Mario Draghi: The world economic recovery and Italy's part in it

Speech by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the 16th Associazione Italiana Analisti Finanziari (AIAF) – Associazione Italiana Operatori Mercati dei Capitali (ASSIOM) – ATIC FOREX Congress, Naples, 13 February 2010.

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The recovery

The strains in the international financial markets have eased considerably in the last twelve months: the banks are once again raising funds and, in several cases, they have made significant increases to their capital; asset writedowns have diminished. Nevertheless, in the last few weeks the markets have become more volatile.

The world economic recovery is under way, although in a different manner in different areas. The international organizations and private analysts are forecasting that this year China, India and Brazil will return to their high pre-crisis growth rates; not the advanced economies, whose growth is expected to remain modest, even in comparison with the initial upturns in previous recessions. The prices of oil and other raw materials have risen again. Despite this, inflation is still being held down by ample unused production capacity; in the next few months inflation in the euro area is expected to reach levels only slightly higher than in January, and it is likely to remain moderate in the medium term.

The return to growth is still fragile, particularly in the euro area. Employment is slow to recover. Credit conditions for small and medium-sized enterprises are still tight and hindering recovery.

Last year in Italy GDP fell by almost 5 per cent. Recovery is expected to be slow, with great uncertainty linked in particular to trends in the international business cycle and to labour market conditions. For many Italian companies, preexisting structural problems have been aggravated; others are able to take advantage of the crisis-induced changes in the market to increase their competitive edge. Domestic demand is still weak.

At the end of last year, the number of people employed in Italy was down more than 600,000 from the peak of July 2008. The share of the potential labour force that is currently experiencing enforced idleness is large and growing. Until the fall in employment ceases, there remains the risk of repercussions on consumption and hence on GDP.

Policies

During the crisis, extremely far-reaching economic policy measures were essential in many countries: the central banks cut their interest rates to unprecedentedly low levels and resorted to unconventional expansionary measures; governments used their budgets to support the financial system and sustain demand and employment. These measures will have to be gradually phased out.

As we emphasized at the last meeting of the Governing Council of the European Central Bank, the current level of official interest rates in the area is appropriate; no medium-term risk of inflation has emerged. The Eurosystem's operations to support liquidity and banks' lending capacity are continuing. Nevertheless, the unconventional measures that are no longer necessary thanks to improved financial market conditions are being gradually discontinued. In December, we announced that the main refinancing operations with twelve and six-month maturities would not be repeated beyond December and March, respectively.

The exit from the current set of unconventional monetary policy measures should not be premature so as not to hinder recovery, but neither should it be tardy so as not to put price stability at risk and so as to avoid fuelling market distortions and speculative bubbles that would constitute the premises for new crises. At the beginning of March, we will take further decisions on the phasing out of the extraordinary operations, considering the prospects for price stability. The demand on the part of banks which may have difficulties raising funds can be satisfied without affecting monetary policy.

As of now, it would appear necessary to normalize budget policies, at least by drawing up clear exit paths.

The International Monetary Fund estimates that since 2007 in the leading advanced economies there has been a five-fold increase in the deficit, from 2 to 10 per cent of GDP. It also forecasts that budget deficits in the euro area will still be more than 3 per cent of GDP in 2014.

In recent weeks, the state of the public finances in Greece has alarmed the international financial markets. If the Greek government adjusts its budget with determination, with careful monitoring by the European Commission and the ECB, the markets will subscribe new securities as old issues fall due, as happened in Italy at the beginning of the 1990s. It is nevertheless important that the euro-area countries have expressed their intention, should it prove necessary, to take decisive and coordinated action to ensure financial stability within the area.

The public finances in many countries will be increasingly burdened in the coming years by costs associated with population ageing and climate change. A prompt and credible indication of the ways to correct the trend of the public debt is needed, among other things to reduce volatility in the financial markets and the issue costs of government securities. Increases in long-term interest rates would impact on the real economy, with possible repercussions on banks’ balance sheets, casting doubt on the strengthening of the financial system.

Rules and controls on finance

The purpose of the package of regulatory proposals recently announced by the Basel Committee on Banking Supervision is to strengthen banks’ stability and contain liquidity risk.

