Mario Draghi: Overview of economic and financial developments in Italy

Concluding remarks by Mr Mario Draghi, Governor of the Bank of Italy, at the ordinary general meeting of shareholders, Rome, 31 May 2006.

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Ladies and Gentlemen,

As I take the floor for the first time before this annual meeting, allow me to begin by conveying my best wishes to the President of the Republic, Giorgio Napolitano, to whom I confirm the continuing institutional commitment of the Bank of Italy to serving the nation. In the same spirit of invaluable institutional continuity, I pay my respects to the Government that led Italy for the duration of a legislature and wish the Government that has just taken its place success in its endeavours.

In December of last year Antonio Fazio resigned as Governor of the Bank of Italy. He had joined the Bank in 1965, become Head of the Research Department and then Central Manager for Economic Research. As Governor since May 1993, he directed the monetary policy that accompanied Italy's entry to Economic and Monetary Union.

His actions towards the end of his tenure are still open to judgement. To him I wish to express recognition that is not merely formal for having dedicated his entire professional life to the service of this institution.

The end of last year brought with it the conclusion of a convulsive period of scandal and speculation, during which it had seemed that the market, the savings of Italians, and the destiny of companies in key sectors of the national economy were prey to the caprice, self-interest and schemes of a few individuals.

The action of the judiciary prevented these schemes from succeeding. The outcome of the judicial proceedings now under way is awaited. Although the institutional integrity of its supervisory structure was unscathed, the Bank of Italy has been wounded. As President Carlo Azeglio Ciampi did me the honour of appointing me Governor, on the proposal of Prime Minister Silvio Berlusconi, it was and it is my responsibility to lead the Bank in the restoration of the prestige it has always enjoyed, and to guide its evolution in a national and international environment radically different from the one that has shaped its history.

The field of action is vast: contributing substantively to the formulation and implementation of monetary policy in the euro area; expanding and strengthening banking supervision while adapting it to the new international rules; making the Bank once again the trusted, independent advisor to Parliament, the Government and the general public; and, internally, reconfiguring the central administration and branches, with a rethinking of their tasks and structure, and reconsidering the role of the Italian Foreign Exchange Office. These are the lines of action to be undertaken. In tackling the evolution of the Bank in these new circumstances, the contribution of the staff and of the trade union representatives is essential. In a few days' time I shall set out these strategy guidelines to them in practical terms, confident that they will share my belief in their necessity.

At its next meeting the Board of Directors will discuss the proposed amendments to the Statute of the Bank, in compliance with the new legislation. This begins the mandated procedure, which will culminate in examination by the Government and the issue of a decree by the President of the Republic.

I know, to borrow an expression from Guido Carli, that my strength is not equal to the objectives. I would doubt ever being able to attain them if I could not count on the integrity, professional competence and sense of institutional responsibility of the entire staff of the Bank. But there is also something else on which I am certain I can rely: the rightful pride of this institution, which has always transformed difficulties into a spur to growth. In the Bank of Italy, which from Einaudi to Ciampi has provided the nation with Presidents of the Republic, Prime Ministers and cabinet Ministers, I have found an institution of excellence, where the nobility of public service is deeply felt.

It is to that service that I, like other Governors before me, intend to dedicate my efforts. It is from this collective sentiment that I shall draw my strength.

Returning to growth

The cyclical recovery that is now beginning in Italy cannot by itself solve the growth problem that has afflicted the country for more than a decade, but it will facilitate the necessary structural changes.

If slow growth persists for long, it stifles an economy's ability to innovate, saps the aspirations of the young and portends regression. It is especially worrying in a country such as ours, with its adverse demographic trend and high public debt.

Financial stability is a necessary condition for economic growth, but in Italy growth is in turn a prerequisite for financial stability. It is essential, while preserving the one, to rekindle the other.

The international context

In the last two years the world economy has grown at an average rate of 5 per cent, the euro-area economy at an average of 1.7 per cent. World trade has increased by just under 9 per cent.

Increasing demand, supply bottlenecks and geopolitical tensions have driven up the prices of raw materials and energy. The latter have more than doubled in real terms in the last three years.

Monetary policies are becoming less accommodating everywhere, though differences in the timing and intensity of the change reflect different cyclical conditions and inflationary risks. Fiscal policies have not yet taken advantage of global growth to make the adjustments to the public finances that are necessary to reduce imbalances and cope with the ageing of the population. A rise in interest rates tends to increase the cost of servicing the public debt. The higher the debt, the greater the effect; Italy is particularly exposed.

