

Ignazio Visco: Overview of economic and financial developments in Italy

Concluding remarks by Mr Ignazio Visco, Governor of the Bank of Italy, at the Ordinary Meeting of Shareholders 2012 – 119th Financial Year, Bank of Italy, Rome, 31 May 2013.

* * *

Ladies and Gentlemen,

In these remarks I will give an account of a difficult year and speak about the severe test that we have all had to face. I will recall you of what has been done, describing the role of the Bank of Italy. I will speak about the progress made, even if it is insufficient; about the results achieved, although these are still fragile; about the need not to waste but to defend and consolidate these achievements in order to set the recovery process in motion; and lastly about the conditions for a return to balanced growth.

Allow me to start with a farewell, in fact with more than one. On 28 April, in this delicate moment in the life of the country, our Director General Fabrizio Saccomanni was called to join the Government as Minister for the Economy and Finance. Endowed with outstanding personal and professional qualities, he has worked in almost all of the Bank's institutional and administrative fields of action. His experience, his thorough knowledge of the European and international organizations in which he has held prominent positions and performed important tasks for Italy, the competence and balance he has demonstrated in his many years of service to the Bank, for which we owe him a debt of gratitude, will be even more essential in the test that awaits him. We extend our warm best wishes to him.

He is succeeded by Salvatore Rossi, our former Deputy Director General, who has for many years combined broad managerial responsibilities with economic analysis attentive in particular to innovation and development. As Director General, he is also Chairman of the Insurance Supervisory Authority, which at the beginning of the year was placed by law under the direction of the Governing Board of the Bank of Italy, assisted by two outside directors.

In July 2012 Anna Maria Tarantola, the first woman on our Governing Board, left the Bank to become president of the state broadcasting corporation RAI, a challenging assignment that recognizes her management skills and professional rigour. In December, at the end of a career that was exemplary for commitment, dedication and analytical and institutional contributions, Deputy Director General Giovanni Carosio concluded his mandate. I would like to thank both of them warmly for their contribution of ideas and activity on behalf of the Bank.

Between October 2012 and 10 May the Governing Board was brought back up to strength with the appointment of Deputy Directors General Fabio Panetta, Luigi Federico Signorini and Valeria Sannucci. The new members of the Governing Board previously held positions of responsibility at the highest levels in the fields of monetary policy, financial stability, supervision, internal administration, and coordination of the activities connected with the Bank's participation in the Eurosystem and the banking union project.

The Bank of Italy is required to submit a yearly report on its activities to Parliament and the Government. Starting this year, the report has been enlarged and will be presented together with the annual report and financial statements. In this way we will be able to give a full account of the Bank's operations and activities, its analyses, guidelines, administrative actions and organization.

The fundamental responsibilities of the Bank of Italy for monetary policy within the Eurosystem and for supervising the national banking and financial system are well known. At the same time the Bank is a complex organization providing services that benefit both intermediaries and the general public. We administer the resources entrusted to us with diligence. The report on operations describes the steps taken to rationalize our procedures, improve the quality of our services and achieve greater efficiency.

As a member of the Eurosystem, the Bank is involved in the payment systems, in the production of banknotes, and in ensuring the business continuity of common IT systems, often as lead institution in charge of joint activities and projects. Together with the three other largest central banks of the euro area we are creating a centralized platform for the settlement of securities transactions.

At home, last year we made further progress in automating the centralized state treasury service and promoted the widespread adoption of the European format for payment services, thereby helping to cut costs and foster competition. Against a background of worsening economic conditions and risks for financial stability, we further strengthened our supervisory controls on banks and other intermediaries, stepped up inspections, and broadened our checks on compliance with the rules for consumer protection and against money laundering.

The European Central Bank, the national central banks and the national supervisory authorities are working to create the single supervisory mechanism. This far-reaching institutional innovation will require an organizational adaptation as significant as, and even more complex than, the one leading to the single monetary policy. The project must capitalize on the best national practices; it must aim to achieve a common system of supervisory rules and practices ensuring pursuit of high and strict standards. We attach special importance to aspects that are a fundamental part of our tradition, such as the central role of inspections, methodologically robust analysis, and continuous discussion and dialogue with banks' boards of directors and top management.

