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 2014 – 121st Financial Year, Bank of Italy, Rome, 26 May 2015.

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Ladies and Gentlemen,

Last year was one of important changes: in Europe, by reason of the evolving institutional context and major economic and monetary policy decisions; in Italy, by reason of the quickening pace of the reform effort. It was a year of difficult choices, whose early results – significant but still fragile – must be resolutely defended. The economic recovery that got under way in Italy in the first quarter of this year is likely to strengthen in the current and subsequent quarters.

For the Bank of Italy, 2014 was a year of engagement in the euro area in formulating and implementing monetary policy and launching the Single Supervisory Mechanism, and in Italy in enhancing our services to the national community and further modernizing our organization and operations.

The Bank of Italy's total assets declined by nearly €24 billion, to €530.6 billion, reflecting a reduction in Eurosystem refinancing operations. This year the implementation of the extraordinary securities purchase programmes will expand our balance sheet again.

Our gross profit fell from €6.9 billion to just under €6 billion in 2014. Today the Board of Directors proposes that this meeting allocate €1.8 billion to general risk provisions and €750 million to statutory reserves. Taking market conditions into account, it also proposes to distribute dividends of €340 million to shareholders. On the basis of the indications laid down in the Statute, €1.9 billion goes to the State, in addition to a tax liability of €1.2 billion.

At its meeting on 30 April the Board of Directors determined that in future years dividends should ordinarily be in the range between last year's and this year's amounts, conditional on the size of net profit and on capitalization needs, unless the general conditions of the financial markets or the Bank's profitability have undergone significant changes. The commencement of the redistribution of holdings of the Bank's shares, as required by law, may be facilitated by awareness of this orientation. Meanwhile the Bank is working on the dematerialization of the shares. Once the new system is fully phased in, transfers will be made electronically in a dedicated market segment, so as to make the investment liquid.

The Report on Operations and Activities, which we present today together with our Annual Report, describes in detail the tasks carried out, organizational developments and resource management in 2014.

Practically 40 per cent of the work done by the Bank of Italy's staff relates directly to our participation in the Eurosystem and the Single Supervisory Mechanism. Our technical structures are heavily and constantly engaged in the committees and working groups acting in support of the decisions of the ECB Governing Council.

Designing and implementing the monetary policy for the euro area draws on a broad range of competences in the fields of economic analysis and market intervention. To date, nearly a third of the total liquidity supplied by the ECB's targeted longer-term refinancing operations has been taken up by Italian banks. For the Bank of Italy, the outright purchase programmes of private and public securities have entailed daily market interventions averaging €450 million.

The launch of the Single Supervisory Mechanism has required an extraordinary allocation of resources. We have taken part in its construction by making our knowledge and experience available. The new European system of banking supervision has been designed as a "system of authorities". The ECB and the national authorities agree jointly on decisions and

practices. The ECB has direct supervisory responsibility for the 123 most important, or "significant", banks; decisions are taken by the Governing Council acting on a proposal from the Supervisory Board on which the national authorities sit.

Each of these banks is supervised by "joint supervisory teams" consisting mostly of staff drawn from the national authorities – chiefly but not exclusively those of the country in which the bank is headquartered. The Bank of Italy has assigned 58 of its analysts to the teams supervising Italian banks, and another 20 to 18 groups responsible for supervising non-Italian banks. Finally, 60 Bank of Italy inspectors are assigned to on-site inspections at significant banks. The number of experts involved in these activities will grow further already in the coming months.

The new arrangement is complex; it seeks to balance an overall vision with immediate and effective action that makes the most of the national authorities' accumulated knowledge and expertise. The result is a network architecture in which every significant bank is examined by many eyes of diverse nationalities.

The Bank of Italy dedicates considerable resources to the oversight of market infrastructures and the provision of European-wide payment services. The migration to the new Single Euro Payments Area for retail payments has been successfully completed. With the Deutsche Bundesbank, the Bank of Italy operates the TARGET2 settlement system for payments within the euro area, and we will also operate the TARGET2-Securities platform for settling securities transactions.

For the "less significant" intermediaries, supervisory responsibility and direct supervisory action are left to the national authorities, within the framework of the common mechanism. In Italy, this covers 56 banking groups, 435 non-group banks, and 77 branches of foreign banks, plus 456 non-bank financial intermediaries also subject to our prudential supervision.