Banks’ capital bases will have to consist of high-quality instruments, genuinely capable of absorbing losses; leverage will be curtailed; the procyclical aspects of regulation will be attenuated through the build-up of capital buffers and provisioning in periods of strong growth for use when losses materialize.

In the early part of this year, the Committee will conduct a detailed impact assessment, in order to appraise alternative proposals, calibrate the new rules and set the new, higher capital requirements for banks. It will be important to verify the overall consistency of the framework, imposing stricter prudential requirements on those banks that operated with the particularly risky business models that were at the root of the crisis.

The G20 leaders decided that the new rules do not have to take effect immediately, but only at the end of 2012, and in any event under the proviso that they not impair the stability of the markets and the resumption of an adequate flow of funds to the economy. They called on the Financial Stability Board to examine the macroeconomic implications of the reform, and to ensure the requisite gradualness of its implementation, with appropriate transitional and grandfathering clauses governing the instruments already issued.

The crisis demonstrated the devastating repercussions of the failures of major financial institutions. Governments and central banks intervened to mitigate its impact; in so doing, at times they supported and protected the very institutions that had triggered the crisis in the first place. Moral hazard was compounded by the crisis: financial institutions have felt sheltered from the risk of failure and the fear this inspires, they have been taking new risks and, thanks to the extraordinary market conditions that have been created, are reaping enormous profits. Reducing moral hazard is a shared objective. This is to be done by lessening the likelihood of failures and circumscribing the attendant damage; creating mechanisms for their orderly management; and centralizing the channels that transmit their effects, such as derivative instruments, which nowadays are traded outside regulated markets and bilaterally.

Criteria must be devised to determine the systemic importance of an institution. This will have to be done without compiling lists of intermediaries, which would create an unjust segmentation of the banking system and could have adverse effects on risk-taking.

The following measures are being considered: more stringent capital and liquidity requirements, which will have to take account of the proposals already set out by the Basel Committee; the intensification of supervision; and robust and harmonized crisis management procedures.

Other proposals aim to reduce the complexity of cross-border groups. One, in particular, would make it obligatory to operate in each foreign jurisdiction via a subsidiary, i.e. a company enjoying substantial autonomy in its funding, liquidity and operations. The segmentation of computer systems and procedures within a group may impede consolidated supervision; the groups' international integration and the overall development of financial markets could be adversely affected. In any event, it is important that banks' organization be simple, so that supervisory authorities can make a full assessment of the systemic risks in the event of a failure; in addition, it is more likely that we will move towards the subsidiary model if it proves impossible to attain minimum harmonization of the procedures for the resolution and winding up of major banks.

The Financial Stability Board, which will present a report to the G20 summit in November, also envisages that banks will draw up emergency plans for refinancing, curbing risks, and in cases of evident insolvency, liquidating their assets in the most orderly fashion possible.

Also under discussion is the desirability of separating traditional banking business from investment banking, with a view to limiting risk-taking by banks.

As can be seen, there are various measures being discussed to address systemic risk, but they are all part of the process of international cooperation. Indeed, many are similar to those set out in the Basel Committee's plan, where the higher risk of investment banking compared with traditional banking is dealt with through higher capital requirements. In this area it is unlikely, however, that countries with different banking structures, each affected by the crisis in its own way, will adopt the same measures; international cooperation will probably achieve minimum harmonization, while the capital and liquidity regulations provided for by the Basel reform aim at achieving maximum harmonization.

In the new design of the structures of European supervision, the Commission's project aims at harmonizing national authorities' crisis powers and instruments through the introduction of special provisions for cross-border groups. We believe that Italy has complete and effective legislation in this field, together with valid practices and experience, all of which will need to be turned to account in the negotiations with the Community institutions.

Europe has shown that it wants to increase the stability of the financial system while preserving a high degree of integration of the markets in the area.

The analyses of the different authorities will need to be supplemented to arrive at truly uniform risk evaluations in the supervisory colleges of banking groups. Within the colleges for which we are responsible, we have vigorously promoted this integration.

The objective of reconstructing a world financial system with more capital, less debt and the ability to withstand the collapse of large financial institutions without public aid is now unanimously shared. Agreement on a gradual transition towards this objective is also close.

