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Global finance and the Italian economy

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Contents

1. *Finance and the world economy*

The rapid expansion of international banking and financial activity in the last fifteen years has helped to raise the rate of growth of the world economy by allocating financial and real resources more efficiently.

Past experience nonetheless teaches that international liquidity may also fuel speculation, lead to a deterioration in the quality of credit and foster the spread of financial turbulence.

The stock of public and private-sector bonds in the G-10 countries grew from 90 to 127 per cent of their combined GDP between 1985 and 1998, the capitalization of their stock markets from 30 to 97 per cent. Since 1990 the notional value of the derivatives listed in these countries has risen from 37 per cent of GDP to approximately double that aggregate.

The flow of new loans originating in countries reporting to the BIS — namely the industrial countries and the leading off-shore financial centres — and destined for non-residents peaked at $1,100 billion in 1997. Most of the total was accounted for by interbank transactions.

A major contribution to the conspicuous flows of world finance in recent years has come from the monetary expansion in Japan; to a considerable extent this has fuelled capital outflows that have boosted international liquidity.

In the three years between 1995 and 1997 net outflows from Japan amounted to about $230 billion. Most of this ended up in the banking systems of the other industrialized countries, which used them to grant loans to intermediaries located in off-shore centres, including highly leveraged institutions such as hedge funds.

The major international non-bank intermediaries — primarily hedge funds, pension funds and insurance companies — together own assets on the order of $30 trillion, the value of annual world output; they raise liquidity where the cost is lowest and pour it into the markets offering the highest expected returns. These movements have contributed to the sharp rise in share prices of the last five years; in a setting marked by low inflation and a tendency for budget deficits to decline, they have also led to a rise in bond prices, that is to a fall in interest rates.

At the root of the crises that hit some of the leading developing economies was a combination of macroeconomic imbalances, weaknesses in the institutional arrangements governing finance and industry and shortcomings in prudential supervision.

In Asia, in particular, capital inflows had brought an excessive increase in corporate borrowing and given rise to inflationary pressures. In the absence of hedging against exchange rate risk, the substantial stock of short-term debt in foreign currency had accentuated these economies' vulnerability. The intermingling of finance, industry and government had encouraged corruption and misuse of funds. The lack of transparency on the one hand and the determination of national authorities to defend the exchange rate on the other had led intermediaries to ignore the signs of imbalance.

In 1998 the full effects of the crises in Asia and other emerging countries caused a reduction in international interbank exposure almost everywhere; off-shore banks recorded nearly $200 billion of net capital outflows towards banks in Japan and the other industrialized countries.

In 1998 and 1999 the crisis became increasingly dramatic in Russia, where the economy is afflicted by political and institutional instability, widespread corruption and the waning of trust among those engaged in production and commerce.

There is a phrase of Adam Smith's that can help to explain recent events in Russia: "Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice."

As the crises spread to Latin America and Eastern Europe, international capital was switched on a major scale into dollar-denominated assets and the United States, considered as safe havens. The result was a gradual appreciation of the dollar, notwithstanding the worsening US balance of payments.

The inflow of capital into the United States helped to sustain that country's prolonged economic expansion. Consumption increased steadily. The growth in investment with a large information and other high-technology component was exceptionally strong; the bulk of capital spending was in the services sector.

The deteriorating balance-of-payments deficit was easily financed. Carefully regulated immigration continued to supply low-cost labour. The generally moderate rise in wages and salaries and higher productivity made it possible to contain inflation, despite the strong growth in domestic demand, which helped to sustain world economic activity by boosting imports.

Since the second half of 1998 the Asian economies have shown signs of recovery, in the wake of the contraction in domestic demand and sizable currency devaluations. Productive activity in Japan began to expand again in 1999, thanks to massive public-sector deficit spending programmes. Economic difficulties persist in some of the leading Latin American economies, although the most critical stage appears to have passed in Brazil.

The improvement in economic conditions worldwide, and especially in Asia, has had a beneficial effect on the European economy.

2. International cooperation for financial stability

The shift in international portfolios towards safer financial instruments was accompanied by an increase in the sovereign risk premium investors required. The fall in the prices of shares issued by emerging countries undermined the stability of major international financial intermediaries.

