Mario Draghi: Overview of economic and financial developments in Italy

Concluding remarks by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the Ordinary Meeting of Shareholders 2010 – 117th Financial Year, Bank of Italy, Rome, 31 May 2011.

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Ladies and Gentlemen,

When I first took the floor before this annual meeting on 31 May 2006, I said that I felt that one of my duties was to lead the Bank of Italy towards change, in all its vast field of action, "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".

The Bank responded. It answered the call thanks to its wealth of skills; thanks to its independence.

In these last five years we have changed the structure, organization and work procedures of the Bank.

The number of branches has passed from 97 to 58. We now have a more efficient network, better able to respond to the needs of the local communities.

The Italian Foreign Exchange Office (UIC) has been closed. The Financial Intelligence Unit has been instituted with the task of preventing and combating money laundering and the financing of international terrorism.

The Bank of Italy and UIC together employed almost 8,500 people in 2005; the number now stands at just over 7,000.

The path of change will be pursued with determination, with a spirit of innovation. We are counting on everyone's active collaboration.

The Bank's staff is its greatest asset. We are continuing to refine our recruitment procedures and focusing on professional development, well aware that our institution's future rests on the knowledge and skills of the men and women who work here.

On 18 December Tommaso Padoa-Schioppa passed away, all too soon. He joined the Bank of Italy in 1968 and left almost thirty years later as Deputy Director General to serve successively as Chairman of Consob, member of the Executive Board of the European Central Bank and Minister for the Economy and Finance. His death deprives our country of his gifts of intelligence and passionate civic commitment. We will be holding a conference in his memory here in December, a year after his decease.

The Bank of Italy has been a precious source of dedicated public servants for Italy and Europe. Merit and independence: these are the essential conditions for the credibility of its analyses and for the effectiveness of its action. These are values to be preserved if the country is to continue to benefit from an authoritative voice with no vested interests. These have been the guiding principles of my mandate.

The world after the crisis

The economic policy response to the 2008–09 crisis was rapid, effective and coordinated internationally. Support from budgetary policies and the injection of liquidity to sustain the markets were unprecedented. The collapse of the international financial system was averted. There are some lessons to be drawn from this crisis: the social safety net, which held, is

essential; bank failures must be managed; international cooperation, indispensable during the emergency, remains so when reconstructing the system.

In 2010 the global economy returned to growth at a rate of almost 5 per cent. In the emerging countries huge numbers of people are leaving poverty behind, even though this process is being held back by rising food prices. Overall the financial system is gradually recovering.

But the legacy of the recession is a heavy one. The most advanced economies, with the exception of Germany, are struggling to return to the previous rates of growth; the recovery is still too weak to reduce unemployment. In the emerging countries, with growth rates close to 10 per cent in some cases, signs of inflation are beginning to appear; in several of these countries inflows of capital have reached the high levels prevailing before the crisis.

The economic policies energetically applied in the advanced countries to counter the worst effects of the crisis have reached their limits. The public debt of these countries, equal to 73 per cent of GDP in 2007, will exceed 100 per cent this year. The risk premiums on public debt are growing everywhere, dramatically so in the economies where the public finances have deteriorated the most. In the euro area, the sovereign debt crisis of three countries – which together account for 6 per cent of the area's GDP – can potentially have significant systemic effects.

Public finances must be brought under control. A prolonged expansionary policy undermines the sustainability of the debt and damages economic growth. In Europe a start has been made on adjustment. This could not be postponed, despite the weakness of the recovery.

The emerging economies' prompt return to growth, adverse climatic events and socio-political upheaval in the Mediterranean and Middle East have pushed up the prices of energy sources and food, by more than 30 per cent in the last six months.

The risk of inflation is rising. There is now a greater need to proceed with monetary policy normalization so as to prevent expectations of higher inflation from becoming entrenched.

External current account imbalances between large debtor and creditor countries, one of the factors underlying the crisis, have begun to increase again. Differences in the propensity to save and in the composition of domestic demand are the main causes, together with rigid exchange-rate policies.

Today the Group of Twenty is committed to a global economic policy promoting strong, sustainable and balanced growth.

However, the imbalances in international payments are set to last and they must be funded. It is therefore crucial that the financial system is solid. The reform of the rules remains a priority on the international agenda. It must be completed.