The Bank of Italy is also tasked with activating macroprudential policies to safeguard the overall stability of the financial system. When enlarged to include two additional members, our Governing Board also takes externally relevant decisions concerning insurance supervision prepared by the Insurance Supervisory Authority.

As part of our action to protect the consumers of banking and financial services, inspections focusing on transparency and correctness in customer relations were carried out at 124 intermediaries in 2014. In 71 cases shortcomings were detected and actions taken to overcome them and improve service quality. The public is increasingly sensitive to this issue. We received nearly 14,000 complaints last year, 2,200 more than in 2013, and we take them into account in our supervisory action. Appeals to the Banking and Financial Ombudsman increased by 40 per cent to over 11,000, with more than two thirds of the 8,500 rulings favourable to customers.

The Financial Intelligence Unit was reorganized and its analytical capability reinforced. Thanks to investment in skills and technology, together with the dedication of its staff, the Unit handled the steadily rising number of suspicious transaction reports, which has more than tripled over the past five years to 72,000. It further shortened its response time last year, informing the law enforcement and judicial authorities more and more promptly.

In recent months we have decided on a new rationalization of our branch network following that completed in 2010. By the end of 2018 the number of branches will be reduced to 39, down from 58 today and 97 in 2007.

The new configuration takes account of developments in technology, concentrating activities and personnel in larger units endowed with specialized professional skills that are updated constantly; it will improve service quality, maintaining a balanced territorial presence. The duties of the branches will be extended in the areas of consumer protection, supervision of non-bank intermediaries, assessment of asset eligibility for monetary policy operations, and inspection and control of cash circulation.

Today the Bank has 7,100 employees, including nearly 170 seconded to other institutions, primarily the ECB. In 2009 we had a staff of over 7,500. In the past five years the Bank's operating expenses have diminished by more than 14 per cent in real terms, thanks above all to measures to curb current expenses.

With investment in technology, among other things, our drive for organizational improvement will proceed. In managing human resources we will continue to adapt to social and economic changes. In agreement with the trade unions we have enhanced flexibility in working hours. We will reinforce the areas whose workload has been made heavier by the new European arrangements. We will continue to invest in people, seeking out and rewarding excellence, fostering career-long development of skills and promoting diversity.

On behalf of the Board of Directors, the Governing Board, and myself personally, let me voice our appreciation and gratitude to the women and men who work at the Bank of Italy, whose integrity and capability have always constituted the strength of this institution.

Monetary policy and economic growth in the euro area

The past year saw a slowdown in the emerging economies, related to the dwindling stimulus of commercial integration and the emerging effects of structural fragilities. Developments in the advanced countries diverged. Economic activity in the euro area remained weak for much of last year. Within the area, growth differentials narrowed but the remaining cyclical differences were reflected in the labour market: the increase in employment was robust in Germany and Spain, very modest in France and Italy. Although the unemployment rate fell slightly it was still high, especially among young people. Inflation continued to decrease, with the change in consumer prices turning negative at the end of the year.

We have emphasized on several occasions the risks stemming from a prolonged period of exceptionally low inflation, if not outright deflation. Studies carried out by the Bank of Italy show that the price deceleration is largely due not only to the drop in energy costs, but also to the lack of aggregate demand. They confirm that there is a risk of disanchoring of inflation expectations, which have reached an historical minimum. They point to the potentially heavy cost of low inflation, especially in conjunction with high levels of public and private debt.

In view of these risks the Governing Council of the ECB cut its policy rates to the lower bound, started new targeted longer-term refinancing operations, and launched covered bond and asset-backed securities purchases. In January of this year it decided to extend its asset purchases to public sector securities.

Under the expanded asset purchase programme the ECB will make monthly purchases amounting to €60 billion until the end of September 2016, and in any event until it sees a sustained adjustment in the path of inflation consistent with a return to price stability. This action will restore the Eurosystem's balance sheet to the peak levels recorded in the first half of 2012. About €150 billion worth of Italian government securities will be purchased, of which more than €130 billion by the Bank of Italy and the remainder by the ECB.

The single national central banks will bear the risks associated with the government securities they purchase. This decision takes account of the concerns of some members of the Governing Council that the programme could lead to transfers of resources between countries. Full risk sharing would have been more in line with the singleness of monetary policy and consistent with the Treaty on European Union. However, the measure's effectiveness is undiminished: it depends above all on the scope and timing of the action. The decision in favour of only partial risk sharing reflects the delays and limitations of the process of European unification.