At times the close link between international liquidity and financial variables on the one hand and the real economy on the other appears no longer to exist. In the working of closely integrated markets there is an intrinsic risk of financial instability that national authorities cannot handle alone and that requires some form of global financial governance.

There is a need for crisis-management mechanisms that do not hinder the responsible assumption of risk by private agents, financial intermediaries and states.

It is to be hoped that emerging countries will adopt clauses facilitating coordination between claimants in cases of insolvency and ensuring that all creditors receive equal treatment.

In the case of banks, the imposition of capital requirements in proportion to the level of country risk can prompt a careful evaluation of loan operations.

The exposure of Italian banks to the crisis-struck countries is modest on the whole. A contribution to curbing the volume of loans has come from the provisioning rules for unsecured lending to non-OECD countries.

The international efforts to tackle the recent episodes of instability have been on an exceptional scale, more than $150 billion dollars have been allocated to sustain the Asian and Latin American countries involved. The foundations for a wide-ranging structural reform of the international system have been laid.

At the initiative of the Finance Ministers and central bank Governors of the G-7 countries, the Financial Stability Forum has been established, bringing together governments, central banks and supervisory authorities.

The Forum is assessing potential areas of vulnerability in the world financial system with a view to identifying measures to prevent systemic instability.

High priority has been assigned to the issues raised by the size and instability of short-term capital movements, hedge funds' operations and dealings with off-shore centres.

Efforts are being made to tackle the problems caused by the most variable component of capital flows, on the one hand by inviting intermediaries to assess the risks associated with international lending more carefully and on the other by calling on borrower countries to introduce rules to prevent the excessive accumulation of short-term foreign liabilities.

For highly leveraged financial institutions possible forms of regulation are being discussed, such as borrowing limits and codes of conduct; work is also under way to make good the shortcomings that have emerged in banks' assessments of loans to borrowers whose risk profiles can change rapidly.

The recently established Group of Twenty can play an important role in building consensus and promoting the necessary institutional adaptations in emerging countries.

3. Off-shore centres

Off-shore centres carry out a very large volume of intermediation in international markets. For some of them the inflow of capital reflects the efficiency of their markets for innovative products; this is the case of derivatives trading in Hong Kong and Singapore.

Low taxes have played a role in increasing the volume of transactions, but so have light regulation and notably strict bank secrecy laws.

The activity of these centres raises tax competition issues; it alters the international allocation of financial resources. Intermediaries from many countries locate in off-shore centres in order to gain tax advantages. They can become conduits for laundering the proceeds of criminal activity.

As regards tax competition, the fiscal regimes of other countries also produce effects similar to those of off-shore centres. Initiatives aimed at harmonizing national tax laws and strengthening cooperation between authorities have been under way for some time at the international level.

The obstacles that national supervisors banks face in controlling international banks and the quality of the controls over banks and firms located in some off-shore centres are a source of concern. The ease with which companies can be established facilitates the creation of financial conglomerates whose complexity is designed to reduce the effectiveness of controls.

The Bank of Italy has long had contacts with authorities in off-shore centres. Agreements have been reached with Hong Kong and Singapore on the exchange of information and the carrying out of inspections by Italian supervisors at the branches and subsidiaries of Italian banks. Hong Kong and Singapore account for 40 per cent of lending to residents in off-shore centres.

The Bank participated in drafting the 1995 EC Directive on reinforcing prudential supervision. This prohibits the creation of group structures that prevent the effective exercise of supervisory functions.

The Bank of Italy adopts a selective approach in authorizing branches and subsidiaries of Italian banks in non-EU countries, verifying the existence of adequate legislation and supervisory controls in the host country and ascertaining whether it is possible for the parent company and the Bank to gain access to information. Applications for authorization are turned down or restrictions imposed on the business that branches may conduct if these conditions are not fully satisfied. In such countries authorizations have been granted only to intermediaries of considerable soundness and high standing, with organizations capable of carrying out effective internal controls.

The level of international cooperation in tackling the problems posed by off-shore centres is still unsatisfactory. The Bank has studied the possibility of prohibiting Italian banks from operating in these centres. However, excluding them from advanced financial markets would weaken their capacity for innovation and reduce their international role.