The reform of finance

Important steps have already been taken. Thanks to unprecedented international cooperation, the measures adopted will make the financial system much more resilient. All the leading countries have revised their systems of regulation and supervision in three directions: to reduce the risks for stability, increase cooperation among authorities, and broaden the scope of the rules.

Basel III has established higher requirements for banks' capital and raised its quality. It has placed restrictions on financial leverage and introduced new liquidity rules.

We have eliminated many of the perverse incentives that encouraged the assumption of excessive risks in securitizations, by revising the role of rating agencies and reviewing accounting standards and prudential rules.

Transparency and the reduction of systemic risk are guiding the reform of over-the-counter derivatives: the standardization of contracts, centralized clearing, more demanding capital

requirements, and the obligation to provide information to trade repositories are the pillars of the new system.

The reform has not yet been completed, however: it is necessary to tackle and reduce the moral hazard associated with systemically important financial institutions; it is necessary to increase the transparency and reduce the risks generated by the shadow banking system, a grey area between the regulated and the unregulated sectors.

Either because they received public support at the height of the crisis to prevent failures with devastating consequences or because governments provided them with more or less explicit guarantees, it is widely believed that the largest banks cannot fail. This leads to serious competitive distortions but above all to the unacceptable idea that profits are private and losses public.

Systemically important financial institutions must be allowed to fail if necessary, in an orderly manner, while preserving the essential banking and payment system functions and with the costs of their collapse not borne by the taxpayers but by the shareholders and certain categories of creditors. Beginning with those of a global size and nature, they will also have to be able to absorb larger losses. Common equity remains essential to the achievement of this objective.

The supervision of these institutions will have to be enhanced, made commensurate with the risks they can create. In many countries this will require a significant increase in the authorities' powers and independence.

The Financial Stability Board will present detailed recommendations at the G20 summit in November.

Before the crisis, much of the financial leverage and liquidity risk originated within the shadow banking system. The first objective of the Financial Stability Board is to establish the capacity to assess the risks in this sector adequately. Rules will then be introduced for the activities of the shadow banking system that can generate systemic risks. In tracing the new perimeter of regulation, the FSB will concentrate on those currently unregulated bodies that engage in credit intermediation with maturity transformation that are currently unregulated and are therefore subject to liquidity risks. The extension of the perimeter should follow the principle that similar activities and risks must be subject to the same rules.

It is now essential to ensure the complete implementation of the new rules, as scheduled and in all the different jurisdictions. The United States and Europe have a key responsibility. National interests must not prevail, otherwise the credibility of the reform and financial stability itself will be undermined. Intermediaries cannot call for shared rules to ensure a level playing field and at the same time seek competitive advantages through their less strict application at national level.

The euro and Europe

The euro-area budget deficit should be about 4.5 per cent of GDP this year, less than half those of the United States and Japan; at 88 per cent the public debt is lower than that of the United States and far below the Japanese level; the external current account is nearly in balance. The economic recovery is gathering strength, with GDP growth not far from 2 per cent expected this year.

The Economic and Monetary Union is nonetheless faced with the most difficult test since its creation.

In three years the public debts of Ireland, Greece and Portugal have grown in relation to GDP by 71, 37 and 25 percentage points respectively.

The European surveillance of national budgetary policies revealed itself to be inadequate; it had been weakened at the initiative of the three largest countries in the middle of the last

decade, precisely when it became essential. A simple accounting exercise shows that if the rules of the Stability and Growth Pact had always been obeyed, on the eve of the crisis the ratio of public debt to GDP would have been over 10 percentage points lower in the euro area and 30 points lower in Greece. Even assuming that the worsening of budget deficits during the crisis was inevitable, at the end of last year no country's debt would have been more than 100 per cent of GDP.

For a long time the single currency concealed the differences between member countries' underlying conditions and economic policies and the absence of really binding common rules. For a long time risk premiums did not reveal the truth.

The global crisis has accentuated the perception of risk by some investors and disclosed weaknesses in the architecture of the Union. The yield spreads on member countries' securities have widened; the process was sometimes so sudden that some market segments risked paralysis.

National governments and European authorities responded to the emergency with exceptional measures, so as to limit the risk of contagion and safeguard the area's financial stability. In cooperation with the International Monetary Fund, loans were granted, conditional on rigorous adjustment plans that the countries in difficulty have undertaken to comply with.

