Mario Draghi: Overview of economic and financial developments in Italy

Concluding remarks by Mr Mario Draghi, Governor of the Bank of Italy, at the Ordinary Meeting of Shareholders, Rome, 31 May 2007.

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Ladies and Gentlemen,

I wish to pay grateful and affectionate tribute to the members of the Directorate who left the Bank in 2006 after decades of dedicated, rigorous and judicious work. They accompanied me in my first steps in this institution, providing the support of their loyalty and experience.

Vincenzo Desario, who was appointed Director General in 1994, served the Bank in the exercise of highly sensitive functions, notably in the area of banking supervision. He led the Bank on an interim basis after the resignation of Antonio Fazio. He stamped his mark indelibly on the Bank's approach to prudential supervision, principles of internal organization and daily administrative practices. The Board of Directors has named him Honorary Director General.

Pierluigi Ciocca, who had been Deputy Director General since 1995, gave the Bank the benefit of his profound, original thinking and his vast economic and legal knowledge. He promoted the study of law and economics, inspired research for many years and helped to refine the analysis of the functions of central banking.

In 2006 the Directorate acquired new members with expertise and experience, some of it gained abroad. Fabrizio Saccomanni, who as Vice President of the European Bank for Reconstruction and Development was in charge of risk management at that institution for three years, has been Director General since October. Ignazio Visco, Central Manager for Economic Research and previously Chief Economist of the OECD for five years, and Giovanni Carosio, formerly Central Manager for Banking and Financial Supervision, joined Antonio Finocchiaro as Deputy Directors General in December. The Directorate's new membership combines valuable experience in the international arena with intimate knowledge of the Bank, analytical and research skills with specialization in the area of regulation and central banking.

The Bank's new Statute was approved last year. It modifies the operations of the Bank's decision-making bodies: the Board of Directors, the Board of Auditors and the Directorate. It establishes the principle of collegiality for measures that have external significance.

The Bank intends to renew itself, and has already begun to do so. The reorganization taking place affects the functions of the Head Office, the branch network and the representative offices abroad; it provides for the full integration of the Italian Foreign Exchange Office. The aim is to reduce bureaucratic procedures, simplify and rationalize working practices, thus fostering individual responsibility, reallocate resources from the Bank's internal administration to its institutional functions, and tap into new recruitment channels, as with the forthcoming competitive examination for economists that is open to applicants from abroad.

We are on the point of implementing the reorganization of the activities of economic research and international relations, with the objective of structuring their tasks better according to particular needs: to contribute to setting the common monetary policy by monitoring and forecasting short-term economic developments and analyzing monetary strategy and transmission mechanisms; to study the fundamental problems of Italian economic development; to carry out research on the world economy and cooperate with international organizations; to refine economic statistical methodology and disseminate economic and financial statistics. The plan for the reorganization of the supervisory departments is being finalized, to give greater weight to the macroeconomic analysis of risk, the quality of regulation and consumer protection. There will be more interaction between research and supervision, and off-site and on-site supervision will be more closely integrated and have more methods in common. Measures affecting the other functions will follow in due course.

The Bank of Italy is also reviewing the principles and procedures for managing its own portfolio of financial assets. The aim is to increase transparency and separate the investment of its own resources more clearly from its other institutional activities.

The Bank of Italy has recently introduced numerous innovations in its operating procedures. Since the beginning of 2007 banks have been permitted to include bank loans among eligible collateral for

Eurosystem financing operations. Since mid-April the Bank has conducted new very-short-term borrowing transactions on behalf of the Ministry for the Economy and Finance, making treasury management easier and more predictable. On behalf of the same Ministry, it has launched the General Government Transactions Information System, which will enable government entities to evaluate their cash flows in real time and facilitate the adoption of electronic payment procedures. The project for the development of the new TARGET2 platform for settling large-value payments, which is being carried out in conjunction with the Bank of France and the Bundesbank, has reached an advanced stage. TARGET2, which will come into operation in November, centralizes the technical infrastructure of the European payment system, reducing the cost of cross-border interbank transactions. It will allow the ever-growing number of banks with a presence in more than one European country to operate with a single account in central bank money and curb the cost of treasury operations.

The branch network will be reorganized on a regional basis in forms that are more appropriate for the present day and without abandoning the Bank's nationwide presence. Reducing the tasks of self-administration and increasing those with greater technical content will give branch staff new opportunities for learning and professional growth.