The asset purchases boost economic activity and raise inflation through several channels: they reduce yields on public sector securities, with effects on other segments of the financial market and on the conditions for credit to households and firms; they cause a depreciation of the euro, which impacts on imported inflation and on exports; they increase the value of

financial assets and hence the private sector's spending capacity; and they improve inflation expectations and public confidence.

Positive effects on the financial and foreign exchange markets emerged as soon as the preparation of the programme was announced. From the beginning of November, and despite a rise in recent weeks that mainly reflected improved growth and inflation expectations, yields on ten-year German and Italian government securities have fallen by about 20 and 60 basis points respectively. The euro has depreciated by more than 10 per cent against the dollar and by 6 per cent in nominal effective terms. The stimulus has spread to market segments not directly affected by the asset purchases and to credit supply conditions. Inflation expectations have begun to improve, though only slightly.

Fears of deflation have abated, but the positive effects of the programme observed so far should not weaken our determination to take it forward; on the contrary, they are confirmation that we need to carry it through to the end. Improvement depends on the credibility of this commitment, and the cost of non-completion would be very high. Inflation must be brought permanently back to levels consistent with an annual growth in consumer prices of below but close to 2 per cent in the medium term.

With the start of purchases we have entered a new, partially uncharted, territory of extremely low interest rates even on medium- and long-term maturities. In seven euro-area countries these are now negative on horizons up to three years. In the second half of April, just before the recent increase, German rates were negative on maturities up to nine years. Fears have been voiced that the programme could encourage excessive risk taking in the search for higher yields, that it could generate liquidity tensions in some market segments, and harm some categories of financial operator such as insurance companies and pension funds. These risks must be carefully weighed but not overestimated.

There are no signs to date that low interest rates are provoking generalized imbalances. In the euro area as a whole, financial asset and property prices do not appear to be under speculative pressures, investors' risk propensity is still low, and credit growth is weak. Local and sectoral tensions can be controlled with macroprudential measures, as happens already in some other euro-area countries. Asset purchases are being made gradually and continuously so as not to distort price formation; securities lending by the ECB and some national central banks, including the Bank of Italy, is helping to keep the secondary market liquid.

The potential repercussions for specific sectors are not being ignored. The EU-wide stress test carried out in 2014 revealed that the exposure of insurance companies to the risks of a prolonged period of low interest rates is significant in some euro-area countries; it is less marked in Italy, thanks to a basically balanced financial structure. Insurance companies can limit these risks by seeking a better match between the yields and duration of balance-sheet assets and liabilities, improving operating results through diversification of portfolio securities, increasing technical reserves and, where necessary, adjusting their obligations to policyholders to the new market scenario. The authorities should step up their supervisory action and prudential controls as recommended by the European Insurance and Occupational Pensions Authority.

The risks, both real and financial, would have been far greater had we not begun the asset purchases. The greatest threat to the euro area's financial stability comes from the prospect of a stagnation of production and low inflation, which the programme combats.

Signs of a recovery of economic activity in the euro area have gained strength since the end of 2014. According to the latest projections, output growth will acquire a solid basis this year and gain momentum in the next, largely thanks to the support of monetary policy. There is still the risk of a further weakening of productive activity in the emerging countries and of a sharpening of international tensions.

The flare-up of the Greek crisis has had few repercussions to date on sovereign risk premiums in the rest of the area thanks to the reforms undertaken in many countries, the progress made in European governance and the tools available to the authorities to prevent contagion. Still, the difficulties that the Greek authorities are having in designing and implementing the necessary reforms and the uncertainty surrounding the outcome of their prolonged negotiations with European institutions and with the International Monetary Fund are fuelling grave tensions that could prove destabilizing.

Monetary policy cannot guarantee strong and lasting growth on its own. In the short term, demand can draw support from a reasonable use of existing flexibility within the limits of European budgetary rules. As the European Commission too has said, a contribution could come from the countries with the smallest debt and soundest public finances. The Investment Plan for Europe must be implemented without delay. Broader action would require an autonomous fiscal capacity for the euro area. Going forward, this capacity could be achieved by introducing built-in business cycle stabilizers, a first step towards true fiscal union.