There are no shortcuts available. The response to the debt crisis is first and foremost in national policies, in the complete implementation of the adjustment plans that have been agreed. Solidarity among the member countries of the Union must be matched by a sense of responsibility and compliance with the rules. The financial support of euro-area governments allows countries to proceed with adjustments sheltered from market volatility. It is not a fiscal transfer between countries and is subject to stringent conditions.

The return to financial health is possible. In the last few months I have frequently recalled Italy's experience at the beginning of the 1990s, when the country was faced with a major crisis of confidence in the sustainability of the public debt. Every year, we had to place securities on the market worth, in real terms, ten times Greece's current annual borrowing requirement and twice its value in relation to GDP. Italy overcame this crisis without any assistance from abroad, thanks to an ambitious budgetary consolidation plan, important structural reforms, and a programme of privatizations amounting to around 10 per cent of GDP.

Beyond the emergency, some important steps have already been taken to tackle the known but long neglected underlying weaknesses of the European architecture.

The proposals of the EU Commission and Council reinforce surveillance over budgetary policies. They can be made more ambitious by making procedures more automatic so as to shield them from the arbitrary nature of political negotiations. The European Parliament can have an important influence in this regard.

As was hoped, rules similar to those governing national budgets will be extended to the surveillance of situations of macroeconomic imbalance, with special consideration for the state of member countries' external accounts.

A commitment to reinforce the competitiveness and convergence of the national economies has been undertaken with the Euro Plus Pact, which nevertheless needs to be made more binding.

The new European supervisory authorities began operating at the start of the year. The European Systemic Risk Board (ESRB) is laying the foundations of the system to prevent and, where necessary, manage situations that are critical for financial stability. The European Banking Authority (EBA) will consolidate supervisory rules and practices, which are currently fragmented at national level.

Monetary policy

The Eurosystem has played a crucial role in countering the effects of the crisis. The credibility it has gained over the years has enabled it to keep inflation expectations steady and to act with the speed and flexibility demanded by extraordinary circumstances.

Thanks to measures designed to ensure the supply of liquidity to the markets, the European Central Bank has avoided the collapse of the financial system. It has rapidly reduced the policy rate to 1 per cent, the lowest level ever reached by official rates in the euro-area countries.

Since the end of last year, the large rises in raw material prices have pushed the inflation rate to over 2 per cent. The ECB Governing Council has re-asserted its determination to prevent international price trends from provoking, apart from the inevitable short-term effects, a deterioration in inflation expectations. At its meeting in early April the Council raised official rates by 25 basis points. Even with this measure, monetary conditions remain accommodating.

The grave repercussions of the sovereign debt crisis for the functioning of the financial sector have necessitated exceptional measures, as at the height of the financial crisis in 2008 and 2009. Extraordinary measures to refinance the banking system that had been discontinued earlier have been revived; a programme of purchases of sovereign debt securities issued in the euro area (the Securities Market Programme) has been launched.

These measures are by nature temporary and designed to safeguard the mechanism by which monetary policy impulses are transmitted to the economy; in the case of the SMP, moreover, they are for a limited amount and the effects on the monetary base are fully sterilized.

The ECB has the task of ensuring price stability in the medium term; monetary stability represents its fundamental contribution to growth. Future monetary policy decisions will always be guided by this primary objective.

Neither the existence of sovereign risks nor some banks' abnormal dependence on ECB financing can divert it from this objective.

It falls to the national governments to speed up the consolidation of their public finances and implement structural reforms that will raise the potential growth rate of their economies. It falls to the financial intermediaries to continue resolutely towards restoring healthy balance sheets and strengthening their capital base.

The Italian economy

Italy's budget deficit, which this year is close to 4 per cent of GDP, is smaller than the euro-area average. According to official forecasts it will be brought below 3 per cent in 2012. The debt, however, is approaching 120 per cent of GDP.

The objective of achieving budget balance in 2014 is appropriate, as is the plan to bring the definition of the budget adjustment package for 2013–14 forward to this June.

Thanks to the social security reforms introduced in the middle of the 1990s, to a banking system that has not needed government bail-outs, and to prudent management of expenditure during the crisis, the effort we are required to make is less than for many other advanced countries.

Without sacrificing capital expenditure more than the current planning scenario already envisages and without increasing revenue, primary current expenditure must be further reduced, by more than 5 per cent in real terms in the period 2012–14, returning to the same level, in relation to GDP, as at the beginning of the last decade.

