Price Stability and Balanced Public Accounts as a Condition for Sustainable Development *

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Italy's economic recovery forms part of a process of renewal involving the institutions, every area of the economy and Italian society as a whole. The turning point in the economy was in 1992, when Italy emerged from a series of occasionally dramatic events, and chose the path to restore economic equilibrium, drive down inflation and embark on a root-and-branch review of public expenditure.

It was in autumn 1992, during a particularly sensitive phase in relations with the European Union, that the contradictions in Italy's economic policy – ostensibly in favour of European objectives but incapable of acting consistently – came fully to the surface, and the resultant friction with the policy being pursued by the Bank of Italy to achieve monetary stability.

The turning point in favour of consistent conduct was made possible by a general consensus emerging throughout Italian society that European integration was necessary and fully consistent with the national interest.

In the following years, nourished with the successes that gradually ensued, this consensus became entrenched both in the institutions and in the public mind at large. This is the real guarantee that the choice taken at that time will remain steadfast in the future.

The situation obtaining in autumn 1992 has since been reversed. At that time, the economy was suffering from two crucially important imbalances.

The first concerned macroeconomic relations between supply and demand. Italy was consuming more than it was producing, generating a balance of payments deficit, and creating a build-up of foreign debt. Global demand had also risen because of the government deficit,

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□ Minister for Treasury, Budget and Economic Planning, Rome (Italy).

* From a speech given at Deutsche Bank in Frankfurt am Main on 6 February 1988.

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fuelled both by expenditure on current account unable to withstand the social and political pressures, and by interest expenditure that was being bolstered not only by inflation but also by the scant creditworthiness of the Italian Republic.

At the domestic level, and this was the second imbalance, the pressure of costs helped to keep the inflation rate above the Community average.

Today, these fundamental balances have been solidly reestablished.

Today, the three components of economic policy - budgetary policy, incomes policy, monetary policy - are working in tandem, respecting the functions and independence of all the institutions involved, designed to create that stability considered to be the essential condition for any lasting and sustainable growth.

1. The statistics confirm that *inflation*, an evil that has afflicted the Italian economy for twenty years, has now been beaten. Consumer prices in 1997 rose at an average annual rate of 1.7 per cent, and by 1.5 per cent over the 12-month period, in other words almost 1 per cent below the 2.5 per cent target set by the government. At the beginning of the current year January's figures confirmed the 1.5 per cent (Figure 1) consumer price increase recorded for the previous twelve months.

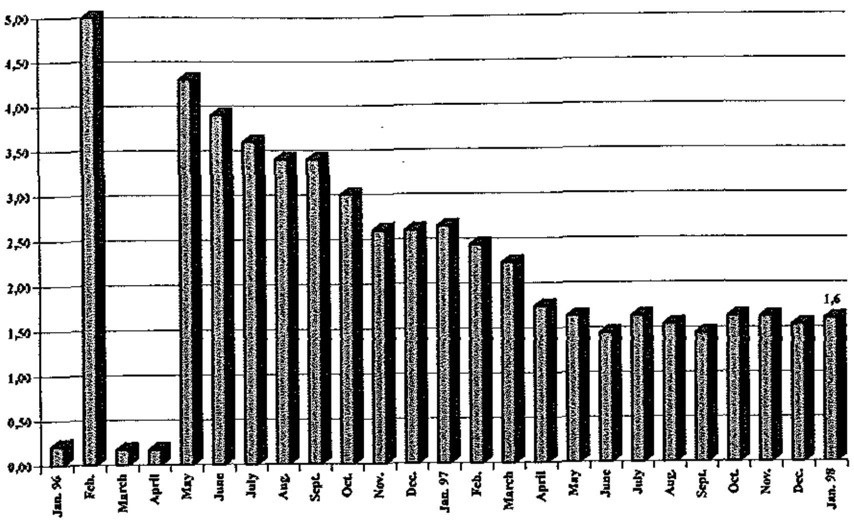
This was no random, one-off result, but the outcome of action taken on several fronts over several years, the effect of a substantial change of mentality and conduct on the part of everyone concerned: households, business, trade unions and government.

