Mario Draghi: 2006 World Savings Day

Address by Mr Mario Draghi, Governor of the Bank of Italy, on the occasion of the 2006 World Savings Day, at the Association of Italian Savings Banks (ACRI), Rome, 31 October 2006.

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1. Savings and investment

Half a century ago, when Italy was moving towards prosperity, it was the parsimony of its population that financed economic growth. Right up to the mid-1970s, while expenditure on investment amounted to 26 per cent of gross national disposable income, private saving exceeded 30 per cent, with more than two-thirds of it due to households; their thrift was encouraged and upheld as a social virtue.

Towards the end of the twentieth century, both expenditure on capital goods and private saving diminished to around 20 per cent of national income; household saving dropped below 9 per cent. Since then, Italian households have started to save again, partly in response to the public pension reforms of the 1990s; they continue to be among the thriftiest of the developed countries.

With no more barriers to capital movements and a globalized financial market, savings worldwide are now in search of investment opportunities, wherever they may arise. The link between saving and investment is no longer related to national borders. Only a growing country will attract capital, from both within and without.

Italy's weak economic growth in the past ten years has been aggravated by inadequate investment, not so much in terms of quantity as of quality and composition. The technological component of real assets, human capital and organizational structure are of growing importance. If the present recovery is to last, economic policy and the financial system must support the restructuring of production, channelling savings towards innovative investment.

2. Returning to growth

2006 is about to become another year of record growth in world output. Since the summer there have been increasingly clear signs of slower growth in the United States, where the lengthy property boom appears to be coming to an end. World demand may be affected by the slowdown, but it continues to be fuelled by the exceptional growth of the Asian economies.

Economic growth in the euro area is considerably stronger now than in the previous months. The momentum could be lessened over the next quarters by the decline in demand in the United States and the need for some of the main euro-area countries to consolidate their public finances.

In Italy, too, GDP growth resumed at a rapid pace in the first half of this year. Industrial production recorded an estimated year-on-year rise of over 2 percentage points in the first ten months and is steadily picking up from the low point of early 2005. The substantial increase in indirect tax revenue is another indication of a cyclical upswing. Available indicators point to strong GDP growth in the third quarter as well.

So far the recovery has drawn strength principally from exports and investment. Italian goods have penetrated further on foreign markets, including the fast growing markets of South-East Asia, thereby slowing the erosion of our market shares. Exports to China are soaring, not only those of traditional products but also of capital goods, suggesting an improvement in the competitiveness of some medium-to-high technology firms. The expansion in foreign demand has helped to rekindle investment in machinery and equipment, which has also been fostered by the shortage of spare capacity, ample availability of financial resources and persistently low interest rates. Domestic orders for capital goods have reached their highest level in five years. The Bank of Italy's business surveys indicate that the trend will continue in the coming months.

Although output growth has been stronger than expected, it is still slower than in the rest of Europe. Productivity in industry remained at a standstill in the first half of this year, while in France and Germany the quarterly increase was over 3 per cent. We need to step up the action, just initiated, to overcome the structural constraints impeding Italy's growth.

The aim of the budget for 2007 is to ensure financial stability in the years to come. It is to be hoped that the debate in Parliament will not attenuate the push for structural reform of the public finances. Achieving this objective is a prerequisite, but also a consequence, of economic growth. The best response to the rating agencies' assessments is a country that is growing.

The Government's budget proposals include measures to help firms recover their competitiveness, such as the reduction in the tax component of labour costs. However, most of the policies to stimulate renewed economic growth remain outside the sphere of the budget because they are concerned with measures to change the rules of the economic game more than with changing the volume of public resources.

Five months ago, in my Concluding Remarks, I listed several areas of action for structural policies. Common to all of them was the need to increase competitiveness, in the goods markets as in the markets for factors of production, by eliminating the protection of vested interests and the monopoly revenues that weigh on firms' costs and households' budgets.

In the summer the Government took steps to open up further the market for private services. Various measures to revive the productive system are now set out in bills recently passed by the Council of Ministers. It is to be hoped that progress in this direction will continue, without deviating from the objective of improving competitiveness and efficiency at every point of the productive system.

As far as incentives are concerned, automatic facilities for firms appear preferable as being less costly and distorting than discretionary measures, which rely on the public bodies concerned to select the sectors for promotion and choosing between different technologies and projects. Such a model requires a remarkable capacity for strategic evaluation. If that is lacking, there is a serious risk of scarce resources not being optimally allocated.