It would be inadvisable to seek a permanent and credible reduction of expenditure by cutting items uniformly across the board: this would make it impossible to allocate resources where they are most needed; it would be difficult to sustain over the medium term; it would penalize the more virtuous government departments. A budget of this kind would weigh on the already weak economic recovery, subtracting about 2 percentage points of GDP over the three years.

What is needed, instead, is a skilfully designed package, based on a thorough analysis, item by item, of the accounts of the public-sector agencies, allocating funds according to today's objectives regardless of past expenditure; refining the indicators of efficiency for the various public service centres (offices, schools, hospitals, courts) so as to introduce widespread improvements in the organization and functioning of the units; maintaining the drive to make the public administration more efficient; and channelling a part of the resulting savings towards investment in infrastructure.

Substantial reductions should be made in the high rates of taxation of labour and corporate income, offsetting the loss of revenue by making further progress against tax evasion, beyond the truly appreciable amounts the authorities have recently recovered.

Timely, structural budget measures that are credible in the eyes of international investors and designed to foster growth could, among other things by significantly reducing the risk premiums weighing on Italian interest rates, greatly limit the adverse effects on the economy.

Fiscal federalism can help by making all levels of government accountable, imposing strict budget constraints and involving citizens more closely in public affairs. There are two essential conditions for this: offsetting the new local taxes with cuts in central government taxes, not summing them; and providing for strict monitoring to ensure legal conduct on the part of the bodies accountable, under decentralization, for spending.

Growth

Since the start of the recovery, two summers ago, the Italian economy has recouped only 2 of the 7 percentage points of output lost in the recession. In the first quarter of this year its growth rate was barely positive.

In the course of the past ten years, Italy's gross domestic product has increased by less than 3 per cent; that of France, with about the same population, by 12 per cent. The gap perfectly reflects the difference in hourly productivity – stationary in Italy, up by 9 per cent in France. Italy's disappointing result applies to the country as a whole, North and South alike.

If productivity stagnates, our economy cannot grow. The productive economy loses competitiveness; widening deficits appear in the current account of the balance of payments. Foreign direct investment dries up. In the course of a decade, Italy received foreign direct investment inflows equal to 11 per cent of GDP, compared with 27 per cent in France.

Wage growth is modest in Italy, as it cannot diverge too sharply from productivity growth: this has repercussions on domestic demand. The real earnings of employees in Italy have been virtually stationary over the past decade, compared with a gain of 9 per cent in France; real household consumption, which has risen by 18 per cent in France, has grown by less than 5 per cent in Italy and only by eroding the propensity to save.

Productivity in Italy is stagnating because the system has not yet adapted sufficiently to the new technologies, or to globalization. Understanding the reasons for this has been the aim of much of the research conducted by the Bank of Italy in recent years. I have reported on it several times, most notably in these annual remarks. Our analyses point the finger at Italy's productive structure, which is more fragmented and static than in other economies; and at government policies that fail to encourage, and often hamper, its development.

The problem of the inefficiency of civil justice has to be tackled at the root. Ordinary lower court cases are now estimated to last more than 1,000 days, putting Italy in 157th place out of the 183 countries covered in the World Bank's rankings. The consequent uncertainty is a major factor of friction in the economy as well as the source of injustice. According to our estimates, the shortcomings of the civil justice system in Italy could subtract up to one percentage point a year from GDP growth.

We must proceed with the reform of the education system, on which a start has been made, in order to raise our levels of academic achievement, which are among the lowest in the Western world even with equal expenditure per student. The disparities within Italy remain unacceptably wide, between North and South and between different schools within the same area, even at the level of compulsory education. At the university level, more competition between institutions is desirable in order to establish centres of excellence that can compete in the world arena. The number of university graduates is still low by international standards. According to OECD estimates, the gap between the Italian education system and global best practices could depress the rate of GDP growth by as much as one percentage point in the long run.

Competition, which is well rooted in a good part of industry, is making very slow headway in services, especially public utilities. What is wanted is not unrestrained privatization but a system of regulated competition in which the customer, the citizen, is better protected. The challenge of growth cannot be left solely to the enterprises and workers that are directly exposed to international competition, while positional rents and monopoly advantages in other sectors depress employment and undermine the country's overall competitiveness.