Wide-ranging discussions with the trade unions on the organizational changes have been under way for several months. I hope that broad consensus will be reached before long on action to strengthen the Bank's role and prestige and an agreement concluded on the necessary measures to assist the workers involved.

The Bank's expanding international commitments, the reform of its governance and the new operational initiatives have posed important challenges. The staff have faced them with their customary professionalism and dedication, born of a tradition that has cultivated the spirit of public service, a sense of identification with the institution and merit-based selection in recruitment and promotions. I wish to express my gratitude to all the members of staff .

The principles of Community law, primary legislation and the provisions of the Bank's Statute protect the absolute autonomy of the Bank in the performance of its institutional functions from possible influence by its shareholders. However, the criteria for share ownership appear obsolete and do not ensure a sufficiently broad distribution of shares. The new bill on the reform of the regulatory authorities goes in the right direction, being based on the principles of the independence of the Bank and of a balanced distribution of its share capital.

Credibility and independence are essential to the performance of our duties. The autonomy of the central bank, though protected by law, can be fragile unless it is supported not only by authoritative analysis but also by consequent action.

The world economy, finance and monetary policy

The world economy grew by 5.4 per cent in 2006, the highest rate for more than thirty years. The slowdown in the United States was off set by continued strong expansion in China and the other emerging countries and by the recovery taking place in the euro area and Japan.

World trade continued to expand at a rate of over 7 per cent. Economic integration has been an important driving force of the uninterrupted growth of recent years. It is threatened by the resurgence of protectionist tendencies; the signs are visible, most notably in the stalled negotiations on the Doha Round of liberalization measures.

The persistent increase in current payments imbalances continues to pose a risk. The current account deficit of the United States reached 6.5 per cent of gross domestic product in 2006, the highest ratio ever recorded; with its counterpart in the growing surpluses of China and other Asian countries and oil producers, it has been financed easily thus far, but the share held by foreign authorities is rising.

The financial sector has made a fundamental contribution to economic growth in recent years by permitting unprecedented capital mobility and facilitating efficient capital allocation and by smoothly financing imbalances that in another era would have been disruptive. Financial innovation has enhanced market liquidity and reduced volatility.

The expansion in the markets and the continued process of financial innovation are also changing the pattern of risks.

The use of derivative instruments has grown further. Their notional value is now equal to ten times world GDP. Alongside instruments serving to hedge market risks, there has been a rapid expansion in those for the transfer of credit risk; the notional value of credit default swaps more than doubled in 2005 and doubled again in 2006. By making it possible to slice up credit risk and evaluate it precisely, allocating it and spreading it among a multitude of market participants, credit derivatives help to raise the productivity of the financial system, just as new production technologies boost that of the real economy. However, they can become a source of instability if intermediaries use them not to hedge existing risks, but to increase the volume of risks they assume. In addition, credit derivatives can modify the modus operandi of the banks that use them. If lenders transfer part of the risk to others, the incentive to evaluate borrowers' creditworthiness can weaken. A sign of this is to be seen in the rise in sub-prime mortgage defaults in the United States, where the transfer of risk is commonplace.

Abundant liquidity and low interest rates have contributed to the vigorous growth of hedge funds and private equity funds. Their role in the functioning of the markets has been positive, but the scale of the phenomenon, the high leverage of hedge funds, the demand from investors and counterparties for greater transparency and the potential risks of instability require the attention of the market and regulators. Supervisors seek to limit systemic risk, relying on market discipline by pressing the intermediaries under their direct supervision to obtain the necessary information from hedge funds and satisfy themselves that procedures are in place for the best management of risk.

Risk premiums have now fallen for a broad spectrum of financial instruments and markets. Investors' perception of risk could suddenly change; an abrupt portfolio adjustment, whatever the cause, would have destabilizing effects on exchange rates and financial markets. Although it is more able than in the past to absorb small and medium-sized shocks, the financial system may have become more vulnerable to "extreme" events that have a low probability of occurring but potentially disruptive effects, due not least to the system's increasing complexity and the growing interdependence between markets.