In the medium term the creation of new income, new demand, and new jobs must be supported by measures and reforms designed, as of now, to raise productivity and growth potential. Technological progress brings about a marked expansion in activities that require expertise and new skills, but it can reduce, even considerably, the scope for employment in the sectors most susceptible to automation and to the growth of the digital economy. These consequences can be mitigated by developing new occupations, even in traditional sectors, that are less amenable candidates for automation. But investment is needed in infrastructure, education and training, and steps must be taken to make the labour market more efficient and minimize the fall-out for individual workers during the transition period. The support that monetary policy provides to aggregate demand is not an alternative to reform but it makes it possible to speed up the process and more easily absorb the short-term costs.

The Italian economy: consolidating the recovery

The recovery has now begun in Italy as well, albeit on a weaker basis than in the euro area as a whole. The expansion of exports has been accompanied by a recovery in domestic demand. The acceleration of household spending continues, especially on durable goods, mainly thanks to the improved outlook for disposable income. Investment returned to growth, and business surveys indicate that it could strengthen during the year. The increase in GDP in the first quarter ended a long period of unfavourable cyclical conditions; output is expected to continue to expand in this quarter and in those to come.

A return to stable growth that can provide new job opportunities requires a continuing drive for innovation, which is necessary to adapt to new technologies and global competition. Progress on this front in the last few years has helped restore Italy’s balance-of-payments surplus on current account, which came to almost 2 per cent of GDP in 2014. Since 2010 the overall adjustment has exceeded 5 percentage points, reflecting cyclical effects as much as structural adjustments.

Italian firms’ renewed capacity to compete is signalled by growth in the volume of goods exports that is greater than that in demand on our outlet markets, in particular those outside the euro area. The performance of the most efficient businesses that have increased their sales abroad, made investments and innovated, contrasts with that of a considerable part of the productive economy, which is characterized by a low propensity to innovate and more traditional organization and management.

There is less innovative activity in Italy than in the other major advanced economies, particularly in the private sector. The latest European survey on innovation indicates that the lag, especially marked in comparison with Germany, is more noticeable in the high-tech

industries. Italian firms have much less capability for in-house research and development and for cooperation with universities and other advanced training institutions.

Compared with those in other advanced countries, firms in Italy not only start out smaller but also struggle to expand; even when they are successful they expand their work force more slowly and for a shorter period. As we have often noted, apart from the financial limitations that I will discuss later on, the barriers to firms' activity and growth are mainly to be found in the environment in which economic activity takes place. The complex regulatory system, the relative inefficiency of public procedures and government action, the slowness of the justice system, and shortcomings in education and training all hinder the reallocation of productive resources to the most efficient firms, which is one of the main mechanisms of productivity growth. This situation is aggravated by corruption and, in several areas, the presence of organized crime.

In the last two years there has been a significant recovery in foreign capital inflows for portfolio investment, including bank and corporate equity and bonds. Nevertheless, the barriers to the renewal and expansion of Italian firms continue to discourage direct investment in Italy. Such investment is an important factor for change in management, for innovation, and for productive and commercial positioning within international networks. Despite signs of vitality, foreign direct investment in Italy is modest by international standards.

Reforms to remove the barriers to Italy's development have been undertaken and have gained recognition from international institutions and markets. In order not to disappoint the expectations of change, the spectrum of the reforms must be broadened and their implementation accelerated. In some cases, the benefits will not be immediate, but this is all the more reason to act without delay, pursuing a comprehensive design.

The recent labour market reforms have extended the income support mechanisms for the unemployed and, for newly hired workers, reduced the disincentive to permanent hiring connected with uncertainty over the outcome of decisions to terminate employment contracts. A full evaluation of the effects of these measures is premature. Trends in employment still reflect weak demand and ample unutilized production capacity. The sharp rise in new permanent contracts at the start of 2015, partly encouraged by the substantial tax relief in force from January, is a positive sign, suggesting that as the recovery takes hold, employment may grow and be oriented towards more stable forms.

There is still the risk, however, especially in the South, that the recovery will not be able to create jobs to the same extent as in the exits from past recessions. The crisis came on top of the great transformation dictated by technological progress and increased integration between different economies, with the large emerging countries among the protagonists. Labour demand from the most innovative firms may not be sufficient to reabsorb all the unemployment in the short term. This would affect the very sustainability of the recovery since domestic demand would not fuel it sufficiently.