The rationale underlying all the economic recovery measures has been the sustainable and lasting reduction of inflation. Italian inflation had its roots above all in bitter social conflict and in tension between supply and demand.

The culture of stability has now become entrenched in our country. The key to this transition was the agreement between both sides of industry and government concluded in July 1993. At that time, the income's policy which had been drawn up one year earlier was clearly and comprehensively spelled out, to become the model henceforth to be followed by all. Since then, that framework agreement has worked and is continuing to work as an anchor ensuring stability.

FIGURE 1

INFLATION RATE IN ITALY



In implementation of that agreement, an "advance" wages policy in both the public and the private sectors has been successfully adopted: wage demands are calibrated in terms of the programmed inflation rate.

The agreement has eased the way to restoring control over public expenditure, which was to a considerable degree influenced by cost inflation. The tight monetary control policy implemented by the Bank of Italy was able to achieve its full effects thanks to this agreement and reduction of the public deficit.

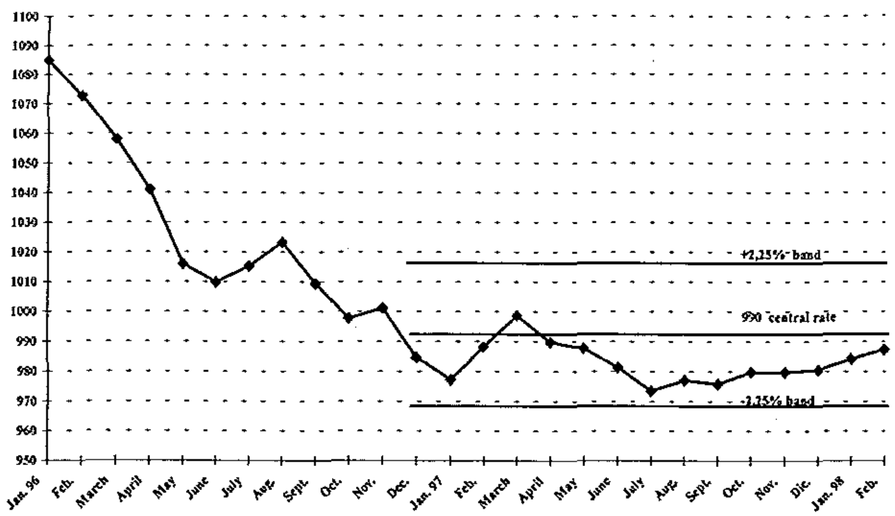
Empirical evidence of the soundness of this approach in terms of stability can be seen in the events that have occurred over the past five years. Even the pressure on prices caused by external shocks has been absorbed.

2. The lira rejoined the EMS exchange rate mechanism in November 1996. And it did so after successfully overcoming the currency turmoil of March 1995 and, since spring 1996, demonstrably proving able to fit within the narrow band.

Since rejoining the exchange rate mechanism, the lira has remained extremely stable: its fluctuations around the parity rate have been slight, never touching the outer limits of the narrow band (Figure 2).

FIGURE 2

LIRA/DM EXCHANGE RATE



Underlying the stability of the lira is primarily the reduction in inflation, as I have already pointed out.

But there is also firm control over the balance of payments on current account, which has recorded increasing and substantial surpluses, rising from 1.1 per cent of GDP in 1993 to over 3 per cent in 1996 and in 1997 (Figure 3).