The single supervisory mechanism will be based on the close integration of European and national structures in the case of the largest banks, and on the direct responsibility of national authorities – within the framework of common guidelines – for the rest; the tasks of customer protection, combating money laundering and supervision of non-bank intermediaries will continue to be conducted at national level. The delicate launch phase will require substantial investment in human and technical resources. The workload will not diminish, either for us or for the supervisory authorities of the other countries, as we strive to combine frameworks that differ in many respects.

Concerning the events involving Monte dei Paschi di Siena, a detailed account of the supervisory initiatives and the measures adopted was made available on the Bank of Italy's website at the end of January and has since been updated. Supervision of Monte dei Paschi has been continuous and increasingly stringent in recent years; the judicial authorities will assess whether this activity was obstructed by former directors and managers. From 2010 to 2012 we demanded that steps be taken to restore a balanced liquidity position, thereby staving off serious threats; we requested a marked strengthening of capital and of the internal control system; we prompted a radical change of management. We are working closely with the judiciary, to the benefit of our respective institutional objectives: safeguarding stability and suppressing illegal actions. The contribution of the Financial Intelligence Unit is fundamental. We have operated properly and with diligence and care, within the scope of the law; we welcome constructive comments.

In 2012 the Bank of Italy considerably increased the volume of its assets, participating in exceptional single monetary policy interventions, particularly the expansion of bank refinancing operations. This has resulted in larger profits, but also in the need for greater precautionary allocations to risk provisions. The Treasury will receive a payment of €1.5 billion, on the basis of the Statute and subject to approval of the financial statements. The taxes owed by the Bank on its income and productive activities for the 2012 financial year amount to almost €2 billion.

From 2008 to 2012 the Bank's operating costs fell by more than 10 per cent; its staff was reduced by about 700 to just over 7,000. Technology has made possible large savings in resources and improvements in services in the payment sector. We have reduced internal administration and reinforced banking and financial supervision. The Governing Board and

the Board of Directors agree on the objective of eliminating most of the Bank's network at the provincial level.

We have not ceased to recruit staff, using transparent and merit-based procedures, including innovative methods, to select highly qualified young people. Women account for 35 per cent of all personnel and 23 per cent of employees with managerial responsibilities; both percentages are rising. We promote gender equality in recruitment, in the assignment of positions and in career progression. We will continue to do so in the interest of good administration.

I wish to convey my personal thanks and those of the Governing Board to the managers, directors and all the staff who work for the Bank of Italy, proudly performing their public duties with discipline and honour, as the Constitution requires; capable, when times are hard, of an outstanding, self-sacrificing commitment of effort, skill, passion, dedication and openness to change. The Bank and the country know they can count on them.

Monetary policy in the euro area

Conditions on the global financial markets have improved, but the world economy has yet to return to a steady growth path. The economic situation differs markedly in the main regions. The major emerging countries are still growing at rapid rates. Among the advanced countries, the United States appears to be gradually returning to the rates of growth that characterized the most recent expansions. In Japan, aggressively expansive policies, not devoid of risk, are seeking to stimulate economic activity. The euro area is struggling to pull out of recession: demand is dampened by the immediate effects of public and private deleveraging in many countries; cyclical weakness is spreading to the economies not directly exposed to the sovereign debt crisis.

Recovery in the euro area requires help from every sphere of economic policy. Including by recourse to "unconventional" instruments, monetary policy has made an essential contribution to averting serious consequences for financial stability; it has safeguarded price stability. The tools of intervention have been chosen based on the characteristics of the financial system, the origin of the tensions and the institutional structure: we have aimed first and foremost to support the liquidity of the banks, which in the euro area, more than elsewhere, play a pre-eminent role in financing the economy, and to prevent sovereign debt market distortions from impeding the proper transmission of monetary policy.

We remarked a year ago that the levels to which sovereign interest rates had risen in many countries of the area reflected not only the deterioration of national growth and fiscal prospects, but also a systemic risk factor, subsequently called "redenomination risk", connected with fears of a break-up of the monetary union, due in part to the incompleteness of its institutional design. We documented this risk swiftly and analytically; our results have been confirmed by the studies of other institutions and have been adopted by the Eurosystem.

