# Mario Draghi: Financial market integration and the intermediation of savings

Address by Mario Draghi, Governor of the Bank of Italy, at the 12th Congress AIAF - ASSIOM - ATIC FOREX, Cagliari, 4 March 2006.

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## 1. The world economy: expansion and imbalances

The world economy is enjoying a period of strong and widespread expansion. Despite sharp increases in the prices of raw materials, inflationary pressures remain moderate. Yet in some respects it remains fragile.

The expansion began in 2002 thanks to the recovery in the United States and the support from China's booming economy. It gained strength from the middle of 2003 onwards, with the average annual rate of growth rising to nearly 5 per cent, and has spread gradually, if unevenly, to every region of the world, although in somewhat weaker form in Europe.

In Italy, after stagnating in 2005, the economy now shows some signs of recovery. There is still uncertainty, however, about the extent and durability of the country's economic growth, which continues to be weighed down by unresolved structural problems.

World economic activity has benefited from the persistence of stable financial conditions that have been exceptionally propitious for investment. Apart from the expansionary stance of monetary and budgetary policies, other contributory factors have been the integration of financial markets, their development in emerging regions, the spread of more efficient instruments for the management of risk and the progress made in the fields of crisis prevention and financial supervision.

The economic upswing has generated strong demand for oil, especially by China and the other emerging Asian economies. Despite increased supply, this demand has been met with difficulty and at rising prices. The price of oil has doubled in real terms since the spring of 2003. So far this pressure has not been passed on to core inflation, which has remained moderate everywhere, testifying to the credibility gained by monetary policy in the leading countries.

This credibility is precious and needs to be preserved. It is the reason, especially in the euro area, why monetary conditions continue to be very relaxed: interest rates remain near the lowest levels ever. The monetary and credit aggregates continue to expand rapidly; the prices of real assets are high; no restrictive impulses are coming from the exchange rate. Keeping inflation expectations firmly anchored at a level consistent with price stability is essential for economic growth and the creation of jobs. The increase in the key rates decided on Thursday by the Governing Council of the ECB serves this purpose.

Although the world economic expansion is widespread, it is accompanied by very large external imbalances. These are caused by the divergences in the growth of domestic demand between the main regions and the massive transfer of resources from oil-consuming to oil-producing countries.

The US external deficit has been increasing since the middle of the 1990s, although the causes have changed over the years. Initially, it reflected the capital formation associated with the spread of new information technology. Boosted by increasingly good prospects of growth, consumption also rose faster than disposable income. The current account deficit was financed thanks to massive inflows of private capital, attracted by the high yields expected on the stock market, especially for high-tech securities, while the appreciation of the dollar further exacerbated the trade deficit.

In 2001 the determinants of the current account deficit began to change. In the face of the risk of recession, monetary and fiscal policies were made expansionary. The saving rate continued to decline. Consumption was sustained by the rising value of property; households' propensity to save turned negative in 2005. The federal budget balance deteriorated by 6 percentage points of GDP between 2000 and 2004 and will show another large deficit in 2006.

The manner of financing the external deficit also changed. The inflow of private capital slowed between 2002 and 2004. The dollar came under downward pressure, despite much larger purchases by the monetary authorities of countries with current account surpluses. Such purchases are liable to undergo rapid change. In 2005 these countries reduced their accumulation of official reserves, only China recording a further massive increase. However, the widening of the short-term interest rate

spread prompted renewed private sector investment in the dollar, which gained strength as a consequence.

The appreciation of the dollar came to a halt last November. However, as things stand, the exchange rates between the major currencies are not conducive to adjustment of the external imbalances. High rates of growth have so far made it possible to postpone the adjustment, but these conditions cannot last indefinitely.

In 2005 various conditions arose that could help initiate a process of adjustment. Domestic demand accelerated in Japan, and to a lesser extent in Europe as well. The reform of China's foreign exchange system, although it has only produced a small appreciation of the renminbi so far, is a step in the right direction; a cooling of the US property market, of which there are signs, might slow the growth of private consumption. An adjustment of the underlying real imbalances is the best guarantee of orderly progress. For this to happen, the current trends need to be supported by a combination of more restrictive fiscal policy in the United States, greater exchange rate flexibility in the Asian economies, and structural reform in Europe.

## 2. International financial conditions

On the international financial markets real interest rates and the volatility of financial assets are low. Relaxed and stable financial conditions foster economic growth, which in turn is conducive to such conditions. At the same time they may reflect a reduced perception of risk by market participants and encourage them to build up illiquid and highly risky positions.