Italy lags behind the other main European countries in its endowment of infrastructure, despite having had a higher ratio of public infrastructural spending to GDP from the 1980s until 2008. Under the Government's programmes the ratio is set to fall to 1.6 per cent in 2012, down from 2.5 per cent in 2009; on average in the euro area, the planned expenditure for 2012 is 2.2 per cent of GDP, down from 2.8 per cent in 2009. Uncertainty in planning, deficiencies in project evaluation and public works selection, fragmentation and overlapping of powers, and inadequate rules on contract awards and project controls result in public works that are less useful and more costly than elsewhere.

The execution time for projects financed by the European Regional Development Fund is nearly twice as long as scheduled in Italy, compared with average overruns of just one quarter in the rest of Europe, and cost overruns are 40 per cent as against 20 per cent. In high-speed rail projects and for motorways, the average cost per kilometre and the realization time are greater than in France and Spain to an extent only partially justified by the different topographical conditions.

It is essential to restore efficiency in expenditure, in order among other things to make the most of project financing and Community resources, which do not burden the Italian public finances.

To date, only about 60 per cent of the motorway network enlargements provided for in the 1997 agreement between the National Road Agency and the main motorway concessionary have been completed, and under 30 per cent of those decided in 2004, while the latest plan, that of 2008, is still under study. The works to be realized are worth €15 billion. Only 15 per cent of the Community structural funds at our disposal has been spent; the unspent portion amounts to €23 billion, to be associated with the required national cofinancing. Speeding these projects up would have a considerable impact on economic activity.

The spread of part-time and fixed-term employment contracts in the past fifteen years has helped to raise the employment rate, but at the cost of creating a pronounced dualism within the labour market: on the one hand the better-protected workers with permanent jobs and on the other a vast area of precarious employment, especially among young people, with little protection and low earnings. A more balanced approach to labour market flexibility, which today depends almost entirely on entry mode, would let young people set their sights higher.

It would spur firms to invest more in the training of human resources, to integrate them into the production process and to offer them better career prospects.

The industrial relations system must foster the modernization and competitiveness of the productive economy, in the interests of both sides.

Steps have been taken to strengthen the role of company-level bargaining, but the predominance of industry-wide bargaining and the lack of definite rules governing trade union representation still limit the possibility of workers' entering into commitments vis-à-vis their firms and weaken their ability to affect their own wages and job security.

Women's low labour market participation is a crucial weakness of the Italian economy, and one on which we are now concentrating our research effort. Today, 60 per cent of Italy's university graduates are women. They earn their degrees faster and with a better academic performance than their male fellow-students; and they are less and less restricted to the traditional women's disciplines in the humanities. Yet the employment rate for women is still no more than 46 per cent, 20 points less than for men. It is lower than in practically every other European country, especially in the higher positions and among women with children. Holding education and experience constant, women's earnings are 10 per cent lower than men's. Women still devote a great deal more time to home and family in Italy than in other countries. Greater availability of services would help, as would the organization of work to facilitate the reconciliation of family and job commitments and an attenuation of the implicit tax disincentives for women's work.

The social safety net must guarantee adequate income support to anyone who loses a job and is actively seeking another. The fate of those working for firms that can no longer survive in the marketplace must be made less dramatic, in order not to impede the natural turnover of enterprises.

Enterprise and finance

Italy's entrepreneurs and workers have the skills and the energy to lift the pace of growth. In spite of crisis and recession, our business surveys of recent years have revealed great vitality in many enterprises.

But those skills and those energies are fragmented.

Italian firms, on average, are 40 per cent smaller than their euro-area counterparts. The top 50 European corporations by sales include 15 German and 11 French but just 4 Italian firms. Italy's industrial structure seems static; rarely do firms grow and move up to the next size class.

In the early 1960s, plants with over 100 workers employed 43 per cent of Italy's manufacturing workers, as against over 60 per cent in France and Germany. Since then the employment share of large plants has declined much more sharply in Italy than in France or Germany, to under 30 per cent.

The flexibility typical of small firms, which in the past helped to sustain Italian competitiveness, is no longer enough today. We need more medium-sized and large firms that can move rapidly and effectively into international markets and exploit the efficiency gains offered by technological innovation.

When one of our firms has a chance to expand, it may be deterred not only by a fiscal, regulatory and administrative framework still perceived as uncertain and costly but also by corporate structures that are often kept impermeable to outsiders. Widespread family control of businesses is not a specifically Italian phenomenon; what is, is the restriction of management to the family circle. Sixty per cent of all Italian manufacturing firms with ten or more workers are exclusively family controlled and managed, compared with

under 30 per cent in Germany and France. These firms have less propensity to innovate, engage less in research and development, and rarely penetrate emerging markets.