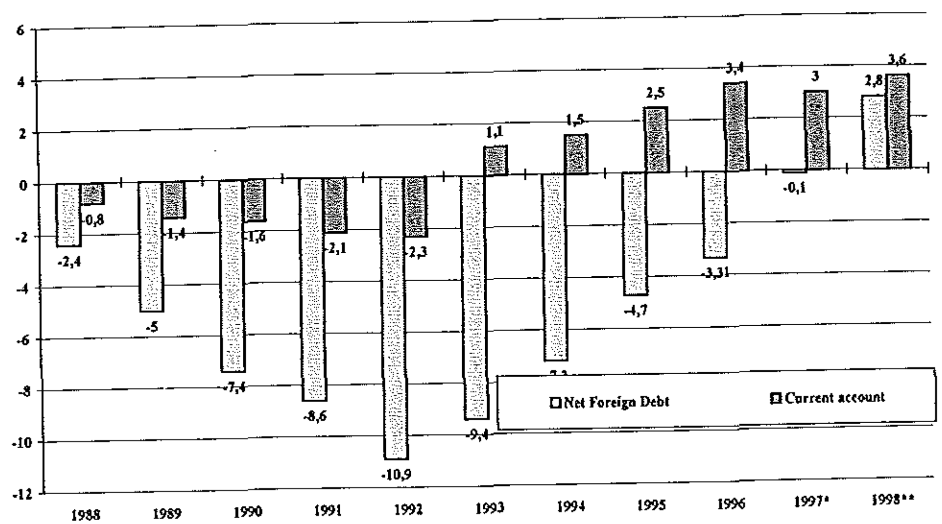
The solidity of Italy's balance of payments on current account is due not only to the competitiveness of the Italian economy, which has created a trade surplus, but also to the fact that Italy's former weaknesses in terms of the services trade has now been overcome, and in particular the yields on Italian financial assets, as compared with performance in other countries.

Much of the current account surplus in the Italian balance of payments refers to relations with countries which do not belong to the European Union. This means that Italy contributes almost one-third of the trade surplus and over 40 per cent on current account of the whole European Union, surpassing every other Community country, in terms of the balance of payments of the European Union according to Eurostat statistics.

In 1992 – the year the Maastricht Treaty was signed – the Italian economy had run up a massive net foreign debt of 11 per cent of GDP (Figure 3). This deficit interacted negatively with the government budget deficit.

FIGURE 3

NET FOREIGN DEBT AND
CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS
(1988-98 in percentage of GDP)



* Preliminary data.
** Estimate from *Relazione Previsionale e Programmatica*.

Since 1993, the accumulation of balance of payments surpluses on current account enabled Italy to gradually reduce its net indebtedness, until it was completely wiped out in 1997. As from 1998, Italy will have a net positive balance of payments position.

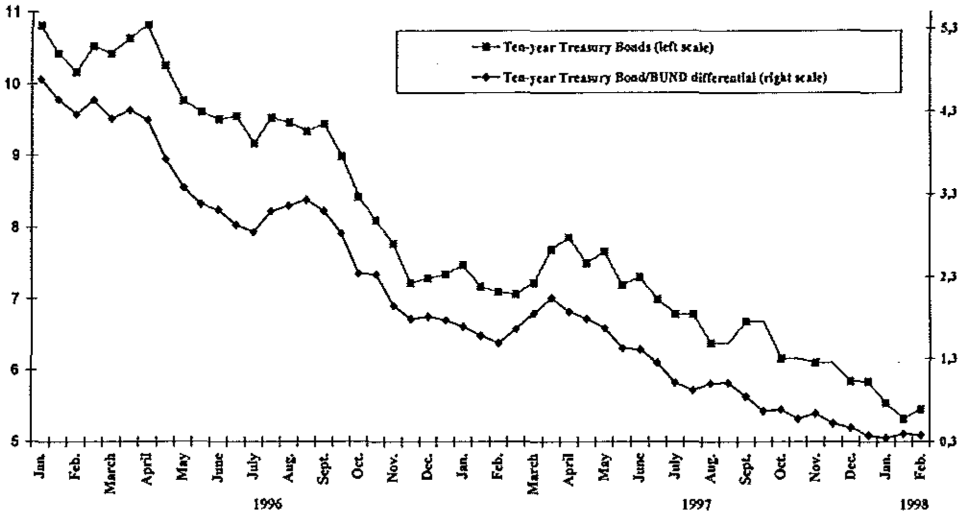
The rebalancing of Italy's balance of payments and the stability of the lira are the results of the overall economic recovery, both public and private.