To promote growth, improving the environment in which the productive system operates is more important than augmenting or refining the incentives offered to firms. The areas needing action are many and well known. They include simplifying the regulatory and tax system, introducing rewards for merit and mechanisms of competition within the educational and training system, reducing the cost and enhancing the effectiveness of business services and local public services, promoting competition in the production and distribution of those services everywhere possible, and acting to ensure that the legal order and governmental authorities are guided by the values of the market and efficiency rather than the deleterious standards of legal formality and bureaucratic power.

3. The financial system's contribution to growth

3.1 The stock market and institutional investors

Structural reform must also extend to the financial industry. The possibility of direct or indirect recourse to the capital market plays an essential role in facilitating the expansion of firms that have growth potential. Market access is assisted by the presence of a large stock exchange, a good number of institutional investors and a web of specialized intermediaries. Progress on all these fronts is needed.

As we know, the Italian share market is smaller than those of the other advanced countries. Both the number of companies listed and the ratio of their total capitalization to GDP are not only far lower than in the United States and the United Kingdom but also below the euro-area average.

As for specialized intermediaries, in 2005 total private-equity investment in Italy was half the European average in proportion to GDP. The resources invested in Italy go largely to buyouts. Only 15 per cent of Italian private-equity investment in 2005 went to venture-capital operations, compared with a European average of 27 per cent. And even of that, only a marginal portion, far smaller than in the other major European countries, went to start-ups. Investment in high-technology sectors is minimal. A good part of the capital is of foreign origin; the domestic component comes largely from banks, while the role of other investors, especially pension funds, is scant.

As a rule, small firms with highly innovative projects are unable to raise funds directly in the capital market, nor can ordinary bank lending suffice. Even medium-sized companies with opportunities for growth are often incapable of attaining stock exchange listing. There is a need for intermediaries that are able to select risky but promising projects in which to invest, with the ultimate aim of placing the equity on the market. More generally, private equity is also helpful in other corporate transitions, such as generational change, management buy-outs, crises and restructuring.

The expansion of the stock exchange and of specialized intermediaries can also be fostered by an enhanced presence of institutional investors, pension funds above all. In the countries where pension funds play a significant role, even relatively small firms tend to seek stock exchange listing. Institutional investors play an active role as minority shareholders, monitoring management's performance. They reduce informational asymmetries and increase the volume of resources available on the market to finance enterprises. They are among the leading sources of venture capital and, more generally, of funds for intermediaries specialized in supplying risk capital to firms.

The spread of private pension funds in Italy is essential to the equilibrium and the equity of the pension system. The rules governing the allocation of workers' accruing severance pay entitlements will play a key role in shaping the funds' development. While the amounts accumulated must be earmarked for retirement purposes, workers must be given full freedom of choice: free and fair competition between classes of asset managers and types of retirement scheme, at low cost to the saver, constitutes a guarantee for the robust, competitive development of the sector. Workers must be provided with clear and complete information on their pension situation and the alternatives available if they are to be in a position to make informed choices. The Finance Bill's provision for the partial transfer to the social security administration of resources now going to firms' severance pay funds must not conflict with the objective of developing supplementary pensions.

3.2 The shape of the banking system

Banks were once virtually the sole agents for collecting savings in Italy and channelling these resources to firms. Overseeing their stability was tantamount to protecting households' savings. Today, banks and the capital market perform complementary functions in sustaining the operation and growth of the economy, but small and medium-sized enterprises still depend decisively on bank credit. Helping such firms to grow is necessary to strengthen them for competition in an increasingly globalized market. When the technological and human factors and the market conditions are right, the careful and rigorous assessment of creditworthiness does not conflict with a lending policy designed to accompany firms' growth in size.

In the 1990s technological progress, privatization and deregulation triggered a wave of consolidation within the banking industry. In the last ten years the number of banks has diminished; mergers and acquisitions have involved institutions accounting for 80 per cent of total assets. And further significant concentrations are being discussed. Those who propose concentrations – board chairmen and directors – increasingly grasp the necessity and the benefits of consolidation and are showing an ability to transcend the localisms and personal interests that impede it. The Bank of Italy wants the stability and competitiveness of the banking system to emerge stronger still. In a financial system that is open to international competition, it encourages banks to continue on the path of consolidation on the basis of plans decided upon independently by the market.