At the end of June the summit meeting of euro-area heads of state and government approved flexible and efficient utilization of the financial support mechanisms – the European Financial Stability Facility and the European Stability Mechanism – to stabilize the financing conditions of the countries exposed to the sovereign debt tensions, provided they honoured their European commitments. The possible use of those mechanisms for the direct recapitalization of banks, after the creation of a single supervisory mechanism, was envisaged.

In early August the ECB Governing Council announced the introduction of outright monetary transactions (OMTs) for purchases of government securities on the secondary market, with no quantitative limits. A few days before that the President of the ECB had promised to do whatever was necessary to safeguard the euro. In September the details of the scheme were defined.

Countering the increase in interest rates on sovereign debt when that increase stems from redenomination risk and distorts the transmission of monetary policy falls fully within the Eurosystem's mandate. The benefits of the announcements of the new measures were immediate: medium- and long-term yields came down in the countries under pressure; the fragmentation of markets along national lines lessened.

The steps taken by the Eurosystem in the last two years have counteracted the worsening of credit conditions in the euro area and its repercussions on the macroeconomic situation. In Italy, according to our estimates, they have helped to buoy output by at least two and a half percentage points over that span. Our estimates, however, cannot measure the effects of the financial collapse that could have occurred in the absence of these interventions, with disastrous consequences for the national and European economies.

In recent months the fears concerning the single currency's survival and financial conditions in the area have abated further; one factor has been the expansion of global liquidity, which has spurred a search for high yields on the part of institutional investors. In Italy, interest rates on government securities have also declined on the longest maturities, returning to the levels prevailing at the beginning of 2010.

Yet these advances have not been accompanied by an improvement of the real economy; economic activity continued to be weak throughout the euro area in the first quarter. Credit conditions still differ from country to country, owing not only to the diversity of macroeconomic situations but also to the residual uncertainty as to the future conditions of funding in the national banking systems.

At the beginning of this month, considering the contraction of demand, the prospect of prolonged cyclical weakness and the decline of both actual and expected inflation in the medium term to well below 2 per cent, the ECB Governing Council lowered the rate on main refinancing operations further, taking it to a new historic low of 0.5 per cent. The Council reiterated that the unlimited supply of liquidity at fixed rates would continue for as long as necessary and in any case until July of next year. The ECB, in concert with other European institutions, is examining initiatives to promote a market in securities backed by loans to non-financial corporations.

The Governing Council stands ready to intervene again as new information becomes available and to consider all possible measures for maintaining credit conditions throughout the area consistent with the monetary policy stance. The ECB's management of official interest rates has proven effective; the effects of last year's reductions have spread to the countries hardest hit by the tensions.

The measures taken, in particular the announcement of outright monetary transactions, are conducive to the national and European reforms which alone can eradicate redenomination risk. Monetary policy can guarantee stability only if the area's economic fundamentals and institutional architecture are consistent with that objective.

Every country must do its part. The procedure for the activation of OMTs presupposes the emergence of very serious tensions; it can only be applied to countries that have previously requested, possibly on a precautionary basis, a European financial assistance programme, and it is subordinated to compliance with the conditions attached. These reflect the awareness that the fears of euro reversibility are not disjoined from those for the sustainability of the public debt and the growth prospects of individual countries.

More than any conditionality, however, what is essential is the shared determination to advance towards a complete European Union: monetary union, banking union, fiscal union and finally political union. Important strides forward have already been taken. Under the pressing time constraints dictated by the crisis, there has been uncertainty, mistakes have been made, decisions have not been easy. But the way ahead is clear.

We must proceed along the path of integration. The banking union project is designed to break the spiral between sovereign debt and the conditions of banks and credit. The

importance of this has been further underscored by the handling earlier this year of the banking crisis in Cyprus, which was resolved only after problems of coordination between European and national authorities had emerged. The creation of a single banking supervisory mechanism in which the ECB and the national authorities play a pivotal role is the first step. It must be completed by rapid introduction of a common bank resolution scheme and common deposit insurance.

The contours of the project for the common budget for the euro area must be defined and a timetable for its realization drawn up. The report of the European Commission last November and the one drafted by the presidents of the European Council, the Commission, the Eurogroup and the ECB move in this direction. The institution of common mechanisms of financial support for structural reforms in single member countries can constitute the occasion for the launch of the project and the issue, on a trial basis, of joint debt securities.