3. The reduction in inflation and the tough action taken to rebalance the budget have enabled the Italian Republic to recover its creditworthiness step by step on the international markets. Daily quotations of government securities on the markets have mapped out this steady return to health.

Government securities have been auctioned at *decreasing interest rates*. Over the past 24 months interest rates have been halved. At the auction at the beginning of 1996, ten-year Treasury Bonds were issued at 10.82 per cent, before deduction of withholdings, while at the latest auction (beginning of February 1998) they were issued at 5.45 per cent before deduction of withholdings (Figure 4).

FIGURE 4

LONG-TERM RATES DIFFERENTIAL
(10-year bonds vs. German 10-year bonds)
January 1996-January 1998



This reduction in interest rates is peculiar to the Italian economy. Over the same two years, Germany's medium-term rates have remained substantially unchanged.

The differential in Italian long-term securities rates has been reduced almost to zero, reaching 30 base points or, in other words, three-tenths of one percentage point. Two years ago it was abnormally high at over 380 base points, showing the diffidence with which the markets then viewed the Italian economy (Figure 4).

Italy's economic policy measures have generated confidence. And generating confidence means thousands of billions of lire in reduced unproductive public expenditure on public debt service charges, savings of thousands of billions in lower debt interest charges

to business, and thousands of billions of lire in reduced investment income.

Over the past 18 months the desired effect of this policy, namely the elimination of the anomalous financial burden, has been achieved through the market.

At present nominal interest levels, and taking account of current and forecast price trends, Italy's government securities are yielding real interest returns more or less matching the potential growth rate of the Italian economy. They therefore still remain attractive, even though for Italian investors options on other countries' securities are becoming more attractive still.

4. 1997 ended with a huge reduction in the *budget deficit*. No accurate figures are yet available for the purposes of the Maastricht criterion, which refers to the ratio between the overall public deficit and GDP. Both these aggregates will only be known at the end of February.

At the present moment, the only information available is the government's borrowing requirement. In the course of only one year, this has been cut by over a half, from 128,850 billion in 1996 to 52,500 billion in 1997.

This result reflects the recovery of control over the public accounts. It has been facilitated by the virtuous circle created between recovery and lower interest rates. Government interest expenditure was cut from 202,000 billion in 1996 to 186,000 billion in 1997. In the same year, the government's borrowing requirement fell below expenditure on government investments. This means that, for the first time in many years, the current account deficit had been wiped out: the difference between total government revenues and total expenditure on current account became positive. In 1997, government debt was needed only to finance investment, partly covered by budgetary revenues.

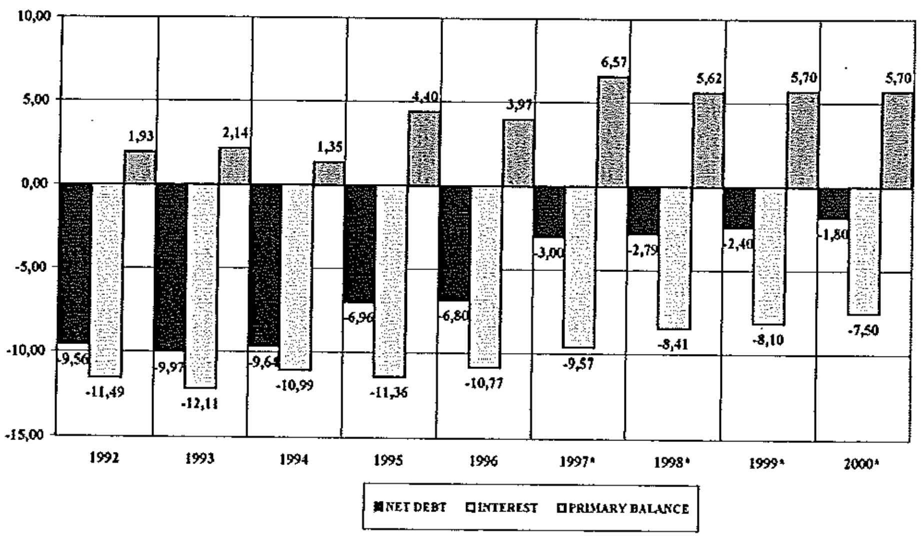
The improvement in Italy's public accounts is undeniable.

