Mario Draghi: Growth and stability of the economy and financial markets

Speech by Mr Mario Draghi, Governor of the Bank of Italy, at the Annual Congress organised by AIAF - ASSIOM - ATIC FOREX, Turin, 3 February 2007.

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Growth and stability

Against the background of an international expansion that remains strong, the euro area is growing at a rate almost double that of the last five years.

In the eight years since the launch of the Economic and Monetary Union monetary policy has created conditions that are conducive to growth and investment. Real short-term interest rates have remained low in all the phases of the cycle, ranging from zero to 2.3 per cent. In the previous two decades they were close to 3 per cent in the countries with a history of monetary stability and to 4 per cent in Italy.

Since the end of 2005 the monetary stimulus to the economy has been progressively reduced, with the gradual raising of interest rates. The European Central Bank has acted to tie expectations firmly to the objective of price stability. The credibility of monetary policy has countered the risks of an increase in inflation in connection with the reduction in idle capacity and, until last summer, the rise in the price of oil.

In this stable environment, the euro-area economy has benefited from the structural measures taken so far. As we recalled at the last meeting of the ECB Governing Council, since the beginning of monetary union Europe's economy has created 12 million jobs, helped by labour market reforms and wage moderation. These results clearly indicate the way forward; they call for further progress in eliminating the constraints that still hold down employment, slow growth and exclude too many people from the labour market.

In the last ten years a large part of the developing world, which historically had been a debtor, has become a creditor. This shift was made possible by the opening up of international trade and has been accompanied by an extraordinary boom in financial innovation. The dismantling of barriers has also opened the way for investment in illiquid assets, which has risen to unprecedented levels; financial leverage is now used more than ever before. One has the impression that the signals coming from the market may occasionally have been distorted by these changes: the exceptionally low level of risk premiums does not fully reflect creditworthiness; real long-term interest rates also continue to be extremely low, both compared with long-term averages and in relation to the economies' position in the cycle. Liquidity continues to be abundant, although the monetary policies of the leading countries have been less accommodating for some time. The world economy continues to grow at a rapid pace.

It is unrealistic to expect that today's orderly market conditions will last forever. This is why there has been a call from many quarters for closer international collaboration, not only in order to take steps towards gradually overcoming global imbalances, but above all to strengthen the world financial structure. We do not know where the next crisis will come from but we must do everything in our power to be ready for it.

We also need to shun policies that could generate financial instability and cause growth to slow. In particular, we must resist protectionist pressures, such as the measures to obstruct international trade with the emerging Asian economies advocated on many sides.

The Italian economy: an opportunity for restructuring and revival

The Italian economy continues to benefit from the favourable European and world cycle, although it is growing at a slower pace than the average for Europe. It is estimated that in 2006 output expanded by slightly less than 2 per cent. The improvement in the economic situation compared with previous years is undeniable. But it is not sufficient: the growth achieved so far mainly thanks to the favourable performance of the European economies, and of Germany's in particular, must be progressively replaced by domestic expansion. If this is to happen a process of strong and lasting growth in total factor productivity, which has stagnated since the middle of the 1990s, must be set in motion. The material and above all human resources, especially young people, that the country possesses in abundance must be brought into play. Positive signs are already visible, mainly among the firms most exposed to international competition, but it is still difficult to distinguish with certainty between the effect of structural changes and that of the factors usually observed during cyclical upturns.

Many national labour contracts have now expired or will do so by the end of this year. Hopefully, action by the social partners will lead to an upturn in productivity and growth in employment. One of the first rounds of negotiations, which will evidently have implications for the rest, is for the renewal of the contract governing the public sector, where increases in per capita earnings in recent years have far outpaced those in the private sector without explicit or adequate consideration for the real performance of productivity. Personnel management in the public sector is subject to strict constraints, incentives are few and the independence and accountability of managers are often insufficient. Satisfactory systems of individual evaluation and differentiation need to be introduced.

Action must be taken to continue and reinforce policies to promote competition in areas where it is still unsatisfactory. The Government is moving in this direction, as the measures recently adopted also testify. The objectives are commendable. The means must be given careful consideration: liberalizing signifies relying for consumer protection as much as possible on transparency and competition and the oversight of the competent authorities.

