## 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 2013 – 120th Financial Year, Bank of Italy, Rome, 30 May 2014.

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***Ladies and Gentlemen,***

Since last autumn, monetary policy in the euro area has been faced with a scenario of very low inflation inconsistent with the objective of price stability, in a setting of persistently modest and uneven economic growth. Work directed to the launch of the Single Supervisory Mechanism in November has been stepped up and the advance towards the completion of Banking Union has continued. Substantial headway has been made in the full operation of the single euro payments area. In Italy, the road out of the most acute phase of recession has been rocky at times owing to political uncertainty. The recovery has not found a firm footing, making it all the more urgent to proceed with reform action.

For the Bank of Italy, the most important change has been in ownership structure. Our commitment to modernizing the Bank's organization and management systems has been strengthened, and operating costs have been further curbed. The results for 2013 permit us to submit to this Shareholders' Meeting a proposal for the distribution of profits which, in addition to the allocation to the provision for general risks, calls for the assignment of adequate resources to reserves against the risks connected with the crisis. Taking market conditions into account, the proposal is for the distribution to shareholders of dividends amounting to €380 million, with the remaining €1.9 billion going to the State, in addition to taxes of €1.6 billion for the year.

The reform of the Bank of Italy's ownership structure, enacted by Parliament, involves technical complexities that have distracted public attention from the objectives that have been attained. The new arrangements maintain the model of shareholding centred on the financial industry, a feature shared with other major central banks. They reaffirm that shareholders have no power to influence the Bank in fulfilling its institutional functions. They supersede anachronistic and anomalous features that had developed over the decades. They make the process of profit distribution more transparent. And they clarify, circumscribing them, the shareholders' economic and equity rights. Shareholders continue to have no claim on the Bank's foreign exchange and gold reserves, whose public function is beyond question.

The value of the Bank's capital, which the law now sets at €7.5 billion (against 300 million lire established in 1936) is consistent with the estimate made by the Bank at the behest of the Government. This valuation, which had specified both a minimum and a maximum value, was endorsed by experts of undisputed competence and independence. The methods and the results were made public. The increase was accomplished by means of the transfer to capital of a portion of the statutory reserves, without affecting the Bank's own funds and at no cost to the public finances.

The reform avoids undue transfers of wealth to the benefit or detriment of the shareholders. Under the previous arrangement, in addition to dividends shareholders also received an amount proportional to the Bank's statutory reserves, which were bound to increase indefinitely owing to the automatic reinvestment of the return on them and the allocation to reserves of a part of each year's profits. Eliminating any claim to the statutory reserves, the new rules entitle the shareholders solely to a dividend drawn from net profits, up to a maximum of 6 per cent of the Bank's capital, hence not more than €450 million. Amounts increasing over time with no limit have been replaced by a dividend that is higher initially but subject to a fixed ceiling.

The concentration of shareholdings in the hands of the main banking groups fuelled the erroneous but persistent perception of possible interference in the Bank's performance of our institutional functions. The reform has broadened the potential shareholder base, capped single institutions' stakes at 3 per cent and instituted effective measures to foster a redistribution of shares to bring holdings down within that ceiling. We expect shareholders to act swiftly and on their own to dispose of their excess holdings. The rights associated with shareholding have now been defined with certainty, which favours trading in the shares and permits transparent price formation. We shall act to facilitate this process.

The actual amount of dividends will be decided, each year, subject to the results for the year and the Bank's capital needs. In order to foster compliance with the limit on shareholdings, the Bank may purchase its own shares temporarily; we shall avail ourselves of this option only if necessary and in such a way as in no case to entail any risk of loss.

The newly acquired clarity concerning the amount realizable from sales of Bank of Italy shares and the prospect of market transactions make it possible to include them in the regulatory capital of banks and insurance companies, which could have a modest positive effect on the supply of credit. The shares do not form part of the banks' initial capital for the asset quality review that the ECB is currently conducting together with national supervisors.

**The Bank of Italy: an institution open to change**

In performing its functions the Bank manages resources entrusted to it in the national and European interest, pursuing the express objective of efficiency. For some time now we have been engaged in an operation of reorganization and rationalization. The initiatives undertaken in this regard are described at length in our *Relazione sulla gestione e sulle attività* (report on operations and activities), which has a specific section dedicated to cost trends in the last few years.

Relying on new technology, we have imparted impetus to the modernization of the payment system and made a sizeable investment in the computerization of our branches. Since the mid-1990s this has resulted in a steady diminution in the resources allocated to cashier and state treasury services. The reorganization carried out between 2008 and 2010 reduced the number of branches from 97 to 58, of which 31 have been converted into more streamlined, specialized units. The yearly cost of the branch network has been cut by about 25 per cent in real terms. A reassessment, open to the contribution of representatives of the staff, is now under way on the best way to guarantee the Bank's efficient presence throughout the national territory.