Some have cast doubt on the longer-term "sustainability" of this situation. They argue, firstly, that some of the corrective measures adopted in 1997 were achieved by "one-off" measures. This is certainly true: the Additional Notes to the 1997 budget clearly highlighted the temporary nature of the provisions designed to ensure that in 1997 the conditions would be met for joining the euro. Under the 1998 Finance Act measures have been adopted to replace the effects of the "one-off" measures with permanent ones. The European Council of Finance Ministers acknowledged this at their meeting on 19 January, by adopting a Commission Note on the Italian economic situation.

The magnitude of the efforts made to rebalance Italy's public accounts is reflected in the magnitude of the primary surplus, that is to say, the balance between aggregate revenues and expenditure after deduction of interest payments (Figure 5). It is estimated that in 1997 the primary surplus was around 6.5 per cent of GDP. According to this initial evaluation, in 1997 the primary surplus rose by about 2.5 percentage points over 1996. At the same time, the interest charges deficit fell by 1.2-1.5 percentage points. The combination of these two variances, one positive and one negative, shows an overall improvement in the government borrowing requirement of around 4 percentage points.

FIGURE 5

THE ITALIAN DEFICIT AND ITS COMPONENTS
(in percentage of GDP)



* According to the 1997 Programming Document.

Over the coming years, in order to ensure continued compliance with the Maastricht undertakings it will be necessary to continue maintaining a large primary surplus, and the Italian government is committed to this. Given the further benefits that will derive from the gradual filter-down effect of reduced interest rates throughout the whole stock of public debt, the ratio between the aggregate deficit and GDP will fall to below 3 per cent from 1998 onwards.

5. The capacity to sustain substantial primary budgetary surpluses in the longer period will also be underpinned by the implementation of *structural reforms.*

For a long time, it has been repeated over and over again that in order to consolidate the improvement in Italy's economic situation, reforms had to be carried through. And in fact both the government and parliament have recently adopted a series of major reforms.

I am referring to tax reform, reform of the central government budget, reform of the civil service and pensions reform, implemented on various occasions (in 1992, in 1995 and finally readjusted in the 1998 Finance Act). On 16 January this year initial approval of the reform of Italy's commercial system was given by the Cabinet.

The tax reform measures approved by the Italian parliament at the end of 1996, and made effective with a series of implementing orders during 1997, have introduced a radical change in relations between local and central government departments, between the tax authorities and tax-payers, and between government departments and business. Streamlining and simplification measures have led to the replacement of many different taxes with a single tax; the tax burden has been redistributed, removing traditional distortions in the fiscal system; powerful impetus has been given both to strengthening companies by encouraging venture-capital financing rather than debt-financing, and by shoring up the financial markets. Positive effects are expected from this, also in terms of reducing tax evasion.

The open, modernising and liberalising spirit underlying the tax reforms is the same spirit underlying the trade and commerce reforms. These involve deregulating every area of trade, abolishing licenses and commodity-based market segmentation and liberalising opening hours. Beneficial effects are also expected for the consumer thanks to the price stability resulting from enhanced competition.

Trade and commerce reform follows on the heels of a wide-ranging programme of structural deregulation measures and the overhaul of the civil service. The Italian parliament has given the government ample powers to re-structure the civil service in order to heighten its efficiency, both by reviewing the operation of central government and by devolving many functions onto the regional governments and local authorities. This is now being done.

Reform of the central government budget has also given a powerful boost to simplification, transparency, and the principle that direct responsibility over the various components of the "budget" should be given to executive officers of the civil service.

On pensions, the provisions adopted in 1992, 1995, and the corrective measures implemented last December under the 1998 Finance Act have reduced pensions expenditure to bring it into line with potential income trends as illustrated in Figure 6.