The structural reform agenda is still a long one and I shall come back to it on another occasion. Let me just say here that it is easier to implement reforms when the economic situation is favourable; the present offers an opportunity that must not be missed.

The recovery also creates favourable conditions for continued action to consolidate the public finances. In 2006 these benefited from higher-than-expected revenue, partly due to the good performance of the economy. The temptation to squander this fiscal windfall must be resisted. The public debt, the cumulative result of improvident decisions over a long stretch of time, remains extremely large – the largest in Europe in relation to gross domestic product. The low interest rates obtaining since the introduction of the euro have diminished the public's perception of the burden this represents for us and for future generations. The size of the debt makes any increase in the return on government securities very costly for the public finances; it is also an obstacle to public investment and the restructuring of public spending; and it hamstrings fiscal policy. If the debt can be cut over the next decade, which will remain fairly favourable in demographic terms, the costs of an ageing population could be tackled more gradually and distributed more equitably.

The public debt can be reduced significantly within a short space of time. We must aim to achieve a structurally balanced budget. At the end of the 1990s the public debt represented the same proportion of GDP in Italy and in Belgium, 114 per cent. In Belgium, a virtually balanced budget and greater growth than in Italy by some 6 percentage points over the period allowed the debt ratio to be reduced to less than 90 per cent in 2006. In Italy it currently stands at 107 per cent. This year interest payments in Belgium will be about 1 percentage point of GDP less than in Italy. For the ratio of debt to GDP to be reduced on a lasting basis two conditions must be met: economic growth and the curtailment of expenditure.

The level of taxation in Italy is high, imposing a penalty on the firms and households that pay their taxes in full. In the future it needs to be attenuated. The fruits of the fight against tax evasion must be used to lower tax rates. It is estimated that general government revenue increased by about one percentage point of GDP in 2006 and it is forecast to rise further in 2007. Permanent adjustment of the public finances requires structural measures that will hold the rate of increase in outlays in the main areas of expenditure below the potential growth rate of the economy. In 2005 the ratio of primary current expenditure to GDP was the highest since the Second World War, and the figures now available indicate that it remained near that level in 2006.

In the field of pensions, it is necessary to ensure, at the same time, tolerable contributions, the financial equilibrium of the system, and the payment of adequate benefits. Italy's employment rate among persons aged 55 to 64 is scarcely 31 per cent, which is more than ten percentage points lower than the European Union average and nearly twenty points short of the target for 2010 set by the European Council in Lisbon in 2000 with Italy's accord. What is needed is a collective coming to grips with the situation, similar to the effort that – in the mid-1980s and then with the concertation agreements of 1992-93 – enabled Italy to break the rigid wage-price spiral with hard but farsighted decisions on wage indexation.

The transformation of the financial markets

A year ago on this occasion I recalled the necessity of pursuing the integration of the European markets and lowering transaction costs. Since then a number of far-reaching transformations have begun in the configuration of Europe's financial markets.

The merger between a leading European and a leading American stock exchange will give rise to a circuit offering competitive liquidity and cost conditions to issuers and investors.

The implementation of the Markets In Financial Instruments Directive will heighten competition between regulated markets and the trading platforms operated by major financial institutions or consortia of intermediaries. The greatest impact will be felt in countries, Italy among them, that had previously required all equity trades to be carried out on the official stock exchange. Some significant initiatives are now materializing. A group of international banks have an agreement to construct a platform for trading in equities and a common system for gathering and sharing the equities trading data.

The cost of cross-border transactions in Europe is still too high. The initiatives for cooperation undertaken by the main settlement providers have not yet produced satisfactory results, and the Eurosystem central banks are weighing the possibility of directly managing the final phase in the settlement process, in order to lower costs and facilitate the settlement of transactions.

The European Commission has recommended a code of conduct for market operators, securities depositories and central counterparties to eliminate barriers to access to the various services, enhance transparency on costs and income, and achieve interoperability.

Together, these developments will result in a rapid and significant heightening of competition and concentration at European and world level. The challenge has been issued. Italian banks and the stock exchange must take note and prepare to meet it.

The banks will have to make choices, and promptly. The main initiatives already taken in Europe range from stepping up the internal provision of trading services to forming consortia. In Italy the major banks, if they do not consider they have the size and range of business to follow either of these courses, must capitalize on their position as shareholders of the organized markets.