At the start of this year our head office was reorganized. In place of the old functional areas, we now have eight directorates general, with autonomous management responsibilities. The directorates with responsibilities for human resources have been unified. Procurement has been assigned to a single specialized unit. The number of units assigned to administrative tasks has been reduced.

The total staff of the Bank of Italy, including the Italian Foreign Exchange Office personnel taken on by the Bank in 2008, has come down from a peak of over 10,000 in the early 1990s to 7,850 on the eve of the branch reform and to some 7,000 at present. Operating costs have been lowered by 14 per cent in real terms over the past four years.

We will continue along these lines, carefully reviewing every expenditure item. Our ongoing reform action has lowered costs and improved efficiency, maintaining high quality service and capitalizing on staff skills.

The reduction in resources employed and costs incurred has been achieved despite an increase in the number and complexity of the tasks performed. European integration, with the creation of the European Central Bank, has not resulted in any diminution of the responsibilities of the national authorities in the field of monetary policy or banking supervision; nor will it in the future with Banking Union.

The ECB's monetary policy decisions are taken collegially by the Governing Council, which consists of the governors of all the national central banks of the Eurosystem, acting in the European common interest and using for this purpose the research and analysis of their own institutions. The ECB's own preparatory analytical work is conducted through the intense activity of committees and working groups that bring together experts from the various national central banks.

Our capability for economic, statistical and legal research and analysis is also placed directly at the service of the nation, with advisory services and operational support to Parliament, the Government and other institutions, and with activity in international forums.

The implementation of monetary policy is delegated wholly to the national central banks: open market operations, the refinancing of banks, and the acquisition, management and valuation of the collateral they provide in exchange for liquidity.

The central banking function includes the production and distribution of banknotes. Our works print about 18 per cent of the euro area's paper money, with a peak last year of 1.36 billion notes. The Bank of Italy regulates and controls the activities of banks and other cash handlers, with off-site analysis and on-site inspections involving its branch network.

Our institution develops and manages the technological platforms and infrastructure for the clearing and settlement of domestic financial transactions. Together with the Bundesbank, we are entrusted with operating the euro area's TARGET2 gross settlement system, to be flanked by the TARGET2 Securities system for the settlement of securities trades in the euro area, now under development. The Bank of Italy is the Italian national authority competent for the realization of the single euro payments area for retail transactions. The Bank and its branch network also manage the state treasury service. We exercise oversight of the payment system and financial market infrastructure in cooperation with our European counterparts. Together with Consob, we oversee wholesale trading in government securities and post-trading activities in financial markets.

In November, with the launch of Banking Union, the Single Supervisory Mechanism created by the ECB and the national competent authorities of the participating EU member states will be operational. With the decisive contribution of the national authorities, the ECB will supervise banks identified as systemically important according to specific criteria, such as size. For Italy, this group should include nearly all the fifteen intermediaries currently subjected to the comprehensive assessment. The national authorities will maintain direct supervision over all the other banks – in Italy they number around 600 – according to common standards and methodologies to ensure uniform supervisory action.

The Supervisory Board, which is charged with preparing decisions to submit to the ECB Governing Council, is already operational. It consists of representatives of the ECB and of the national supervisory authorities, including the Bank of Italy. Committees in which experts from individual countries can deal with issues of common interest are already active.

The quality of European banking supervision will depend strictly on the contribution of the authorities that have had the most experience in this field. We are now actively working to ensure the adoption of best practices in the Single Supervisory Mechanism, collaborating within the European Banking Authority on the design of a Single Rulebook to ensure a level playing field. In order to participate effectively in the decision-making process of European banking supervision, we shall extend our analysis to the banking industry and the major banks in other countries.

The launch of the Single Supervisory Mechanism will affect the daily activities of all the authorities involved. Off-site controls on systemically important banks will now be carried out by teams consisting of both ECB and national personnel. Inspections will be conducted by groups in which national staff may be flanked by members from other countries.

The Bank of Italy is also entrusted with the prudential supervision of securities firms and asset management companies, financial companies, payment institutions and electronic money institutions. The Bank has full jurisdiction over all intermediaries, including banks, in matters of consumer protection and transparency. It is engaged in the promotion of better financial awareness on the part of the general public, in particular in schools. It will continue to provide assistance to the panels of the Banking Ombudsman for dispute resolution. Our branches contribute significantly to these activities.

Financial stability requires a macroprudential commitment. In this context the Bank is a member of the European Systemic Risk Board and participates in the work of the Financial Stability Board and the G20 to complete a series of reforms to make the financial system sounder and more resilient.

We have intensified our efforts to combat money laundering and terrorist financing, both within our directorate general for financial supervision and through the Financial Intelligence Unit, an autonomously managed body instituted within the Bank of Italy, which regulates the Unit's operation and provides the necessary human, financial and technological resources.

In January 2013 the new insurance supervisory authority (Ivass) was constituted, in close relation with banking and financial supervision. It is chaired ex officio by the Senior Deputy Governor of the Bank of Italy, who runs it together with two Councillors. Measures with significant external implications are decided on and issued by the Governing Board of the Bank enlarged to include the two Councillors. Cooperation between the operational structures of the two institutions is extensive and growing.