The government realises, however, that various problems affecting pensions, and in particular the demographic factors, make it necessary now and in the future to keep this area of expenditure under careful and constant review to ensure that it remains compatible with the fundamental macroeconomic variables of the economy.

6. Government accounts record not only the annual deficit but also the *debt* which the accruing deficits have generated. This is a very heavy burden which weighs down on all of us, and will continue to do so over the coming years.

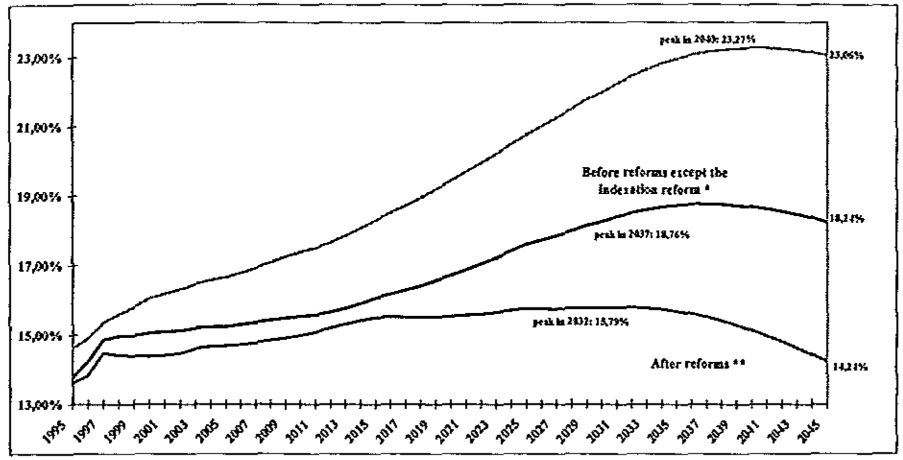
Even though this burden is eased by lower interest rates, it has to be lightened as quickly as possible in comparative terms, namely, as a proportion of the gross domestic product.

Since 1995, the ratio has been falling thanks not only to the reduced deficit but also to privatisation revenues. The sell-off of state-owned corporations is subject to only one restriction, and that is to prevent public monopolies from being replaced by private ones. At the same time, the government intends to sell-off all state assets for which there is no longer any functional requirement.

In 1997 revenues from the privatisation of the state-owned corporations and IRI Group companies totalled some 40,000 billion lire.

FIGURE 6

PENSION EXPENDITURE BEFORE AND AFTER 1992, 1995 AND 1997 REFORMS
(in percentage of GDP)



N.B. Projections made on the basis of the following hypotheses: an increase from 1.18 to 1.45 in the fertility rate in the 1995-2000 period and in life expectancy from 75.3 to 78.3 for males and from 81.7 to 84.7 for females; annual net immigration numbering about 50,000; 2.2% increase in labour productivity (1.5% in the 2001-2006 period, 1.8% in the 2007-2015 period, 2.2% for 2016-2025, 2.6% subsequently); real increase in wages corresponding to productivity increase, annual career increase 0.5%. These demographic and macroeconomic hypotheses imply a mean annual 1.5% GDP growth rate. The average retirement age derived from regulations and conjectured propensity to retire is about 60 years.

* Revision of the indexation system led to suppression of indexation for May and November each year in November 1992, with unification on 1 January 1993, and of real wage indexation. No change is expected in indexation policy for the period in question. Assessment of wage indexation is made taking the wage dynamics of the industrial sector, assumed to account for 60% of mean productivity for the period in question.

** Indexation is taken to refer to prices alone with 10 yearly revision of the transformation coefficients based on life expectancy trends consistent with the mortality tables used in the projections.

The intermediate objective of containing the public debt, which we intend to achieve within six years, is to bring it down to below 100. This target forms part of a microeconomic and financial scenario which is wholly realistic. Once beneath the 100 threshold it will be easier to reduce it still further because of the combined effect of holding back the numerator, the debt, and increasing the denominator, GDP.