The average Italian firm has less equity capital than its counterparts in the other advanced countries. There is little diversification of sources of funding – consisting largely in bank credit – and the incidence of short-term debt is high.

To encourage recourse to equity capital, as part of a comprehensive redistribution of public revenue and expenditure the taxation of the share of profit corresponding to the remuneration of equity should be reduced. Including the regional tax on productive activity, the statutory tax rate on company income in Italy is nearly six percentage points above the euro-area average.

Banks and banking supervision

Banks have stepped up their lending to firms markedly, in response to the recovery in demand for working capital: the increase amounted to 5.2 per cent on an annualized basis in the three months ended in April; the rate of growth in the twelve months to April was 4.4 per cent, the highest among the main countries of the euro area.

The ratio of new bad debts to outstanding loans remained high in 2010, at 1.9 per cent, though far below the figure recorded after the recession of the early 1990s. The data for the first few months of this year signal improvement.

Many intermediaries have supported customers by granting debt restructurings or loan repayment moratoria. Such measures, which rarely provide for capital increases or new business plans, must be targeted at firms actually capable of overcoming the crisis and not be merely a way for banks to put off booking losses.

Small banks have provided support to the economy, including during the recession. They have expanded their business both outside their territory and with large customers. They must now make their governance arrangements, organizational structures and credit risk control systems adequate to their larger shares of intermediation.

The cost and availability of the funds that banks can raise on the markets have been affected by the pressures on sovereign debts. Our leading banks have nearly completed their funding programmes for this year, albeit at higher costs and with 40 per cent in the form of covered bond issues.

A third of the bank bonds now outstanding will mature by the end of 2012; this is a significant share but similar to that of the main European banks. Compared with the intermediaries of other countries, which rely more heavily on wholesale funding, our banking system benefits from a broad base of retail funding, which is relatively less sensitive to the volatility of the markets.

Italian banks' liquidity position, monitored constantly by the Bank of Italy, has remained balanced as a whole. Their holdings of assets eligible as collateral in Eurosystem refinancing operations are substantial; recourse to such operations is more limited than that of other euro-area banking systems.

Since last year the Bank of Italy has asked banks to strengthen their capital bases. Shareholders, banking foundations and investors have responded readily.

Between October 2010 and April of this year capital increases totalling more than €11 billion were launched. The majority of these operations will be completed by the autumn. They make it possible to approach the objective set by Basel III for 2019.

It is commonly thought that an increase in banks' equity translates into higher costs for customers and ends up braking the growth of the economy. However, quantitative studies show that a stronger capital base for banks has a positive net effect on the economy: it

increases the system's ability to withstand adverse shocks and reduces the likelihood of crises; for individual intermediaries, it reduces the risk premium on fund-raising and the cost of equity capital itself.

A recovery in earnings makes it possible to increase capital internally. In 2010 the five largest Italian banking groups' return on equity was again about 4 per cent, compared with an average of 7.8 per cent for twelve large European intermediaries. Sluggish asset growth, higher funding costs and low credit quality were the main factors.

The gains in operating efficiency achieved before the crisis must not be lost. The rationalization of distribution networks must continue.

Good governance encourages investors to supply capital.

Cooperative banks listed on the stock exchange need more effective controls on the activity of directors, greater participation of the shareholders in the annual meeting, including by means of proxies. As I have had occasion to remark in the past, a legislative measure is necessary; amendments to bylaws, which we have nonetheless called for, cannot be the definitive solution.

The quality of the banking foundations' governance and internal control arrangements, the safeguards to preserve their independence and prevent conflicts of interest, and the efficiency and transparency of their financial operations are crucial in order to reconcile their holding bank equity with banks' operating autonomy.

In our country there was no banking crisis. However, the recession, by aggravating weak situations that already existed, has produced a rise in the number of provisional management, special administration and liquidation procedures. In line with international guidelines, we now have to revise the framework of rules in two ways: expanding the spectrum of crisis resolution measures; and giving the Bank of Italy, as supervisory authority, the power to remove corporate officers responsible for conduct harmful to the sound and prudent management of a bank.

Suitable rules alone are not enough to ensure good supervision: without strong operating practices, without stringent and efficacious action, crises will not be averted. This has been made abundantly clear by the dramatic recent experiences.

