Mario Draghi: Economic growth outlook, regulatory measures and the situation of Italian banks

Speech by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the 17th Associazione Italiana Analisti Finanziari–Associazione Italiana Operatori Mercati dei Capitali (The Financial Market Association of Italy) (AIAF-ASSIOM FOREX) Congress, Verona, 26 February 2011.

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The economy

The world economic recovery is continuing, albeit amidst many uncertainties. Global output grew by 5 per cent on average in 2010; the previous year it had fallen by almost one percentage point. It is commonly believed that the expansion will continue at almost the same pace as last year.

In the United States, GDP growth accelerated to almost 3 per cent at the end of 2010; the increase in consumption became more robust. Growth at similar rates is expected for the current year. For the emerging economies, the growth estimate is on the order of an average of 7 per cent this year and next.

In the euro area the German economy is providing the strongest impetus for growth, thanks to sharp increases in exports and investment in machinery and equipment.

In Italy growth is running at around 1 per cent. The expansion of output is concentrated at exporters, particularly large firms, with outlets in the emerging economies. Domestic demand remains weak, especially consumption, which is affected more severely than in other euro-area economies by uncertain employment prospects and the protracted stagnation of households' real incomes.

The improvement in the world macroeconomic situation and the overcoming of the financial disorder engendered by the crisis are nevertheless accompanied by old and new weaknesses. Sharply divergent growth rates can easily accentuate the volatility of exchange rates and interest rates, jeopardizing the recovery.

The interconnections between economies make the system vulnerable even to local shocks.

The human dimension and the still uncertain outcome of the popular uprising in Libya are of concern to the international community. The immediate impact of potential problems for energy supplies from northern Africa may be mitigated by the abundant unused capacity of the other producer countries, but the dramatic events we are witnessing may undermine investment in the oil industry in the area and raise energy prices, with repercussions for world growth. For the Italian economy, other things being equal, a 20 per cent rise in oil prices would shave half a percentage point off growth over three years.

Economic policies

Economic policies have less and less room for manoeuvre.

In the last three years the crisis has increased the government budget deficit for the advanced countries as a group by over 6 percentage points of GDP and the public debt by almost 25 points to almost 100 per cent of GDP. In the United States and Japan fiscal consolidation can hardly be put off any longer: the OECD considers that just stabilizing the debt ratio of these two countries within the next fifteen years would require a correction of the primary budget balance on the order of 8–9 percentage points of GDP. In Europe we are already working to reduce the imbalances in the public finances. The strains that affected the sovereign debt of some of the euro-area countries have focused attention on the risks of prolonged imbalances.

The euro area's budget deficit is expected to improve sharply this year from 6.3 to 4.6 per cent of GDP according to the European Commission's latest estimates. The debt ratio is likely to rise further, but much more slowly than in the last two years.

In Italy the ratio of public debt to GDP, close to 120 per cent, should begin to decline next year, when the Government intends to bring the deficit down to below 3 per cent of GDP.

In the ten years preceding the crisis, current expenditure, net of interest on the public debt, grew by 4 per cent per year in nominal terms, far outpacing GDP. Last September's Public Finance Decision forecasts that its increase will be limited to 1 per cent per year in 2011–12. This trend must continue beyond 2012 and the composition of primary expenditure must be geared to growth. There is no other way to reduce the deficit, since the burden of taxes and social security contributions is already 3 points above the euro-area average. Additional revenue that comes in as a result of the reduction of tax evasion should be used to ease the burden on the taxpayers who already pay what is due. It may also be necessary to offset at the central government level any increases in decentralized taxation caused by fiscal federalism.

The financial aid that Greece and Ireland received last year from the European Union and the IMF was conditional on their enacting strict fiscal consolidation plans and incisive economic and institutional reforms. A major contribution to preventing new sovereign debt crises should come from the reform of European governance now under discussion, which aims to strengthen multilateral surveillance of national economic policies. It is important that semi-automatic rules come into play when deviations from the agreed parameters occur, as this will drastically reduce the chance of their being evaded. Rescue funds should be used only in emergencies and, as IMF experience suggests, should be tied to rigorous adjustment programmes.

Monetary policy faces different situations in different parts of the world.

