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Ordinary Meeting of Shareholders

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CONTENTS

THE INTERNATIONAL ECONOMY AND THE EURO AREA

1. MACROECONOMIC DEVELOPMENTS AND POLICIES AND THE INTERNATIONAL FINANCIAL MARKETS

In 2014 the expansion of global economic output fell short of expectations, maintaining the same moderate rate as in the last two years (3.4 per cent). In the advanced economies the gap widened between the faster pace of growth in the United States and the United Kingdom and the much weaker pace in Japan and the euro area (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area'). In the emerging and developing countries economic activity instead slowed overall, as it had in the previous three years, held back by structural weaknesses and, in some instances, by stronger external constraints, mostly of a financial nature.

Inflation declined in all the advanced economies, reflecting persistently weak global demand and falling commodity prices. Monetary policies remained accommodative but varied from area to area: the Federal Reserve stopped buying securities and continued to signal that it would gradually raise interest rates, while Japan and the euro area instead adopted strong expansionary measures. Towards the end of 2014 low inflation in China and India paved the way for the relaxation of monetary conditions.

Volatility on the financial markets continued to be very limited, but there were occasional flare-ups at signs of a deterioration in the global outlook, developments in Greece, and the escalation of tensions in Ukraine. The strengthening of growth prospects in the United States triggered a sharp appreciation of the dollar. Long-term interest rates fell in all the advanced economies. The sharp retrenchment in capital flows to emerging economies in the second half of the year stoked pressures on currencies, feeding through to inflation in the most vulnerable countries (Brazil, Russia and Turkey), whose central banks responded by tightening monetary policies notwithstanding the worsening economic outlook.

The main advanced countries

The pace of growth accelerated slightly in the advanced economies, to 1.8 per cent, but divergences between the main countries widened. Growth was slack in the euro area and nil in Japan; in the United States and the United Kingdom, instead, domestic demand supported the recovery, against a background of growing confidence bolstered by relaxed financial conditions and the strengthening of employment prospects. In both countries, however, labour productivity stagnated, confirming the signs of weakness that had emerged after the crisis (average annual productivity growth was less than 1 per cent for the past five years) and raising the specter of prolonged stagnation (see the box 'The secular stagnation hypothesis').

THE SECULAR STAGNATION HYPOTHESIS

The weakness of the global economic recovery and the slowness of productivity growth since the 2008-09 crisis have engendered worries about a prolonged phase of economic stagnation – "secular stagnation" as Hansen defined it during the Great Depression.[1] According to some studies, this prospect could be the outcome of a decline in the growth rate of potential output in the advanced economies, triggered by such factors as population ageing, the failure of the rise in average levels of education to keep pace with the requirements of the new technologies (which could also be reflected in higher structural unemployment), and a progressive diminution of the scope for advance of the technological frontier.[2] Historically, productivity has provided the largest contribution to the growth of per capita GDP (accounting for three-quarters of it in the United States since the Second World War).

The pessimistic scenarios may underestimate existing technologies' further potential for supporting productivity, however, such as the contributions that could still derive from the digital revolution. There is evidence that this has already happened many times in the past: fears of secular stagnation have been voiced in the wake of nearly every severe recession.[3] The new technologies could support innovation, among other things by making scientific research more efficient through the improvement of the tools available to it, a historically decisive factor for new breakthroughs, and also by permitting wider and faster dissemination of knowledge.

Nevertheless, there is the risk that a high propensity to save at global level, falling investment rates in the advanced countries and growing income inequalities could drive down equilibrium real interest rates.[4] With inflation very low or even negative and with interest rates already at zero, the stimulus coming from conventional monetary policies could be insufficient to ensure an expansion of output sufficient to reabsorb unemployment. In the near term, this could make it necessary to support aggregate demand with quantitative easing; going forward, there is no sidestepping the need to boost growth by intervening on public investment to modernize infrastructure, on education and training policies to strengthen human capital, and on the mechanisms for efficient reallocation of labour.[5] An adequate endowment of human capital is essential to reap the benefits of technological progress, ensuring sustainable and inclusive development and countering the risk that the rapid change in the skills required as new technologies come on line could marginalize many workers, exacerbate income equalities and compress aggregate demand.

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1 A.H. Hansen, 'Economic Progress and Declining Population Growth', *The American Economic Review*, 29, 1, 1939, pp. 1-5.