The public functions assigned to us, which I felt it was appropriate to recall here today, require adequate technology and, even more, high quality human resources. The competence, motivation and commitment of individual staff members are essential to effective action and to the Bank's reputation. We are taking steps to ensure that the Bank of Italy maintains its ability to attract talented young people who have successfully completed rigorous courses of study. We are well aware that we can still improve the organization of work, through reconsideration of the assignments and the professional development of individual employees, in fruitful dialogue with the trade unions. I join the Board of Directors and the Governing Board in thanking the staff of the Bank for the capability, spirit and dedication with which they perform their duties.

**The exit from the sovereign debt crisis: monetary policy, Europe, Italy**

Financial conditions have improved greatly in the euro area since last year. After Ireland, Greece and Portugal too are once again issuing government securities. Yields on Italy's ten-year BTPs have fallen to 3.0 per cent, less than half the peak figure recorded in November 2011. The yield spread with German securities is now around 160 basis points; it had hit 550 points in November 2011 and was still 470 points in July 2012.

The contribution of monetary policy has been crucial: during the most acute stages of the crisis it prevented the situation from precipitating; it helped allay investors' fears for the integrity of the Economic and Monetary Union; it accompanied the implementation of important reforms at national level and in European governance.

Since last summer there have been large inflows of capital from the emerging economies, mainly following the announcement by the Federal Reserve of its plan for tapering monetary accommodation. The resulting downward pressure on long-term euro interest rates could be transient; less expansionary monetary policy in the United States could provoke a rebound in global yields. Volatility on the financial markets in the advanced economies has subsided to well below the historical norm, reaching levels that in the past sometimes preceded rapid changes in the orientation of investors. The fluctuations in government securities yields in recent weeks remind us just how sensitive the markets can be to any signs of uncertainty.

The consolidation of the public finances in the countries hit by the crisis, necessary per se and imperative to eliminate any doubts about debt sustainability, constitutes a guarantee against the rekindling of tensions on the sovereign debt markets in the euro area. However, the combined costs of the recession and restrictive budgetary policies have been high. The economy and, in particular, the labour market remain fragile.

Structural reforms make our economies more resilient to future shocks, but it will take time for them to yield their full fruits. Income support for those worst hit by the crisis and re-employment mechanisms for workers forced out of traditional production work can make a contribution. In addition to expansionary policies in the countries where the public finances allow it, concerted action at European level could help to boost investment and consumption demand. The opportunities provided by favourable external conditions must not be missed; the conditions for transforming the capital now available into lasting productive investment have to be guaranteed.

## Monetary policy and Europe

Monetary policy in the euro area now faces challenges somewhat different from those addressed over the last two years. Economic activity returned to growth in 2013, but only in part of the euro area and at very uneven speeds. The most recent data confirm this. Credit market conditions remain difficult. Financial fragmentation along national lines has diminished but it has not disappeared. Above all, there has been a sharp reduction in consumer price inflation; since the middle of last year the rate of inflation has been well below the ECB Governing Council's definition of price stability.

During 2013 we lowered the official interest rates twice, in May and in November, bringing the cost of the main refinancing operations to an all-time low of 0.25 per cent. In July we began to provide explicit indications of our monetary policy stance, announcing that the official interest rates would remain at or below the then current level for an extended period, in consideration of the outlook for inflation, the weakness of the real economy, and monetary and credit dynamics. This forward guidance attenuated the volatility of short-term interest rates.

The rapidity of the fall in inflation has surprised the main forecasters, who have revised their short- and medium-term expectations downwards. This pattern has been more pronounced in the countries directly hit by the sovereign debt crisis, but it is common to the entire euro area. It reflects not only the fall in energy prices, compounded by the appreciation of the euro, but also the persistent weakness of the economy. Core inflation has fallen to its lowest levels since the introduction of the single currency.

Just like excessively high rates of inflation – and we can still well remember how difficult it was to overcome that problem more than twenty years ago – prices that are growing too slowly are also detrimental to financial stability, especially when public and private debt is high and growth is weak. Excessively low inflation must be countered with equal firmness, also to prevent it from being incorporated into medium-term expectations. The formation of expectations is not a linear process: even large changes can materialize very quickly, discontinuously.

Since July 2012 the euro has appreciated by an average of 9 per cent against a basket of other currencies; against the dollar it has gained 12 per cent. The appreciation began following the announcement of Outright Monetary Transactions, which allayed fears about the reversibility of the single currency that had turned investors away from financial assets issued in some euro-area countries. The exchange rate is not in itself a monetary policy target, but at this stage the euro's appreciation has compressed consumer price inflation, both directly, by reducing the prices of imported goods, and indirectly, by increasing competitive pressure on domestic products.

Eurosystem inflation projections will be made public on 5 June. According to those published in March by the ECB, inflation is expected to remain well below 2 per cent over the next two years. This is not consistent with our definition of price stability. If this pattern is confirmed, the Governing Council is determined to act, even with unconventional policies, to ensure that in the medium term price developments do not diverge from the desired path.