The Italian economy

Italy's weak recovery following the global financial crisis ended in the second half of 2011, when our government securities market came under pressure. There ensued a vicious circle between the state of the public debt, of banks and credit, and of the real economy. Economic activity contracted by 2.4 per cent last year.

This year too will register a substantial fall in output and employment. A cyclical upturn towards the end of the year is possible; it will depend on the acceleration of world trade, the implementation of appropriate economic policies, positive developments in expectations and investment conditions, and the availability of credit.

The recession is deeply undercutting potential output and threatens to erode social cohesion. In 2012 Italy's gross domestic product was 7 per cent smaller than in 2007, households' disposable income was more than 9 per cent lower, and industrial production was down by a quarter. Hours worked were down 5.5 per cent, and more than half a million jobs had been lost. The unemployment rate, at 11.5 per cent this March, has practically doubled since 2007; it is nearly 40 per cent among young people and higher still among those in the South.

The financial and international origins of the crisis, on which economic policy makers have mostly focused, must not blind us to the fact that in Italy more than in other countries the cyclical ups and downs are superimposed on serious structural weaknesses. In the ten years preceding the crisis, this was already evident in the overall performance of the Italian economy, which fared worse than those of nearly all the other major advanced countries.

We failed to respond to the extraordinary geopolitical, technological and demographic changes of the last quarter-century. The adjustment required, and put off for so long, is historic in scope. It will affect the accumulation of tangible and intangible capital, product specialization and the organization of production, the education system, skills, career paths, the characteristics of the welfare system and income distribution, the positional rents that are incompatible with the new competitive environment, and the working of government. An adjustment of this magnitude needs a decisive contribution from the political system, but the response of society and all the forces of production is essential.

Firms are called upon to make an exceptional effort to ensure the success of the transformation by investing resources of their own, seizing the opportunities for growth, adapting their corporate structures and organization, relying on innovation and their ability to hold their own in the most dynamic markets. They have demonstrated their ability to do so at other times in our history. Some are doing so now. But too few have been willing to take the plunge; at times, instead, the illusory solution of public support is advocated.

This year's Report contains a special section on innovation in Italy. The ability to renew products and processes, to export to emerging markets and to internationalize, including by heading or joining global production chains, divides the firms that are continuing to expand sales revenue and value added from those that, instead, are struggling to remain on the

market. The recession has deepened this divide and made the inadequacy of some parts of the productive system glaringly obvious.

Transferring activity from ailing to growing sectors and firms requires profound changes in employment relationships and in the education system. The point is not so much to foresee which sectors and activities will attract consumption and investment demand in the decades to come as to facilitate the transition, reduce the social costs, and capitalize on opportunities.

Many occupations are disappearing; in the years to come young people cannot simply count on replacing their seniors as they retire. Now is the time to establish the right conditions for the birth and growth of new enterprises and to generate new job opportunities. Lifelong vocational training must be developed to cover working careers characterized by mobility and change, with workers safeguarded by reinforced safety nets and insurance systems, both public and private, during periods of inactivity. Schools and universities must support this process by ensuring education of adequate quality and quantity, acting with determination to raise levels of academic achievement and develop new skills.

Italy needs conditions that are conducive to enterprise and to the reallocation of productive factors. The lag we have accumulated is accentuated by a redundant regulatory framework, by complex and costly administrative obligations that must be drastically reduced, law that must be rendered more certain, widespread corruption that must be stamped out, and insufficient protection from crime. Immediate, visible progress in removing these serious obstacles can stimulate productive investment, including from abroad, in all the country's regions, especially in the South, where what is most critical is the environment for business activity, on which the balanced development of our economy ultimately depends.

The programme of reforms launched in the last two years stems from these considerations. But in many instances, after the enactment of reform laws, the implementing measures have been slow to follow; in some cases they are still lacking and administrative practices remain unchanged. This is a recurrent feature of our country's history: the chief difficulties reside not so much in the substance of the laws as in their effective application.

The pace of reform has slackened in the past year, owing in part to the progressive deterioration of the political climate. In resuming the path of reform with determination – as the European Commission too urges in the recommendations accompanying the closure of the excessive deficit procedure – it is vital to adopt a comprehensive approach that fixes medium-term objectives from the outset. Structural reforms take time; they can be implemented in succession, provided that they are designed as part of a bigger picture that immediately clarifies their goals, implications and benefits. A credible programme can have an impact on expectations at once, dispelling uncertainties, fostering investor confidence and favouring the prospects of employment and income, above all for the young, who today find it difficult to imagine any future in our country.

