

Antonio Fazio: Economic developments and the banking system

Address by Mr Antonio Fazio, Governor of the Bank of Italy, at the Italian Bankers' Association Annual Meeting, Rome, 13 July 2005.

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The expansion of economic activity in the euro area is proceeding slowly.

In 2004 euro-area output rose by 2 per cent, compared with 5 per cent for the world economy; GDP growth was 2.3 per cent in France, 1.6 per cent in Germany and 1.2 per cent in Italy. Euro-area growth this year will be lower than in 2004.

Germany's economy is suffering from the weakness of domestic demand, Italy's from a progressive loss of competitiveness.

In the early months of this year the euro-area index of industrial production continued to waver. In the spring the cyclical indicators signaled the persistence of a very cautious attitude among firms and households. Incipient signs of recovery have appeared recently; in France and in Germany, the climate of confidence among industrial firms improved in June for the first time since the start of the year; the euro-area index based on surveys of purchasing managers has risen.

The Italian economy faces the second half of the year starting out from conditions that are less favourable than those of the other main countries of the area. The fall in output in the fourth quarter of 2004 and again in the first three months of this year has made the fragility of our productive system more evident. By comparison with 2000, in January the negative gap between Italy's index of industrial production and the euro-area average was equal to 8.1 percentage points, the widest in the last four years.

The erosion of competitiveness in the international markets under way since the middle 1990s is continuing. Since 2000 Italian exports have contracted by 4.9 per cent, while the exports of the other euro-area countries have grown by 17.2 per cent. The problems of competitiveness have continued to weigh especially on firms in the Centre and North and on smaller firms.

Price strains have not emerged. Inflation has benefited from wage moderation and the appreciation of the euro; it has also been influenced by the weakness of demand. Looking ahead, the rise in oil prices and the performance of the euro could have a negative impact. Household spending is being held down by uncertainty about the outlook for income and employment; the propensity to save

has been rising since 2000.

In the first quarter of this year investment in construction fell further. After declining in the second half of 2004, productive investment staged a slight recovery.

In April industrial production picked up sharply from the low levels to which it had fallen in March; the estimates for the subsequent two months indicate that the index has fallen, but not enough to cancel out the April rise.

The progressive decline of production levels in industry appears to have come to an end. After the pronounced fall recorded in the first quarter, GDP is expected to return to growth, albeit modest, in the second.

The banking system

Italian banks are continuing to ensure an ample supply of credit.

Bank lending rates are very low. In May the cost of short-term credit for businesses was 4.9 per cent in nominal terms, and 1.2 per cent net of the change in producer prices. The overall effective interest rate on loans to households for house purchases was 3.8 per cent, or 1.9 per cent net of inflation. In the middle of the 1990s lending rates were above 10 per cent and more than 6 per cent in real terms.

Despite growing concern about the evolution of the business cycle, the periodic surveys of the leading banking groups have not picked up signs of a tightening of credit disbursement standards. Lending is expanding rapidly. In the first few months of 2005, accommodating the strong demand of households and the more moderate demand of firms, it grew at a rate of more than 8 per cent, about

two percentage points higher than the euro-area average.

Fueled by low interest rates, the increase in credit to households has stabilized at around 15 per cent since mid-2004. A decisive factor in all the regions of Italy has been the expansion in loans for house purchases. In 2004 new mortgage loans amounting to €49 billion were granted; disbursements in the first quarter of this year were 11 per cent up on the corresponding period of 2004.

Households' access to credit is also facilitated by the marketing policies banks are pursuing; under the stimulus of competition, they have diversified supply, adapting it to the needs of customers. Fixed-rate mortgage lending is relatively underdeveloped by international standards: about 80 per cent of outstanding loans for the purchase of houses are at variable rates or rates renegotiable within one year.

In addition to real-estate lending, consumer credit granted by banks and financial companies is also expanding rapidly.

Italian households' debt is very low by international standards. The risks to the financial system from the rapid growth in lending to households are limited. At the end of 2004 household debt was equal to 28 per cent of GDP in Italy, compared with a euro-area average of 55 per cent and about 90 per cent in the United States and the United Kingdom.