Balance-of-payments disequilibria have become more pronounced. While current account surpluses are widely distributed, the deficit is concentrated in the United States, where it has reached nearly 2 per cent of world GDP, a record high. A rise in the US domestic saving rate, a recovery in growth in Europe and Japan and an acceleration in domestic demand in China and the oil-producing countries may lessen the danger that the inevitable correction of the disequilibria will come about by means of disorderly changes in exchange rates.

The expansion in world liquidity and low interest rates contributed to the rise in the prices of financial assets and housing. Interest rate differentials and the volatility of the financial variables fell to historically low levels. The possibility that investors will underestimate risk is a potential source of instability. The volatility of exchange rates and securities prices has increased in recent weeks, triggering a rapid unwinding of carry trade positions that in its turn has affected exchange rates.

These factors of fragility are counterbalanced by the credibility of monetary policies, which has subdued inflation expectations. The recent rise in energy prices has not affected core inflation, which has been contained partly by international competition. The talent, capital and technology now available in the financial markets have increased their ability to reallocate risk and strengthened their resilience to shocks. However, the rapid spread of derivatives may amplify the transmission of shocks, with systemic implications that have still not been fully quantified.

Persistent disequilibria, high oil prices and the protracted, rapid growth in liquidity are a cause of concern to monetary authorities in view of their potential repercussions on inflation, the prices of financial assets and exchange rates.

The distinctive features of the international scene today are the development and spread of new information technology and the rapid growth of the large emerging economies.

The digital revolution that took place at the end of the last century has triggered an efficiency competition between national economies. It is essential to rise to the challenge.

The emerging economies' share of world exports of manufactures has risen to 30 per cent, and the proportion of their products with a medium or high intensity of capital and technology is increasing. Consumers in the advanced countries have derived large and immediate benefits. Producers can meet the fierce challenge from competitors with low labour costs if they seize the opportunities offered by the internationalization of production and the emergence of new markets.

In a situation of continuing rapid growth in the world economy and world trade, we must be guided by the optimism of initiative, not by melancholy regret for a protectionism that has had its day.

Italy's productivity crisis

Since the middle of the nineties output per hour worked has risen much less in Italy than elsewhere: on average, by over one percentage point less each year than in the OECD countries. The delay in adapting the technological and organizational capacities of firms and the economy in general has caused total factor productivity to decline, making Italy unique among industrialized countries.

Improvements in efficiency are being impeded by the skewed size distribution of firms, which is scarcely compatible with the new paradigms of technology and competition. This is accompanied by sectoral specialization that is still excessively geared towards traditional products. Removing the obstacles to the expansion of firms is a prerequisite for seizing the opportunities offered by market globalization and for stimulating the widespread and systematic application of innovations in corporate organization, production processes and product ranges. This is the way to regain international competitiveness and to stimulate renewed growth.

Defending competitiveness by devaluing the currency, which in any case gave only temporary relief from the effects of a productivity gap, is now impossible. The only options are increasing output per man-hour and containing nominal incomes. In the long run, only rising productivity generates economic well-being.

This year the growth in gross domestic product could be close to 1.5 per cent, thanks to a recovery in exports and investment. The cyclical upturn may facilitate measures to encourage adjustment in the economy.

Stability: a necessary condition for growth

Macroeconomic policies contribute to stimulating renewed growth by ensuring a framework of stability.

The common monetary policy has given the euro area price stability and protection from the volatility of the financial markets. Between 1999 and today, actual and expected consumer price inflation in the area has been barely above 2 per cent, albeit with significant rises in the prices of some items, in particular in sectors less exposed to competition. The price stability objective established by the Eurosystem anchors the expectations of producers, consumers and the social partners. Testifying to the credibility that the European Central Bank has acquired, short-term interest rates in the euro area reached their lowest level in fifty years.

The convergence towards price stability has served the interests of all the participants in the monetary union, and continues to do so. The benefits of the euro are especially valuable in Italy. The decline in interest rates enabled firms to keep their financial costs low in relation to value added, even during a downturn in which corporate debt increased. The interest rate differential between Italian and German long-term government bonds had averaged 340 basis points between 1992 and 1998; between 1999 and 2005 it fell to just 25 basis points. Interest expenditure on new issues of public debt was drastically reduced.