The consolidation of the public finances was also postponed for too long; in the face of demographic pressure on important expenditure items, the priorities for the allocation of resources were not clearly set. In 2007 public expenditure excluding interest payments was 43 per cent of GDP, two percentage points more than in 1997; the primary surplus had contracted by more than three points. In the same period in Germany primary expenditure decreased by more than four percentage points of GDP to just under 41 per cent.

The response of budgetary policy in the wake of the collapse of Lehman Brothers was prudent in Italy: the support to economic activity in 2009 was provided through discretionary measures affecting the composition of the budget, without increasing the deficit.

From 2010 onwards, the budgetary stance became restrictive. Following the explosion of sovereign risk, to avoid a potentially devastating confidence and liquidity crisis, in the second half of 2011 a correction to the public finances of the order of 5 per cent of GDP was introduced. This made it possible to bring the deficit down within the 3 per cent limit in 2012 and to aim at structural balance as early as this year.

The adjustment had a negative impact on GDP growth in 2012 of about one percentage point. A larger impact, of about two points, resulted from the effects of the liquidity crisis on the cost and availability of credit for the private sector, the slowdown in world trade, and the increase in uncertainty and the related loss of confidence. The adjustment of the public finances helped to reduce the tensions on the government securities market, thereby preventing even worse developments.

The advances made must be preserved. Squandering them would have grave consequences. It would be illusory to imagine we can overcome the crisis by means of budget deficits: investors and market participants allow us only a thin margin of confidence today. The volume of government securities to be placed every year to finance the deficit and, above all, to roll over the maturing debt is on the order of €400 billion.

This year there is no room for any further increase in the deficit, since the margin available has been earmarked to pay general government's commercial debts in relation to capital outlays. These payments can be brought forward, however, and those relating to current expenditure, which affect the debt but not the deficit, can be increased; above all, no new debts of this kind must be formed. The conditions need to be created for taking full advantage of the existing instruments and subsidies to enable young people to enter and remain in the labour market.

The European Commission has undertaken to examine ways to allow national budgets to deviate temporarily from their medium-term objectives – keeping the deficit below 3 per cent of GDP – in order to finance investment projects, subject to specific conditions. In Italy, this could benefit investment to protect and enhance the value of the environment and our artistic and cultural heritage.

Reductions in taxation, which are necessary in the medium term and which could be planned now, will necessarily be selective, giving priority to labour and production: the tax wedge on labour acts as a brake on employment and business activity. Tax evasion distorts the allocation of the factors of production, gives rise to unfair competition, hinders growth in firm size and increases the burden borne by law-abiding taxpayers. It needs to be fought at the supranational level as well. A significant contribution to better fiscal conduct can derive from the simplification and rationalization of taxes and formalities. The certainty of tax rules and their careful and balanced formulation can influence expectations, and hence demand, more and better than immediate tax cuts of uncertain sustainability.

A reallocation of expenditure in favour of the more productive components is possible by pursuing improvements in efficiency and recoveries of resources across the board. If this method is adopted permanently, the functioning of general government can more nearly approach international standards. Significant results will not be possible without involving local government. Transferring resources on the basis of standard costs, with any excess expenditure borne by the local authorities concerned, encourages the dissemination of best practices. The efficient use of public resources requires a reassessment of the different levels of government, with the elimination of redundancies.

The banks and lending

The outlook for domestic demand also depends largely on credit access conditions. Lending to firms slowed sharply in the second part of 2011 and since the beginning of December of that year has contracted by about €60 billion. The decline, which was particularly abrupt at first owing to the banks' severe difficulties in raising funds on the international markets due to heightened sovereign risk, continued at a more moderate pace during 2012; in the first four months of 2013 the contraction accelerated again, to nearly 4.0 per cent on an annual basis. Lending to households has also declined but less so. The cost of credit to firms, which rose in the course of 2011, declined for most of last year but stopped falling in the autumn. Bank lending rates are still higher than the euro-area average by about one percentage point for loans to firms and by half a point for mortgage loans to households.