Albeit in a situation of emergency, and not without some hesitancy, European policies have achieved significant progress during the crisis: the strengthening of fiscal rules, the extension of multilateral surveillance to macroeconomic imbalances other than those of public finances, the establishment of common funds for financial assistance to countries in difficulty, and the launch of the Single Supervisory Mechanism.

As I have observed on other occasions, the euro is a currency without a state and suffers from this deficiency. To complete the journey towards integration other essential elements of sovereignty need to be shared; Banking Union, now being implemented, should be followed by the creation of a true common budget. Designing instruments that will make it possible to intervene in support of economic growth and better public welfare would help the European Union to regain the consensus that has been partially lost.

In the shorter term, the central bank can support domestic demand through the pursuit of monetary stability. But the return to sustained and balanced growth requires broader economic policy action at European level. Measures must be taken immediately to speed up the creation of infrastructure, both tangible and intangible, indispensable to the formation of a true single market. Joint intervention would help to give market expectations a positive orientation.

### The Italian economy

In Italy, the long recession in progress since 2008 with only a brief interruption came to a halt at the end of last year, mainly thanks to foreign demand and to the reduced need for fiscal adjustment. A contribution came from the accelerated payment of general government commercial debts. A real recovery is struggling to get under way, however. The gradual improvement in expectations has been slow to translate into a solid upturn in economic activity.

The recession has left a burdensome legacy. Many Italian companies have managed to safeguard their shares of foreign markets and some have increased them; the current account is back in surplus, even on a cyclically adjusted basis. But the contraction in domestic activity has been dramatic: industrial production has shrunk by 25 per cent overall. In the last quarter of 2013, while exports were almost back to the same level as at the end of 2007, household consumption was still down by about 8 per cent and investment by 26 per cent, with a capacity loss in manufacturing of approximately 15 per cent. Although there are signs that confidence is picking up, the need to compensate for the erosion of accumulated savings and uncertainty about prospective income in the medium to long term will continue to weigh on household consumption. Household spending can benefit from the recently approved tax cuts, but it will not become the driving force of the recovery without an enduring increase in employment.

The recession has had a heavy impact on the number of persons in employment and hence on household income. Between 2007 and 2013 employment fell by more than a million, with almost all of the contraction in industry; the average number of hours worked also decreased. The unemployment rate has more than doubled compared with the low point of 2007, reaching 12.7 per cent in March. The supply of jobs will only begin to rise slowly; usually the first variable to react to an increase in output is the number of hours worked per employee.

We must not underestimate the risk that a further lengthening of the duration of unemployment – and there are signs of this particularly in the South and among the younger population – may erode individual skills and know-how and distance them from those that firms require. In the past, deep recessions have been associated with extensive restructuring of the productive system that has resulted in the introduction of new labour-saving technologies and organizational models. But the crisis can be the occasion for our firms to carry out and extend what up to now has often been missing: a profound renewal of the mode of production in connection with the digital revolution, which can give life to new forms of enterprise and employment in new fields of activity.

Productivity gains and employment growth can go hand in hand if domestic demand revives. The key is the growth of fixed investment, which forms the linkage between demand and supply. On the one hand, given the right external conditions, investment is the demand component that reacts most promptly to changes in expectations, while on the other it bolsters supply capacity by exploiting technical progress and responding to the globalization of markets and production processes.

The ratio of gross investment to GDP has fallen by 4 percentage points since 2007, reaching a post-war low of 17 per cent in 2013. The difficulty of many firms in accessing bank credit has been a factor. But it is above all the widespread uncertainty over the prospects for demand growth and the orientation of economic policies that is responsible for postponements and cutbacks of plant restructuring and expansion plans.

Towards the end of 2013 opinions of the conditions for investment became more favourable, especially among the largest companies. In manufacturing industry, spending plans suggest a stabilization this year, thanks to the support of the capital goods component. These first positive signs can strengthen if the business environment improves.

Economic policy measures that act on both the demand and the supply side in a comprehensive, consistent framework can support economic activity in the short term and lend strength to the reform project. If that project is vast, vigorous and credible, it can alter the course of expectations, reinforcing the growth of investment, employment and consumption. The response to the acute phase of the crisis was notable, but the results have suffered from the fragmentary nature of the interventions and from the incomplete implementation of many of the measures adopted, in some cases owing to successive, at times substantial revisions made to them soon after.

It is important to build on the foundation of what has already been done. For example, thanks to the measures in the service sector, the OECD indicators show that Italy is now more open to competition. But at the end of last year only half of the implementing measures envisaged by the 69 reform laws passed between November 2011 and April 2013 had been issued. In the field of taxation, the rapid implementation of the enabling act can ensure greater certainty in the application of rules and sanctions and make the fight against tax evasion and avoidance more effective and closely targeted.