The benefits of the single currency for the public finances have been largely dissipated, however. The upward trend in rates now calls for urgent action on the structural determinants of public spending. The burden of the public debt must begin to diminish again. Its ratio to GDP increased by 2.5 percentage points last year to 106.4 per cent, despite asset disposals worth about one point. General government net borrowing rose to 4.1 per cent of GDP; it exceeded the limit set by the Treaty of Maastricht for the third consecutive year. The primary surplus has steadily declined, from 6.6 per cent of GDP in 1997 to 0.4 per cent last year. Net of privatization receipts and excluding the effect of one-off measures, the borrowing requirement – on which the trend in the public debt depends – came close to 6 per cent of GDP.

Net borrowing may again exceed 4 per cent of GDP in 2006; the debt ratio would rise further.

To bring the public finance balances back to levels that permit a predictable, continuous and permanent reduction in the debt ratio, structural adjustments affecting the main expenditure items and all levels of government are necessary. In the light of current trends, a correction of around two percentage points of GDP is needed to achieve the net borrowing objective of 2.8 per cent of GDP set out in government programmes for 2007 and to begin to reduce the ratio of debt to GDP again. Additional resources would have to be found to fund any measures to ease the burden of taxation or boost public investment.

Primary current expenditure, which has risen in real terms by 2.5 per cent per year over the past decade, has to be curbed. In addition to containment of the operating cost of government, there are two unavoidable priorities: tackling the problem of the average age at which people retire and making regional and local governments fully responsible for controlling their expenditure.

Pension outlays amount to 15.4 per cent of gross domestic product. Almost one quarter of this consists of old-age and seniority pensions paid to persons under 65 years of age. The greatest number of workers retire when they meet the minimum pension requirements. In recent years, as a result of the reforms that tightened the eligibility requirements, the average age at retirement has been about 60 in Italy; it is 61 in Germany, 62 in the United Kingdom and over 65 in the United States. At age 60, women can expect to live another 25 years and men another 21. In the future, together with the development of supplementary pension schemes, only a significant rise in the average age at retirement can square the payment of adequate pensions with the financial sustainability of the contributions-based pension system. A lengthening of the working life will also help raise the labour force participation rate.

Regional and local governments account for more than 40 per cent of total general government expenditure on labour costs; they make nearly 80 per cent of total public investment. Health care, which is a regional responsibility, constitutes more than 13 per cent of general government spending. The decentralization of government functions can improve the overall efficiency of the system only if a close link is created between spending and responsibility for its financing. The decentralization of spending has not yet been accompanied by sufficiently broad powers of taxation, transparent and systematic criteria for revenue equalization and effective constraints on borrowing.

In order to contribute to stimulating renewed economic growth, not only must budget balance be restored but the composition of expenditure must also be modified. Savings on other items would release resources with which to improve infrastructure, strengthen social security, thus facilitating the operation of the labour market, and reduce the tax burden to enhance competitiveness. A lasting impact on the budget requires a decisive change in the laws and rules on expenditure. Otherwise, as experience has shown, even dramatic budget adjustments produce only short-lived results.

Measures to stimulate renewed growth

Heightened competition and a broadening of the scope for market mechanisms to operate are necessary for a revival in production and complementary to decisions regarding equity. Competition is the best agent of social justice in an economy, and in a society such as Italy's in whose history the privileges of the few have commonly been rooted in the protection of the State.

In recent years numerous areas of action have come to the attention of observers and economic policy-makers as crucial for restoring the growth of the economy: employment, education, services and the legal and administrative environment are issues of particular importance.

Labour costs are affected directly or indirectly by the level of wages, by taxation and social security charges and by the rigidity of regulations.

The coordination of wage bargaining at national level not only safeguards equity but also helps to ensure that wage trends in sectors where there is little competition and areas of the country with low unemployment do not become incompatible with price stability. The 1993 agreements between employers and trade unions assigned the distribution of productivity gains to decentralized bargaining. The adoption of employee-compensation schemes explicitly linked to the firm's productivity is still very limited, however, and remains concentrated among large industrial enterprises.

In 2005 State levies, in the form of taxes and social security contributions but not counting the regional tax on productive activities, amounted to 45.4 per cent of the cost of employing a typical worker in industry. The average in the OECD countries is 37.3 per cent. Too large a tax and contribution wedge distorts resource allocation and hampers growth.