2 R.J.Gordon, 'Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds', NBER Working Papers, 18315, 2012.

3 P. Pagano and M. Sbracia, 'The secular stagnation hypothesis: a review of the debate and some insights', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 231, 2014.

4 IMF, *World Economic Outlook*, April 2014.

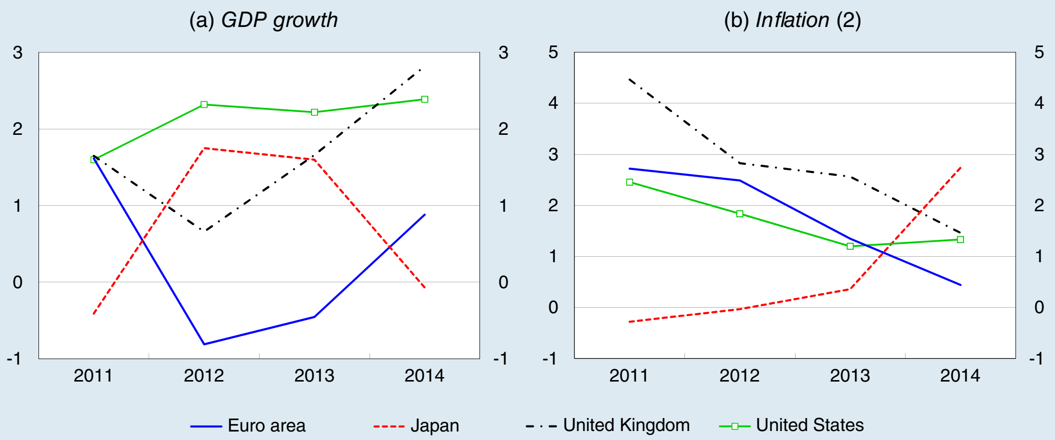
5 IMF, *World Economic Outlook*, October 2014.

Low productivity growth was in part a reflection of the slow recovery of productive investment following the recession: in the United States, although for several years now financial conditions have been favourable to capital investment, non-residential fixed investment did not regain its pre-crisis share of GDP until last year; in the United Kingdom, as in the other main economies, it has yet to do so.

United States. – In the United States output grew by 2.4 per cent in 2014 (Figure 1.1.a). Private consumption strengthened slightly, while the rate of expansion of non-residential fixed investment doubled to 6 per cent; residential investment, on the other hand, was virtually stagnant. The contribution of net exports was negative, if only by a little, reflecting the slackness of foreign demand and above all an acceleration in imports.

Figure 1.1

GDP and inflation in the main advanced economies (1)



Sources: National statistics.
(1) Annual data; percentage changes on previous year. – (2) For the United States, the consumption deflator; for Japan, the consumer price index; for the euro area and the United Kingdom, the HICP.

In contrast to previous years, the US economy also benefited from the diminished uncertainty over the state of the public finances. Even though the federal deficit declined from 4.1 to 2.8 per cent of GDP, the restrictive effects of the budgetary policy moderated: the fall in public expenditure came to a halt and the cyclically-adjusted correction of the general government deficit (equal to 0.8 percentage points of GDP) was only about half the average recorded in the previous three years.

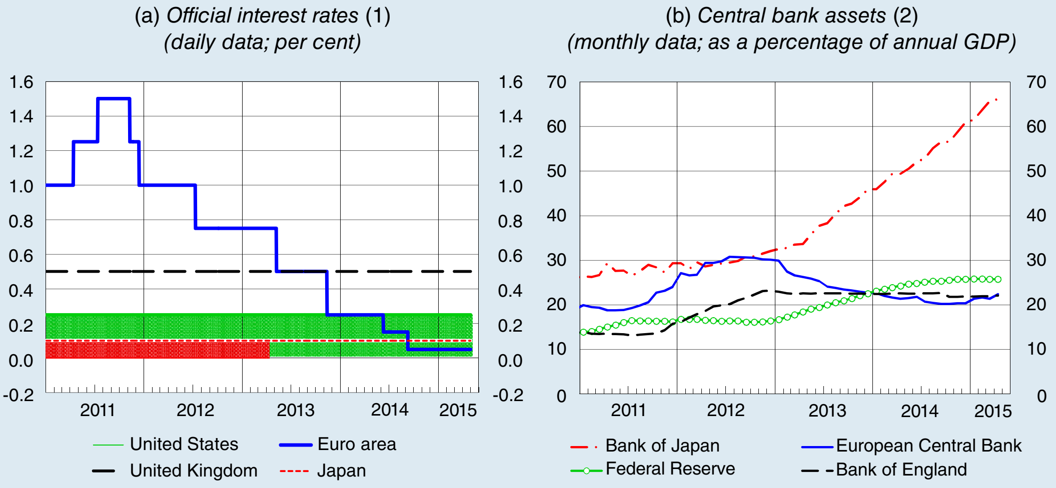
Labour market conditions improved markedly: in 2014 employment increased at a rapid pace of 2.6 per cent, and in April 2015 unemployment was down to 5.4 per cent, not far off the long-term equilibrium rate estimated by the Federal Reserve of between 5 and 5.2 per cent. The availability of labour could, however, be greater than the unemployment rate alone suggests, as is indicated by the still high numbers of employed workers who are involuntarily on part-time and of the marginally attached, i.e. those who say they would like to work but are not actively job hunting.