The development of new instruments and the emergence of new types of intermediary also pose unprecedented challenges for monetary policy. More than ever before, the financial markets are a source of information on trends in economic activity and the expectations of economic agents; central banks' actions are reflected more rapidly in the prices of financial assets. At the same time, the money and credit aggregates are being increasingly affected by the conduct of non-bank intermediaries; financial innovation is complicating the interpretation of the behaviour of monetary aggregates.

From December 2005 onwards the Governing Council of the European Central Bank has gradually moved towards a less accommodating monetary policy stance; it has raised official interest rates by 1.75 percentage points since then. At a time of strengthening economic activity, expanding employment and sharply rising energy and commodity prices, our decisions have kept inflation expectations firmly anchored to the objective of price stability. For the first time a powerful oil shock had no repercussions on inflation.

Money and credit continue to grow strongly. Despite the impact of financial innovation on the velocity of circulation, monetary aggregates remain a fundamental element in the strategy of the Eurosystem.

In nominal effective terms, the euro appreciated by almost 5 per cent in 2006. One factor in the strength of the single European currency has been the improved economic outlook for the area, in the face of fears of a slowdown in the United States.

Monetary policy has remained conducive to growth. Real short-term interest rates are still below the average for the area over the last twenty years. Long-term rates have risen, but by less than in comparable phases of past cycles. The gradualness and careful communication of monetary policy decisions have helped maintain stable conditions in the money and financial markets.

Consumer price inflation in the euro area was 2.2 per cent in 2006, just over half the rate recorded in the early nineties. A similar reduction occurred in the industrial countries as a whole, while in the emerging economies inflation fell from 60 per cent to 5 per cent. This remarkable achievement is attributable to the independence of central banks and the clarity of their statutory objectives, and also to the increase in competition triggered by the opening-up of markets.

To strengthen growth in Italy

The Italian economy has been recovering since the middle of 2005. Growth strengthened during 2006, to an average of nearly 2 per cent, a result that had not been achieved for five years. A similar rate of growth is expected in 2007, despite the slowdown in the first quarter. The recovery has been fuelled by investment and the growth in demand abroad, especially in Germany. Employment has risen substantially, but still largely in the number of temporary jobs.

The Italian economy may have shaken off economic stagnation, but its rate of growth is still one of the lowest in the euro area. In the first half of this decade labour productivity fell in every sector, and especially in industry. The disparity in relation to the rest of the euro area indicates slowness in the adaptation of Italian industry to the changes in the technological and competitive environment.

The recent improvements in productivity and exports, though still modest and largely cyclical, may nevertheless suggest that a process of restructuring has begun.

The restructuring of the industrial sector

A survey of more than 4,000 firms carried out in recent months by researchers at the Bank provides initial indications that this is indeed happening. More than half of the industrial firms in the sample have changed strategy in the last five years. The 12 per cent of firms that have shifted their product range towards new sectors earned higher than average profits in 2006. One firm in five, almost double the ratio compared with the beginning of the decade, is adopting some form of internationalization, ranging from cooperation with foreign partners, the preferred solution for small firms, to the outsourcing of manufacturing or marketing. In all the firms the importance of investment in product development, design, brands, and distribution and customer-service networks has increased. Among medium-sized and large companies the use of new technologies for integrated corporate management is becoming more prevalent and the proportion of better-educated staff is rising; corporate profits have benefited as a result. Profits are also inversely correlated with the age of company leaders, a fact of great significance in the country of family capitalism: firms that have tackled generational changeover report higher average profits.

Our survey, the many case studies accompanying it and data from other research bodies paint a picture of change, owing partly to a more severe winnowing of firms. According to the Chambers of Commerce, the number of manufacturing firms deleted from the registers has exceeded new registrations by more than 50,000 over the last five years. Confronted with the dual shock of globalization and technological change, the economy is beginning to react.

It would be wrong to conclude that the crisis of productivity and competitiveness of the last few years is now behind us. Productivity in industry, which fell by 3 percentage points between 2001 and 2005, rose by just over 1 point last year; in Germany, France and Spain it increased by between 3 and 6 per cent. The divergence of trends in unit labour costs has become more pronounced. We still have a long road ahead of us.

Company size remains crucial. Companies must achieve sufficient scale to support the high fixed costs of continuous innovation and an active presence in distant markets; even more than in manufacturing plant, scale matters in developing products, fostering brand recognition and standing, and organizing production. Field surveys reveal obstacles to growth. In our study, 40 per cent of the firms that considered themselves to be too small missed out on opportunities to expand by means of acquisition or merger over the past decade.