The budget constraints leave little room for financing a reduction. Shifting taxation from labour to consumption offers benefits in terms of resource allocation and certainty of coverage, but it has macroeconomic and distributive effects that need careful assessment, in conjunction with the social partners.

Rigidity in the utilization of labour has implicit costs for business. It may be rooted in hiring procedures, in the deployment of human resources within the firm, or in termination procedures; the latter are made onerous, above all, by the length and cost of possible legal proceedings, which are uncertain and frequently very high. Some flexibility has been recovered during recent years with the spread of atypical employment contracts. If the labour market is well-regulated and typical contracts not overly rigid, atypical contracts will offer a useful range of options to firms and workers. However, if they become a surrogate for ordinarily flexible employment, they prevent many young people from planning for the future, reduce the incentives for firms to invest in training and curb macroeconomic productivity.

Efficiency and equity require that market segmentation be lessened by establishing more uniform rules under which employment becomes more stable with the passage of time. In an age in which the economy must rapidly reallocate resources in the changed competitive environment, it is the worker rather than the job that must be protected by ensuring – subject to budget constraints – a decent and non-distorting level of unemployment benefits and real opportunities for training and career change.

This is not enough, however. A return to productivity growth calls for innovation and investment in research and technology, and entrepreneurs with the courage and far-sightedness not to remain passive in the face of difficulties but to seize the opportunity to change the way their businesses operate.

The stagnation in productivity is partly due to the shortage of human capital. The low level of employment among members of the most vital and promising segment of the working population is a serious waste: in Italy the employment rate for people in their twenties is 10 points lower than the average for the European Union.

In the past ten years Italy has narrowed the gap with the other advanced countries as regards young people's educational attainment, but the cumulative deficiencies will be reflected in the average educational level of Italians for a long time to come. In 2003 secondary-school and university graduates made up 34 and 10 per cent respectively of the age group from 25 to 64, compared with averages of 41 and 24 per cent in the OECD countries.

The quality of academic results is also unsatisfactory in several respects. By the age of 15 Italian students are the equivalent of one school year behind in mathematics: according to an OECD survey, Italy ranks 26th out of 29 countries. This lack of educational effectiveness is compounded by a lack of equity: in terms of the variability of achievement levels among 15-year-olds, Italy is in 23rd position among the OECD countries; success in secondary school and at university is closely correlated with the socio-economic status of the student's family.

The seriousness of the problem is a compelling reason to examine the experience of other European countries, such as Sweden, Finland and the United Kingdom, which have experimented with ways of improving the performance of the education and research system by increasing competition among schools and universities; even more than additional expenditure, what is needed are new rules to reward teachers and researchers on merit.

The productivity of the service sector is essential for economic growth. Services account for over 70 per cent of value added in the OECD countries; they are used in production by all the other branches of activity. Monopoly rents that keep prices high, impede innovation and productivity, and depress the economy's competitiveness are more prevalent in the service sector.

Utility companies in Italy were still entirely publicly owned until the middle of the nineties. The large-scale privatization programme involving them helped to reduce the public debt in relation to GDP. The liberalization of these markets has not progressed to the same extent. The problems of network operation and expansion of the number of suppliers remain largely unresolved. Where local public services are concerned, even privatization has made little progress, and liberalization is practically non-existent; contracts can be let to public or mixed companies without a call for tenders. Local authorities still control many enterprises supplying public services. Sometimes they attempt to increase the range of services offered, triggering a return to public control.

Obstacles to competition also stem from restrictive regulations, which in several branches of activity harm the majority of consumers and workers.

In the retail sector the average number of employees is about half the euro-area average. The degree of fragmentation impinges on efficiency; it slows the adoption of new technologies, which are an important source of productivity growth in the sector in other countries. The reform law of 1998 liberalizing the establishment of small shops empowered the regional authorities to regulate the opening of larger outlets. Not all of the regions took this opportunity to liberalize. In the regions that applied the most restrictive standards this hindered productive efficiency and the spread of new technologies, to the detriment of consumers and even of employment growth in the sector.

The European services directive currently in the process of being adopted can offer only modest stimulus to competition. The undertaking of more resolute liberalization policies is still left mainly to the discretion of national governments. Italy has everything to gain by moving resolutely in this direction.

The legal and administrative system significantly affects the costs and competitiveness of businesses. In Italy it has long been indifferent to market considerations. In a World Bank classification of the bureaucratic and administrative formalities affecting businesses, Italy comes 70th, last but one among the OECD countries.