The main shortcomings of our economic system and the prospects for reform, which are also the subject of the National Programme that the Government presented in April, are examined in a chapter of this year's Report. The list of areas requiring action is long; among the most urgent interventions are those to safeguard legality and efficiency in the public administration.

Corruption, criminal activity and tax evasion not only undermine the community but also distort the behaviour of economic agents and market prices, reduce the effectiveness of governmental action, increase the tax burden on those who do their duty, and compress productive investment and job creation. A well-functioning public administration improves the operation of markets and competition, reduces firms' costs, and is reflected in the quality and cost of public services and thus on the tax burden. The efficacy of the reforms depends on it.

Restrictive regulation and a legal and institutional environment that is unfriendly to entrepreneurial activity hamper the transfer of resources towards the more efficient firms and sectors and the growth of productivity. The same elements also affect the Italian economy's ability to attract investment from abroad, which is very poor compared with other economies, ultimately curbing the diffusion of innovative technologies and managerial practices. For potential investors, both Italian and foreign, the lengthiness and complexity of administrative procedures pose the most significant obstacle.

In many cases the benefits of reforms are inevitably deferred. This is true, for example, of interventions on the education and training system, a subject to which we have dedicated another chapter of the Report. But this is no reason to postpone action. The level of education and skills on which the Italian productive economy can count is inadequate: a recent OECD survey ranks Italy last for functional literacy and next to last for numeracy; the gap with the average of the other countries is also found among the younger age groups and increases with the level of educational qualification.

Important progress has been made in adjusting the public finances. The deficit is equal to 3 per cent of GDP, below the European average. With Germany, Italy has the highest primary surplus in Europe, and Italy is close to achieving structural budget balance. The reforms of the past years have reduced the pressure of demographic trends on public expenditure, pressure which instead remains strong in many other countries of the Union.

The lowering of the ratio of debt to GDP remains the ineluctable challenge for our country; its speed depends on a return to stable, rapid growth. Economic growth and budgetary balance can only be pursued in tandem.

The results won with so much sacrifice must not be squandered. They make it possible to undertake actions in support of growth, for example by continuing to shorten the payment times of general government entities and to reduce the tax wedge on labour. The budgetary rules that we have agreed in Europe and transposed into our national law are aimed at ensuring the long-term sustainability of the public finances. The margins of flexibility that they afford can be exploited as part of a cogent strategy of structural reforms directed at clear and credible objectives.

Careful action to recoup efficiency in the public administration, conducted as part of the spending review, can assist a reallocation of expenditure to the benefit of the more productive items. This objective should be accompanied on the revenue side by greater reliance on the less distortionary items at both central and local level.

The endowment of infrastructure, in which Italy is inferior to the other main European countries, influences firms' productivity, their choices of where to locate and the quality of life of the population. The delays accumulated in the past decades reflect not so much insufficient resources as inefficiency in their use, but in the last four years public investment expenditure has diminished by nearly 30 per cent. European resources and private capital can contribute in greater measure to the financing of infrastructure and territorial protection, with benefits for the building industry, which has been hit especially hard by the recession.

**Banks, credit, supervision**

In Italy, more than in other countries, the banks play a central role in financing the economy. Their business is concentrated in the traditional intermediation of savings, mostly within the country. This is one reason why they withstood the initial impact of the crisis, which originated in foreign markets and speculative financial products. In recent years, however, they have been badly hit by the protracted recession and the sovereign debt crisis. Our Annual Report details the role of the banks in the intermediation of Italians' savings; the Report on Operations and Activities describes the supervisory action of the Bank of Italy.

Bank loans to households and firms at the end of 2013 exceeded €1.4 trillion and 90 per cent of gross domestic product. Credit accounts for almost two thirds of firms' financial debt. More than one third of households' financial wealth is invested in bank deposits and bonds.

In recent years the exceptional decline in GDP has undermined the soundness of many firms, increasing their debt-service burden. The repercussions for banks have been very serious: loan losses accumulated since 2008 amount to €130 billion; those in the past two years have absorbed almost all of banks' operating profits.

Banks have stemmed the deterioration of profitability by curbing costs. Between 2008 and 2013 the number of employees in banking was reduced by 30,000 and 2,400 branches were closed. The cost-to-income ratio was lowered from 66.7 to 62.1 per cent.

Following the collapse of funding on the international markets in autumn 2011, extensive resort to the Eurosystem's three-year refinancing operations enabled Italian banks to sustain a volume of lending to the economy that exceeded domestic funding and to meet the future redemption of bonds previously placed in foreign markets.

With large-scale purchases of government securities the banks built up resources to withstand new liquidity crises, at a time when the increase in sovereign risk was driving foreign investors away from Italian markets. Interest income and capital gains on these securities partly offset the heavy losses on loans to households and firms. In mid-2013, with the return to orderly market conditions, banks began to sell off government debt.

**The financing of the economy**

Total credit to the Italian economy is shrinking. But the aggregate data mask different trends for the various categories of borrower. Given the persistent uncertainty about the timing and strength of the recovery, businesses have lowered their demand for credit. The largest firms have increased their recourse to the bond market. In 2013 gross placements by Italian issuers were close to €40 billion, almost twice the amount recorded in the years preceding the crisis.