Consumer price inflation averaged 1.6 per cent last year (Figure 1.1.b); after increasing during the first half of the year, the twelve-month change in prices was virtually wiped out, owing to the fall in the prices of oil and of imports more generally, which also affected core inflation.

In view of the tangible progress in the labour market the Federal Reserve proceeded to gradually taper quantitative easing, ending its purchases of long-term securities in November; the size of its balance sheet stabilized accordingly (Figure 1.2.b). Its monetary policy stance nonetheless remained accommodative: the target range for the federal funds rate was left unchanged at 0.0 to 0.25 per cent (Figure 1.2.a), while from March 2014 forward guidance softened the emphasis on the unemployment rate in favour of a broader set of indicators of labour market conditions (see the section 'United States' in Chapter 1 of last year's Annual Report). The economic situation of the United States appears to be consistent with a phase of interest rate increases beginning in the second half of this year, which, however, are expected to be very gradual.

Figure 1.2

Official interest rates and balance sheets of the main central banks



Sources: ECB and national statistics.
(1) For the United States, federal funds target range; for Japan, uncollateralized overnight call rate (up to 4 April 2013, the target range; since 5 April 2013, the Bank of Japan's monetary policy has been based on a quantitative target, not an official reference rate); for the euro area, rate on main refinancing operations; for the United Kingdom, rate on commercial banks' reserve deposits with the Bank of England. – (2) For the Bank of England, from 2 October 2014, only assets purchased in monetary policy operations (over 90 per cent of the total).

Japan. – Last year saw a faltering of the impetus imparted by the expansionary policies launched in 2013, as part of the strategy to revive the economy known as 'Abenomics' (see the section 'Japan' in Chapter 1 of last year's Annual Report). The Japanese authorities have yet to undertake the decisive structural reforms that the programme nonetheless deems essential. On average last year activity stagnated, a brusque slowdown compared with the 1.6 per cent growth registered in 2013; the drop of 1.2 per cent in private consumption offset the marked increase of 4.1 per cent in non-residential fixed investment; the contribution of public expenditure was negligible and that of foreign trade nil, notwithstanding the further depreciation of the yen.

Last year consumer price inflation rose to 2.7 per cent on average (Figure 1.1b), showing the temporary effects of the increase in indirect taxes in April, which the Bank of Japan estimates at around two percentage points and without which inflation would have slowed from 1.6 per cent in December 2013 to 0.3 per cent in March 2015; from last summer onwards, this trend also involved the core components, in view of the continued very low wage growth and firms' reluctance to grant pay rises.

Wage acceleration represents an important turning point for the revival of Japan's economy, both in order to achieve a sustainable expansion of domestic demand and to ensure more rapid convergence of inflation towards the 2 per cent target set by the Bank of Japan, thereby activating a virtuous circle capable of anchoring inflation expectations stably at that level.[1]

For this purpose in October the central bank stepped up its programme of quantitative easing, raising the target for growth of the monetary base (from ¥60-¥70 trillion to ¥80 trillion per year). At the same time the Government put off to 2017 the second increase in the consumption tax (originally scheduled for last November) and, following its success in the early elections called at the end of the year, launched fiscal stimulus measures amounting to 0.7 per cent of GDP, thereby slowing the restructuring process; by the Government's own estimate, the objective of a budgetary surplus by 2020 now appears out of reach.