In bank mergers, rational governance arrangements in the new bank are essential to reap all the benefits of consolidation. Innovative corporate governance models may serve to facilitate concentrations; they must be organizationally effective and not jeopardize efficient decision-making.

A fundamental contribution to the reorganization of the banking system has come from the banking foundations. The great majority of them have disposed of their controlling interests but they are still significant shareholders of banks, even if consolidation has nearly always diluted their holdings. Their conduct is directed today towards enhancing the value of capital invested, in keeping with their role of long-term investors; their interest lies in pursuing institutional objectives. It might be appropriate to reconsider the regulatory discriminations that limit their ability to acquire and manage bank shareholdings, such as the sterilization of voting rights in excess of 30 per cent.

Consolidation has also involved cooperative banks, whose number has fallen from 95 to 36 in the last ten years. Based mainly in the most developed regions of Italy, they diversify the structure of the banking system, draw competitive advantages from their proximity to the productive system at local level, and play a significant role in the investment of households' savings. There is scope for further concentrations permitting potential synergies to be exploited, without the new groups' greater complexity compromising their mission of financing the local economy.

Consolidation has accentuated the differences between cooperative banks. Alongside banks that preserve an exclusively local vocation, there have emerged groups of considerable size and national reach. A reflection is necessary on how to adapt the corporative governance rules typical of cooperative banks to the reality of each bank. Recent events have demonstrated the risks of instability that can derive from inadequate rules. The inflexible rule of one vote per head, limits on the collection of proxies and restrictions on individual shareholdings can result in a self-referential attitude of management, insufficient protection of shareholders and obstacles to capital strengthening. Parliament has examined various reform projects in recent years. Towards the end of the last Government’s term of office a broad consensus had been reached on a bill that would have eased the shareholding limits, especially for institutional investors, and strengthened the protection of shareholders of listed cooperative banks, while preserving the essential features of the cooperative form. The matter needs to be taken up again.

The rules imposing rigid separation between banking and industry, particularly those setting strict quantitative limits on shareholding in banks by investors not belonging to the financial sector, constitute an isolated case in Europe and have to be assessed also for their compatibility with the legislative reform proposals now under discussion at Community level.

The need for adequate safeguards is undiminished. It remains essential to ensure the autonomy of the bank vis-à-vis companies that, as a result of conflicts of interest, can unduly influence its decisions, distorting the allocation of loans and imperiling its very stability. But, as with other aspects of supervision, the instruments to be used change. They now consist first of all in governance rules that ensure transparency of decisions, checks and balances, the presence of independent directors, interaction between the different corporate functions and effective internal controls. Secondly, the rules that limit the concentration of risk, particularly vis-à-vis related parties, take on increasing importance.

Likewise, with regard to the restrictions “downstream”, on shareholding by banks in firms, the experience acquired and the development of risk management and control techniques make it possible today to ease the existing limits, bringing Italian rules into line with Community provisions. The management of the conflicts of interest that arise in private-equity activity requires adequate transparency safeguards and decision-making guarantees, including the separate conduct of private-equity business by companies within banking groups, and rules on the spreading and diversification of risk.

Replacing rigid regulatory constraints with flexible supervisory principles restores autonomy to banks and entrepreneurs and stimulates efficient decision-making. At the same time, this increases the responsibility of the supervisory authority, demands continual refinement of its technical apparatus and requires it to be fully transparent in accounting for its actions.

3.3 Banks: costs and transparency

The efficiency gains deriving from concentrations must be transferred in full to households and firms.

The costs of banking services for customers are still too high in Italy. Customer protection must be entrusted above all to instruments that guarantee complete information on terms and conditions and the application of a general canon of correctness in business relations. Ordinarily, competition is the most effective means of curbing the costs charged to customers. However, one set of costs - those directly or indirectly connected with closing bank accounts - hinder customer mobility and thus constitute in themselves an impediment to the free working of the mechanisms of competition. Such costs should be eliminated. The full portability of accounts, including accessory services, must also be ensured.

The aim of the recent measure that provides for the closing of accounts without expense and other rules protecting bank customers are therefore commendable.

However, the formulation of the measure, based on the dictation of economic clauses by statute, has engendered problems of interpretation, particularly as regards the obligation under certain circumstances to modify lending and deposit rates simultaneously and the exact identification of the items to be considered in the charges connected with closing accounts. A situation of uncertainty has been produced that creates operational problems for banks, keeps customers from taking full advantage of the new rights and may cause costly litigation. It would be better if the statutory provisions were limited to laying down general rules, referring their implementation to secondary legislation and self-regulation.