Credit supply restrictions are hardest on small and medium-sized firms, generally more risky and now especially weakened by the recession. In this setting the funding difficulties of firms with good growth opportunities but no direct access to the capital markets are a cause for concern.

In the coming weeks the Bank of Italy will adopt measures to improve banks' liquidity further, thereby facilitating lending to small and medium-sized firms. The range of loans eligible as collateral for Eurosystem refinancing will be extended. Innovations in the characteristics of contracts will enable banks to pledge new types of loan such as credit lines that are widespread among small firms. Banks will be allowed to use loan portfolios with more flexible collateral management and with lower haircuts; it will be possible to include mortgage loans to households.

The chief obstacle to the supply of financing continues to be credit risk. Non-performing bank loans, net of provisions, have risen to 10.0 per cent of total lending; bad debts alone account for 4.0 per cent. At a time when banks are deeply concerned about borrowers' soundness and prospects, the dearth of credit has been alleviated by the granting of government guarantees.

In 2013 the Central Guarantee Fund accepted more than 77,000 applications to guarantee loans amounting to almost €11 billion. Recent measures have expanded the range of potential beneficiaries of the Fund and more than doubled, compared with the previous period, the resources allocated for the three years 2014–16. A portion of these resources has nevertheless been earmarked for purposes other than those originally envisaged. They must not be dispersed: the piecemeal nature of the interventions risks reducing the effectiveness of an instrument whose purpose must continue to be to facilitate access to credit for small and medium-sized firms that have been weakened by the recession but are fundamentally sound.

A recovery in the securitizations market could help reactivate the flow of credit to the economy. Enabling investors to make an informed assessment of these transactions requires rules that increase their transparency and standardization, and distinguish between complex and simple products in favour of the latter. The European Commission recently announced initiatives that move in this direction.

Italian firms' indebtedness and dependence on bank credit are signs of their financial vulnerability. With almost €1.3 trillion in financial debt and €1.6 trillion in net equity, Italian firms' overall leverage is 44 per cent; bank loans account for 64 per cent of the total debt. For the euro area these ratios are considerably lower, averaging 39 and 46 per cent respectively.

A larger endowment of equity capital could facilitate firms' access to credit. This, together with greater diversification of the sources of external funding, would make them stronger. Bringing financial leverage into line with the European average would require a capital increase of around €200 billion and an equal reduction in debt: this is an ambitious objective but one within the reach of Italian firms in the medium term. Structural reforms to kick-start growth would attract equity-type funds from external investors and encourage entrepreneurs to invest their own resources, thereby being the first to show confidence in their firms' prospects.

Firms' funding model reflects the structural traits of Italy's economy, such as the modest size and family-based ownership of businesses. Entrepreneurs are reluctant to admit new partners or to raise funds directly on the market, partly owing to a taxation system that has long done little to favour equity capital.

The capital-building incentive introduced by Decree Law 201/2011 (the Allowance for Corporate Equity), reinforced by the 2014 Stability Law, corrects the tax disadvantage of equity with respect to debt. It represents an important opportunity for all firms; it is estimated that almost 40 per cent of firms with 20 or more workers increased their capital in 2012–13.

### Supervisory action

In 2013 the Bank of Italy continued the verification of the adequacy of loan loss provisions that we initiated in mid-2012. The supervisory authority continued to call on banks to strengthen their capital in order to ensure their solidity.

At times our interventions have been harshly criticized. We believe that they were decisive first to preserve and then to reinforce investors' confidence in the banking system's ability to withstand the impact of the crisis. Thanks in part to this action, in 2013, notwithstanding the sharp increase in non-performing loans, the coverage ratio on them went up from 39 to 42 per cent.

Core tier 1 capital rose from 7.1 per cent of risk-weighted assets in 2008 to 10.5 per cent in 2013; substantial issues of new equity and retained profits contributed nearly €60 billion to the increase in capital. Capital strengthening proceeds: in the first five months of this year ten banking groups made or announced capital increases amounting to €11 billion; for the banks subject to the comprehensive assessment carried out at European level this will raise capital ratios by around one percentage point.

Capital strengthening has been achieved almost entirely with private capital. The Italian State's contribution has been minimal; it reached €4.8 billion in the first quarter of 2013 (0.3 per cent of GDP), a level far below those of most of the other European countries; it will be wiped out by the repayment of the State's loan to Monte dei Paschi di Siena, of which €3 billion has already been authorized by the Bank of Italy. Overall, public support for the banks has generated substantial net gains for the Italian State.

The banking foundations have participated in capital-raising operations, thereby contributing to the solidity of the banking system in the most difficult phase; sometimes, as a matter of choice or out of necessity, they have reduced the share of capital they owned. The inflows of resources connected with investors' renewed confidence in Italy's prospects provide an opportunity for banks to strengthen their capital bases and for foundations to further diversify their assets. At the same time it is necessary, as I have indicated on several occasions, to reinforce the separation between foundations and banks by prohibiting persons from moving between the governing bodies of foundations and banks and extending the ban on control to cases in which it is exercised de facto, even jointly with other shareholders.