This risk must be countered by supporting, including with innovation, activity in sectors where Italy has important traditions but also serious shortcomings and where production still depends on substantial inputs of labour, diversified according to skills and knowledge. Greater attention and greater public and private investment in urban modernization, land and landscape protection, and the exploitation of our cultural heritage can bring important benefits, combining innovation and employment, and not only in such directly involved sectors as construction and tourism.

In this delicate phase, special importance attaches to the full integration of the active and passive labour policies outlined in the enabling act for labour market reform. It will be easier to keep pace with technological innovation if the requisite skills can be acquired through effective retraining and if income support allows the unemployed to undertake such retraining with dignity. As regards young people, schools must provide the prospect of a reasonable return, not exclusively economic, on their investment in knowledge. For some time many

indicators have shown that Italy lags behind in both educational attainment and skills. To improve the curriculum, enhance quality and channel resources to where they are needed, requires first of all a systematic and in-depth assessment of the services provided and the knowledge and skills acquired.

Our Annual Report, with its new format and content, this year includes an in-depth examination of the public administration. Our business opinion surveys clearly show that there are difficulties stemming from an excess of bureaucratic requirements and an unstable regulatory framework. International comparisons place us quite far down the rankings, even if in every part of Italy backward and virtuous situations coexist. The renewal of the public administration, which began several years ago and is one of the Government's explicit objectives, is also the condition for carrying out a review of public spending that can preserve and improve the quality of services.

In a situation that remains difficult, fiscal policy has sought to balance rigour with support to the economy, in accordance with the margins for flexibility allowed under the European rules, while keeping the deficit under 3 per cent of GDP in recent years. Following the severely restrictive measures necessitated by the crisis of confidence in 2011, it has been proper to dose fiscal consolidation measures carefully so as not to hinder the recovery.

Thanks in part to the reform of the public pension system, in Italy more than in other European countries the long-term sustainability of the public finances can be preserved. Nevertheless, since the onset of the financial crisis the debt-to-GDP ratio has risen by more than 30 percentage points to 132 per cent, owing above all to the lack of economic growth. A return to higher levels of growth of nominal income, together with still prudent fiscal policy, will make the rapid reduction of the debt ratio possible.

Banks and the financing of the economy

The global financial crisis and its repercussions on the economy have prompted a widespread revision of the rules governing the financial system at international level. Vigorous measures have been taken both in the sphere of banking supervision and at macroprudential level with a view to restoring and preserving financial stability.

In the euro area, Banking Union has been set in train rapidly after a discussion of the essential points between the European institutions and the governments of the member countries. In Italy, measures have been adopted or are being studied to strengthen the banking system, debilitated by the long recession, and enable it to support the recovery of the real economy.

In the past months Parliament has reformed the cooperative banking sector. The biggest cooperative banks have long outgrown the confines of local markets. Like the other large Italian banks, they are now facing the changes imposed by economic integration and by technology. The cooperative form has deterred assessment of these banks by investors and impeded their ability to access the capital market swiftly, a crucial factor at times for coping with external shocks. The reform will facilitate efficient credit intermediation in a market made more competitive by Banking Union.

The need for the banking foundations to perform their role of shareholder while respecting the investee banks' management autonomy and to diversify their investments is a point that the Bank of Italy has stressed for some time. The Memorandum of Understanding between the Ministry of Economy and Finance, responsible for supervising the foundations, and the Association of Banking Foundations and Savings Banks is a step in this direction. The concentration limit on investment in a single issuer protects the interests of both the foundations and the banks. The Memorandum safeguards compliance with the ban on control, including joint or de facto control, of investee banks. It also improves the quality of governing bodies, increasing their degree of independence.

For mutual banks to be able to continue to support their local markets and communities, preserving the spirit of mutualism that is their hallmark, it is necessary to pursue forms of integration based on membership of banking groups. Scant diversification of risk and the difficulty of capital strengthening are creating crisis situations in more than a few cases. The mutual banks' trade association is drafting concrete proposals that will be evaluated in the light of their ability to remove the obstacles to recapitalization and to resolve these banks' problems. Change cannot be delayed.

Signs of improvement in the credit market are emerging. The flow of new loans has been growing since the closing months of 2014; in March the twelve-month decline in bank lending to firms was 2.2 per cent, a sharp abatement of the contraction that we have been witnessing for three years. Italian banks' ample recourse to the targeted longer-term refinancing operations and the start of government bond purchases by the Eurosystem have permitted a significant reduction in the cost of bank funding and led to a gradual improvement in that of credit. The interest rates on new loans to firms have come down by more than a percentage point since the beginning of last year; the spread with respect to German and French rates has more than halved compared with the peaks of two years ago. In the course of 2014 the decline in interest rates, which until then had been confined almost exclusively to exporting firms and larger companies, began to involve firms operating on the domestic market and smaller enterprises.