The low level of long-term interest rates is mainly the result of continuing expectations of moderate inflation, even over a very considerable time span. These expectations are based on the credibility of monetary policies. Investors accept modest returns in part because they have a perception of diminished risk, related to the limited volatility of securities prices and to conditions in the real economy. The expansionary cycle and wage moderation have sustained the growth in corporate profits, thereby improving the state of firms' finances. The insolvency rate is well below the long-run average. The spread between corporate and public-sector bonds is now unprecedentedly narrow.

Other contributory factors in keeping interest rates down have been the investment of current account surpluses by the Asian economies and the oilexporting countries and an increase in investments by pension funds. These flows have proved unresponsive to the tightening of monetary policy by the Federal Reserve and the ECB; its effect has been limited to the shorter term maturities. The yield curve has flattened, particularly in the United States. In view of the historically low level of interest rates on risk-free assets, there has been a surge in the demand for riskier securities by investors in search of higher returns.

In this context, the reduction in risk premiums no longer reflects only a diminution of the underlying risks, but also agents' reduced risk aversion. Nor can it be ruled out that the premiums asked to hedge risks underestimate their true magnitude. The favourable conditions on the financial markets delay the correction of real imbalances, masking the symptoms without removing the causes.

The international markets have become more robust, contributing to an orderly reallocation of financial flows. The conditions are right for this to take place gradually, in a context of more balanced but strong global growth. However, geopolitical events, such as sharper internal and international tensions in the oil-producing countries or shocks due to individual corporate events or linked to single sectors of production, could trigger brusque changes in agents' attitudes and a sudden reallocation of savings and investments, leading to wide swings in the prices of real and financial assets and in exchange rates.

This possibility is small today but not entirely absent. The widespread use of derivative instruments may offer a better means of risk management, but it could also accelerate the propagation of extreme events.

## 3. Integrated, efficient and robust markets

Efficient and well-regulated markets, apart from performing their normal function of allocating financial resources in the best way possible, are crucial to ensuring that the system is robust enough to withstand violent shocks, however unlikely.

Policies designed to speed the integration of Europe's financial markets and their infrastructure contribute to orderly and lasting economic growth. Market integration allows firms to exploit economies of scale by reducing the cost of access; it increases the opportunities for diversifying investments; it ensures more efficient allocation of resources; it improves the ability to absorb shocks; it strengthens the stability of the system.

In Europe, market integration has been furthered by the single currency and the stability-oriented monetary policy. It has not gone far enough yet. Additional measures are needed to harmonize laws and regulations and adapt the infrastructure.

The greatest progress has been made in the money market, thanks among other things to the development of the TARGET settlement system. In November 2007 this will be superseded by TARGET 2, which will bring further benefits to firms in terms of liquidity management. As you know, the Bank of Italy has been a key figure in the project, alongside the French and German central banks, and intends to maintain that role.

In the case of government securities, common platforms such as MTS have gradually extended their operations, increasing the liquidity and efficiency of the European market.

The equity market is still fragmented. There are evident advantages, typical of a network economy, in concentrating trades; the attraction of a stock market for issuers and brokers grows with the number of present and prospective participants. On the other hand, for the stock of smaller firms in particular, the information advantages of national markets lead to better liquidity conditions. Forms of horizontal consolidation and federation between national markets would achieve both benefits. Unrestricted and equal access to settlement systems and multiple links between the various markets would foster both competition and efficiency.

Italy's stock exchange faces the challenge of adapting to the new context. Our primary goal should be to ensure ease of access to European markets and infrastructure for our firms and intermediaries. We need to reflect together on the best way to achieve this.

The integration of securities clearing and settlement systems has not yet reached a satisfactory level owing to differences in national infrastructures that predated the launch of the monetary union. The existence of numerous national systems, with their non-standard services, diverse market practices and different laws and tax rules, increases the risks and costs of settling cross-border transactions.

Some specific barriers to integrating post-trading systems have been clearly identified. The removal of those created by differences in laws and regulations will require sometimes complex legislative intervention. The removal of strictly technical barriers and barriers created by market practices can be effected at the initiative of market operators themselves. There is no reason to wait.

A set of European rules is already in place to promote market integration and transparency by regulating such matters as settlement finality, market abuse, collateral, prospectuses and takeover bids. The directive on markets in financial instruments issued in April 2004 will spur competition by abolishing the requirement to conduct all transactions on regulated markets, encourage the provision of crossborder financial services and strengthen investor protection. The complex process of implementing the directive must be speeded up, at both Community and national level.