Partly as a consequence of subdued investment, the financial conditions of firms have remained good on the whole. In 2004 firms' operating profits were higher in relation to value added than during the cyclical downturn of the early 1990s. However, the data for the sample of around 40,000 non-financial corporations surveyed by the Company Accounts Data Service show a fall in profits in the period 2000-03, notably in the textile, clothing and transport equipment sectors.

Firms' interest expense has diminished thanks to the reduction in interest rates, due in part to the lengthening of the average maturity of corporate debt. Leverage is seven percentage points below the level of the 1990s; the average maturity of Italian firms' bank debt is gradually approaching that prevailing in the other European countries.

There continues to be rapid growth in financing to categories of firms that in the past encountered greater obstacles in gaining access to credit during cyclical downturns; credit to firms resident in the South of Italy increased by 8.5 per cent, two points more than the national average.

In the period 1996-2004 the value of mergers and acquisitions between banks in Italy accounted for 27 per cent of the euro-area total, compared with the Italian banking system's roughly 14 per cent share of euro-area bank assets.

The far-reaching transformation of the banking system since the middle of the 1990s has had positive effects on operations. Since 2001 loan quality has remained unchanged despite the weakness of the economy. At about 1 per cent the ratio of new bad debts to outstanding loans is very low by comparison with the past.

Households and firms have benefited from part of the banking system's efficiency gains through more favourable rates on deposits and loans.

In 2004 banks' profits amounted to €11 billion, or 10.7 per cent of capital and reserves, compared with 6.7 per cent in 2003. Contributing to the improvement in the results for the year were the decline in value adjustments to loans and a significant increase in net non-recurring income. Operating costs diminished by 0.5 per cent with respect to 2003. The ratio between costs and revenues was in line with the European average.

The growth in self-financing and capital increases have strengthened the banking system's capital base.

At the end of 2004 Italian banks' supervisory capital amounted to €149 billion. The ratio of capital to risk assets was 11.6 per cent; the difference with respect to the average ratio for banks of the EU countries has narrowed in recent years to about one percentage point. For the largest banking groups, the ratio of supervisory capital to risk assets has increased significantly since 2001.

Italy's banking system, like those of the other advanced countries, is adapting to the principles of the new Basel rules on capital.

In its supervisory capacity the Bank of Italy is evaluating whether banks' risk management systems satisfy the quantitative and qualitative requirements established by the new rules. Evaluation and validation are carried out by means of examination of the statistical documentation submitted by

banks, meetings with corporate officers and direct examination of the state of progress of the project and the organizational processes.

At our request, the main banking groups performed simulations of the impact of the new international accounting standards on their balance sheets. On average for the system, the results indicate larger writedowns of bad and doubtful debts and capital gains on buildings and, to a lesser extent, shareholdings. The total capital of the groups concerned would not be significantly affected. This April the Bank of Italy began a survey extended to all banking groups, with the aim of estimating the impact of the new rules on supervisory capital, on the basis of a rigorous hypothesis regarding the prudential regulations that will enter into force at the end of the year.

The supervisory action of the Bank of Italy is increasingly oriented towards forward-looking analysis whose compass includes an evaluation of the solidity of individual banks and of the system in the face of adverse events which, though highly improbable, are nonetheless possible. It proceeds through exercises designed to check the income and capital margins in case of increases in credit and market risks deriving from major negative shocks.

Economic policy

Public-sector net borrowing looks set to exceed 4 per cent of GDP this year. The negative performance of the public finances reflects the slow growth of the economy together with difficulties in implementing some of the planned budgetary measures.

Owing in part to the lapsing of one-off measures, net borrowing in 2006 will be equal to about 5 per cent of GDP in the absence of corrective action; the primary surplus will fall to nil.

The persistent contraction of the primary surplus affects the process of bringing down the ratio of debt to GDP.

The structural situation of our public finances requires continual adjustment measures, which threaten to create distortions in the management of resources and to fuel uncertainty; the scope for stabilization policies is limited. Negative effects on the cost of the debt must be averted.

It is important that the Government and Parliament decide, on the basis of the Economic and Financial Planning Document, measures for the next four years able to reduce current expenditure in relation to GDP, increase public investment and gradually diminish firms' tax burden.

As requested of Italy by the Council of Finance Ministers of the European Union, it is necessary to reduce the deficit below the threshold of 3 per cent by 2007.