A gap to close

The transformation of the economy is being hampered by an institutional framework that still has major shortcomings, although it must be recognized that progress has been made. The reduction of unemployment, though important, is the only area in which Italy is in step with the timetable envisaged in the Lisbon Agenda. Italy is behind schedule as regards raising the employment rate, especially for women and older workers, education, vocational training, reducing the risk of poverty, innovation, and compliance with environmental constraints; in many cases the lag is greater than the average for the Union as a whole.

Last year I pointed to areas where structural measures are of particular importance for the growth of the economy and its enterprises. I would like to revisit some of those issues in the light of developments since then.

Education continues to head the list of fields where change is most necessary. The low international ranking of the Italian school system has a geographical aspect that deserves attention. The disparity in levels of scholastic achievement between North and South is significant even in primary school and tends to widen thereafter. One of every five 15-year-olds in the South is "knowledge poor", which is the prelude to economic poverty; the disparity is even larger if the South's higher drop-out rate is taken into account. Such a marked geographical difference shows that the problem lies not only in the rules but also in their practical application.

The recruitment of teachers, their distribution between regions and different types of school, and their career paths are governed by mechanisms that feature, at different stages, both precariousness and irremovability. Mobility bears little relationship to educational need, merit or capability. Every year more than 150,000 of Italy's 800,000 teachers change assignments in an arduous progression towards their desired position. Another negative factor is the delay in developing an effective school assessment system, which the experience of other countries suggests is an indispensable complement to school autonomy. Changing the Italian school system must begin with a recognition of the vicious circles that penalize it, demoralize teachers and betray the mission of public education. It is here that the problems originate, and not in a shortage of resources for education per student, which in Italy are actually above the European average.

For an advanced economy, an even more direct and immediate contribution to growth comes from the university system. Some important reforms enacted in the past, ranging from financial autonomy to the evaluation of the quality of research, have still not been completed. Priority in the allocation of public resources should be given to financing scholarships for worthy and less welloff students. Universities should be able to compete for students and public funding on the basis of the quality of their teaching and research staff , selected for their academic standing and paid accordingly.

The degree of competition in the domestic market in both public and private services affects the growth of firms competing in the international arena. In the countries where the legal and regulatory obstacles to competition in energy, telecommunications, transport and professional services are greater, manufacturing industry grows more slowly. Until a short time ago Italy was – and in some respects still is – among the countries where regulation is most unfavourable to consumers. To date, liberalization in the energy sector has been halting. Although the price of electricity for industrial users in Italy has risen only very slowly in recent years, excluding taxes it is still among the highest in Europe, about 20 per cent above the average. Action to liberalize the market for services, which has been initiated, is essential to regain competitiveness and growth. This objective should also be pursued because of the effects it will have on consumers' welfare, not least in terms of income distribution. In 2005 more than 15 per cent of the monthly consumer spending of the poorest 20 per cent of the Italian population went for goods and services now the subject of liberalization measures: €140 out of a total of €940, half of which was for energy in various forms.

The shortcomings are particularly prevalent in local public services, notably urban public transport and the collection and disposal of waste. The succession of rules enacted in the nineties were designed to separate the management of services, to be awarded by competitive mechanisms, from activities that are natural monopolies, and assigning regulatory powers to local government. These guidelines have been frequently disregarded. The results in terms of the cost and quality of services have been disappointing, with geographical differences depending on the administrative capabilities of local authorities.

Liberalization has progressed in other fields. In professional services, where Italian regulations had been the most restrictive among the advanced economies, the initiatives undertaken in 2006 have brought the level of regulation close to the middle of the international range. Action in the retail sector needs to be continued, by establishing not only in law but also in practice the principle that sales outlets should not be rationed geographically except on sound environmental grounds and by guaranteeing the full application of this principle at regional and local level.

The failings of the Italian civil justice system are documented in international studies and demonstrated by the inconvenience suffered by individuals and firms. An international comparison of the length of legal proceedings is unforgiving. To take just one example: labour disputes take an average of more than two years to pass through the lower courts in Italy, compared with a year in France and less than six months in Germany. The slowness of justice is due not so much to lack of resources as to organizational weaknesses and defects in the system of incentives. Here too there is a specific Southern problem; an ordinary civil case in lower court takes three times as long in Messina as in Turin, averaging 1,500 days against 500. The universal application of information technology would make proceedings speedier and more efficient and the operation of the various offices transparent; it would also supply the basic information that is indispensable for effective reorganization.