Italian banks have 28 branches and 18 subsidiaries in off-shore centres. In June 1999 their fund-raising totaled $22.4 billion, of which 1 per cent came from Italian non-banks.

Lending by Italian banks to off-shore centres is small by comparison with the other leading countries. Loans to residents in such centres account for 5 per cent of total international lending by Italian banks, compared with 8 per cent for France, 11 per cent for the United States and 20 per cent for Japan.

Off-shore centres remain a problem for the financial community and for Italy. A satisfactory solution will necessarily involve international cooperation. It is essential to prevent any move towards a lowering of regulatory standards that would jeopardize the stability of intermediaries and markets.

In 1997 the Basle Committee issued a series of core principles for effective banking supervision, which all countries have been asked to adopt. These principles require that supervisory bodies have sufficient resources and effective powers of intervention to conduct periodic analyses and inspections of supervised entities. They emphasize the need for international cooperation among authorities.

The application of the supervision principles to off-shore centres is currently being studied by the Financial Stability Forum. It is necessary to develop methods for assessing supervisory arrangements in the various centres and to define measures to encourage the implementation of the core supervisory principles.

4. Preventing and countering economic crime

In a context characterized by rapid cross-border movements of funds, there are ever greater opportunities to use the financial system for money laundering. In off-shore centres preventive action against laundering is often insufficient. This is also true in other countries with inadequate legislation and controls.

Extensive use of anonymity, coupled with barriers to the exchange of information with the authorities of the industrial countries, also facilitate money laundering.

The deliberate fragmentation of transactions hinders authorities in their efforts to reconstruct movements of funds and identify those deriving from illegal activities. Such funds are usually transferred to off-shore centres by means of false commercial or financial transactions with front companies.

Leading off-shore centres have recognized the importance of improving their reputations through more effective banking supervision. This could help to increase the stability of the international financial system.

Awareness of the extent of money laundering and its links with criminal activity has led numerous international organizations to fight the phenomenon.

Beginning with the Vienna Convention of December 1988, the UN has been a driving force in the fight against the laundering of drug money. In 1990 the Council of Europe promoted the Strasbourg Convention on money laundering and measures for the seizure and confiscation of the proceeds of criminal activity. In 1991 the European Union issued a Directive, currently being amended, on preventing the use of the financial system for the purpose of money laundering.

The Financial Action Task Force, created in 1989 by the G-7 countries, has developed a set of measures that should be introduced in all legal systems in order to ensure effective prevention and repression. Efforts are being made to define criteria to identify countries that do not cooperate and create incentives for international collaboration.

The nature of money laundering and the instruments used mean that illicit funds pass through the system of financial intermediaries without these normally being aware of it.

According to initial assessments by the Financial Action Task Force, money-laundering transactions are equal to several per cent of GDP in every country.

The Italian Parliament had legislated before the Community Directive was adopted in 1991 and has ensured full compliance with the international standards established by the Financial Action Task Force. International comparison shows the breadth of the measures enacted in Italy and the quality of the structure of public controls. Parliament recently extended the system of safeguards to non-financial operators in order not to leave any gaps.

The stratification of successive measures diminishes the effectiveness of the legal structure, however. The time is ripe for a thorough reorganization with a consolidated law.

Money laundering cannot be fought solely with the investigative and judicial tools of criminal law.

The distinction established at the international level between investigative action and administrative controls has prompted Italy to assign the task of conducting financial analysis in money-laundering cases to the Ufficio Italiano dei Cambi (UIC), which has recently acquired the legal status of an instrumental body of the Bank of Italy.

Control of money laundering requires the active cooperation of intermediaries, whose knowledge of the characteristics and operations of customers makes them an invaluable source of data and evaluations. They are required to make a monthly report to the UIC of aggregate data on transactions exceeding 20 million lire and to report transactions that, on the basis of guidelines laid down by the Bank of Italy, appear to involve funds of illegal origin. Suspect transactions are scrutinized with the help of the sector supervisory authorities and the use of appropriate techniques; the results of such examinations are subsequently transmitted to investigative authorities.

Achieving cooperation requires adequate guarantees for reporting intermediaries. Placing the UIC between the reporting institutions and the investigative authorities contributes to this. The information can only be transmitted to bodies authorized by law to receive them; the data cannot be used for other examinations.