For many small and medium-sized banks close relationships with their home territory are a source of stability, which has a beneficial effect on the local economy. However, a misguided interpretation of these relationships can distort the disbursement of credit, thereby jeopardizing the soundness of banks' balance sheets and the efficient allocation of resources. Cases of this kind become more likely during prolonged recessions, such as the one we have passed through. We are working to persuade banks to strengthen their operational, organizational and corporate governance safeguards in order to prevent credit relationships with customers from degenerating and to take remedial action when they do.

Taking account of the numerous suggestions deriving from public consultation, the Bank of Italy has recently issued regulations on bank governance. The rules foster the correct exercise of the functions of strategic guidance, management and control, enhance the functionality of decision-making chains, exert downward pressure on costs, and make directors more accountable. Some of the rules are immediately applicable, others could require banks to make changes to their bylaws, to be implemented without delay. The innovations introduced for cooperative banks encourage shareholders to attend shareholders' meetings, foster internal debate and facilitate the raising of equity capital.

Bank crises are often associated with weaknesses in corporate governance systems, which sometimes breed episodes of malfeasance. The Bank of Italy tackled 11 new cases of intermediaries in difficulty in 2013 and another six in the first four months of this year. The banks currently under special administration are small or medium-sized; they account for about 1 per cent of the total assets of the banking system. Since 2009, ten intermediaries have been placed directly in liquidation and 55 under special administration; about half the crisis procedures that have been completed saw the banks return to ordinary operations, including by way of takeovers. The continuity of customer services was guaranteed together with the protection of depositors.

In the last two years 340 inspections were carried out at banks that accounted for 80 per cent of the banking system's total assets. In 63 cases serious shortcomings were found in banks' corporate governance. In 45 of these there were irregularities of a possibly criminal nature that were promptly reported to the judicial authorities. With the proper distinction of functions and instruments, cooperation with the magistracy is intense.

Where necessary the Bank of Italy requests banks to radically renew their board of directors, strengthen their organizational structure and capital base, and draw up new business plans. This makes it possible to avoid recourse to crisis procedures, which might be required if the problems found persisted. Our action would become even more effective with the attribution of the power to remove a bank's directors when necessary and on the basis of convincing evidence, as is envisaged in the draft law for the transposition of the European Capital Requirements Directive.

Italy's large banks, as well as granting loans, often hold equity interests in non-financial firms. Such shareholdings must not distort lending decisions or delay the emergence of borrowers' difficulties. The risks associated with these relationships, in the same way as for those deriving from dealings with counterparties closely related to banks, must be carefully monitored by the latter's governing bodies. The Bank of Italy cannot and must not assess individual lending decisions in advance, but lays down rules for related-party transactions and checks that they are complied with. The rules are intended to prevent allocative distortions and minimize conflicts of interest; they establish quantitative limits to risk, strengthened decision-making procedures, organizational safeguards and obligations to inform the supervisory authority.

## Banking Union and the implementation of the Single Supervisory Mechanism

The ongoing construction of the Single Supervisory Mechanism is driving forward the Banking Union project, one aim of which is to counter the fragmentation of the euro area's financial markets. The new European supervisory system shares the basic principles of the approach followed in Italy: emphasis on close integration of on- and off-site controls, quantitative and qualitative assessment of risks, and close linkage between the results of analyses and remedial action.

The Single Resolution Mechanism for crises will come into operation in 2015. The handling of banking crises will involve numerous national and European institutions participating in the context of a Single Resolution Board. Provision is made for recourse to a fund made up of contributions paid in by the banks themselves. Even though the decision-making process appears complex and the pooled resources limited, the compromise reached is a further step towards the completion of Banking Union.

Together with the ECB and the other national supervisory authorities, we are now conducting the comprehensive assessment of the most important euro-area banks. The aim of the exercise is to increase the transparency and reliability of banks' balance sheets and increase the market's confidence in the soundness of the European banking system, thereby contributing to the recovery of lending to the economy. The key aspects of the comprehensive assessment are an asset quality review and a stress test of the banks' balance sheets.

The exercise under way is of unprecedented complexity, both in terms of the volume of activities to be carried out and for their concentration in time. It considers a wide range of bank assets, going from loans to households and firms, to government securities and complex financial instruments, so-called third-level assets.

In the cases where the assessment shows that a bank needs to raise its capital ratios, this can be done in several ways, ranging from not distributing profits to the disposal of non-strategic assets, the cutting of costs and the issue of new equity. The manner of carrying out these interventions and their timing will be determined in relation to the nature of the capital weakness and according to whether it derived from value adjustments to balance-sheet items or from the results of stress tests. Capital-raising measures will have to be agreed with the national supervisory authorities.