Information is vital if inefficiencies are to be eliminated. The quality of the services supplied must become the yardstick for evaluating government departments and the activity of their managers. The objectives must be clear and verifiable. Differentiating earnings partly on the basis of individual productivity, evaluated uniformly and transparently, would help attain them. This is provided for in the Memorandum of Understanding concluded between the Government and the trade unions last January.

Infrastructure represents an unresolved problem. The experience of recent years, after the amendment of Title V of the Constitution, has shown that concurrent decision-making between central and regional government is laborious and frequently ineffective. In the general interest, consideration should be given to the possibility that in certain cases it would be advisable, once a certain time has elapsed, to relieve the central government of the obligation to obtain the assent of the regional and local authorities. It must be possible to allow local needs to be expressed without for ever blocking public works that are necessary to the modernization of the country.

Sustainable public finances

According to Government estimates, net borrowing will come to 2.3 per cent of GDP in 2007, half a percentage point better than the target set at the end of last year. The primary surplus will rise to 2.6 per cent.

To ensure the sustainability of the public finances, deficit reduction must continue, with incisive action on the size and composition of the budget.

At the end of 2006 Italy's public debt reached €1,575 billion, or nearly €27,000 per person. For thirty years, from 1964 to 1994, its ratio to GDP rose steadily, from 32 per cent to 121 per cent. It then declined by 18 points by 2004, turning upwards again since then. Without asset disposals and the restructuring of liabilities, the ratio of debt to GDP would be approximately the same today as in 1994.

The accumulation of debt has not helped Italy to grow. It has not endowed the country with adequate infrastructure.

High debt constrains public policies; it requires higher taxes and reduces the resources available for investment and welfare expenditure. With interest rates rising, albeit by very little so far, interest payments are again tending to increase. They are already equal to the amount spent on public education and to two thirds of that spent on health care.

In 2005 there were 42 persons aged 60 or more for every 100 of working age. By 2020 they will have risen to 53 and by 2040 to 83. These trends will affect spending on pensions, health care and social assistance. The choice we face is whether to reduce the debt burden in the next ten years, before the aging of the population becomes more pronounced, or to wait, but in this case accepting major changes in the support that society will be able to provide to its weakest members.

The recent improvement in the public finances is due to the sharp increase in revenue. According to the Government's estimates, the ratio of tax and social security contributions to GDP will rise further this year. It is higher than the European average and close to the peak levels of the last few decades. Among the large European countries, France alone has a higher ratio. Because of tax evasion, which remains high despite signs of a recovery in tax receipts, the difference between Italy and the rest of Europe is greater in terms of the burden on honest taxpayers. The statutory tax rates on both labour and capital are high; the corporate income tax rate is only lower than that in Germany, where the Government recently announced a cut of 9 percentage points. An excessive level of taxation and the variability and complexity of tax rules discourage investment in physical and human capital and raise the cost of compliance.

Only by permanently reducing current expenditure can the deficit be curbed and the debt lowered without increasing the tax burden. Since 2000 primary current expenditure has risen by an average of one percentage point more per year than GDP. Its ratio to GDP has reached 40 per cent, comparable to the highest post-war levels.

The expenditure mechanisms need to be changed. In 2006 primary current expenditure still grew by 3.6 per cent, compared with the Government's budget forecast of 1.1 per cent. There is scope for saving in all the major items of the budget; the revision of expenditure programmes that the

Government has commenced goes in the right direction. Redistributive policies also need to be subject to a cost-benefit analysis.

A lasting adjustment requires action on the pension system. Life expectancy continues to rise and the number of Italians of working age to diminish; meanwhile, the employment rate is the lowest in the euro area. It is necessary to raise the average effective retirement age over time, not least in order to maintain an adequate level of benefit. The architecture of the system introduced in 1995 must be applied. Close correlation between an individual's pension contributions and benefits reduces the distortions in levies and disparities of treatment between different categories of worker, and permits flexibility in the choice of retirement age. Rigorous and prompt application of the adjustment mechanisms envisaged by the current legislation is essential.