From the middle of the nineties onwards, steps were taken to simplify administrative procedures and improve the system of regulation. They have been only partially successful. The discrepancy between measures as formally drafted and their practical application continues to be a general problem of the Italian system.

The recent reform of bankruptcy law has introduced instruments to promote earlier detection of critical situations and the rapid reorganization of firms in temporary difficulty; it has streamlined and modernized liquidation procedures. However, the new legislation only applies to about half of all businesses; in particular, a large set of firms are not eligible for the cancellation of residual debts at the end of the procedure. The penal provisions, based on a punitive view of bankruptcy, remain unchanged.

Much remains to be done in the general area of the application of the law, although this is not the place to suggest remedies, which can be sought in the experience of other countries. The reforms passed in the last fifteen years to speed up civil proceedings have not yielded the desired results. Civil actions still last far longer than in other European countries; debt recovery proceedings in Italy take five times the OECD average. International studies show that, in relation to the size of the population, the number of judges and officials in Italy and the amount of public spending on the justice system are comparable to the figures for other countries of similar size and legal tradition.

In the tax field, action to improve the clarity of the rules and regulations and the way they are applied reduces litigation and guarantees firms a more certain framework in which to operate. Compliance with tax and social security obligations is discouraged by frequent recourse to amnesties and immunity from prosecution; between 1970 and 2004 only two fiscal years were not covered by provisions of this kind.

The revival of domestic economic growth and the reduction of geographical disparities are complementary objectives. Measures that will have an impact on the structure of the economy, particularly on the growth in the size of firms and changes in their product specialization, serve both purposes. In fact, they bring greater benefits to the economy of the South, which suffers more acutely from the national ills, notably in public services and infrastructure but also in the enforcement of law and order.

Specific policies offering incentives to firms may be helpful, but their usefulness must not be overrated. They involve administrative costs, possible distortions in the allocation of resources, and the risk that they will be abused, especially if they rely on discretionary mechanisms. Even the benefit of stimulating investment, despite being greater for firms in the South, is modest in relation to the resources employed. According to Bank of Italy surveys, one fifth of industrial firms in the South received public incentives in 2005, compared with nearly one quarter of those in the rest of Italy. In the case of firms in the South, the additional investment generated is less than 30 per cent of the funds distributed; in the Centre and North the corresponding figure is about 10 per cent.

A scaling-down of the system of transfers to firms would release resources for other spending priorities and for reducing the tax burden and social security contributions. By contrast, an attempt to force the growth of the South financially by assigning inappropriate tasks to banks could once again lead to situations that have already proved harmful in the past both for the economy of the South and for the stability and efficiency of the banking system.

The financial system in the South has made important strides in the last ten years, especially in the quality and efficiency of banking, thanks in part to the involvement of banks based in the Centre and North. On a risk-adjusted basis, the difference between the cost of credit in the South compared with that in the Centre and North has almost vanished. However, there is still a lag in the spread of more advanced financial instruments among households in the South, and even in the use of banking services. Banks and financial institutions have considerable growth potential in the South.

A financial system serving development

The capital markets

Funds raised directly in the market by firms in the form of listed shares and bonds represent only 17 per cent of their financing in Italy, about a quarter less than in France and Germany; the figure is higher than 40 per cent in the United States and close to 50 per cent in the United Kingdom. In relation to the size of the economy, Italy's stock exchange is much smaller than the average for the advanced countries.

Development of the capital markets is necessary for the growth of firms, and vice versa. The markets play a crucial role in mobilizing financial resources. The total financial wealth of Italian households is large in relation to GDP and also by comparison with the other major European countries. Although the behaviour of savers has changed in the last few years, the diversification of households' portfolios is still limited, to the detriment of the balance between returns on savings and protection from risk. Broader, efficient and well-regulated financial markets will make it possible to encourage current trends, benefiting households, firms and intermediaries themselves.

In the life of a firm, admission to stock exchange listing is the first step towards a more solid financial structure, possibly paving the way for a leap in size, with a higher proportion of bond debt and often with a lower cost of bank credit. But fear of losing control of the firm and the costs connected with the transparency requirements for listed companies, including their tax implications, deter many entrepreneurs from seeking a listing. Regulation must seek to strike a balance between safeguarding investors and minimizing the costs for firms. It is up to the entrepreneur to assess the opportunities offered by stock exchange listing, which detracts nothing from his passion or creativity; on the contrary, in difficult moments of transition, it can represent a compromise between keeping all the capital in his own hands, thereby sacrificing the opportunities for growth, and relinquishing control entirely.