It is important that the international banking community participate in this process and fully appreciate the determination with which it is being pursued. That the new rules threaten the recovery by causing a contraction in credit is a claim that is easily refuted: the new system will be introduced gradually, and credit stopped expanding some time ago without the new rules even being known. Moreover, to believe that regulatory arbitrage will make it possible to elude the new rules underestimates the broad consensus on their introduction. It is possible that the combination of the various measures under discussion will result in a fall in banks' profits, but it will also reduce the risks they run. It will be advisable to respond to the former with appropriate and far-reaching reorganizations and not to oppose the latter with the assumption of new risks.

Italian banks

Thanks to the interventions of the last few months, Italian banks are bolstering their liquidity and capital, an essential condition for tackling the significant deterioration in loan quality and profitability.

Banks' liquidity continues to improve, thanks in part to the partial reopening of the wholesale markets for funds. In January euro-area banks issued about €60 billion of bonds on the Euromarket, compared with an average of about €30 billion a month in the second half of 2009.

Italian banks are well placed to cope with the international environment, which is being made more complex by the phasing out of support measures by monetary authorities and governments. Their capital bases have been strengthened by share issues, disposals of non-strategic assets, the ploughing back of a large part of profits and, in some cases, public interventions. Between the end of 2008 and September 2009 the average core tier 1 ratio of the five largest banking groups rose from 5.8 to 7.3 per cent. The capital strengthening is continuing: it is necessary in order to increase banks' ability to hold up under adverse macroeconomic scenarios. The market's evaluation of the riskiness of banks has improved.

The regulatory changes currently released by the Basel Committee for consultation will require Italian banks to make significant adjustments. They nonetheless start out from a better situation than other banking systems in terms of capital quality, having issued mostly high-quality capital instruments.

The biggest impact could come from the proposal to deduct deferred tax assets from capital. For Italian banks such assets are considerable, owing to the restrictions in Italy on the tax deductibility of loan losses, which it is to be hoped will soon be revised. On this front the impact assessment will make it possible to evaluate alternative options, such as deducting only part of these assets, so as to attenuate the competitive distortions created by the differences in national tax treatments.

Italian banks, which tend to engage to a greater extent in traditional forms of intermediation, have a low leverage by international standards. Measured by the ratio of total assets to tier 1 capital it was 24 for the largest groups in June 2009, as against 34 for the leading banks of the other European countries. The introduction of a prudential leverage ratio should therefore not have significant consequences. The same can be said of a tightening of the prudential requirements for trading books in view of the smaller share of innovative financial transactions and structured credit products in Italian banks' balance sheets.

The profitability of Italian banks has declined markedly, in parallel with the deterioration in the quality of their loans. In the first nine months of last year the net profits of the largest banking groups were down by 50 per cent compared with the same period of 2008 as a result of larger loan loss provisions. On an annual basis the return on equity fell from 9 to 4.2 per cent.

In the third quarter of 2009 the ratio of new bad debts to outstanding loans to firms was above 3 per cent, its highest value in ten years. According to preliminary estimates, the deterioration in loan quality continued in the last part of the year, probably depressing banks' results for the fourth quarter. The increase in substandard loans and past due instalments points to a further deterioration in the months to come.

The priority use of the profits earned must be to strengthen banks' capital bases.

Credit

In December the total stock of outstanding bank loans was 0.7 per cent lower than a year earlier. Lending to non-bank customers in the Centre and North was down by 1.3 per cent, while lending in the South recorded further growth of 2.7 per cent.

The contraction in credit regards businesses, not households. In December the stock of loans to firms was 3 per cent smaller than in December 2008. On the one hand, demand for loans had fallen owing to the steep drop in investment; on the other, banks had become more cautious in supplying financing during a phase of deep recession.

By contrast, lending to households has continued to grow at a twelvemonth rate of about 3 per cent. The expansion is concentrated in home mortgages, mostly variable-rate. The contracting parties must be warned of the risk they run in the event of rate increases.

According to the latest surveys of banks, there is a moderate recovery in loan demand on the part of firms. Those engaged in technological upgrading and internationalization merit greater attention. The Government took various measures in the course of 2009 to strengthen the support provided by banks to small and medium-sized enterprises. Collective loan guarantee consortia will continue to play an important role in improving the conditions of access to loans and preserving the quality of bank credit.