In the emerging countries, good growth prospects and high yields are attracting abundant inflows of private capital from abroad. In 2010 these amounted to around $900 billion, equal to almost 5 per cent of these countries' GDP. At a time when demand is already expanding rapidly and the financial system is not yet well developed, such inflows can cause high inflation and financial bubbles. The inflation rates already recorded in these countries – about 6 per cent on average and well over 4 per cent in China – are partly due to the higher cost of food and energy products, although the acceleration in domestic demand also plays a part, since it is behind the jump in international commodity prices. These increases, which are particularly hard on the poorest, could be countered by currency appreciation, which is necessary in any event in order to reduce global payments imbalances. In the absence of such appreciation, monetary policies in these countries are becoming more restrictive.

In the advanced economies inflation is dampened for the time being by the ample margins of spare capacity. In the United States, the Federal Reserve recently confirmed its plan of last November to increase liquidity by purchasing Treasury paper.

In the euro area, consumer price inflation, driven up by the sharp rises in commodity prices, in January widely overshot the definition of price stability fixed by the ECB Governing Council. Core inflation remains low, given the moderate growth in domestic costs and a cyclical recovery proceeding without any spurts. Inflation expectations over the medium term remain well-anchored.

However, the appearance of inflationary tensions does require that we carefully assess the timing and methods for restoring normal monetary conditions and interest rates. Monetary policy must prevent a deterioration of expectations, in order to keep the stimulus of international prices from passing through to domestic prices and wages in the longer-term.

Real short-term interest rates that are markedly negative, as they have been over the past two years, have not improved the growth prospects of the less dynamic economies. As economic policies reach the end of their expansionary phase, this will not necessarily endanger growth. In the weakest countries, in particular, the cost of borrowing could benefit from the narrowing of spreads on government securities following the adjustment of budget policies and from the containment of risk premiums as inflation expectations are kept under control.

International financial rules and controls

Considerable progress was made last year in building a more robust international financial system, better able to withstand crises.

The Basel III regulatory framework was drawn up, with new capital and liquidity requirements and limits to financial leverage. Its gradual phasing in will prevent it from impeding economic recovery. The over-the-counter derivatives markets will have a sounder and more transparent basis, with greater standardization of transactions, the requirement to use central counterparties for standardized contracts, and full and prompt access to data for the authorities. We have identified many of the perverse incentives that encouraged excessive risk-taking – in banks' executive compensation systems, in the role of rating agencies and in the accounting rules – and begun to rectify them.

But much still remains to be done.

The activity of the Financial Stability Board is now concentrating, in accordance with the mandate given by the Seoul Summit of the G20, on the moral hazard problem posed by systemically important financial institutions (SIFIs), those that in the latest crisis and earlier ones were considered too large, or too complex and interconnected, to be allowed to fail and that have often received injections of public capital. Knowing that they cannot fail encourages them to take greater risks, while the markets finance them at lower interest rates than they apply to intermediaries exposed to the risk of failure.

The ability to wind up these institutions without undermining the markets or using public money, the certainty that they can absorb larger losses than those that less important intermediaries can bear, and more extensive and penetrating supervision; these are the three pillars on which the FSB's recommendations will be based. Within the year the Board will publish the essential features of national rules for the winding up of SIFIs, a framework for the restructuring and winding up plans that every SIFI must prepare, and a preliminary analysis of the questions involved in the international coordination of laws on this matter. It will then be up to governments and parliaments.

By the middle of this year we plan to have established the parameters for identifying global SIFIs, to which to start applying more rigorous prudential rules. The criteria will include not only the size of intermediaries but also the extent to which they are interconnected with others and their importance in specific segments of the financial market. The necessary discretion to be left to national authorities in applying the criteria will have to be balanced by peer reviews starting at the end of 2012.

SIFIs' ability to absorb losses needs to be improved in order to minimize the probability and systemic impact of a crisis; the measures to this end include capital requirements additional to those laid down by Basel III. There are various possible techniques: higher ordinary capital ratios, the participation of some creditors in losses (bail-in) and debt instruments that convert into common equity on the occurrence of specific events (contingent capital).

Another field for action by the FSB concerns the "shadow banking system". We are preparing a map of the non-bank activities and intermediaries that, insofar as they create credit and transform maturities, need rules and supervision similar to those of the regulated banking system.

The new European supervisory bodies are now operational. The first task, in which the European Banking Authority will be primarily engaged, is to carry out stress tests on the leading banks. The tests will have to satisfy four requirements: very severe scenarios; strict assessment of the results using a common methodology and backed by thorough peer review; complete transparency; and prompt identification of the remedial measures. The requirements are essential for the credibility of the exercise and the markets' assessment of the European banking system.