United Kingdom. – The expansion of output in the United Kingdom reached 2.8 per cent in 2014, accompanied by an acceleration in employment and fall in the unemployment rate to 5.6 per cent. Consumer price inflation continued to decline, falling to zero this February. The Bank of England kept its Bank Rate unchanged at 0.5 per cent and maintained the quantity of financial assets in its portfolio at £375 billion; its assessments suggest that rates will normalize very gradually before stabilizing, for some time at least, at markedly lower levels than those preceding the crisis.

The EU countries of Central and Eastern Europe. – In the countries of this region that have not yet adopted the euro (including Lithuania, which did so in 2015), GDP growth doubled last year to an average of 2.9 per cent. The expansion of domestic demand, which was sustained by improving labour market conditions and more intensive utilization of European structural investment funds, blunted the impact of the unfavourable economic situation in the euro area, the tensions in Ukraine and the economic and financial difficulties of Russia. Consumer price inflation declined, turning negative in the early months of 2015, prompting central banks to adopt more expansionary stances, cutting reference rates by between 100 and 225 basis points in Poland, Romania and Hungary and, in some cases, taking unconventional measures. Lending growth remained weak, however.

The main emerging economies

Last year the expansion of economic activity in the emerging and developing countries slowed to 4.6 per cent, reflecting both cyclical factors, such as the prolonged slump in foreign demand and the fall in commodity prices, and structural factors, which account for about half of the slowdown observed since the crisis.[2]

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1 R. Piazza, 'Deflation expectations and Japan's lost decade', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

2 E. Di Stefano and D. Marconi, 'Assessing potential growth in emerging countries after the global financial crisis'. Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 256, 2015.

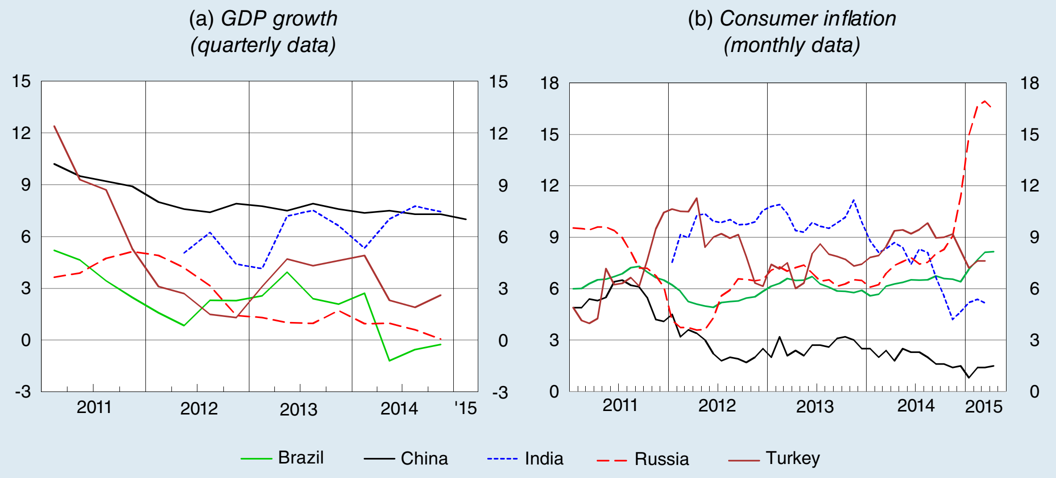
Supply bottlenecks and the inefficient allocation of resources, in many instances exacerbated by the monetary and fiscal stimulus policies adopted during the global crisis, are weighing on productivity growth, though to varying degrees among countries. The rapid increase in public and private borrowing fuelled by abundant international liquidity has worsened imbalances, especially in China, where debt has expanded sharply in the property sector and in heavy industry, and in Brazil and Turkey, where the increase in consumption led to a marked deterioration of the external accounts; in Brazil, and especially in Russia, these problems are compounded by the negative effects of the decline in commodity prices, on which their exports and tax revenues depend.

The Indian economy's good performance contrasted with that of the other main emerging countries, thanks above all to the launch of an ambitious reform programme that will raise growth potential and reinforce the country's credibility, and to the resulting improvement in confidence.