Besides, it is in the banks’ own interest to strengthen the consumer safeguards they have already put in place as part of the sector’s self-regulation, by extending their scope and introducing effective mechanisms for settling disputes. In Italy there are already bodies for the out-of-court settlement of banking disputes. For banking business the law on the protection of savings has entrusted the

Interministerial Committee for Credit and Savings with the task of regulating the procedures and decision-making bodies. Forms of direct involvement of the supervisory authority could be considered.

Transparency and fairness in customer relations are an integral part of the sound and prudent management of banks. Every transgression creates legal and reputational risks. Banking relationships are based on trust; loss of trust can cause risks of instability, including at a systemic level.

The Bank of Italy must verify that banks' organization and internal controls provide adequate protection against risks deriving from business practices that are unfair to customers. Proposed rules on the compliance function have been sent to financial intermediaries and the public for consultation; the related regulations will be issued shortly.

Transparency of banking business also requires that banks' financial statements and other public information on their financial positions be comparable. There has been a significant increase in such comparability in Europe with the adoption of international accounting standards. Greater convergence is necessary with regard to the methods of classifying impaired loans.

Adopting the strictest definition of defaulted loans - which includes overshoots and payments overdue by more than 90 days - the figures for Italian banks are high owing to the tolerance of late payments. Banks must further shorten their reaction times by speeding up the organizational and procedural interventions that have already reduced overshoots from 1.7 to 1 per cent of the total loans in the last twelve months.

3.4 Payment services

Technological progress offers plenty of scope for increased competition and greater efficiency in the payment system. The spread of mobile telephony, which can be used to provide financial services, and of cards and equipment prepared by the suppliers of electronic payment services is conducive to the entry into the market of new operators and the growth of innovative payment mechanisms, especially for small amounts.

The Bank of Italy has already authorized the purchase of products over the phone, when they are supplied by the operator of the service and it does not involve the creation of payment instruments for general use. But in view of the evolution of technology and the market the rules on the reserves for electronic money and the collection and transfer of funds will need to be re-examined, in line with the revision of the European rules now under way. Access to a variety of competing operators must be ensured, while maintaining the public's trust in the payment system.

4. The Bank of Italy

4.1 Ownership structure

In my recent testimony before Parliament concerning the law on the protection of savings, I drew attention to the need to reflect on the implementation of the provision calling for the redefinition of the Bank of Italy's ownership structure and the transfer within three years of those of its shares held by persons other than the state or other public entities.

As I pointed out, it is not up to the Bank of Italy to choose its owners; but it is in the Bank's interest, indeed it is its duty, to call attention to any solutions that are likely to conflict with the safeguarding of its independence.

A plurality of shareholders, a balanced distribution of shares, non-interference in the Bank's institutional functions, a guarantee of its financial autonomy and, above all, consistency with Community law - an aspect to which the European Central Bank has drawn attention several times - are the principles with which the central bank's ownership structure and corporate governance must conform.

In light of international standards and the experience of other countries, it may prove necessary to reflect on the choice made by the law and move towards a configuration of the Bank's ownership that fully protects its independence, the guarantee of stability and a cornerstone of the European economic constitution.

4.2 Organizational developments

A working document has been sent today to the trade unions present in the Bank of Italy on the overhaul of the Bank's organization. The document identifies and details the medium-term strategic objectives for the performance of the Bank's central banking functions, in harmony with the evolution of the Italian and European institutional framework.

The measures outlined in the document aim to increase the Bank's effectiveness and efficiency both at international level and in Italy, by concentrating its local structure in appropriately strengthened units at regional level. The new organizational structure - which also envisages the incorporation of the Italian Foreign Exchange Office (UIC) - must be able to respond to the challenges imposed by change and to offer staff greater participation in decision-making and operational processes and better opportunities of professional and cultural growth.

The reorganization will call on the vast stock of professional skills available within the Bank. A path will be agreed with the trade unions that sets out the timetable and content of the changes and the manner of achieving the objectives of the reorganization. Clear objectives, gradual implementation and dialogue are what are needed for this to be completed in a reasonably short time and without trauma. The ability of the Bank of Italy to go on playing its role in Italy and the European System of Central Banks efficiently and authoritatively depends on the success of this project, which will require the joint efforts of all concerned.