Credit conditions nevertheless continue to be uneven. In the sectors of the economy where economic prospects have already improved, lending to firms with sound finances has begun to grow again. In those where recovery is proceeding more slowly, and especially in construction, credit is still contracting.

In the first quarter of this year the loan quality and the profitability of the largest banking groups showed signs of improvement, but the legacy of the recession still weighs on banks' balance sheets. At the end of 2014 the stock of bad debts approached €200 billion, equal to 10 per cent of credit outstanding; other non-performing loans amounted to €150 billion, 7.7 per cent of loans. Before the crisis, in 2008, the overall ratio of non-performing loans was 6 per cent. Against these exposures banks have set aside substantial resources; they are making write-downs which absorb most of their operating profit and crimp self-financing. The upshot is a constraint on new lending.

The large stock of non-performing loans also reflects the very long and variable duration of insolvency and credit recovery procedures, due in turn to the country's cumbersome civil justice system. These widespread inefficiencies depress potential buyers' valuations of impaired assets and discourage their sale on the market. The unfavourable tax treatment of loan loss provisions, though mitigated, still does not allow their immediate deduction from taxable income, as happens instead in the other main European countries; this determines an accumulation of deferred tax assets. Measures are being drafted to eliminate these competitive disadvantages, which weaken the Italian banking system.

The development of a secondary market in non-performing loans, which is practically non-existent at present, would contribute to fully reactivating the financing of households and firms. For some time we have been proposing initiatives along these lines, with scope for public-sector participation. We are working together with the Government to design them, in compliance with the European rules on state aid. A discussion that we hope will be rapid and constructive is now under way with the European authorities.

In 2014 the large increase in Italian banks' capital ratios, with the average core capital ratio rising to 11.8 per cent from 10.5 per cent the year before, was achieved mainly with the capital increases carried out, at our prompting, in the first half of the year; the contribution of self-financing was negative for the system as a whole. In order to recoup profitability, banks can curb costs further and expand their sources of income.

More than a few banks, especially medium-sized ones, are evaluating mergers and acquisitions, including in response to recent regulatory innovations. There are sizeable potential

benefits of these operations but they cannot be taken for granted; they require vigorous action at the organizational level, in rationalizing distribution systems, risk management and technology uptake.

The revision of international prudential standards aims to protect the integrity of the banking system as a fundamental infrastructure for the functioning of a modern market economy. The new rules on capital, leverage and liquidity and the establishment of crisis resolution mechanisms will make the system more stable and lessen the possible effects of bank crises on the economy and the public finances. At the same time, they will result in a reduction of banks' capacity to take risks and a structural reduction in the return on capital invested in them. The granting of loans will become more selective; the development, within a well-defined regulatory framework, of alternative forms of financing necessary to avert a shortage of resources for the real economy will have to be stimulated.

Looking ahead, the shift of a part of the intermediation process from banks to markets will benefit both firms and households, allowing the former to expand their sources of financing and the latter to diversify their savings to a greater extent. Banks will continue to play a central role in the financial system if they prove able to accompany this evolution by expanding their activity in the field of services and assisting firms in direct capital raising. A trend of this kind is under way in many countries, but here in Italy the transition will not be easy. The underdevelopment of the Italian capital market reflects the characteristics of the structure of the economy and the consequent difficulties of assessing the risks and opportunities of financial investments.

Banks' leverage, measured as the ratio of total liabilities to own funds, is declining in all the major countries. In the United States, that of the ten largest banks has been halved since 2007; the effects on the overall financing of the economy have been limited, thanks to the contribution of the markets; bonds account for more than 40 per cent of firms' borrowing.

Banks' leverage has also fallen sharply in the euro area, as a result of both capital increases and the contraction in credit. Since 2007 loans to firms have diminished in relation to GDP by five percentage points, to 42 per cent. The compensatory possibilities offered by the financial market are modest: at the end of 2014 bonds accounted for just over 10 per cent of firms' financial debt. Failing a marked increase in their self-financing capacity, an overly rapid deleveraging of banks' balance sheets would end up having procyclical effects on the economy, threatening to create a vicious circle between the reduction of credit and the erosion of productive activity.