China. – GDP growth in 2014 fell from 7.7 to 7.4 per cent, the lowest level in 25 years and below the authorities' target; consumer price inflation declined to 2 per cent, mainly owing to the slowdown in the prices of food products (Figure 1.3). The slowdown in output affected the heavy industry and construction sectors most, services less so. Demand continued to shift gradually towards domestic consumption, whose contribution to growth rose to almost four percentage points, thanks to gains in employment and disposable income. However, at 28 per cent the household saving rate was still very high, suggesting the persistence of precautionary motives and structural factors that limit the propensity to consume.[3] Growth in real estate investment, which accounts for 15 per cent of GDP, was halved to 10 per cent in 2014, owing to measures adopted from 2011 onwards to restrain the flow of credit to the sector, while house prices began a gradual downward correction, falling by 6 per cent in the twelve months to March.

Figure 1.3

GDP and inflation in the main emerging countries (1)



Sources: National statistics.
(1) Percentage change on corresponding period of previous year.

[3] R. Cristadoro and D. Marconi, 'Households' savings in China', Banca d'Italia, Temi di Discussione (Working Papers), 838, 2011.

The Chinese authorities are currently managing a complex transition designed on the one hand to increase the weight of domestic consumption compared with investment and that of services compared with industry, and on the other to reconcile a greater role for the market in the allocation of savings with the need to limit the risks created by the accumulated debt of the real estate and local government sectors (see the section 'The main emerging economies: China, India, Brazil, Russia and Turkey', in Chapter 1 of last year's Annual Report). The Chinese economy accordingly looks set to enter a 'new normal' phase of slower growth, as evidenced by the new official target of 7 per cent for 2015, half a point lower than in 2014. In any event, the transition to the new phase will be conditioned by the need not to hinder the absorption of China's rural workforce, which remains plentiful.

This is the light in which the recent initiatives of the Government and the People's Bank of China should be interpreted. The Government speeded up the completion of planned infrastructures and introduced stimulus measures for small businesses, on which a good part of the growth in employment depends; and with a view to curbing expenditure by local governments, it embarked on reforms to make the public finances more transparent. For its part the central bank has subjected the shadow banking system to stricter regulation, to slow the growth of the riskiest forms and sectors of credit, while it has selectively lowered banks' compulsory reserve ratios to facilitate access to credit for small and medium-sized enterprises. To prevent real interest rates from rising too far consequent to the fall in inflation, starting in November it began to inject liquidity into the interbank market, cut the reference rates on commercial bank loans and deposits and lowered the mandatory reserve ratios further for all banks.

India. – In 2014 GDP accelerated to growth of 7.2 per cent, led by services. The twelve-month rate of consumer price inflation was halved, falling to 4.9 per cent this April, mostly thanks to policies to keep food prices down; the fall in oil prices was instead partly offset by an increase in excise duties on fuels.

The disappointing results, in terms of growth and inflation, of the policy responses to the 2007-08 crisis had made it urgent to enact reforms capable of addressing the structural weaknesses of the Indian economy. After the spring elections, confidence improved thanks to the impetus imparted by the new government, which launched a highly controversial and still uncertain land rights reform, which is vital to strengthening the transport infrastructures; it further opened the insurance sector to foreign investment; and it announced administrative simplification provisions to boost job creation in small and medium-sized enterprises. The credibility of the Reserve Bank of India, which had deteriorated in recent years,[4] was bolstered by a clear definition of its mandate and strategy with the announcement of inflation targeting (in a range of 2 to 6 per cent) from April 2016 onwards.

Brazil, Russia and Turkey. – Output in Brazil stagnated in 2014, weighed down by weak consumption and above all investment, which fell by 4.4 per cent. The economy

[4] R. Cristadoro and G. Veronese, 'Monetary policy in India: is something amiss?', *Indian Growth and Development Review*, 4, 2, 2011, pp. 166-192.

suffered as a result of the fall in commodity prices and considerable political uncertainty. The large budget deficit (which more than doubled in the year, to 6.2 per cent of GDP) and rising inflation limited the leeway for economic policy action. Price pressures, which were already strong, were amplified by the depreciation of the currency, and in April 2015 consumer price inflation reached a twelve-month rate of 8.2 per cent, well above the maximum tolerance threshold of 6.5 per cent set by the Central Bank, which responded by raising its benchmark Selic rate repeatedly by a total of 325 basis points, from the beginning of 2014, to 13.25 per cent.

The macroeconomic situation in Russia deteriorated sharply. Last year economic activity slowed to growth of 0.6 per cent, from 1.3 per cent in 2013, penalized by the sanctions imposed by the United States and the European Union (see the box 'The economic repercussions of the crisis in Ukraine') and by the fall in oil prices. Massive capital outflows led to a rapid depreciation of the rouble, leading to a significant increase in inflation, which jumped to 17 per cent this March. To counter these developments the Central Bank intervened repeatedly on the foreign exchange market, drawing on its reserves, and abruptly raised its policy rate to 17 per cent in December, before cutting it to 12.5 per cent in April as the rouble stabilized.