Harmonization of the prudential rules is the other urgent object to achieve. A set of common rules – the single rulebook – will help to prevent less strict supervisory rules and practices in one country from jeopardizing the stability of the European financial system, having repercussions on the economies of other countries and distorting competition. A first test will be the implementation in Europe of the Basel III rules. All the countries of Europe have pledged to transpose those rules into law, in keeping with rigorous principles, already present in our model of supervision, whose validity was confirmed in the course of the crisis.

The European Systemic Risk Board, charged with signalling areas of risk and making recommendations, will need to be able to accompany its analyses with effective intervention measures. It will avail itself of systemic stability risk assessments shared with the micro-prudential supervisory authorities.

Italian banks and the Bank of Italy's supervisory action

The money and financial markets are now functioning better, but the return to complete normality will take time. Banks, particularly European banks, are having difficulty raising funds in the market. Their balance-sheet assets are exposed to significant risks stemming from the after-effects of the recession and the strains in the sovereign debt markets, which give rise to liquidity risk and the possibility of capital losses.

With the financial crisis, the global environment in which Italian banks operate has been altered. Competition for funding, including competition with sovereign borrowers, has become fiercer. The structural contraction in the volume of assets in some capital market segments has brought a permanent decline in income.

In the closing months of 2010 the main Italian banking groups' net liquidity position one month ahead remained positive, on average, but shrank. In January, however, they made bond issues worth some €10 billion, or about one fifth of the wholesale funds maturing in 2011. Short-term funding capacity also showed improvement, although the volume of these placements remains smaller and the duration shorter than before the sovereign debt crisis.

Maintaining adequate reserves of liquidity is vital to safeguarding stability and continuing to provide finance to the real economy, especially while the market is still vulnerable to sudden crises of confidence. Prudence must not be sacrificed to profitability.

In 2008, in the thick of the financial crisis, the fall in the earnings of Italian banks due to write-downs of securities, trading losses and reduced fee income was quite modest compared with the severe losses suffered by banks elsewhere. But since 2009 the situation has changed. Italian banks' profits are weighed down by a contraction in net interest income and a deterioration in loan quality, the consequence of the severe economic recession.

In the first nine months of last year the earnings of the five largest groups declined by 8 per cent compared with the corresponding period of 2009. Return on equity fell below 4 per cent on an annual basis. In two years net interest income has fallen from 2.0 to 0.9 per cent of total assets, owing to the slowdown in lending and the decrease in the mark-down on sight deposits caused by the low level of interest rates. Value adjustments to loans, though lower than their 2009 peak, continue to absorb more than half of operating profit. The average balance-sheet cover ratio for impaired loan assets remains below its long-run level. The recovery in margins is also slowed by the heightened competition for retail funds.

In recent months a country-risk effect has been added. Today Italian banks, even the most efficient, are penalized in fund-raising on the wholesale markets. They pay about 70 basis points more than their German counterparts.

The low profitability of Italian banks reflects not only the sluggishness of the Italian economic recovery but also their prevalent business model: concentration on lending to retail customers (households and small businesses); retail fund-raising; low leverage; limited securities trading on own account; and less maturity transformation than banks in other countries, owing in part to the predominance of variable-rate loans. This model means our banks are less exposed to financial market volatility and protected them during the crisis. The other side of the coin is that it makes them heavily dependent on net interest income and macroeconomic conditions. It makes their operating costs more rigid.

Resolute action is needed to lower the ratio of costs to total income. In recent years the largest Italian banks have enhanced their operating efficiency, bringing the cost/income ratio closer to that of their European competitors: 62 per cent, against an average of 58 per cent for all EU banks in the first half of 2010. Italian banks must improve further, and decisively, by rationalizing sales networks, extending and refining the use of technology, simplifying the structure of production, selling other non-strategic assets, and adapting compensation policies at all levels.

Curbing costs will permit the recovery in profits needed for the capital strengthening that the markets and the new capital rules demand. Given the difficulty of raising fresh equity capital, it is essential to generate sufficient resources internally.

The capital ratios of the top five Italian banking groups are rising overall. At the end of September the tier 1 ratio stood at 9.0 per cent, while core tier 1 capital came to 7.9 per cent of risk assets, up from just 5.7 per cent at the end of 2007.

On average Italy's smaller banks already have levels of capitalization in line with the new regulatory minimums set by Basel III. These banks supply more than half the credit needs of the country's small and medium-sized enterprises. For the major banks, which use internal rating models, the Basel II rules for containing the capital charges for loans to smaller companies stand confirmed.