Intermediaries must make organizational arrangements that fully safeguard the anonymity of employees who report suspect transactions.

Since 1 September 1997 more than 8,000 suspect transactions have been reported, more than during the entire period of the regime introduced in 1991.

Reports have come almost entirely from banks, with a few being received from securities investment firms and insurance, trust and financial companies. Banks representing nearly all of the banking system have transmitted reports. Two out of three reports have come from thirty large banks with extensive branch networks in Italy and abroad. Low volumes and the concentration of business in a small area may be obstacles to cooperation. Ways to overcome these difficulties need to be found.

Reports mainly originate in the north-west of the country, especially Lombardy. Relative to the number of branches, the largest number of reports came from Campania.

The analytical methods used to evaluate suspect behaviour are constantly being improved.

The most common money-laundering transaction is the so-called “triangular operation”, in which the beneficiary of funds is located in an off-shore centre different from the one hosting the intermediary that receives them. The transaction is structured so as to prevent authorities from linking the funds to the beneficiary.

The Bank of Italy and the UIC provide the basic information for the application of the law enacted in 1996 to combat usury, whose main victims are households, small tradesmen and artisans; it provides a means for organized crime to penetrate the productive sector.

Quarterly statistics on loans, of which there are now more than 12 million, are used to calculate the average market interest rate; increasing this by a half gives the benchmark rate for determining whether individual loans are usurious.

Concern about the possible effects of the law on the supply of credit mainly regards periods of rising interest rates, when administrative limits, which are inherently slow to adapt to rapid changes in market conditions, may prevent loans from being granted where an adequate risk premium cannot be incorporated.

Together with other bodies of the State, the Bank of Italy and the UIC participate in the work of the Observatory headed by the Government's Special Commissioner for the coordination of anti-racket and anti-usury initiatives.

Police data and statistics compiled by the judicial authorities are combined with credit, financial and national accounts data to construct summary indicators of the exposure of different parts of the country to the offences of extortion and usury. The Report published this year confirms the critical situation in the southern regions and finds signs of these forms of criminal activity spreading to the rest of the country.

It is necessary to prevent and repress usury in view of its devastating effects on the social environment. Economic difficulties aggravate the phenomenon. The consequences for its victims can be alleviated by appropriate forms of public intervention.

Once again it needs to be stressed that prevention requires private bodies and institutions, backed by the authorities, to play a larger role in spreading awareness of the dangers associated with borrowing from irregular sources and in educating people to use money responsibly.

Intermediaries capable of moving huge amounts of money of illegal origin are a threat to the banking system and the financial market.

The establishment of new banks is a delicate link in the chain. The Bank of Italy grants authorizations after verifying that the essential conditions for sound and prudent management of the business are met: a fully paid-up minimum amount of initial capital; satisfaction of integrity and experience requirements by the persons destined to play a major role in the bank's activity; and submittal of a valid programme of operations.

In the three years from 1997 to 1999, 56 authorizations were granted and 24 applications rejected; in several cases rejection was due to the presence of shareholders or corporate officers who were not deemed fit to guarantee proper administration.

Constant supervision of banking markets and intermediaries facilitates the prevention and repression of the unauthorized performance of reserved activities.

Strict controls are also provided for in the event of the acquisition of significant shareholdings in banks that are already in operation.

The information requirements and authorization procedure for acquiring control of a bank have recently been amended; the Bank of Italy assesses the business plan of the acquirer, the effects on the bank's capital and operating costs, and the integrity and reliability of the persons who will formulate the strategic guidelines for operations.

The regulations governing internal controls have been revised with the aim of ensuring sound and prudent management. The Bank of Italy's Supervisory Instructions require banks to adopt procedures to minimize the risk of employee fraud and dishonesty and to prevent involvement, deliberate or otherwise, in money laundering.

The board of auditors has a fundamental role to play in ensuring the regularity and legitimacy of operations.

Banks and other intermediaries have shown awareness of the importance of their role in preventing the penetration of the financial system by illicit interests.

The costs that cooperation in law enforcement imposes should be considered as ordinary operating costs of the business and capable of generating returns in terms of stability and reputation.