But it will not be possible to return the system to a sustainable path and at the same time guarantee workers adequate pensions without a rapid and resolute launch of supplementary pension provision, which is still underdeveloped. The returns on investments in supplementary pension plans are likely to be better than those on severance pay funds, and further advantages derive from the additional contributions from employers and favourable tax treatment. The decision to bring forward the introduction of implied consent for the assignment of accruing severance pay to supplementary pension funds to 2007 and the new forms of flexibility in the use of accumulated savings move in the right direction. However, in many cases enrolment in supplementary funds is being discouraged by the excessive fees charged to savers; little of the benefit of the economies of scale generated by the growth of pension fund assets has materialized so far. Competition must increase; fees are insufficiently transparent and the restrictions on portability are excessive. The limits on the transferability of employers' contributions need to be reconsidered. Information must be improved: if workers are not fully acquainted with the facts of the public pension that they will receive in the future, they are not in a position to make informed decisions. Supplementary pension plans need to be extended to public employees as soon as possible.

Without prejudice to the stability of the public finances, and given that overall contributions to the public pension system equal 33 per cent of wages, by far the highest rate among the major European countries, thought should also be given to permitting individual employees to make voluntary allocations of a limited portion of their public pension contributions to supplementary pension schemes.

The financial industry and the capital markets

Italian open-end investment funds, which had 17 per cent of Italian households' savings under management in 1999, now have barely 7 per cent. The outflow of resources, which is still influenced by tax disparities, has gathered pace lately, and in the last three years amounted to almost €100 billion. The presence of foreign funds has grown as a result of distribution agreements with Italian banks, while Italian banking groups have moved part of their operations abroad.

Asset management strategies are still subordinated in large part to those of the controlling companies. Reducing the conflict of interest inherent in the cross-shareholdings with banks and insurance companies and the consolidation of asset management companies are vital for the growth of the industry. As I have already had occasion to remark, an open architecture and a clear separation between companies and between owners benefit bank shareholders and fund clients alike.

The presence of private equity in Italy is growing, although the volume of transactions remains far below that of the other main European countries. Between 2003 and 2006 the number of Italian management companies rose from 26 to 49 and funds' financial resources from €3 billion to €6 billion. Above all, the growth is among companies not belonging to banking or insurance groups; in 2006 they accounted for more than half the total resources invested.

Intermediaries specializing in the provision of equity capital can foster the growth of small and medium-sized enterprises, contribute to strengthening management, facilitate listing on the stock exchange and accompany generational changeover. Family ownership is a pillar of Italian capitalism; the entrepreneur's sense of identification with his enterprise is a driving force of growth. Precisely for this reason it is important to have the means of facilitating a changeover when this is necessary. When family owners lose their taste for creative risk, when the wealth invested in the business begins to be seen only as a source of rents or private benefits of control, the immobility of ownership may hold back the growth of the business and set it on a downward path. It is at this juncture that firms have the greatest need of these intermediaries. The potential benefit to all from a changing of the guard is then at its highest, as sometimes is the resistance of the owners.

There is a close link between the spread of specialized intermediaries and the growth of the stock exchange. More than a third of the Italian companies that listed between 1995 and 2006 were assisted by private equity firms, thus increasing access to the stock market in Italy, which until now has remained restricted mainly to large firms and has a much lower market capitalization than its counterparts in the other industrial countries.

In a rapidly evolving international context, the strategies that Borsa Italiana intends to pursue remain to be defined: its shareholders need to provide clarification. Consolidation between companies managing the international markets is under way; the integration of technical infrastructures has accelerated sharply. This offers excellent growth prospects for those who participate, but raises questions as to the long-term fate of those who remain on the sidelines.

Simple ownership structures increase firms' ability to attract equity investment. An appropriate system of corporate governance satisfies a need for fairness in the treatment of shareholders' property rights, but also criteria of efficiency. Less-than-transparent systems make it difficult for minority shareholders to provide a stimulus, accentuate the self-referential nature of management and protect the private benefits of the controlling group.