The banking system is the main source of funding for our economy. At the end of 2012 bank credit to firms and households amounted to just under €1.5 trillion, or 94 per cent of GDP; banks' investment in government securities came to around €350 billion. The highly unfavourable state of the economy depresses credit demand today. The contraction in lending reflects the decline in business investment, the fall in purchases of durable goods and the weak property market. But the decline in lending is also due in significant measure to the tightening of supply, which is in turn linked to a deterioration in customer creditworthiness and its impact on banks' asset quality. In turn, the credit supply conditions have an adverse effect on economic activity, creating a negative spiral that must be broken.

The acute restriction of credit supply at the end of 2011 in response to funding difficulties was attenuated by the unlimited supply of three-year liquidity by the Eurosystem and by the increase in the range of the assets eligible as collateral for refinancing operations. The Bank of Italy allowed Italian counterparties to use less creditworthy illiquid assets, in this case charging all the associated risks to its own balance sheet. The collateral pledged with the Bank of Italy based on bank loans currently amounts to around €180 billion, which represents slightly less than a third of all the assets eligible for central bank refinancing and half of those actually in the collateral pool.

Thanks to these measures immediate liquidity risks have been averted. The funds obtained through the three-year refinancing operations do not constitute a permanent resource, however. Tension on the government securities markets has not completely dissipated. There is still uncertainty regarding the banks' ability to regain full access to the international markets, particularly the long-term segments. We are working, through discussions with the banks and in collaboration with the ECB, to expand the range of eligible assets.

An increased risk of corporate default is driving up the interest rates on loans. Since the middle of 2012 this has offset the effect of the lowering of official rates and, more recently, of the decline in yields on government securities.

The credit supply tensions seem to be affecting even firms with a balanced financial situation, albeit to a smaller degree. The difficulties are greatest for small and medium-sized firms, which are less able to tap other sources of finance. Gross issues of corporate bonds amounting to €35 billion last year were attributable almost exclusively to large groups. In 2012 the interest rate differential between bank loans of up to €1 million and those for larger amounts averaged 160 basis points, about twice the value recorded in the three years prior to the crisis.

At the end of 2012 the stock of bad debt had risen to 7.2 per cent of total lending, compared with 3.4 per cent in 2007; and that of other non-performing loans to 6.3 per cent, up from 1.9 per cent. For corporate loans, the new bad debt ratio recently rose to over 4 per cent on a seasonally adjusted annual basis, a level not reached for twenty years. The leading indicators suggest that it will remain high until the end of 2013.

The Government and trade associations have taken many steps in recent years to mitigate firms' difficulty in obtaining credit and to meet their liquidity needs, strengthening measures already adopted and introducing new ones. Between 2009 and 2012 almost €60 billion in financial benefits was made available to small and medium-sized enterprises through debt moratoria and the interventions of Cassa Depositi e Prestiti and the Central Guarantee Fund. The Fund's resources can be increased, taking care to ensure that the guarantees to be provided are for additional loans granted on more favourable conditions, and that beneficiary firms are fully informed about the public support measures.

Faced with the deterioration of banks' loans, the Bank of Italy has intensified its scrutiny of banks' provisioning. Off-site and on-site checks have been conducted, with banks asked to continually assess the adequacy of the coverage ratio of their non-performing-loan and urged, when necessary, to take corrective measures. This action will continue, partly in conjunction with similar exercises agreed at international level, with a view to the creation of the single European supervisory mechanism.

For the twenty large and medium-sized banking groups so far subjected to checks, coverage ratios ceased to fall and instead rose by two percentage points in the second half of 2012 to 44 per cent. Increases were recorded for the other banks as well.

If the Bank of Italy's supervision had been less incisive, the risks for the banks and for the economy would have been extremely serious. The promptness and credibility of supervisory action reassured international investors about the quality of Italian banks' balance sheets, sparing Italy's banks the destabilizing wave that struck other European banking systems and enabling them to continue to supply credit to households and firms. The coverage ratios reached must be maintained and in some cases raised.

To minimize the procyclical effects of the interventions, we called on the banks to increase their internally generated resources by further curbing operating costs, dividends and executives' and directors' compensation, consistently with banks' profitability and capital adequacy. For banks that will have to undertake more far-reaching adjustment, a contribution must come from the sale of non-strategic assets. A correction of the current tax penalization of value adjustments to loans would be opportune. The stretching out in time of their tax deductibility, which is not the rule in the major countries of the European Union, discourages lending to firms during economic downswings.