THE ECONOMIC REPERCUSSIONS OF THE CRISIS IN UKRAINE

In response to Russia's annexation of Crimea, in March 2014 the European Union and the United States imposed economic sanctions, which were then progressively tightened in the course of the year as the political and military tensions in Ukraine grew more acute. Measures taken in August and September limited the access to international financial markets of a substantial part of the Russian banking system and several leading energy corporations. In addition, sales of weapons and technologies and services destined for oil industry projects were embargoed. In return, Russia restricted imports of some food products from the EU, the US and other countries that had imposed sanctions.

The sanctions, together with the fall in world oil prices, heightened uncertainty over the outlook for the Russian economy, accentuating the slowdown already under way owing to structural causes.

In 2013, 2.8 per cent of Italy's goods exports went to Russia. Their value fell by 11.6 per cent last year, but the impact of the decline in Russian demand on Italian economic growth was modest.[1] The effects on the Italian banking system were also limited. At the end of 2014 our banks' exposure to Russia amounted to €18 billion, second only to that of French banks. This was still less than 1 per cent of the overall exposure of the Italian banking system, however, and it was mostly indirect, i.e. due to the activity of the Russian subsidiaries of Italian banking groups.

The risks of an exacerbation of tensions with Russia mainly involve the possible blockage of oil and gas deliveries. Russia accounts for 12 per cent of global oil supplies and 19 per cent of natural gas supplies, and it is essential to satisfying the European Union's energy requirement, supplying 30 per cent of the latter's imports of oil and gas in 2013. In turn, the EU is the main outlet market for Russian energy exports.

[1] R. Cappariello and A. Felettigh, 'How does foreign demand activate domestic value added? A comparison among the largest euro-area economies', Banca d'Italia, Temi di Discussione (Working Papers), 1001, 2015.

The degree of energy dependence on Russia varies considerably within the EU; it is especially great for some countries in central and northern Europe. As for Italy, Russia supplied 18 per cent of oil imports and 45 per cent of natural gas imports in 2013, and the gas is routed mostly through Ukraine. Nevertheless, Italy has the capability for rapid diversification of supplies by exploiting pipelines from northern Europe and North Africa and increasing purchases of liquefied natural gas.

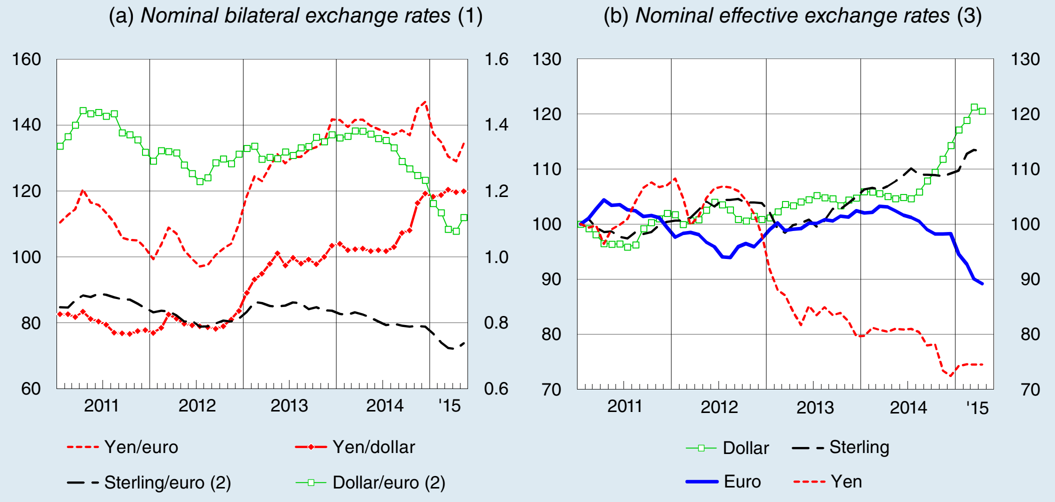
In Turkey GDP growth fell from 4.2 to 2.9 per cent last year. Domestic demand was dampened by the restrictive monetary policy introduced at the start of the year to stem capital outflows and the depreciation of the lira, which together with soaring food prices drove consumer price inflation to almost 10 per cent in mid-2014. To counter the economic slowdown, from May onwards the Central Bank repeatedly lowered its main refinancing rate, the one week repo rate, by a total of 250 basis points, to 7.5 per cent, but conditions on the interbank market remained restrictive.