The statistical models employed by banks to rate borrowers are now using companies' 2008 financial statement data; in the spring they will begin to process the data for 2009, which, if the recovery continues, could provide an outdated picture of the situation. It is necessary to supplement financial statement data with information gathered locally, review credit facilities in a more timely manner, refine screening procedures and establish balanced incentives for those who manage relations with customers.

The Italian financial market

Unlike bank lending, the bond market showed signs of recovery in 2009. Net issues by non-financial companies rose to exceed pre-crisis volumes. All the main industrial groups made bond issues. In the stock market, instead, both the number of listed companies and the ratio of market capitalization to GDP are down. The market capitalization ratio in Italy is one of the lowest among the advanced countries.

Fund-raising by Italian mutual funds was negative again in 2009, albeit with signs of recovery in the final part of the year, confirming the structural nature of the crisis of the asset management industry. At the end of the year foreign funds had more assets under management than Italian funds.

In order to enhance the autonomy and independence of asset management companies belonging to banking groups, in October we issued rules on the exercise of the parent company's powers of direction and coordination. Groups must comply with them by June.

To revive the sector, it is also necessary to intervene on the transparency and correctness of dealings with customers. The differences of tax treatment that penalize asset management products vis-à-vis competing instruments must be eliminated. Lastly, the asset management industry's strategies and organizational arrangements need to be reviewed.

As a consequence of the crisis a trend is taking hold, with strong encouragement from central banks and the Financial Stability Board, to shift over-the-counter trading to organized markets, to use central counterparties that can minimize the risks for individual participants and to centralize the data on contracts in so-called trade repositories. We hope the work by the European Commission to define a harmonized legislative framework will soon help to increase the transparency, liquidity and stability of the derivatives market, above all that in credit default swaps, which is most susceptible to speculative manoeuvres.

Italy's market infrastructures are at a decisive juncture. There is growing competition between organized markets and in post-trading. At European level the centralization of settlement is a tangible prospect and the development of a market patterned on our Collateralized Interbank Market is becoming a possibility.

Italy has everything necessary to respond to these challenges. It has trading platforms for financial instruments and post-trading infrastructures that are at the cutting edge in Europe and integrated with the international markets. Wholesale trading in government securities takes place on a transparent and broad regulated market that held up well under the crisis and has recovered in the last few months. By international standards, the post-trading structures are among the least costly.

Italian banks have significant ownership interests in the main systemic infrastructures; if they recognize their value, they can draw great benefits from them.

Bank-customer relations

The Bank of Italy has completed a broad survey – with more than 500 banks accounting for some 80 per cent of the current accounts supplied to customers – of the types and amounts of the fees applied to credit facilities and overdrafts.

The results, transmitted to the Ministry for the Economy and Finance, to which the decrees assigned supervisory tasks regarding bank fees, were made available today on the Bank's website.[1] They show a marked differentiation among the intermediaries: although there has been an overall reduction, in a third of the cases the charge has increased.

The variety of new fees makes it difficult for customers to compare the different offers. The fee structure needs to be drastically simplified. New legislation to resolve the ambiguities of its predecessor would appear necessary. Within days we will submit to the Government a comprehensive regulatory proposal that can lead to clearly stated charges, so that all customers can compare different banks and competition can operate freely, without the impediment of opacity.

For a month, new rules on transparency in banking and financial services and on the "basic current account" have been in effect.

A major contribution to improving relations between intermediaries and customers comes from the institution of the Banking and Financial Arbiter, which has been in operation since 15 October. Customer appeals have come in steadily, and the panels have already handed down their first decisions. In a number of cases disputes were settled in the customer's favour even before the Arbiter's ruling. The initial signs are therefore very encouraging. The overall outcomes of customer complaints will be made public in April, providing useful information for supervisory action.

[1] http://www.bancaditalia.it/vigilanza/banche/questio/comm_banche.pdf (only in Italian).

Supervisory action

The action of the Bank of Italy in supervising banks and financial intermediaries is governed by a consistent logic. On-site inspections, off-site controls, measures on capital and liquidity, provisions on banks' by-laws and managers' compensation, and rules and controls for transparency and correctness in dealings with customers are all shaped by the assessment of the risks to which intermediaries are subject.