Italian listed companies frequently use complex organizational structures. Compared with other methods of separating ownership from control, a pyramid structure may make it more difficult to evaluate intra-group transactions adequately and increase the group's opaqueness. The complexity of the leading groups has declined in Italy in the last few years. Between 1990 and 2006 the average number of listed companies per group fell from 6.8 to 2.5, the number of layers of control diminished, and the control leverage decreased. Although changes in tax law and in the rules on group transparency played a part, this reduction in complexity was mainly due to market pressure. It is above all the application of the rules on intra-group transactions and the protection of minority shareholders that still needs to be strengthened. In the same period the market value of listed companies controlled under shareholders' agreements rose from 18 to 22 per cent of the total and their number from 5 to 11 per cent.

Banks

A year ago Italy's two largest banks ranked seventh and eighteenth in Europe in terms of stock market capitalization. The top three cooperative banks held 49 per cent of the category's assets in Italy. Today, if the operations announced by their boards of directors go ahead, the two leading Italian banks will climb to third and eleventh place, and the three largest cooperative banks will account for 73 per cent of the assets of that category.

What is happening in Italy is part of the process of banking consolidation that has been under way in Europe for several years. Most of the mergers have originated within individual countries; in some cases they have subsequently evolved into cross-border operations. Where the outcome has been successful, the resulting banks enjoy considerable economies of scale, benefit from greater risk diversification, and are highly capitalized.

The lead time before the synergy underlying a merger or acquisition must translate into greater shareholder value and more efficient customer service has been drastically reduced, however. The advent of the single currency, the growth of the financial services industry, and globalization itself have created a European and world market in bank ownership and control. Neither size nor nationalistic defences can safeguard those banks which, although sound, do not constantly seek to increase their value; the market therefore needs to see the fruits of consolidation very soon after the more complex stages of the operation have been completed. Concentration of the supply of banking services must not lead to a lessening of competition: customers must reap the full benefits of economies of scale.

Crucially, the governance, corporate structure and organizational arrangements the new banking groups adopt must ensure that they are soundly and prudently managed.

In many instances, the banks created by consolidation have introduced new forms of corporate governance, opting for the two-tier system; the activities of the new groups are coordinated by their operational holding company. The two-tier system of governance is effective if it is adopted in a way that ensures a clear division of responsibilities between the various corporate bodies. Overlapping responsibilities are detrimental to efficient decision-making and are considered by shareholders to destroy value; clear lines of responsibility also safeguard stability.

Particular attention must be paid to internal controls where a group holding company is formed or its scope is expanded to embrace the entity created by the consolidation. New banking groups must take prompt measures to ensure centralized risk management, particularly with regard to the most vulnerable lines of business. Special emphasis must be placed on reputational risk. Risk assessment models must be adopted and control functions put in place without delay.

The acquisition of large corporate shareholdings has become part of the strategy of the leading banking groups. For the banks, this means assuming new types of risk and may give rise to conflicts of interest. By law, such holdings have long been restricted in order to safeguard the stability of credit intermediaries. Developments in risk management techniques and in supervisory best practices now make rigid limits ineffective. Some time ago the Bank submitted a proposal to the Interministerial Committee for Credit and Savings that would allow to reduce administrative constraints by raising the limits on banks' permissible shareholdings; this is rendered possible by a supervisory system based on precise assessment of all the risks, adequate capital to cover them, the control of conflicts of interest by means of governance and transparency safeguards, and in the future more effective regulation of connected lending.

Assessment of the merit of individual mergers is left to the market and the banks' shareholders, who must be assured full information and adequate opportunities to be heard. They in turn have a duty, particularly in this regard, to be especially active in ensuring that the objective of mergers and acquisitions is to increase value and then in verifying that management decisions are consistent with that aim. This role should be performed in particular by institutional investors, given their fiduciary responsibility towards those who have entrusted them with their savings, and by banking foundations, which manage funds in the interest of the community. The latter's responsibility is all the more delicate and important for being less clearly defined in formal terms.

The present limits on non-financial corporations' shareholdings in banks and the associated prohibition on their acquisition of controlling interests will also be reviewed in the light of the forthcoming Community legislation.

Conditions are now ripe for reform of the legislation governing cooperative banks, to which it is hoped they will make a constructive contribution. A regulatory structure originally designed for small banks is in some respects no longer adequate to cope with the increasingly broad and fragmented ownership that has emerged as a result of consolidation. The legislative proposals to raise the limits on individual shareholdings, strengthen the role of institutional investors and broaden the mechanisms for proxy voting, without destroying the cooperative nature of such banks, are to be welcomed.