It should be remembered, however, that:

- although Italy has a high public debt, it also has a very high level of private savings, indeed the highest in Europe. The borrowing requirement to cover the debt comes entirely from domestic savings. Confirmation of this is the fact that the balance of payments has been constantly in surplus on current account, which means that Italy exports savings rather than importing them;

- the composition of the debt over the five-year period 1993-97 has gradually improved with an increase in the share of medium- and long-term fixed-yield securities. The average life of Italy's public debt is around five years.

7. As the results of 1997 emerge they confirm the positive development of the Italian economy. Production is expanding.

The increase in GDP will almost certainly exceed the 1.2 per cent the government has set as its target when the final figures for 1997 are published.

After an initial six-month period characterised by the persistence of the stagnant situation of 1996, Italy's economy has decidedly resumed the path to growth. For 1998 the 2 per cent forecast GDP increase, on which central government budget forecasts have been based, is now generally considered to have been too conservative.

The exceptional success of Italy's economy in 1997 lies precisely in this combination of a rebalancing of public accounts, price stability, a balance of payments surplus on current account and economic recovery. Fears of recession triggered by the determined reduction in the public deficit, and hence in demand, have been dispelled.

I believe – although the final word must go to the economists – that the primary explanation for this is the fact that Italy has entered what I like to call the second "virtuous circle".

The first virtuous circle was in the public sector, as I have shown: an increased primary surplus and reduced interest charges on government debt. But in addition to this there is a second virtuous circle within the productive economy, also hinging on reduced interest rates. The reduction in the cost of debt has improved corporate balance sheets, at least partly offsetting the braking effects of reduced public demand. More financial resources are now available to the productive economy as a result of diminished take-up of savings by the public sector.

Cheaper money and a greater availability of resources have stimulated and continue to stimulate private enterprise, while strengthening the financial markets and stock exchanges.

On this latter point, corporate management and more generally operation of the whole business and financial system will benefit from the new Act which parliament and the government are about to adopt, governing company law, managed savings and the organisation and control of the financial markets. This is another reform to be added to the list I have already mentioned.

8. The Amsterdam European Council ended in June 1997 with the signing of the Stability and Growth Pact.

The Pact is an addition to the Maastricht Treaty, spelling out the principles and obligations more explicitly and making them more binding.

Italy has signed the conclusions of the Amsterdam Council in full knowledge of the commitments undertaken there, but also realising that these commitments are in line with the present Italian approach to economic policy, adopted by parliament and underlying the work of the government.

Italy knows that she can take part in European Monetary Union contributing monetary stability and enterprise.

The Italian lira, which will merge with all the other currencies to bring the euro into being, is a solid currency. Its solidity is based upon a culture of stability which Italy has taken up, returning to the "virtuous" behaviour which enabled the country to enjoy such a long period of economic and social progress throughout the post-war reconstruction period.

Rooting-out inflation has been the key to this recovery, backstopped by a sound balance of payments. Price stability and a healthy balance of payments have always been the basis for the solidity of any currency. And this is the situation underpinning the lira today.

We know that with the European single currency exchange rate flexibility within the area will no longer exist. The *extrema ratio* of modifying parities, to which Italy had to resort so often during its experience within the EMS, will no longer exist.

This is why we are seeking greater flexibility in the use of the factors of production both by making further changes to the labour market and by implementing the reforms already planned to reduce government intervention in the economy, with deregulation and enhanced efficiency for the government and civil service. We know, in particular, that we must be capable of mobilising that inactive mass of valuable resources, Southern Italy's unemployed, and converting it from a social problem and a burden on the economy into an opportunity for progress in the depressed areas, for the good of the whole country.

The concrete proof that we have given in recent years of a single-minded sense of purpose and determination in pursuing our goals bears witness once again to the vitality of the Italian economy; a vitality fuelled by two well-known features of the Italian character: a capacity for enterprise and entrepreneurship, which has brought into being a myriad of small businesses, and a propensity to save.

Underlying the results we have achieved there is the strength of support from a country which wishes to be fully within Europe, in a continuity of traditions and intentions that have never wavered since the very conception of the European project.