

## **Mario Draghi: Italy's path towards stable growth**

Address by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the Annual Meeting of the Italian Banking Association Rome, 13 July 2011.

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### **The crisis and the euro**

Growth prospects and the financial markets are being influenced by the sovereign debt crisis. Despite the decisions taken by the Greek Parliament and the Eurogroup, the tensions have increased and spread, partly owing to the inertial nature of processes of this kind. It is essential that the countries that have agreed an adjustment programme with the European Union and the International Monetary Fund continue the considerable efforts they have made to date. The European Council has reaffirmed its commitment to the financial stability of the euro area. In no country is there an alternative to credible fiscal consolidation, the necessary, but not sufficient, condition for strengthening the outlook for growth.

For years interest rates in the various parts of the euro area did not diverge significantly from those obtaining in Germany. For a long time the spreads between sovereign securities and German Bunds remained narrow and the interest rates charged by banks reflected the credibility of the public securities of the euro-area countries. This is no longer the case: the solvency of sovereign states has ceased to be a foregone conclusion but something that has to be won in the field with rapid and sustainable growth, which is only possible with sound public finances. Interest rates reflect today's new situation: they are higher for countries with low growth and weaker public finances. The cloak of credibility provided by the stronger euro-area countries has been lifted; we must grow without relying on its shelter. The structural reforms invoked for years are now even more crucial.

On several occasions I have noted that Europe reacted to the global financial crisis by drawing on the credibility of the ECB and the latter's timely and innovative conduct of monetary policy and by equipping itself with a more appropriate set of economic governance tools. We now have a system of autonomous authorities for banking and financial supervision, a European body to monitor and mitigate systemic risks, and new procedures for the coordination of fiscal and structural policies.

The present crisis is also an opportunity, however, to reflect on the limits of the action taken to date at European level. A new phase has begun. It has to be recognized that in the handling of financial crises recourse has not infrequently been made to partial and temporary measures, thereby increasing the uncertainty on financial markets. It is now necessary to give certainty to the procedure for handling sovereign crises: by clearly defining the political objectives, the instruments and the volume of resources. This is needed to ensure the stability of the area and its currency, and to take full advantage of the strength of its economy and monetary and financial situation.

### **The Italian economy**

The Italian economy is benefiting from the expansion of world trade. Compared with many other advanced countries, it has the advantage of a solid banking system. The unemployment rate has been falling since the autumn. After six months of barely positive changes, in the second quarter Italian GDP grew at a rate in line with the euro-area average.

In the medium term the growth rate of the Italian economy is expected to remain below that of our main European partners. The Bank of Italy's Economic Bulletin, to be published on Friday, will contain our detailed assessments for 2011–12.

The tensions of the last few days involving Italian government securities and share prices were due in part to the uncertain outlook for the public finances.

The budgetary adjustment prepared by the Government is an important step in the consolidation of the public finances. The measures before Parliament give impetus to the process of reducing the public debt. This year will see a significant primary surplus; according to European Commission estimates, next year it will grow further and be the largest in the euro area. Having moved in advance of the normal deadlines, the additional measures needed to achieve a balanced budget in 2014 must now be rapidly established. This is what the markets are mainly looking at. There is a risk that these measures will distort the structure of the adjustment, appropriately based to a large extent on expenditure cuts. Unless other expenditure items are also cut, it will not be possible, however, to use the power to enact tax and welfare reforms to complete the adjustment in 2013–14 without raising taxes.

But, as for the other euro-area countries, the consolidation of the public finances must be accompanied by an increase in our economy's growth potential by the timely adoption of effective and credible structural policies, together with consistent behaviour on the part of all the key figures in the country's political and economic life.

### **The regulation of international finance**

In my latest Concluding Remarks I referred to the agenda for the coming months: after establishing the requirements for capital and the measures to be adopted with regard to leverage and liquidity, the Financial Stability Board and the Basel Committee, at the instigation of the G20, are now working on the two main issues that remain to be addressed: systemically important financial institutions (SIFIs) and the shadow banking system. Proposals will be submitted to the G20 in November.

With regard to SIFIs, the proposals are now broadly established. Before the end of the summer there will be a public consultation on the mechanisms for overcoming crises and the measures needed to increase SIFIs' ability to absorb losses.

Provision is made for global SIFIs to have a larger capital endowment than other intermediaries. The additional buffer for the SIFIs that are identified is to vary between 1 and 2.5 per cent of their risk-weighted assets, depending on their systemic importance as measured by an indicator that takes account of their size, complexity, interconnections with other intermediaries, international operations and specialization in certain fields of activity. The augmented requirement will have to be met with capital of the highest quality. Implementation will proceed gradually starting in 2016. The new regime will be fully in force at the beginning of 2019.

As for the shadow banking system, the Financial Stability Board has decided to concentrate on highly leveraged activities that involve maturity transformation or that can give rise to regulatory arbitrage. Proposals are being prepared. In Italy, financial regulation, which has recently been strengthened, already covers all the financial institutions that deal with the public.

A frequent topic concerns the effect of the new international standards on bank-based systems, such as Italy's, with a large number of small and medium-sized enterprises; it is rightly noted that banks with basically different balance-sheet structures and equally different risks should not be treated in the same way.

The risk-weighting of banks' assets is crucially important. Basel II assigned a much lower weight to purely financial activities than to lending, in which Italian banks are specialized. This is why Italian banks, when subject to international comparison on the basis of current data, appear better capitalized in terms of financial leverage than risk-weighted assets. The decision to treat financial assets more favourably was based on the implicit assumption that

the markets in which they were traded would always be liquid. The crisis dramatically demonstrated the fragility of this assumption and the need to rebalance the system of weights.