Over the past five years the Italian banking system, starting from sound initial conditions, has weathered the global financial crisis, the instability of the sovereign debt market, and two deep recessions. Since the onset of the crisis, the highest quality capital has increased from 7.1 to 10.7 per cent of the entire banking system's risk-weighted assets; for the five largest groups the ratio has risen from 5.7 to 10.9 per cent.

The soundness and resilience of the Italian financial system were recently confirmed by the International Monetary Fund at the conclusion of its periodic financial sector assessment. The outcome of the IMF's stress testing to date shows that our banks as a group are in a position to withstand shocks thanks to their capitalization and the liquidity provided by the Eurosystem. The Fund emphasized the fundamental contribution of supervisory action to systemic stability.

The capital ratio gap between Italian banks and the European average, which has narrowed to about two percentage points, is due in large part to the massive injections of public capital to banks in other countries. In December government support to the banks amounted to 1.8 per cent of GDP in Germany, 4.3 per cent in Belgium, 5.1 per cent in the Netherlands, 5.5 per cent in Spain and 40 per cent in Ireland. In Italy it came to 0.3 per cent including the interventions in favour of Monte dei Paschi di Siena.

These interventions, now being vetted by the Commission, were necessitated by the European Banking Authority's recommendation that EU banks procure extraordinary, temporary supplementary capital buffers to cope with fluctuations in the value of their government securities holdings. These resources will also facilitate the restructuring plan adopted by Monte dei Paschi's new management. The government has granted the bank a loan on onerous terms. The restructuring plan has ambitious objectives; its success will depend in part on economic and financial developments in the country as a whole.

Italian banks' financial leverage ratio (total balance-sheet assets over capital) is 14 to 1, compared with an average of 20 to 1 in the rest of the European Union. In the last two years the Italian banks taking part in the Basel Committee's periodic monitoring have sharply reduced the additional capital they would need if the new "Basel III" requirements (including the capital conservation buffer) were fully in effect from €35 billion to €9 billion.

Capital strengthening, transparency of accounting and rigorous risk evaluation criteria sustain investor confidence and help contain banks' outside funding costs in particularly adverse circumstances. But the ultimate guarantee of banks' stability is their capacity to generate earnings. Looking ahead, declining profitability threatens to weaken capital and undermine banks' ability to finance the recovery of the real economy. Between 2007 and

2012 Italian banks' return on equity declined. Last year it was 0.4 per cent net of extraordinary items in connection with goodwill impairments.

The risk of unfavourable developments over the next few years must be countered first of all by effective action to curb costs. In a highly labour-intensive industry like banking, consideration must be given to measures, even temporary ones, to reduce staff costs in relation to revenue. The provision of the 2011 industry-wide labour contract for company-level agreements to combine flexibility and solidarity moves in the right direction. In order to cope with contingent difficulties and actually preserve jobs, banks must proceed resolutely along this path.

Change in the use of productive factors and in the channels of distribution must be promoted, fully exploiting the opportunities offered by the new technologies. In the last fifteen years the Internet channel has gained importance in relations with customers, but the impact on the traditional branch network has been limited. Differentiating between these two channels, one for standardized services and the other for more complex and customized products and services could help to reverse the Italian banking industry's decade-long upward trend in costs as a proportion of revenues.

In any event, customer trust remains fundamental. Progress has been made on this front, but further improvement is needed to enhance the quality and completeness of customer information, to ensure that the contractual terms as advertised correspond fully with those actually applied, and to prevent improper charges being levied on customers. The Bank of Italy has drawn up clear rules, compliance with which it verifies also by means of special inspections, imposing fines when irregularities are detected.

For several years now, for individual disputes there is the Banking and Financial Ombudsman, acting through three territorial panels and independently of the Bank of Italy. It has proved to be effective and highly regarded. We intend to strengthen it further and are considering increasing the number of panels. Promptness of compliance with the Ombudsman's decisions is one factor in the Bank of Italy's assessment of banks.

