of related capital market activities, benefiting enterprises and economic activity and supporting their extension to world markets.

Looking ahead, the international monetary system will increasingly be divided into three large blocs: those of the dollar, the yen and the European currency. The currencies of smaller countries will tend to be grouped around, and refer to, the three of greatest importance.

The strength of each currency will depend on the credibility of the monetary policies adopted. In the background there will be a tendency for the productivity and competitiveness of the real economy to take on renewed importance. It is necessary to foresee a recomposition of the area's value added in the medium term at the expense of more traditional industries and to the benefit of more advanced services, especially financial services.

Important opportunities are opening up for Italian and European operators that they must succeed in grasping by updating strategies and professional skills and by correctly assessing the related risks through the application of more advanced and complete models.

4. Italy

Italy recorded another surplus on its external current account in 1997, of the order of 60 trillion lire or just over 3 per cent of GDP.

Towards the end of the year the country's net external position returned to near balance. Some 470 trillion lire of net government liabilities vis-à-vis non-residents (mostly short and medium-term lira paper purchased on the Italian market, but with about one fifth consisting of foreign currency bonds issued abroad) were matched by net assets of more than 350 trillion held by the non bank private sector, about 100 trillion held by the Bank of Italy and smaller amounts held by banks and other financial operators.

The Bank of Italy's gold reserves amount to 2,500 tonnes; in addition the central bank's external position improved from 51 trillion lire at the end of 1995 to 96 trillion at the end of last year.

Households and firms have converted Italy's substantial current account surpluses into external financial assets. They first repaid foreign currency debts taken on in earlier years and then increased their holdings abroad. Their overall position in foreign currency improved from near balance in 1993 to a surplus of more than 200 trillion lire last September.

Capital outflows in the form of portfolio investment increased from a monthly average of 4.5 trillion lire in 1996 to one of about 9 trillion last year. This reflects a propensity for portfolio diversification aimed at achieving a better combination of risk and return, a process that is structural and that is bound to become more pronounced over the next few years. Increasingly, these outflows are being channelled through Italian and foreign intermediaries specialized in asset management.

Despite the large volume of capital outflows in 1997, the net supply of foreign currency in exchange for lire remained very substantially positive, enabling the Bank of Italy to achieve the build-up in its foreign exchange reserves referred to earlier at stable exchange rates.

The supply of foreign currency derived not only from the trade surplus but also from a large volume of inward portfolio investment by institutional investors, banks and private operators. In response to more favourable domestic conditions and abundant international liquidity, the foreign investors continued to make very large purchases in 1997: 118 trillion lire, in line with the previous year. At the same time, the improved climate of confidence was reflected in a sharp reduction in the share of purchases foreign investors financed in lire in order to hedge the exchange risk.

Net purchases of Italian government securities by non-residents exceeded issues by a wide margin. The economy’s regained credibility, the prospects for the consolidation of the public finances, low inflation and the upward trend in bond prices encouraged investment and accentuated the decline in yields on medium and long-term securities, which are now comparable to those in the markets with the most stable currencies.

Italian savers directed the bulk of their investment to the various forms of managed savings; through this channel they increased their purchases of foreign assets and Italian shares. Problems may arise in this connection with respect to the risks that households and firms may sometimes run with this new configuration of their portfolios. The declining yields on Italian government paper and the lower liquidity of these alternative instruments also strengthened the demand for money, and in particular for current account deposits.

The climate of confidence that has prevailed in the markets has also been reflected in the surge in share prices, which has continued even after the outbreak of the Asian crisis. Financial conditions facilitated major privatizations of public sector banks, coupled with their recapitalization, along lines we had frequently suggested.

Economic activity remained weak in the first half of 1997, bearing out the forecasts we made at the end of 1996 and early last year. In 1997 the growth in GDP, which had been a disappointing 0.7 per cent in 1996, would have been just over 1 per cent. Incentives for the purchase of consumer durables stimulated economic activity despite the further fiscal tightening and permitted annual growth estimated at about 1.5 per cent.

Investment in plant and machinery has shown signs of picking up, partly in response to favourable conditions in Europe; by contrast, the construction sector continues to stagnate.

The situation with regard to employment is not improving, however; in fact, in the more depressed regions it is deteriorating further. Growth in consumer spending is still hesitant, owing to the uncertain prospects for employment and the slow increase in households’ income.