This is the direction taken with the recent regulatory reforms, against the background of a significant overall strengthening of the quality and the quantity of capital.

Recently, the capital requirements for trading portfolio exposures have been increased and the prudential treatment of the risks associated with securitizations and off-balance-sheet vehicles has been tightened. Basel III has increased the stringency of the calculation of the capital requirements for counterparty risk in connection with derivative transactions. The whole matter is now undergoing a fundamental revision by the Basel Committee in order to eliminate any discrimination of loans with respect to trading assets. The Bank of Italy is working in the technical fora to proceed in this direction with determination.

At the same time (it is worth recalling) the new rules confirm the facilitations, already present in Basel II and invoked by the Italian supervisory authorities, that, other things being equal, allow a lower weighting for loans to small and medium-sized enterprises.

### **The Italian banks and the action of the supervisory authorities**

Italian banks have shown, and continue to show, an ability to resist and react in times of difficulty, not only at the height of the financial crisis, when they were saved by a model firmly rooted in core banking business, but also in its aftermath, when the crisis gave way to a deep recession in all the advanced countries that hit Italy particularly hard because it came after a decade of stagnation and was followed by a slower recovery than elsewhere.

In the three months to May bank lending to households and firms grew at an annualized rate of 5.7 per cent, well above the euro-area average of 2.2 per cent. Lending to firms grew by 6.1 per cent and that to households, driven mainly by loans for house purchases, increased by 5.2 per cent. The rapid expansion in lending to firms is ascribable to the growth in demand, sustained by the need to finance inventories and working capital.

The deterioration in credit quality was much less serious than during the recession of the early 1990s, which was not as deep. Although still substantial, the flow of adjusted bad debts, especially of firms, is beginning to show signs of slowing. Compared with a year earlier, in April there was a decrease in banks' exposure to borrowers reported for the first time with positions classed as bad debts.

There has not been a housing bubble in Italy; the banks' losses in this sector have been limited on the whole and have not sparked a crisis. The low level of nominal interest rates has helped to avoid a vicious circle in which borrowers with temporary liquidity difficulties suddenly become submerged by financial burdens even when the firm's economic prospects are good.

The banks benefited from strong local roots, which ensured stable sources of funds and underpinned the qualitative assessment of their creditworthiness, and from a fundamentally unadventurous corporate culture.

The test was, and still is, a hard one, though.

We insisted that the banks strengthen their capital without delay. This was not only because they need to move progressively into line with the new international standards, but also because the present situation demands it. They responded without hesitation, giving the lie to the sceptics. Their shareholders, including leading institutional investors, understood the need for this step.

Since the beginning of this year the Italian banks have made or approved huge capital increases.

The core tier 1 ratio of the five largest banking groups averaged 7.4 per cent at the end of 2010; in March it had increased to 7.8 per cent and it is estimated to have risen further still, to 8.6 per cent, as a result of subsequent recapitalizations. The banks have readied themselves in time for the European stress tests, as we asked them to do, and the results will be published in a few days' time. We are confident they will be well above the threshold of 5 per cent for the core tier 1 ratio.

The capital strengthening that the Italian banking system needs to implement in order to meet the new Basel III requirements by 2019, which was estimated at €40 billion in relation to June 2010, is now about €20 billion.

We are making good progress.

For the future, the progressive increase in banks' capital will be essential to ensure the growth of lending while guaranteeing the sound and prudent management of the banking system. It is very important that the tax treatment of intermediaries should not discourage them from strengthening their capital.

It was a wise decision to bring bank bond issues scheduled for 2011 forward to the beginning of the year. The volume of securities already issued by the leading banks is equal to the entire stock of bonds due for redemption during the year. Despite the sacrifice in terms of cost, both gross and net bond funding has increased significantly, the former totalling €31 billion from July 2010 to June 2011 whereas it was negative twelve months earlier. Overall, deposits and bonds rose by 1.8 per cent in May compared with a year earlier.

The Bank of Italy continues to call on the banks to maintain balanced liquidity positions. This policy was introduced well before international liquidity standards were first discussed in Basel. It has helped to shelter the Italian banking system from the financial storm; it continues to be necessary in the face of persistent market instability. Convergence towards the Basel liquidity standards, the details of which are not yet fully defined, will take place gradually, according to plan.

In the first quarter of 2011, the profitability of the five largest banking groups improved somewhat with respect to a year earlier. The annualized rate of return on equity rose from 3.0 to 3.4 per cent. Losses on loans decreased by 12 per cent, but they still absorb almost half of the banks' operating profit.

The improvement is encouraging; it should continue in the coming months when the recovery in lending reflects positively on banks' earnings.

However, for the banks to return to satisfactory profitability it is essential that they persist with their efforts to reduce costs. Some groups are taking steps to rationalize their networks; these must be pursued with determination. A difficult round of labour negotiations awaits the banks, during which they must reconcile the need to reward the professionalism and productivity of employees with the impelling need to ensure that the evolution of costs is in line with the sector's economic prospects.

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There are favourable factors we can rely on to carry forward the consolidation of the public finances, overcome the emergency now overshadowing the economic outlook, and set Italy on a path towards stable growth. We have the advantage that private sector debt and the country's overall net foreign debt are both limited. Our banks are sound; they have emerged unscathed from the financial crisis that shook large foreign institutions. We possess fundamental resources that have always characterized the Italians: individual initiative, ability to innovate, willingness to work. We must believe in our economy's capacity for growth. We must find a common goal, above and beyond individual and factional interests. We must rediscover how to act for the good of all.