Following the coordinated exercises conducted last year by the European supervisory authorities, a new round of stress testing of the major EU banks has begun in recent weeks. The results will be released by the end of June. Stress tests are by now an ordinary supervisory tool; the Bank of Italy, with the active participation of the banks, has promoted the corrective actions needed to refine and reinforce them.

In 2009 we intervened repeatedly to remind banks of the need for full compliance with the rules on corporate organization and governance.

For the cooperative banks, the aim has been to strike a balance between ensuring the stability of the governance structures approved by membership meetings and avoiding the risk of overly self-referential management. To this end we have recommended the amendment of by-laws to guarantee sufficient representation of minorities within the banks' governing bodies and to facilitate membership participation at meetings through such means as increasing the number of proxies and allowing distance voting. Additional progress along these lines is all the more necessary when cooperative institutions move away from their original localist character to become systemically important intermediaries listed on regulated markets with complex business and group structures.

The guidelines issued by the Financial Stability Board envisage two basic principles for bank managers' compensation: that it must be tied to the risks taken; and that it must not jeopardize the preservation of the bank's capital.

We asked the six largest banking groups to verify that their compensation and incentive schemes are also consistent with the Financial Stability Board's standards. The main open questions concern the proportion between the fixed and the variable parts of top management's compensation, the introduction of medium and long-term incentives and methods for deferring the variable pay component, and the refinement of risk-adjusted performance parameters.

The reports to the banks' next shareholders' meeting must give thorough information and precise data on their effective adaptation of contracts and incentive schemes to the regulations.

A bank's reputation also depends on how it prevents and combats money laundering.

The new rules in effect since the start of the year on the single database to counter money laundering increase the traceability of transactions.

Controls have been redoubled by means of new assessment procedures and dedicated analytical and inspection processes. Checks at individual branches, concentrated in the parts of the country considered to be at the greatest risk of infiltration by organized crime, are now being carried out in the inland areas of Campania, the Milanese hinterland and the province of Palermo.

Capital repatriations under the foreign assets disclosure scheme ("tax shield") need to be closely scrutinized by intermediaries in order to detect and report transactions that may be suspected of money laundering.

So far, scarcely fifty reports of possible crimes in connection with transactions under the disclosure scheme have been received. This low number is explained only in part by the fact that the law abrogates the reporting requirement for a number of types of crime. The banks need to step up their commitment to careful scrutiny of the repatriation transactions.

It is important to dispel all doubts over the way in which the anti-money-laundering rules are to be applied to these transactions. Italy's foreign assets disclosure scheme will soon be examined by the Financial Action Task Force.

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Little more than a year ago Italy was beginning to feel the full effects of a crisis that, following the failure of Lehman Brothers, had become global. It went into the recession with a low growth rate, one of the lowest in Europe.

On the financial front our economy withstood the impact of the crisis better than many others: the soundness and prudence of the banks meant that support measures of the magnitude that weighed so heavily on the budgets of other countries were not necessary in Italy. But the loss of output and income has been enormous. The social protection network, though not systematically reformed, has rightly been extended to cope with unemployment, social hardship and neglect.

We are now emerging from the recession with a low growth rate, one of the lowest in Europe.

Rapid economic growth is the basis of well-being; for a country like Italy, with a large public debt, it is a prerequisite for financial stability. For the young, it means a future; for the old, decent living standards; our South would benefit from it and could be its engine.

A precondition of rapid growth is structural reform, the lack of which has marked the loss of competitiveness that has been under way for fifteen years now.

This is not a strictly Italian problem, it is common to the other countries of Europe. It lies at the origin of today's fragility. European integration has brought price stability and, until the crisis, the effective control of public deficits. Ten years ago, at the launch of the single currency, there were calls for it to be accompanied by stronger economic management at European Union level; these voices were drowned out by the chorus of enthusiasts who celebrated the achievement together with the commitment to resist all further integration.

The euro is sound. Clearly, a crisis that generates world financial instability will have an impact on the economies of the area that varies with the structures upon which they rest. It is essential that within the Union there form the common will to extend to economic structures and to the reforms they require the same careful verification and the same vigorous pursuit that have been devoted over the years to government budgets.