### 4. The role of intermediaries in asset management

The saving rate of the Italian economy, especially among households, is still high, despite a long-term downward trend. It is associated with a level of household wealth that is also high. Savings continue to be a fundamental resource for economic growth. Efficient management of the country's savings is a competitive challenge and an opportunity for growth, both of the economy as a whole and of the financial industry.

In Italy as elsewhere the composition of households' financial wealth has shifted in the last few years, as a result of more active, diversified and efficient portfolio management. Between 1995 and 2004 the share of bank and postal deposits fell from more than 40 per cent to barely 25 per cent and that of publicsector securities from 23 to 7 per cent, while the incidence of private-sector bonds, equities and investment fund units increased. Fund units are now as important as in the other leading industrial countries. The share of insurance products and private pension funds is much smaller, however, essentially because of the broad coverage provided by the public pension system. The share of private-sector bonds, in particular bank bonds, is high, as they enjoy a more favourable tax regime

than deposits. Full advantage is not being taken of the portfolio diversification that professional managers can provide.

Banks continue to play a crucial role, both because the level of direct intermediation is still high and because the major banking groups include management companies that control almost the entire investment fund market. This market therefore contributes decisively to the size and profitability of banks, which accordingly have a strategic interest in increasing its competitiveness.

Management companies distribute their products almost exclusively through the networks of the group they belong to. This vertically integrated model enabled the Italian investment fund industry to grow rapidly, households to rely on relationships of trust with their banks when turning to asset management services, and banks to diversify their sources of income.

Asset management offers Italian banks considerable scope for expanding their business, increasing their profits and improving their stock market ratios. However, in a fast-changing competitive environment, this will require appropriate strategies for both products and customer relations. The reliance on a captive market and the small size of most asset managers are not conducive to innovation or economies of scale, which are crucial to competitiveness and profitability in this sector. Foreign competitors are gaining ground in the Italian market, especially as regards innovative products; more than 85 per cent of the exchange traded funds listed by Borsa Italiana are managed by foreign groups. The independence of asset managers whether it is the result of decisions regarding their ownership or of strict corporate governance rules is essential not only for their growth but also to resolve the conflicts of interest inherent in their relationships with their parent banks.

## 5. Financial regulation

The large proportion of savings not entrusted to professional investors, the scale of households' investment in financial products and the growing complexity of the financial instruments available require the authorities to refine supervisory regulations and practices constantly.

The law on the protection of savings recently approved by Parliament strengthens some of the safeguards for investors. The division of responsibilities between the Bank of Italy and Consob has always been based on the distinction between safeguarding the stability of intermediaries on the one hand and protecting investors and supervising markets on the other. This distinction, essential for effective action and the clear attribution of responsibilities, requires cooperation among the authorities in drawing up rules, in verifying intermediaries' compliance and in promoting investors' financial education. The Bank of Italy stands ready to continue this cooperation.

Regulation of the markets cannot eliminate risks for investors, nor should it; what it should do is facilitate their allocation by enhancing transparency and limiting and managing conflicts of interest, with a view to protecting the weakest investors. This is necessary on grounds of both efficiency and fairness. In preparing laws and regulations, every effort must be made, with the assistance of the operators involved, to strike a better balance between pursuing objectives and containing the costs borne by issuers, intermediaries and investors. Without breaching the key principle of the distinction between functions, the Bank of Italy verifies intermediaries' compliance with the rules for the protection of savings. Irregular or over-aggressive conduct exposes intermediaries to legal and reputational risks, which need to be addressed by prudential supervision.

The management of both old and new banking risks is now set to reap the benefits of the substantial investments that have been made by banks and regulatory authorities to bring the Basel Accord into operation. The new regime creates incentives for banks to direct their choices towards the objectives of prudential supervision, enhances the effectiveness of the rules and reduces their distortionary effects under a highly innovative approach. Based on the risk management techniques of the most sophisticated banks, it will promote competition and significantly improve the quality of most banks' operations.

The Accord could become the model for the regulation of investment firms and insurance companies as well. The convergence of the three sectors of financial intermediation should reduce the risk of regulatory arbitrage and rationalize the management of financial conglomerates.

The supervisory review process, the second pillar of the Basel Accord, requires each bank to make its own assessment, which should also be forwardlooking, of the capital considered adequate in relation to its specific features, its risk exposures not considered for the minimum capital requirements and the

quality of its organization. It is up to the supervisory authorities to examine, discuss and approve the systems adopted.