Thanks to low prices and the quality of its services, Borsa Italiana has a powerful competitive tool at its command. In addition, it can still benefit from the informational edge deriving from the customary practice, common to all financial marketplaces, of channelling trading in securities, especially in equities, to domestic exchanges. Nevertheless, the spur of growing competition will inevitably make itself felt. In the long run, the significant network externalities and economies of scale that characterize financial markets and the natural gravitation of liquidity to deeper markets threaten to squeeze out exchanges that remain isolated. This is what happened to Italy's regional bourses. Looking to the future, a failure to exploit scale economies could even undermine the competitiveness of Borsa Italiana's prices. In the choices it makes, the exchange must succeed in combining the advantage deriving from its roots in the national economy with the benefits of integration. Its shareholders will have a unique opportunity: to make the most of their investment while simultaneously contributing to the development of Italy's corporate sector.

The transposition of the European directive on takeover bids into Italian law is now imminent. The fruit of an unhappy compromise, the directive lays down only minimum harmonization and leaves considerable scope for national law to limit the contestability of control of listed companies. This approach threatens to undo past progress in the protection of minority shareholder rights in countries, such as Italy, where these safeguards are strongest. Transposition must not provide the occasion for overturning the principles established in this respect by the Consolidated Law on Finance. The mandatory nature of the passivity rule has to be confirmed and there must be strict and extremely limited conditions for invoking the reciprocity clause. Finally, considering the importance of shareholder agreements in the control of Italian corporations, the law transposing the directive should confirm shareholders' right to withdraw from such pacts in the case of a takeover bid.

In other countries pension funds, along with other institutional investors, help to ensure the efficiency and the liquidity of the financial markets. They stimulate innovation and competition between intermediaries, they increase the resources available to firms in the form of equity and bond issues, and they exercise continuous monitoring of the strategy of listed companies, to the benefit of the transparency and quality of corporate governance. The relative underdevelopment of pension funds in Italy is an impediment to the growth of the financial system and to the restructuring of the productive economy. Bringing forward the entry into force of the new retirement system rules to this year has been a step in the right direction.

Enrolment in supplementary pension plans is low especially among the groups whose public pensions are likely to be smallest – self-employed workers, young people and women, all penalized by the greater variability and discontinuity of their earnings. These workers must be offered pension plans that afford ample freedom in determining contribution flows and facilitate totalization and the portability of contributions, including those paid in different phases of one's career, from one form of retirement saving to another. The possibility of enjoying the advantages of supplementary pension plans should be extended to public employees.

The investment of severance pay in supplementary pension plans can bring substantial benefits for workers. Accumulation over a considerable time horizon is necessary in order to reach pensions of adequate size. On the financial markets investment strategies can be used to obtain, with limited risks, real rates of return in line with or higher than those delivered by the revaluation of severance pay funds. Over long time horizons higher rates of return can be achieved through investment in equities, though at the cost of additional risk.

According to recent surveys, workers continue to overestimate the amount of their future pensions by a large measure and are still poorly informed about supplementary pension schemes. It is their right to get clear, regular and complete reports on their accumulated position in their compulsory pension system; the experience of other countries, especially Sweden, is enlightening in this regard. It is necessary to increase workers' knowledge of supplementary pension schemes; to highlight the flexibility they are given in using the different forms of saving, particularly as regards the right to transfer their accumulated position between schemes and to obtain advances in case of exceptional needs, such as the loss of their job, the purchase of a house or serious illness. The Finance Law included a specific appropriation for information campaigns that will give workers the facts they need to make an informed decision on enrolment in supplementary pension plans.

The banking system: efficiency, competition, fairness

The number of banks operating in the euro area fell by more than 900 between 2001 and 2005. In the euro-area countries, the average share of total assets held by the top five banks rose by 4 percentage points to 43 per cent. In the same period the degree of concentration of the Italian banking system diminished slightly. Using data referring not to the top five banks but to all the domestic banks in the five largest groups – figures that give a more accurate picture of the Italian banking system – the share declined from 46 to 44 per cent between 2001 of 2005; it rose to 48 per cent last year. Although substantial, the latest consolidation left the overall degree of concentration little changed, owing to the fragmentation that still marks the second tier of banks. Italian banks were at the centre of major cross-border transactions. They are stronger today in Italy and abroad but there is still room for mergers and acquisitions able to create synergies, with benefits for shareholders and customers.