The construction of a diversified system that can offer the economy the necessary financial support – not in the shadows but in full transparency – cannot be deferred. The European Commission has put forward proposals for the creation of a Capital Markets Union by 2019. The proposed reforms aim at removing the obstacles to equity and debt capital raising, especially on the part of small and medium-sized enterprises and across borders. The success of the initiative requires that progress also be made in the harmonization of company, bankruptcy and tax laws.

In Italy, important measures have been taken to strengthen the capital market. Equity issuance by firms has been encouraged by mostly eliminating the tax advantages of debt financing. Tax benefits have also been introduced for stock-exchange listing and for venture capital funds, along with incentives for bond issuance by unlisted companies. The possibility of making loans has been extended to insurance companies, and credit funds have been regulated. An additional contribution will come from the reform of non-bank financial intermediation, implementation of which is at an advanced stage. The results of these measures are positive, but much work remains to be done, including in the field of financial information and education.

Supervision and Banking Union

The Single Supervisory Mechanism became operational on 4 November 2014. Its launch was preceded by the comprehensive assessment of the balance sheets of the euro-area's largest banking groups, which was designed to increase transparency and confidence. It was the first test of the new system, requiring a close comparison of national supervisory practices and cultures. The results confirmed the Italian banking system's overall resilience to extreme shocks, even though it had received no significant state support during the crisis. The adverse scenario hypothesized in the stress test found capital shortfalls at two Italian banks under scrutiny by the Bank of Italy for some time, both of which are now carrying out capital strengthening plans.

Given the institutional complexity of the new mechanism, the particularly tight deadlines for its construction, and the differences in national supervisory practices, the results to date are positive. The new supervisory system's operating rules have been finalized, the decision-making mechanisms are being fine-tuned, and the 2015 supervisory programme, agreed in common for the first time, is being implemented. The pooling of experience and know-how will take time, requiring profitable cooperation and openness to discussion at every level.

In recent months work has begun on several major projects; special importance attaches to the review of banks' assessments of asset risk based on internal models previously validated by the national authorities. The aim of the exercise is to ensure consistent risk assessment and the accurate measurement of RWAs. The Basel Committee is also taking steps to enhance the transparency and comparability of internal models. The Bank of Italy supports these objectives fully.

The capital targets notified by the ECB to the area's significant banks in February, following the prudential review in 2014, were broadly based on the outcome of last year's comprehensive assessment. The criteria for establishing banks' capital objectives in the future are now being defined. In this phase of still uncertain recovery, the primary requirement of guaranteeing the solidity of individual institutions must be met without undermining their overall ability to supply credit to the economy.

The euro area's Single Resolution Mechanism will become operational in 2016, heralding important changes and with repercussions for the laws and practices governing crisis management, which have differed markedly between countries in the past. The mechanism will make use of the harmonized tools envisaged under the EU Bank Recovery and Resolution Directive, which implemented the international recommendations of the Financial Stability Board at European level.

The mechanism has been designed to harmonize bank crisis resolution policies in the euro area, guarantee centralized crisis management for cross-border groups, and mitigate the risks associated with the failure of systemically important banks. Once up and running, it will make available common resources for the necessary interventions. As with supervision, tasks will be divided between the area's Single Resolution Board and the national authorities in accordance with banks' characteristics. A number of institutions will be involved in making decisions: the Commission, the European Council, the ECB, and national supervisory and resolution authorities. The complexity of the process calls for smooth and effective decision-making procedures. Any resolution of very big and complex banks will also require the preparation of an adequate backstop at European level that can be activated at short notice. It may also prove necessary to increase the resources of the Single Resolution Fund, which is financed by the banks.

The inclusion of a bail-in provision in the Directive marks a radically new approach to resolving bank crises, whereby the necessary resources should be drawn first of all from the bank's shareholders and creditors in order to keep costs down for the taxpayer. The aim is to prevent implicit state subsidies from becoming an incentive for opportunistic behaviour and to strengthen market discipline. Under this approach a wide range of bank liabilities could be bailed-in except, in particular, insured deposits and covered bonds.