With the Bank of Italy's supervisory role, our country has been able to count on a solid tradition.

We have strengthened the most valid aspects of that tradition: the principles of a rigorous supervisory approach that was never converted to the "light touch"; supervision ready to persuade if possible, to prescribe if necessary, within the limits of law, performed by well-prepared and upright public servants.

On-site supervision is now more closely targeted and more selective, with better use made of our resources. Targeted inspections and thematic inspections, which enable us to assess the same risk profile for multiple intermediaries, have taken their place alongside the all-encompassing inspections carried out at long intervals.

We have forcefully safeguarded the principles of transparency and begun an open dialogue with the banking industry and the public, making good use of consultations on our measures.

We are acting to strengthen the protection of banks' customers, at one and the same time a civil value and an essential component of confidence in the banking system, failing which there can be no lasting stability.

In this delicate phase in which the system is called upon to implement new, stricter international rules, the Bank of Italy is acting on two fronts: on the one hand, we are working in international fora to see that the rules take the specific characteristics of Italian banks into due account; on the other, we have worked closely with our banks to ensure that they fully

conform with the evolving rules, especially the definition of capital components, and accordingly are able to stand up well under international examination.

The results of this action up to now have been encouraging. It is in the interest of all to preserve them.

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The Governor's annual concluding remarks have always represented an occasion for voicing assessments. This time they also provide the chance to look back over these five years.

My constant theme has been the problem of our country's economic growth. It is not a new problem, but I do claim for the Bank of Italy the credit for having made it the top economic policy priority. What kind of country will we leave to our children? Many times we have pointed to objectives, suggested lines of action, indicated areas for intervention. Five years on, seeing how little of all this has been translated into reality, the "useless sermons" of a far more illustrious predecessor of mine come to mind.

Why doesn't the political system – which alone has the power to translate analysis into law – take to heart Cavour's dictum that "reforms, when enacted in time, do not weaken authority but reinforce it"?

Thanks to hard work, ingenuity and sacrifice, in the 150 years of its history as a nation Italy has made enormous progress in the material conditions of life. We have experienced periods of booming growth. During the first fifteen years of the twentieth century per capita gross domestic product increased by 30 per cent. In the fifteen years following the Second World War, it rose by 140 per cent. In each of these historical periods Italy demonstrated a fundamental unity of purpose: in its capacity to withstand the trials of the First World War and in the civic and moral mobilization that, notwithstanding the heterogeneous political forces involved, resulted in our Republican Constitution.

In other periods in our history, progress and growth were hampered by divisions, factional strife, a weakening of trust between the citizens and the State. Many disparities, above all that between North and South, have been overcome only in part. Diversity has been one of Italy's historical characteristics, more than in other countries. Not infrequently, instead of being a source of enrichment the differences have been transmuted into mutual vetoes, the blockage of development.

Our condition today is better in many respects. In large part, age-old conflicts have been superseded. The progress towards ever more advanced forms of integration in Europe and a new, shared diagnosis of the problems afflicting the economy in Italy offer good starting points. We must achieve unity of purpose on the fundamental lines of action. What unites us is more powerful than what divides us.

Today, first of all the public budget must restored to its proper role as a factor of stability and an engine of economic growth, bringing it into balance without delay, revising the composition of spending to favour growth, and easing the heavy tax burden on so many honest workers and entrepreneurs.

Economic growth does not stem solely from economic factors. It depends on public institutions, on citizens' faith in them, on shared hopes and values. It is these same factors that determine the progress of a nation. To cite Cavour again: "A nation's political resurgence can never be divorced from its economic resurgence. … Civic virtues, wise laws affording equal protection to each and every right, sound political arrangements, essential to the betterment of a nation's moral condition – these are also the prime cause of its economic progress." The intertwined vested interests oppressing the country in so many ways must be eliminated. This is an essential condition for joining solidarity with merit, equity with competition, for renewing the country's prospects for growth.

In March 2006, in my very first public speech as Governor of the Bank of Italy, I noted that the Italian economy appeared to be weighed down, but that its structural lags were not to be taken as signs of inevitable decline. They could be faced and matters clearly explained to the public, even when the solutions ran counter to the short-term interests of some segments of society. A few weeks later I opened my address to you in this forum with the words "Returning to growth". It is with these same words that I would like to close these concluding remarks.