The restructuring has been driven by market forces. The Bank of Italy does not promote or guide mergers and acquisitions, neither does it impede them; it does, within the scope of its powers, evaluate the market's choices, with a view to ensuring conditions of stability serving to protect savers and guarantee the orderly functioning of the financial system. It does not create unjustified barriers to entry for new bank operators.

The consolidation of the banking industry can and must produce greater efficiency among intermediaries, not less competition; it must lead to lower prices and better service quality. The groups created by mergers and acquisitions must demonstrate that they are able to reduce the costs for customers significantly and swiftly by accelerating the integration of previously separate organizations.

An effective governance structure is one of the necessary conditions for banks to achieve efficiency gains. A rational use of the diversified system of administration and control recently introduced into Italian law can contribute to this. In the two-tier system, the supervisory board, clearly separated from the management board, which is responsible for operating decisions, is interposed between shareholders and managers and performs some of the oversight functions that in the one-tier system are left to the shareholders. Where ownership structures are particularly complicated, the two-tier system can permit more effective control of management's performance. In the case of recent bank mergers, the initiators have seen the two-tier system as a means of capitalizing on the traditions and experience of the pre-existing institutions. Against this, however, there is the risk of an unclear division of roles and responsibilities, detrimental to efficiency and speed in decision-making. The pros and cons of the choices made will have to be weighed in the light of developments. The two-tier system has facilitated the mergers; it may prove not to be functional in the future, in which case it will be necessary to obviate the shortcomings in a pragmatic spirit.

The time has come to revise the governance of cooperative banks, especially the largest, in order to adapt it to the changed competitive conditions. Their contribution to this revision is important. Without prejudice to the core principles of cooperation, it is desirable that Parliament act to increase the room available for outside investors to participate in their capital and decision-making. This must happen in a transparent and open manner; under the legislation now in force, the Bank of Italy can only demand compliance with the letter and the spirit of the existing rules.

Protection of the users of banking services is a reference point for the Bank of Italy. A correct relationship between intermediaries and customers is important to banks' stability itself. Industrial and financial crises, including recent episodes, have exposed banks and the entire financial system to serious legal and reputational risks.

Regulatory action to protect customers must be effective and measured. Competition between intermediaries in serving customers must remain the linchpin of regulations governing bank-customer relations. All measures that enhance the transparency of price structures are appropriate. The spontaneous initiative of the banks themselves is the best defence against intrusive regulation, which could rigidify the market and thwart the intended objective of safeguarding the weaker party. Hopefully, legislative proposals for the protection of bank customers with regard to overdraft fees will increase the transparency of banking terms and conditions without turning into a detailed prescription of contractual clauses.

In my Concluding Remarks last year I stressed the need to eliminate the costs associated with the closing of current accounts. The statutory provisions recently passed have proved difficult to apply, which may give rise to litigation; the expected benefits risk being annulled. In order to foster the mobility of bank customers and increase competition, the abolition of these costs must be accompanied by simplification of the bureaucratic formalities and the automatic transfer of account-related services within a short and definite time limit. This is the message of the European Commission's recent report on competition in the banking sector. According to the report, the annual management fees for a bank current account in Italy amount to €90, compared with a European average of €14. An earlier survey by the Bank of Italy on a sample of accounts at banks subject to inspection indicated a figure of €163. Naturally, difference between the estimates also reflects the number, type and frequency of use of the services considered.

The Markets in Financial Instruments Directive, which I mentioned earlier in connection with its influence on the structure of financial markets, will also inevitably have a significant effect on the relations between banks and customers. A new and clearer definition of the information and conduct requirements applying to banks will increase the transparency of their relations with customers and make the latter's choices better informed. The new rules, especially those concerning conflicts of interest and inducements, will have a major impact on banks' operations and organization.

Effective protection of customers also requires rapid and economical ways to enforce rights. The law on the protection of savings requires banks to adhere to mechanisms for the out-of-court settlement of disputes. The rules governing the procedures and the composition of the decision-making body will build on the experience gained with the banking ombudsman; they will adopt an approach based on self-regulation by intermediaries and careful consideration of customers' claims and interests.