The credibility of the exercise and its success in restoring confidence in the soundness of the European banking system require that instruments of public intervention be available to act as financial backstops, as established by the European Council in June 2013 and reaffirmed by the Ecofin Council in November. They will have to conform with the basic principles of national and European law, with the ultimate objective of ensuring financial stability.

The results of the comprehensive assessment of banks' balance sheets will be published in October. The exercise is already making a contribution to the strengthening of banks' capital bases. The effects on the supply of credit in the short term will need to be carefully monitored. In the longer run, the positive relationship between banks' capital and growth in lending will be reinforced.

## The challenges immediately ahead

In the closing months of last year the flow of new bad debts began to diminish. However, historical experience teaches that economic recovery will improve credit quality only gradually, and with a lag. To cope with the additional loan loss provisions that will be necessary, the banking system will have to increase its efficiency further.

The rationalization of the branch network is beginning to make a dent in operating costs, but there is still ample room for improvement in the use of technology. The European-wide intensification of competition in the banking market that will stem from the shift to single supervision will stimulate a rethinking of banks' business models, organization and distribution methods. The structural measures on banking now under discussion at European level can work in the same direction, with effects circumscribed to a limited number of banks. Mergers based on solid economic foundations and market logic can facilitate the recouping of efficiency. In considering proposed mergers, the Bank of Italy weighs their compliance with the regulations and with the standards of sound and prudent management.

Banks must reduce the volume of non-performing loans in order to free up the resources needed to finance the economy. There is growing interest in these assets on the part of specialized investors, who are now willing to pay higher prices than in the past thanks to the easing of the sovereign debt crisis and the reduction in risk premiums. The revival of this market also benefits from the increase in provisioning, which translates into a decline in the prices at which banks are prepared to dispose of these loans. The market is also gaining from the recent changes in the tax treatment of loan losses, which have reduced – but not eliminated – Italy's strong fiscal disincentives to the prudent valuation of risk.

Some disposals of non-performing assets have already taken place, and others may be well-received by national and international investors. Several large banks are acting to rationalize their management of non-performing loans by creating special units for the purpose. The need to shrink the stock of impaired loans arises also for smaller banks, which could find it hard to develop autonomous strategies for dealing with them.

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The year 2013 was another trying one for Europe and for the Italian economy, harder than had been predicted twelve months back. The exit from the recession remains laborious, the recovery fragile and uncertain. In Italy, as elsewhere, there is no lack of positive signs: capital inflows are growing, consumer confidence is strengthening, manufacturing orders are rising. In order to consolidate these gains, it is necessary to build on what has been done so far, moving vigorously ahead on the path of reform and promoting the drive for efficiency in public services as in the private sector. We also know that gains in productivity, stagnant for too long, must be accompanied by the expansion of demand, and hence the growth of household income, which has to be sustained by the formation of new jobs. Investment – private and public, Italian and European – is essential.

The union of the nations of Europe, whose fullest expression to date is the euro, is a work in progress that the peoples of the continent must be able to believe in, to recognize as the source of peace and prosperity. What is asked of the institutions is policies to make the European construction robust but that also respond to the challenges of our time. We are all citizens of this Europe, and together we must make it grow – and not only in economic terms. In the face of public opinion that is divided, not always well informed, the need is for profoundly European policies, implemented within the limits of national responsibilities but in the spirit of cooperation. Monetary policy and Banking Union are two key areas in which the Bank of Italy is intensely engaged.

In monetary management the primary objective is price stability. Monetary policy as such cannot stimulate productivity or determine growth paths. But these are premised upon stable monetary conditions, which the Governing Council of the ECB is striving to ensure. As for banks, which are now subject to common rules and single supervision, in Italy they remain the fundamental pillar for financing the economy. For them to continue raising capital and borrowing in the markets, which is indispensable to the performance in full of their intermediation function, their governance must be strengthened, integrity of conduct must be guaranteed, and profitability must be increased. The possible repercussions of taxation and other burdens on their ability to compete in an integrated financial market must be weighed carefully.

The recovery of the economy and renewed creation of jobs depend on the ability to finance deserving investment projects. Even in the present difficult phase, this is the fundamental task to be performed by bank credit, with the crucial support of capital invested directly in firms and resources procured in the market. Compliance with the rules and transparent conduct are essential conditions, and we shall continue to monitor them.

The path to recovery – economic and beyond – will be neither short nor easy. Uncertainty is intrinsic to the rapid transition towards a radically different world, more open and mobile, in which protections for the vulnerable must go hand-in-hand with opportunities for young people. Ambitious policies need to be embodied in a clear, comprehensive set of actions. Investors, workers and consumers must be presented with a programme that takes due account of all the aspects of society and the economy that need to be reformed, fosters innovation, inculcates observance of the law, adheres to the principles of efficiency and equity, and rewards merit and responsibility. Although single measures may come at different times, not just for budgetary reasons, the visibility of such a coherent design will reassure citizens and bolster faith in the future, without which all progress is inconceivable.