5. The Italian banking system

A sound and efficient banking system, open to competition at home and abroad, contributes to the healthy growth of economic activity based on principles of proper business conduct and market rules.

Supervision is conducted continuously through analysis of banks' profitability and capital adequacy, meetings with corporate officers and regular inspections, which supplement the information available with special reference to the quality of assets, risk management and the overall reliability of the organization and internal control systems.

On average inspections are carried out every year at 150 banks, accounting for between 10 and 15 per cent of the banking system's total assets; smaller banks are normally inspected every three years.

The Italian banking system has made significant progress in the nineties. It has succeeded in correcting structural traits that hindered modernization and reduced the ability to generate income. It has overcome difficulties arising from the cyclical performance of the economy and markets on a par with those that gave rise to large-scale banking crises in other industrial countries.

The consolidation taking place within the system, involving both large and medium-sized banks, is strengthening the capital resources and organizational structures of individual intermediaries and creating institutions comparable in size to the leading European banks.

Changes in the ownership of southern banks have increased the presence in the local banking market of intermediaries established in other parts of the country, whose activity helps to spread advanced management methods and operational techniques.

The share of total banking business accounted for by public-sector intermediaries has fallen considerably. The shareholdings of foreign intermediaries in Italian banks are substantial and proportionally larger than in other leading countries.

The entry of new banks has increased competition in local markets. Profit margins on traditional credit business have contracted sharply. Banks are responding by offering a wider range of services. Self-financing and the raising of equity capital, which has benefited from the rise in share prices, have enabled banks to strengthen their capital resources.

The reorganization of the Italian banking system that is under way, driven by market forces and encouraged by the Bank of Italy, has no precedent in the last sixty years. The process is not yet complete; there must be further consolidation, especially among medium-sized banks.

The range of services must be broadened and their quality improved in order to meet the needs of a rapidly expanding economy and financial system more effectively; costs must be further reduced and the proportion of income absorbed by labour costs reduced to the average level in Europe. The labour contract signed last summer permits greater flexibility; it must lead to a closer correlation between labour costs and corporate performance and to an increase in productivity.

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The recovery under way in the international economy will boost growth in Europe to around 3 per cent in the year 2000.

After the unsatisfactory result recorded this year, the Italian economy appears destined to lag behind in the next two years as well, with annual growth of between 2 and 2.5 per cent.

Investment continues to fall short of the saving available, even though interest rates are exceptionally low compared with their level in the last twenty years.

The loss of competitiveness is reflected in a reduction in the trade surplus. New employment is concentrated in the economically advanced regions and is mostly in the form of short-term contracts.

While fulfilling the obligations deriving from international commitments with regard to net borrowing and the public debt, determined efforts must be made to reduce taxation. The steps in this direction taken in the Finance Bill for 2000 must be accompanied by the announcement of further reductions in the following years.

This necessarily implies a downward trend for the ratio of public expenditure to GDP.

Inefficiency, which has accumulated over the years and is reflected in the volume and composition of public expenditure, offers an opportunity precisely because the sector is so large. Determined efforts are necessary to sustain the action already taken within the public sector, especially in the directions laid down by the laws on the streamlining of bureaucratic procedures.

Reform of public spending on pensions and welfare is needed to maintain Italy's advanced social security system and guarantee future benefits.

The drive to revive public works, which has already led to an increase in tenders, must be continued with the opening of sites and the start of construction. The effects of the near halt in public works projects in the last five years have been most pronounced in the weak southern economy, which is already underendowed with infrastructure.

The measures to accelerate growth can count on an ample supply of labour, especially young people wishing to find work, including jobs involving new forms of employment relationship.

If growth recovers, forms of employment that are theoretically more flexible can lead to stable jobs.

Faster growth in itself brings an improvement in the public finances.

For decades Italy has enjoyed an abundance of the key raw material for growth, saving.

Although not yet completed, the reorganization and strengthening of the banking and financial system will create the infrastructure for the transformation of saving into investment.

We have the resources; the inefficient elements of the system and the unresolved structural problems have been identified. We must have confidence in the general will to achieve a more secure society that can eliminate the most strident forms of exclusion and social hardship, offer opportunities to the many young people on the threshold of the labour market who wish to provide for their own and their families' well-being through a regular job and to cooperate for the good of the entire community.