Development of the markets requires rapid and effective protection of minority shareholders from opportunistic or non-transparent behaviour. Prevention must be able to rely not only on primary and secondary legislation and its application by the supervisory authorities, but also on the autonomous initiative of operators in the market: banks, rating agencies, investors. There is ample scope for self-regulation and shareholder activism.

If this is not fully exploited in Italy, it is partly because institutional investors carry little weight. Their voice, which is strong and insistent elsewhere, is faint in Italy. Their presence contributes to the assessment of the quality of corporate management, the protection of minority shareholders and the correct handling of conflicts of interest; it deepens the market and increases its allocative efficiency; it facilitates the placement of equity capital and the spread of long-term financial liabilities. Where institutional investors play a more prominent role, the average size of the companies that seek a listing is smaller.

Pension funds in particular have great potential for growth in Italy. In the most advanced financial systems they are among the main investors in listed shares. In the United States they hold about one fifth of the market capitalization, corresponding to roughly one third of GDP; in Italy the proportion is close to zero. The financial assets managed by Italian pension funds amount to 2.1 per cent of GDP, those of funds created after 1993 to 0.8 per cent.

More rapid expansion is necessary. The income replacement delivered by the public pension system will decline in the decades ahead as a consequence of the reforms introduced in recent years. The rapid growth of supplementary pension schemes is essential to provide adequate incomes for future generations of retirees.

In addition to workers' contributions, it will be necessary to use the flow of resources now set aside for severance pay, which for the private sector amounts to approximately 1.5 per cent of GDP per year. The advantages for workers are likely to be considerable. Greater investment in equities would increase the return on retirement savings. Over the long run the rate of return on equities has been substantially higher than that on bonds and well above the nominal rate of growth in GDP; it has been far higher on average than that on accumulated severance pay.

Hitherto, the accumulation of severance pay has represented a form of precautionary saving for workers, offering a modest but certain return, which in the event of loss of employment supplemented the often scant protection provided by the welfare system. Ways must be found to guarantee workers adequate flexibility in the use of the accumulated resources and an appropriate limitation of risk.

As for firms, contributions relief such as that which has been announced would amply compensate for the loss of a source of finance at less than market rates.

The development of supplementary pension schemes requires that full competition be promoted between all financial institutions and that workers be guaranteed full freedom of choice. Suitable fund size and greater transparency of terms and conditions must contribute to containing costs.

At the same time, it is necessary to give workers clear information about the public pension that they will receive in the future. According to the Bank of Italy's Survey of Household Income and Wealth, one third of the persons in employment are unable to judge whether their pension will be adequate.

The experience of other countries suggests that the expansion of pension funds is also crucial for the development of intermediaries specialized in fostering the growth of small, innovative firms. Between 2000 and 2003 pension funds in the United States accounted for 42 per cent of the financial flows of venture capital firms, compared with 20 per cent in the euro area and 3 per cent in Italy.

A deep and efficient stock market enables private-equity investors to dispose of their shareholdings by means of stock exchange listings, a method of disinvestment that makes the valuation process transparent while also offering entrepreneurs greater protection against the risk of losing control. The growth of specialized intermediaries, the greater involvement of institutional investors and the strengthening of the stock market are mutually reinforcing.

More widespread use of investment funds would permit greater diversification of the risks in households' portfolios and improve the functioning of the financial markets. The competitiveness of Italian funds is affected by tax disadvantages by comparison with foreign operators; it is in the interest of the development of the Italian financial industry that they be eliminated.

The Bank of Italy will simplify the supervisory rules. The timetable for the launch of funds will be shortened by broadening the range of cases in which the approval of fund rules is rapid or automatic. Hedge funds and funds reserved to qualified investors, which have high minimum investment requirements, will be allowed the greatest possible operational autonomy.

The growth of investment funds could also benefit from changes in the sector's structure. The current governance arrangements for asset management companies are based on the integration of the production and distribution of financial products and on the central role of banking and insurance groups. Initially this model enabled the sector to grow rapidly, but today it threatens to segment the market, reduces its efficiency and restrains its further growth in quality and size, preventing full exploitation of the large economies of scale in asset management.