In 2006 the capital adequacy ratio of Italy's banking system rose to 10.7 per cent, although that of the leading groups declined slightly. In 2008 all Italian banks will adopt the criteria of the Basel II Accord. Depending on the composition of risk, this may lead to reduced capital requirements; it will certainly result in greater variability between banks. In order to guarantee leeway, the Bank of Italy is working to ensure that banks' capital ratios, in relation to the degree of risk and the accuracy of risk management methods, remain well above the minimum requirement. Discussions with the banking groups that plan to adopt internal systems for calculating their capital requirements have intensified of late.

In recent years cost reductions have contributed to the improvement in the operational efficiency of the leading Italian banking groups, which is now on a par with the average for the major European banks. Despite the progress that has been made, return on equity is lower, however, mainly owing to heavier loan losses; although favourable economic conditions are contributing to an improvement, the quality of Italian banks' assets is still lower than that of the other leading European banks.

The exposure of Italian banks to hedge funds represents less than 3 per cent of their capital. Their exposure to private equity funds is larger; together with loans to the companies in which these funds invest, it amounts to 13 per cent of their capital. Exposures are concentrated among the large banks. In the credit derivatives market the banking system is on average a net buyer of protection.

The integration of the European markets brings new challenges for supervisors. The coordination bodies created by the Lamfalussy procedure have helped to harmonize regulation and strengthen cooperation among the authorities of the various countries. In 2006 we took part in coordinated simulations of critical events, so as to be ready to cope with episodes of instability having international effects. The convergence of supervisory practices must be carried further, to make the system less cumbersome, reduce the costs for banks and ensure equal competitive conditions.

To simplify the rules while protecting stability and to keep watch over banks' reputations by increasing the safeguards for customers have been our principles in regulating the banking system.

In 2006 and the early months of 2007 the Bank of Italy abolished the requirement to give advance notice of the intention to acquire control of a bank, repealed the rules on maturity transformation and the limits on banks' medium and long-term lending to firms, simplified the procedures for opening new branches, issued regulations for banks' covered bonds to create a broad and reliable market, and launched a review of all the supervisory legislation with a view to drastically reducing the number of authorizations.

Public confidence remains essential for the soundness of banks. The Bank of Italy verifies compliance with the rules on the transparency of banking and financial transactions and services; the extensive checks it makes at intermediaries help to improve the standard of their dealings with customers. In addition to ensuring contractual correctness, the information banks give to customers must be clear and simple. In order to strengthen the real protection of savers and firms, we plan to review all the legislation on transparency and reduce the bureaucratic formalities.

We have launched a new survey on the cost of bank current accounts, among other things to ascertain the importance of structural factors such as the impact of taxation and the excessive use of cash.

The recently approved European directive on retail payment services opens the market to new operators, such as large retailers and mobile phone companies; it increases competition, reduces costs, broadens the supply of services and lays the foundations for an integrated payment system in Europe. The Bank of Italy will support an extensive application of the directive, which it is to be hoped will soon be transposed by Parliament.

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Italy has transformed its banking system, begun to put its public finances in order and started to grow again.

I have already reported on the progress made by the banking system. The role we played in this regard was neutral, not detached. We indicated the objective, not the actors: to aim for growth, abandoning the parochialism of the past and accepting the challenge of the market. This was where the transformation originated, not in the plans of the authorities. It is now essential that shareholders, households and enterprises clearly discern the benefits, in the shape of stronger banks ready to offer a wider range of services at lower cost. Finally, the conflicts of interest that are ever present in the land of cross-shareholdings have to be resolved. The Bank will follow all of these developments closely.

A modern financial system does not tolerate the mixing of politics and banking. Let the separation be clear-cut, and both will be strengthened.

For the public finances once again to foster growth and not hamper it, their adjustment must involve less current spending, more investment and lower taxes, and above all it must continue; we have ceased to accumulate debt, we have not begun to reduce it.

We must tackle the structural weaknesses of our economy with greater determination. Household consumption, eroded by the extraction of rents and held in check by uncertainty about the outcome of reforms deeply affecting people's lives, must regain its vigour.

Never dealing with the problem of pensions definitively has a cost in terms of lost growth and lower consumption.

These are attainable objectives if we all, each according to his own role and without tarrying to lament lost opportunities but drawing strength from awareness of the progress already made, can rediscover that sense of the common good that is essential to the enduring development of the country.