A return to higher rates of growth that are compatible with the available resources cannot be achieved without a renewed and effective commitment of economic policy to changing the structure of production.

The reduction of the tax burden on businesses should facilitate the growth in size of firms, technological innovation and investment. The efforts to make the operation of public services more efficient and to create a more stable legislative framework need to be intensified. Competition must be strengthened.

Firms must expand their scale of production, increase the professionalism of their managements, orient their specialization towards more dynamic and innovative sectors, and increase their presence in some technologically mature but high-quality segments of the international market.

The financial system must assist firms in this difficult phase of transformation, directing resources towards the companies and projects with the greatest potential.

The growth of pension funds will be of great importance for the financial market and for the supply of capital to the banking sector.

The outlook

Economic activity probably reached a low in the first quarter of this year. The figure for GDP is expected to show an increase, albeit modest, for the three months from April to June.

It is necessary that the still hesitant recovery gain momentum in the second half of the year.

If it does, we will be able to avoid a contraction in GDP this year with respect to 2004, and to achieve growth of more than 1 per cent in 2006.

The performance of GDP this year and next must be along these lines in order to give substance and credibility to the scenario projected for the public finances.

As we underscored on 31 May to the General Meeting of Shareholders of the Bank of Italy, investment is finding it hard to gain momentum, consumer demand remains weak, and the outlook for exports remains uncertain even in a favourable international context.

There is a need for a commitment by the Government, the social partners and firms not to lose the opportunity to reverse our economy's negative trend.

Thanks to the progress made in the last decade, banks are in a position to finance the growth of production and investment. When the difficulties of businesses are cyclical and transitory, banks can, indeed must, contribute to safeguarding production capacity.

Recourse to the Wage Supplementation Fund in industry covered a number of hours equivalent to about 26,000 full-time employees in the first half of 2001; it rose rapidly in 2003 to 48,000 employees. In the early months of this year it rose further, to 58,000 employees. Use of Wage Supplementation has increased especially in the machinery and textile sectors.

Where it is possible and appropriate, banks must work for the restructuring and reorientation of production capacity and assist the business sector in the process of consolidation aimed at augmenting the average size of firms.

A major banking merger at European level has as its protagonist an Italian bank that had previously completed its own restructuring and consolidation in the context of the general reorganization of banking that began in the middle of the 1990s.

Market transactions are under way for the acquisition of control of two important banks.

Once the authorization procedures are concluded, it will be the shareholders, the market, that decide the outcome of the initiatives, which envisage different paths, instruments and objectives. We are following the developments in scrupulous observance of the law and supervisory regulations, bearing in mind the general interest and reporting on the necessary procedures in the competent fora. In any event, the transactions will lead to significant further strengthening of our banking system.

Banks are called upon to address the problems of customer relationships more effectively and systematically. Initiatives to contain the costs of services and the amount of fees are necessary and they must spread. The image banks project is fundamental for their reputations.

As we recently had occasion to argue at length, the problem of the Italian economy lies primarily in the competitiveness of industry.

But there is also a weakness of domestic demand.

According to the Bank of Italy's surveys, investment in public works in the first half of this year was at the same level as in the first half of 2004. The rise in the number of contracts and the opening of sites have yet to show up in an increase in investments actually implemented.

According to the construction firms in the sample, the outlook for the second half of the year is uncertain.

The efforts at both central and local government level must be intensified, and with urgency, to step up activity, to avert a slowing of investment that could jeopardize the recovery.

According to the legislative innovations introduced by Parliament and those now being adopted, the implementation and management of public works does not necessarily have to be totally entrusted to government; it is possible and advisable to leave room for private enterprise, on the basis of rigorous and transparent criteria. The role assigned to banks is that of giving impetus to operations in the sector and carefully evaluating the quality of investment projects.

There are signs that the world economy is slowing down with respect to its exceptional expansion last year, but growth remains robust. Its course must not be affected by the recurrence of terrorism. This requires a coordinated, effective response in the various fields, including at European level, and the continuation of the initiatives for détente and peaceful coexistence.

The present phase of the cycle is a difficult one. A favourable opportunity for recovery could take shape and must be seized. It is necessary to restore a climate of confidence. This depends on what actions are taken but also on the manifestation of a harmonious will to act for our country's economic and civil progress.