In the past few years the Italian financial marketplace has achieved great progress in terms of trading volumes and transaction costs. The market's liquidity and depth can increase further if implementation of the plans for federation with other European exchanges is accelerated, while safeguarding the informational advantages of the national market.

The European directive on financial markets has created the conditions in which integration can strengthen competition between regulated markets and systems operated by intermediaries. However, the benefits may not materialize if barriers to access to clearing and settlement services persist and legislative and technical disparities remain. Further common rules could be formulated with the aim of preventing discrimination in access and creating a harmonized regulatory and supervisory framework that will ensure competition on an equal footing, investor protection and systemic stability.

The banks

The Italian banking system is sound. In the last few years loan quality has remained high, despite the weakness of the real economy; it has benefited not only from improvements in borrower selection techniques but also from the transfer of part of the credit risk away from banks' balance sheets. The profitability of banking groups has improved: the return on equity has reached 12 per cent, two points higher than in 2004; for the leading groups it has risen by five points to 16.2 per cent.

Further development of the banking sector, including in terms of banks' size, can improve the financial system's competitiveness and strengthen the economy. Small banks continue to play an indispensable role in financing local economies; the presence of sufficiently large intermediaries is necessary to ensure that more advanced services are widely available at low cost. The growth and internationalization of firms are facilitated by the growth and internationalization of banks.

As well as engaging in traditional activities, banks now increasingly distribute a wide range of financial products. This alters the composition of the risks they face. Their good name, which depends on proper conduct and the quality of the products they sell, including those of third parties, becomes crucially important for their competitiveness and even for their stability. In addition to traditional credit and market risks, which have now been partly transferred to other intermediaries, banks now face reputational, legal and operational risks.

In this context strict compliance with regulations, with appropriate operating standards and with deontological and ethical principles is a prerequisite for the sound and prudent management of intermediaries. The measures to foster corporate cultures based on rigorous observance of the rules, the correct handling of conflicts of interest and maintenance of customers' trust must be strengthened. The Bank of Italy will issue instructions requiring banks to establish a compliance function to monitor observance of legal and self-regulatory rules.

The code of ethics that the Board of Directors of the Bank of Italy approved this morning contains a provision to that effect for this institution.

Effective governance arrangements are equally important. Especially where ownership is fragmented, self-referential forms of governance must be prevented from taking hold. The clear allocation of roles, the effective exercise of their powers by governing bodies, the existence of adequate checks and balances, and transparent conduct will ensure proper management with the well-informed assumption of business risks.

Banks' greater efficiency and the increase in competition are not yet sufficiently reflected in the prices or quality of some banking services.

Bank charges for closing accounts are especially significant, because they may restrict customer mobility and thereby hinder competition. At the end of 2004, in consultation with the Antitrust Authority, the Bank of Italy initiated an enquiry into the procedures and charges for terminating the main retail banking and financial services. In the last two years some banks have eliminated their charges for closing accounts. In most European countries banks are not allowed to charge for this; in some, such as the United Kingdom and France, self-regulatory codes also lay down standards to ensure that accounts and the related services can actually be transferred within a given time. The extensive data collected in the course of the enquiry are described in the body of the Annual Report; the follow-up is now the responsibility of the Antitrust Authority.

The new Basel Capital Accord introduces some highly innovative principles into the regulation of banking. Its transposition requires a far-reaching revision of supervisory rules. It will simplify prudential regulations, increase intermediaries' freedom of action and enhance the flexibility of the banking system.

The key criterion is the evaluation of the different forms of risk using common quantitative methods, together with a more accurate correlation between capital requirements and the size of the risks faced. The new rules for assessing the capital and organizational adequacy of banks are based on their own methodologies. The Bank of Italy's task is to verify the reliability and rigour of the methods used and, if necessary, to require corrections and improvements. There will be a more intense interaction between the supervisory authority and the banks, but the regulatory formalities will be reduced.

The widespread dissemination of the methods for calculating capital requirements developed by each of the leading banks has made adequate techniques available to a wide range of intermediaries, in some cases through participation in consortiums. However, the most advanced calculation methods will initially be used only by some of the major groups. The market will comprise banks applying credit assessment methodologies of varying complexity. The Bank of Italy is committed to checking that the use of different methods of customer selection does not lead to regulatory arbitrage or adverse selection.