Monetary policy has continued to be firmly directed to stabilizing inflation.

Consumer price inflation fell below 1.5 per cent on a seasonally adjusted annual basis in the second half of 1996 and remained at that level until the summer of 1997. In the fourth quarter of last year it rose to around 2 per cent, reflecting the upturn in producer prices that had occurred in the second.

The expectations regarding inflation have improved continuously and now indicate a rate of 2 per cent for 1998 and 1999.

The lowering of official interest rates from the middle of 1996 onwards was calibrated in relation to actual and expected inflation and the outlook for the adjustment of the public finances, the condition for a lasting return to stability, with constant attention to the changes in residents’ portfolios and the inflows of foreign capital.

We have kept the exchange rate consistent with the lira's central parity, with no need for support intervention in the moments of tension of international origin or related to domestic political developments.

The reduction in the official rates, the discount rate and the rate on advances, decided at the end of last year is helping to sustain conditions that, thanks in part to the good performance of exports, are likely to foster investment. The growth in GDP in 1998 could exceed 2 per cent.

Italy is still faced with difficulties that will have to be overcome, thereby laying the foundations for improvements tomorrow; there is a need for behaviour and policies that will ensure the saving available is used to strengthen productive investment at home. Over the last five years direct investment by Italian firms expanded substantially; the inflow remained virtually unchanged; the balance showed a deficit of 30 trillion lire.

The quest for higher profits in a climate of renewed confidence in stability and economic growth can be directed towards expanding the scale of production and investment, with a view to creating employment.

Wage moderation must be maintained, thereby permitting a reduction in unit labour costs; the albeit limited pressure on prices -- particularly producer prices -- must not be allowed to increase.

Last year saw substantial progress towards the consolidation of the public finances. On the basis of the latest data, general government net borrowing should be less than 3 per cent of GDP. A start has been made on reforms aimed at improving the working of the public administration and rationalizing the tax system. Cuts have been made in some expenditure items and transfers to non-state public bodies reduced.

What is needed now is action of a structural nature to consolidate the results achieved. Public services must be made more efficient and provide effective support for productive activity.

There is a manifest need for flexible formulas in the use of labour that will enhance its productivity. Unit labour costs must be brought down substantially in the less developed regions, where both youth unemployment and the underground economy are present on a large and growing scale and where the labour force participation rate, particularly among women, is very low. It is indispensable to eliminate the rigidities In the economic relations between employers and employees, which prevent wages and salaries and other contractual conditions from adjusting to the level of productivity and the demand for labour. Excessively high labour costs lead to forms of hidden employment; they prevent most young people from embarking on a career in the regular economy and, together with high tax rates, give rise to evasion of abnormal proportions.

A lack of effective demand is increasingly evident. A low level of investment is common to all the European economies; it lies at the root of the decline in employment in certain sectors and the rise in unemployment. It is serious in the more depressed regions, particularly in southern Italy; together with high labour costs, the fall in private and public sector investment is adversely affecting the economic and productive fabric. Appropriate policies are required to restore higher rates of investment. Lower unit labour costs and increased competitiveness provide fertile ground for a recovery in investment.

I have spoken at length elsewhere of the potential and actual availability of private saving in Italy. I have endeavoured to show that a higher level of economic activity and faster growth, combined with monetary and wage stability, can accelerate progress towards the lasting adjustment of the public finances.

The price stability that we have regained with a monetary policy that at times has had to be extremely rigorous, must be bolstered by a competitive and expanding real economy.

By pursuing a stable policy from the summer of 1994 onwards we brought the rate of inflation back into line with that of the leading industrial countries. Wage moderation, the drastic reduction in the Treasury borrowing requirement in 1997 and the weakness of prices in international markets have helped considerably in the curbing of inflation; as a consequence, long-term interest rates have come down. These results, obtained through an unwavering commitment, have made a major contribution to the convergence of Italy's economy towards those of our European partners with a more firmly established tradition of stability.

The months from now until the decisions connected with the launch of Monetary Union, but also the second part of this year, will prove especially delicate for the entire system of European exchange rates. In these circumstances monetary policy, while it will continue to guarantee moderate medium-term inflation expectations, is now focused more on the stability of the exchange rate.

If economic agents' behaviour is consistent, Italy will be able to maintain the international position it has so arduously regained, to the benefit of present and future generations.