Investors must be made aware of the risks inherent in the new crisis management system, and customers, especially those less able to pinpoint these risks correctly, must be properly informed of the fact that if they hold instruments other than deposits and guaranteed liabilities, they may have to contribute to the resolution of a bank. In this new context, initiatives to restrict purchases of the riskiest instruments to professional investors may merit consideration.

The time limit for transposing the Directive expired at the end of 2014 and the bail-in provisions must be incorporated into Italian law by 1 January 2016. These deadlines must be met as a matter of urgency: not just to avoid sanctions by European institutions but also because their transposition is essential to guarantee legal certainty and to enable the authorities to perform their new tasks using the tools assigned to them by European legislation. In this transitional phase, in which new tools cannot yet be used and the traditional mechanisms for intervention are being obstructed or made inoperable by European rules, resolving bank crises caused by recession or malfeasance has been made more difficult. We hope for the rapid passage of the enabling law now before Parliament in order for the Government to issue the necessary decrees to adapt Italy's legislative framework to this new phase of Banking Union.

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Economic regulation cannot ignore market mechanisms. Experience teaches that top-down directives are unlikely to hit upon the best paths of growth. There are cases in which public intervention does not work to the benefit of the community and distorts the allocation of resources. Wealth cannot be produced by law, nor can stable jobs be created. And budget constraints cannot be ignored except at the cost of severe damage.

But where the market runs up against its limitations, regulators can and indeed must intervene, helping it to generate economic growth and employment. No market works efficiently or equitably without public institutions that enforce the rules of the game and guarantee legality and transparency. There can be no solid, balanced development without those collective works that the market, by itself, is incapable of supplying. These limits are perfectly well known to economic theory; the global crisis has brought them dramatically back to the forefront of our attention.

In the financial sector, market failures are not infrequent. There are certainly abuses and predatory acts, which the authorities, including banking supervisors, must prevent as effectively as possible and sanction severely. There are also information asymmetries, problems of coordination of agents' expectations, mechanisms that amplify price fluctuations and that may trigger euphoria or panic and in certain cases sever the link between prices and economic reality. At times prices can lose their essential function of guiding the allocation of resources, helping to orient the choices of consumers, firms and investors.

Economic and financial governance requires accompanying the evolution of the market without bridling its force. There is no foolproof formula for striking this balance. Clear rules, impartially applied, are essential, but so is the ability to make sound and timely decisions in the light of circumstances.

In Europe, public regulation and action in economic and financial affairs are now largely common matters, no longer reserved to single states. The transfers of sovereignty in this field, in part owing to the shock wave of the crisis, have been very substantial indeed; shared responsibility is increasingly the rule, not the exception. This applies to monetary policy, since last year it applies to banking supervision, and starting next year it will apply to bank resolution. Common policies regulate commerce, agriculture and fishing. Competition policy, with its rules, is an essential instrument for ensuring the proper working of the single market.

The further integration advances and the more pressing and global the challenges become, the more the European Union's governance capability must be strengthened. Steps ahead have been taken: rules, institutions, safety nets are being progressively placed in common. Although the path is not always straightforward, the progress made is undeniable and must continue. Within the Commission in particular, a technical core, the custodian of the common

rules, coexists with the embryo of a politically responsible government. A synthesis must be found in the interests of the proper functioning of the internal market and the European economy.

The authorities responsible for monetary policy and for banking supervision, whose independence from political institutions is sanctioned by the European rules, seek to strike a balance between rules and discretion: neither arbitrary power nor blinkered, acritical application of the rules. In the appropriate ways and at the opportune time, actions and decisions are made accountable. Attention is paid both to the inefficiencies of the State and to those of the market. In monetary policy, this explains recourse to unconventional measures; in banking supervision, it explains the effort to achieve an equilibrium – which does not mean laxity – between microprudential intervention at individual institutions and macroprudential considerations relating to the overall stability of the financial system.

Substantial observance of the rules on market protection and equal competition remains indispensable. But in assessing the public role in the prevention and resolution of crises, and not only financial crises, greater consideration needs to be given to the characteristics that distinguish policies designed to activate market mechanisms from state aid that distorts competition.

The national authorities, technical and political, are essential to the European decision-making process. It is up to each Member State to play its part in the common interest, not neglecting national interests and priorities but advancing them effectively within the European arena. In the difficult and sometimes tense debate between members, the voices best able to gain a hearing are those of the countries that are acting successfully at home and fully honouring their commitments. Let this be a spur to consolidate and extend the progress made, in Italy as in our common journey in Europe.