This year we shall again assess the resilience of Italian intermediaries in the face of highly adverse conditions, as part of the new series of stress tests of the European banking system. Thanks to the experience gained to date, the Bank of Italy and intermediaries will be able to interact fruitfully for the success of this new exercise.

For banks to be prepared when the new capital adequacy rules are fully phased in, capital strengthening must proceed, above all through retained earnings. We expect that as in 2009 a large part of last year's profits will be allocated to increasing the banks' capital. Nevertheless, recourse to the capital market would also appear unavoidable as soon as conditions permit.

Another major structural change in Italian banks' business environment involves consumer protection, which is considerably stronger today than in the past. In recent years the Bank of Italy has stepped up its work to improve banks' customer relations. We have acted on several fronts: new rules, intensified controls, new consumer protection instruments. We have always favoured the elimination of the distortions that put the Italian banking industry at a disadvantage vis-à-vis the competition. The Government's recent initiatives concerning the tax treatment of banks go in this direction and respond to long-standing requests of ours. But we are just as strongly convinced that the Italian model of banking, given the nature of banking customers, has a greater need than others for customer relations to be based on transparency. Any retreat on this front will encounter the Bank of Italy's firm opposition.

Growth

The essential objective remains growth – growth that is equitable and pays heed to the quality of life. Without growth, financial stability cannot be consolidated in the world, in Europe, or in our country.

The Monetary Union can overcome the sovereign debt crisis of some of its members if it is able to reach agreement not only on the ways to ensure fiscal discipline but also on the structural reforms needed to impart enduring impetus to growth and on the forms of mutual control over their implementation.

In Italy, growth has been languishing for fifteen years now. We have dwelt on the underlying causes and the contours of reform action in various venues, on the basis of the analyses that we have conducted in recent years. Let me recall some of them.

The growth of the whole economy would benefit from a legislative overhaul keyed, pragmatically, to enhancing the system's efficiency. If legislation is not transparent, well-designed and stable, if the administrative burdens are disproportionate to the activities regulated, in the long run the economy will decline. Despite the progress made, Italy still stands out in all the international rankings for the burdensomeness of its bureaucratic obligations, especially those incumbent on firms.

The educational system is decisive. The achievement gap between our students and their peers in other countries has narrowed but remains wide, and it is particularly large in the South. The school system must reward academic merit and diligence. It must guarantee a satisfactory level of education to all students, irrespective of their social background and geographical origin. Our university system, despite some notable exceptions, is still far from the standards of quality prevailing in most of the advanced countries. Our research institutions are unable to attract talented scholars, technicians and managers, Italian and not, in sufficient numbers. Recognition of merit is one of the central principles of the reform of the university system just approved. This is a first step in the right direction.

For over a decade the entry wages of young people in the labour market have been stuck below the levels of the 1980s in real terms. The recession has made the situation more difficult. The youth unemployment rate verges on 30 per cent. Already high by international standards, young people's dependency on their parent's wealth and income, a factor of conspicuous social inequity, has been accentuated. A major contributory factor is the segmentation of the Italian labour market, where the rule is minimum mobility at one extreme and maximum precariousness at the other. This is a waste of resources that mortifies young people and seriously impairs the efficiency of the productive economy.

Our firms' propensity to innovate and their international projection are insufficient to drive growth, ultimately because too many firms remain small, including successful ones. The conduct of entrepreneurs also reflects improper incentives not to grow. A tax system with less evasion and lower rates would be conducive to firms' decision to scale up and to accept contributions of new equity capital.

As we have seen on several occasions, the North-South gap in Italy depends largely on national policies and their application at local level.

We can regard the possibility of a reform drive with fair confidence. Italy possesses abundant resources, has many companies, entrepreneurial ability and a hardworking and thrifty people. It is a matter of freeing the spirit of entrepreneurs and individuals from many constraints. This has already begun, but bolder reform measures would improve the expectations of firms and households and would give a boost to growth.

This year we celebrate the 150th anniversary of the birth of a united Italy. More than one third of our history has been characterized by the choice – more and more deeply felt with the passage of time – to be part of Europe in every phase of its integration. We have made no small contribution, and received no little in return. More than in the past, the strategic choices that we face as Italians and as Europeans now coincide. To transform this awareness into action shared by citizens is the noble task of politics in Europe.