No formal guarantee can be effective if the persons concerned do not have appropriate instruments for making evaluations. If savers are to be able to find their way among so many different and complex financial products, they will need to have an adequate and up-to-date financial culture. The initiatives undertaken in this field are only a start. The Bank of Italy stands ready to contribute.

In my speech to you last year I drew attention to the need to ensure that asset management companies were independent of the banking and insurance groups that control them and distribute their products. This can be achieved by strict corporate governance rules and, if these are insufficient, by measures regarding ownership structures. The present integration between production and distribution of financial products reduces the scope for exploiting the economies of scale present in asset management, attenuates the pressure of competition, increases the risk of conflicts of interest, and ultimately limits the growth of the sector and the protection of investors. Intermediaries, and especially banks, must make asset management companies independent and permit competition in the distribution of products, so as to reduce the costs borne by investors. As in other fields, market initiatives are to be preferred to legislative measures; in their absence legislation or regulation will be inevitable.

The competitiveness of Italian funds also requires a review of their tax treatment. It is important that the current revision of the mechanism for taxing financial income take account of the need for a reasonable degree of uniformity across countries as regards how and when taxes are levied and their level.

There is room for increased competition and efficiency in the field of payment services as well. Technology now makes it possible to open the market to new participants, such as mobile phone operators and providers of other services. Within the sphere of its regulatory responsibilities the Bank of Italy will introduce the measures needed to permit such developments, while simultaneously ensuring the security of transactions. At European level the creation of a single payments area will require legislative harmonization. The proposals under discussion envisage a new category of specialized European intermediaries that will be able to combine payment transactions with other commercial activities; supervision will be based on the principle of proportionality and prudential requirements related to the risks. This is a development to be encouraged.

The integration of markets and the growing role of transnational intermediaries require the harmonization at European level of the rules governing supervision and a strengthening of cooperation among national authorities. This year will see another review of the Lamfalussy process, including its extension to banking and insurance. Convergence of supervisory practices is essential for the efficiency of the European capital market. There are still important differences, such as those in the treatment of hybrid instruments in computing regulatory capital, that must be analyzed and removed. The Bank of Italy will liberalize and simplify the procedures for opening new branches, thereby increasing banks' independence in shaping their distribution strategies.

What is required of the supervisory authority is not so much rigid regulation as the ability to intervene promptly to facilitate and orientate solutions found independently by the market. In applying the highest standards of risk management, the activity of the Bank of Italy and that of banks pursue largely similar objectives. Prudential rules reinforce, do not replace, the practices of sound bank management.

Sometimes situations arise in which individual intermediaries perceive the need for corrective action but are reluctant to act independently, because none of them, for fear of suffering a competitive disadvantage, has an incentive to move first. In such cases the initiative of the market is insufficient; the authorities must intervene. Here again, rather than introducing legislative measures it is often preferable to persuade intermediaries to cooperate in the search for solutions. There have recently been some encouraging instances of this internationally. In the derivatives market the problem of order confirmation backlogs has been tackled on the basis of a solution promoted by the financial industry rather than imposed by regulators. But without the latter's intervention the problem would have remained unsolved, entailing a significant risk for financial stability worldwide.

There may be other circumstances in which closer cooperation between regulators and regulated entities is likely to contribute to strengthening the financial system. Innovation has increased the efficiency of risk management enormously. But risk itself has not actually diminished. The growth of the financial services industry allows investors and intermediaries, encouraged by the new forms of diversification, to take on greater and more complex risks than in the past, sometimes without being fully aware of what they are. Often these risks migrate from the balance sheets of banks to other parts of the financial system. This brings new challenges for the supervisory authority responsible for stability and especially for ensuring that the regulatory framework and intermediaries' management of their operational risks are adequate.

Quite often the market is well ahead of regulators in perceiving the existence of problems in collective action, risk management and infrastructure shortcomings. It is essential that intermediaries promptly inform the Bank of Italy. In this way the smooth functioning of markets, the stability of the financial system and the protection of their customers will be maintained. With the meeting of 24 January with some large banking groups we gave new force to a practice of consultation whose primary aim must be to foster such cooperation between the supervisory authority and banks.

The principle upon which our action is based is that of a modern and agile supervisory authority ready to listen to the suggestions of the private sector with a view to improving regulation and making it more effective, but at the same time inflexible in working to ensure intermediaries' competence, fairness and solidity.