Using the analysis of different scenarios and stress tests, this instrument can also serve to link supervisory authorities' micro- and macro-prudential assessments, by exploiting the wealth of theoretical and empirical models available. But we must aim higher, taking the opportunity offered by the Basel 2 system to arrive at a significant simplification of today's supervisory rules and practices.

The law on the protection of savings expressly provides for the periodic review of legislation, to check its compliance with the principle of proportionality between the objectives and the costs borne by supervised entities, and for the assessment of the impact of each new provision. These are reasonable and useful criteria, to which we must add that of achieving a high degree of convergence among European countries on supervisory rules and practices, a goal whose importance increases with the number of banking groups operating in more than one national market.

## 6. The Italian banking system

Good laws and efficient supervision are what public institutions can and must contribute to the strengthening of the Italian banking industry, to the benefit of the country's economic growth.

The Italian banking system has made significant progress in recent years. There has been a general increase in productivity. The quality of banks' assets has improved considerably despite the weakness of the economy. The majority of banks have capital in excess of the minimum requirement. The leading groups have completed complex organizational integration and rationalization plans in the wake of mergers, with substantial cost reductions. The positive outlook depends on an improvement in net interest income, which is likely to follow as the European economy picks up, on continued growth in lending, especially corporate loans and consumer credit, and on realization of the major opportunities for synergy afforded by consolidation at the national level. The efficiency gains have been reflected in profitability and market sentiment, which has responded favourably to dividend policies.

The smaller banks have consolidated their positions in local markets, exploiting their comparative advantage in lending to small and medium-sized enterprises.

The European takeover-bid directive, which provides for minimum harmonization, leaves it up to national governments to decide on any further convergence of their laws and regulations and to set the course towards greater or lesser contestability of ownership. The present situation is unsatisfactory because it leaves open the possibility that cross-border consolidation will be undertaken not only on the basis of criteria of industrial and financial advantage but also for reasons of regulatory arbitrage.

Opening the markets for credit and banking services to domestic and foreign competition in conditions of regulatory equality reconciles the private interests of shareholders with the general interest in an efficient allocation of resources. It is the most effective way to stimulate further gains in operational and allocative efficiency, innovation, cost reductions and improvements in the quality of the services supplied to firms and households.

To exploit these opportunities, including by means of mergers and acquisitions, capital is available on a scale that was unthinkable until recently. Protectionism leading to worse regulatory arrangements than today's would entail costs on a comparable scale. We must avoid such an outcome. Hopefully, a rational and constructive spirit will prevail and interest in a level playing field for financial markets quickly re-emerge in the deliberations of the Heads of State and Government and Finance Ministers of the European Union.

## 7. Closing remarks

Italy continues to benefit little from the favourable developments in world trade and international finance. In 2005 GDP stagnated, exports continued to lose market share, the budget deficit widened. Since the 1990s the economy has been as if bogged down. Cyclical indicators and the short- and medium-term predictions of the main forecasting institutions now point to a pick-up in Italian GDP, but with growth still less than the potential, which is already lower than in the other major countries.

The growth gap reflects Italian industry's difficulty in competing. This is rooted in the lack of improvement in productivity. In other countries the revolution in production sparked by information and

communications technology has produced its full effects: firms have adapted their human and organizational capital to the new technologies. Italy has been slow to seize the opportunities of this revolution. The gap is widest in total factor productivity.

New players are coming onto the stage, formidable in Asia but also present in Latin America and Central and Eastern Europe. This has imparted an extraordinary impulse to world trade. It is a great opportunity for growth but also a major challenge, in the face of which Italy has stumbled.

With the end of the illusory remedy of competitive devaluations, productivity growth is the only possible way to achieve prosperity, to create a solid, sustainable foundation for wage increases, and to ensure the development of the country, for ourselves and for future generations.

The structural lags of the Italian economy are not the signs of inevitable decline. They are manifestations of problems that are profound and serious but that can be overcome. We need to devise lasting solutions and explain them clearly to the public.

This week the European Central Bank raised its key rates by a quarter of a point. The time available for the adjustment of the public finances and a return to growth is running out.

Savings, one of the strengths of our economy and our society, are an essential ingredient for growth. It is up to the financial system, markets and intermediaries, to channel them towards the most productive uses, acting in a fully competitive environment and in compliance with the rules. This is your – and our – responsibility.