The risk-weighting system and the special treatment reserved for small loans mean that the new rules will not result in credit rationing or higher costs for smaller firms.

By increasing the role of flexible and market-oriented supervisory instruments and reducing that of detailed administrative prescriptions, the new regulatory system enhances the role and effectiveness of on-site and prudential supervision.

Again with the aim of directing finance toward stimulating renewed economic growth, the Bank of Italy intends to submit a proposal for revising the regulation of banks' equity interests in non-financial corporations to the Interministerial Committee for Credit and Savings. The rules would be fully aligned with Community law by easing the present stringent constraints while introducing rigorous codes of corporate governance in order to safeguard intermediaries' stability and ensure the transparent and correct handling of conflicts of interest.

As regards the authorization of acquisitions of controlling interests in banks, the obligation to notify plans to the Bank of Italy before they have been submitted to the board of directors will be abolished.

Driven by the single currency and progressive regulatory harmonization, the integration of European banking markets derives additional momentum from developments in the competitive environment. The growth of consumer credit and, more generally, of financial products for households contributes in this respect. Such products are becoming increasingly standardized in design and in the technology used, which encourages their large-scale distribution and enhances the value of existing distribution networks. Italy, where households have a low level of debt and still relatively undiversified financial assets, is an attractive market.

In the last ten years the main European banking groups have become highly profitable, partly owing to the restructuring carried out in national markets. They now have the resources to extend their activity abroad significantly. The growth of the main Italian banks has narrowed the gap between them and their leading European counterparts, but has not eliminated it; the process must continue.

It is well known that last year saw important acquisitions of two Italian banks by foreign banking groups and of foreign banks by an Italian group. This greatly increased the degree of internationalization of Italy's banking system, bringing it into line with that of the other leading euro-area countries. Foreign-owned banks' share of the assets of banks established in Italy rose from 8 to 14 per cent; in France, Germany and Spain the corresponding figure is between 10 and 11 per cent, and in the Netherlands it is 14 per cent. The foreign assets of the largest five Italian banking groups rose from 11 to 41 per cent of their combined assets, a figure comparable to that in the other countries I have just mentioned. The increase was entirely due to a single acquisition.

The spread of multinational banking groups in Europe requires supervision performed jointly by authorities from different countries, in accordance with principles established at European level, under which the supervisory authority of the parent company is responsible for coordination. Permanent structures, known as supervisory colleges, have been established to coordinate the supervision of multinational groups. The Bank of Italy has signed agreements with the German authorities and made contact with those of many other European countries with a view to establishing cooperation arrangements for Italian groups with a presence of systemic significance in other countries and vice versa. Cooperation also relates to the convergence of supervisory practices, to ensure that units of groups located in different countries receive uniform treatment.

The law on the protection of savings passed in December 2005 is intended to strengthen the safeguards for savers and increase market transparency, with provisions that affect the regulation of market participants, relations between intermediaries and their customers and the arrangements for supervisory authorities.

As regards the latter aspect, the reform is based on the principle of the purpose-based allocation of responsibilities. In accordance with this approach, antitrust activity in the banking sector has been transferred to the Antitrust Authority and new duties concerning the regulation and control of the supply of financial products by banks and insurance companies have been entrusted to Consob. The purpose-based model of supervision offers advantages in terms of the specialization of controls, the speed of decision-making and the transparent identification of the authorities' responsibilities in relation to the purposes they are assigned and the exercise of the powers they are granted.

The Bank of Italy had already concluded agreements with Isvap and Consob on the supervision of financial conglomerates and is now ready for any additional agreements that the new legal framework may require. For matters that fall under the jurisdiction of more than one authority, it is to be hoped that some of the technical solutions envisaged by the law will be simplified, especially as regards the artificial combination of the various authorizations involved in banking mergers into a single act. Cooperation among the authorities is essential for the more effective exercise of administrative discretion and to curb the costs borne by the entities subject to supervision.

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I began my remarks with the words "returning to growth". This is Italy's absolute priority for economic policy today, as was entering the monetary union ten years ago. While preserving the stability we acquired at so great a cost, we must find our way back to the path of growth. The actions to be undertaken, including the measures to redress the public finances that have now become imperative, must be evaluated first and foremost from this point of view.

Such an objective can only be achieved if there is consensus on the goals for the future and agreement on action in the present. Let us draw encouragement from the knowledge that in the course of its history this country has successfully overcome far more dramatic challenges.