The difficulties in the financing of firms necessarily invite reflection on the overall structure of Italy's financial system, the underdevelopment of the bond and equity markets and the consequent excessive dependence of firms on bank loans. As we have underscored on other occasions, this structure partly reflects Italian firms' reluctance to go to the market, although the banks have not pressed them sufficiently to do so.

The current situation demands that both sides overcome these hesitations. For solid businesses with good growth prospects, the difficult conditions of the market for bank credit are a powerful stimulus to tap the capital markets. On the banks' side, an advanced financial system would enable them to diversify their sources of revenue, maintain a balanced loan-to-deposit ratio and share the risks of financing customers with the markets. While paying due attention to conflicts of interest, banks can encourage firms' recourse to the market by exploiting the advantage in assessing creditworthiness that derives from their long-term relationships.

The capital strengthening of firms and their opening to the capital markets also require far-reaching changes in the entire financial system. It is indispensable that the role of pension funds and other long-term investors be reinforced; appropriate incentives must be provided for the accumulation of equity capital.

In the present difficult economic conditions and with the prospect of a comprehensive revision of banks' business model, the role of shareholders is crucial. They will have to be able to support banks financially, by foregoing dividends if need be, carefully monitor their management without interfering, and accept dilution of control, where necessary encouraging mergers with other banks. They will be compensated by profitability in the longer term.

In the crisis years banking foundations have supported the capital strengthening of some of the largest Italian banks. In their dealings with the banks in which they have an interest they

must comply with the letter and the spirit of the law, refraining from influencing their operational decisions or organization; like any other shareholder, they must promote the choice of directors on the basis of competence and professionalism, by transparent criteria.

The rules governing cooperative banks were drawn up for intermediaries whose business was restricted to a limited geographical area and marked, as in the case of mutual banks, by a high degree of mutuality. Today they may be inadequate for large intermediaries operating at national and even international level, listed on the stock exchange and with institutional investor shareholders representing a multitude of small savers whose aims and interests are unrelated to mutuality. For such intermediaries the rigid application of some aspects typical of the cooperative model may even detract from their ability to strengthen their capital.

On several occasions we have indicated possible measures to facilitate the participation of shareholders and make institutional investors' role more effective. It should be made easier for listed cooperative banks to turn themselves into companies limited by shares, when their size and the nature of their operations make this necessary. Within the scope of our powers, in order to ensure sound and prudent management, we promote changes in the application of governance practices; where the shortcomings are most serious, we require them.

* * *

Europe and Italy are still navigating a difficult passage. To get through it we cannot relax our efforts; we must press on with the work of reform.

European citizens must find in the strengthening of the Community framework a source of common identity, an understanding that everybody stands to benefit. For the countries that brought them into being, the single market and the economic and monetary union have represented an enormous opportunity for growth and stability, which needed – which needs – to be grasped in full. Some have not yet done so, Italy among them. On countless occasions our country has contributed ideas and policy initiatives to the European Community. It is part of our heritage of values and it is in our interest to continue to do so, in these difficult times, in which Europeans' will to cooperate and to unite is sometimes called into question.

We Italians, from the beginning among the creators of the European construction, must show that we know how to extricate ourselves from the grave condition into which we have fallen: jobs that are being lost and not being created; firms that are unable to modernize and finance themselves, that are closing; banks weakened first by the sovereign debt tensions and then by the effects of the recession, with some at risk of being in difficulty. Our political representatives are finding it hard to mediate between the general interest and particular interests; citizens are receiving conflicting and uncertain signals in this respect.

We cannot always ask others to shoulder the burden of reform. All of us must do our share: firms, workers, banks, public institutions. A budget that, apart from cyclical contingencies, is in balance and whose composition fosters employment and growth is the prerequisite for every effective and equitable policy. The sacrifices made to achieve and consolidate financial stability are the consequence of long-ignored rigidities, lags accumulated over time. Italy's release from the excessive deficit procedure is the first fruit of these sacrifices, an achievement not to be squandered. It should be viewed as an investment on which to build.

We must not fear the future, be afraid of change. We can build nothing by defending entrenched positions and our own particular interests; all of us stand to lose. What is needed is awareness, solidarity and foresight. Measures and stimuli that are well-designed, even if they contemplate a not inconsiderable span of time for transforming the country, will engender the confidence needed to decide that today it is already worth the effort to commit oneself, to work, to invest.