The financial and foreign exchange markets

Conditions in the financial markets of the advanced countries remained favourable, notwithstanding spikes in volatility towards the end of 2014 and at the beginning of this year. The increasingly divergent paces of growth and monetary policy stances translated into marked variations in exchange rates (Figure 1.4). In particular, the US dollar – which was practically stable in the first seven months of the year – began to strengthen in August, and by mid-April had gained 26 per cent against the euro and around 15 per cent against the yen and the pound sterling; in nominal effective terms it appreciated by 12 per cent.

Figure 1.4

Exchange rates of the main currencies
(average monthly data)

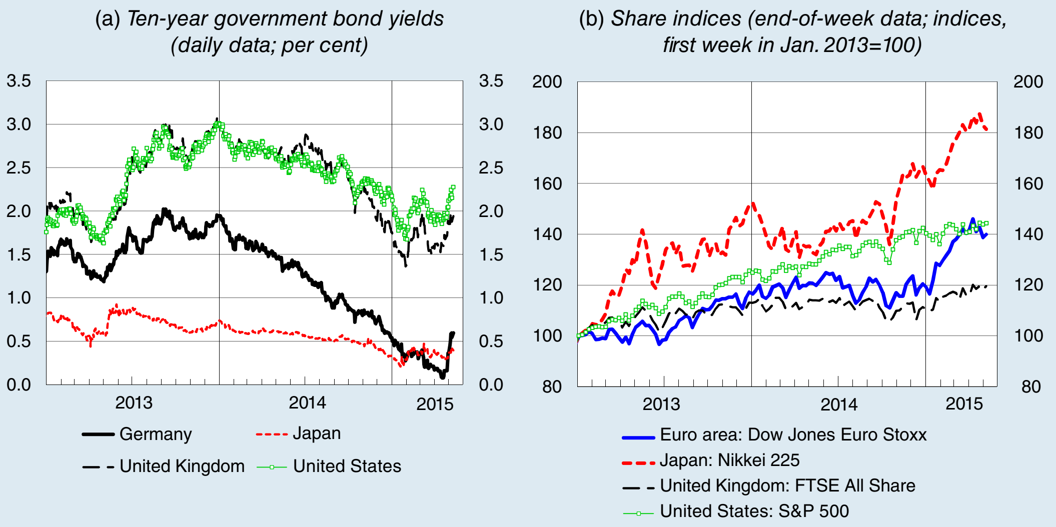


Sources: Bank of Italy and ECB.
(1) Units of the first currency per unit of the second. – (2) Right-hand scale. – (3) Indices, January 2011 = 100.

The yields on ten-year government bonds, instead, fell worldwide (Figure 1.5.a). In Japan and in the euro area the worsening macroeconomic outlook and the new monetary expansion measures drove these yields to record lows in the early months of this year (0.2 per cent, and 0.1 per cent on German bonds); in the United States and the United Kingdom they fell by over one percentage point (to 1.7 and 1.5 per cent, respectively), despite the consolidation of the recovery and the approaching prospect of normalization of monetary conditions in both countries.

Figure 1.5

Long-term interest rates and share indices in the main advanced countries



Source: Thomson Reuters Datastream.

These developments can be traced to two main factors. First, long-term interest rates are highly correlated at international level, reflecting the portfolio choices of the major investors, which tend to diversify their exposure to issuers and currencies, leading to synchronous movements in maturity premiums; in this way, the decline in the rates in Japan and in the euro area appear to have been transmitted to other markets.

Second, there appears to be a widespread belief on the part of market participants that the normalization of rates by the Federal Reserve and the Bank of England, as these institutions themselves have indicated, is likely to be more gradual than expected and that rates could remain below the levels observed before the financial crisis of 2008-09 for some time to come. This could also reflect the intensification of conditions tending to compress equilibrium real interest rates (see the box 'The secular stagnation hypothesis').

By mid-May 2015 the yields on ten-year government bonds had nonetheless regained around 50 basis points (20 points in Japan) from the minimums of the previous months, but they were still significantly lower than at the start of 2014; compared with mid-April, moreover, the dollar had depreciated by around 8 per cent against the euro and sterling.

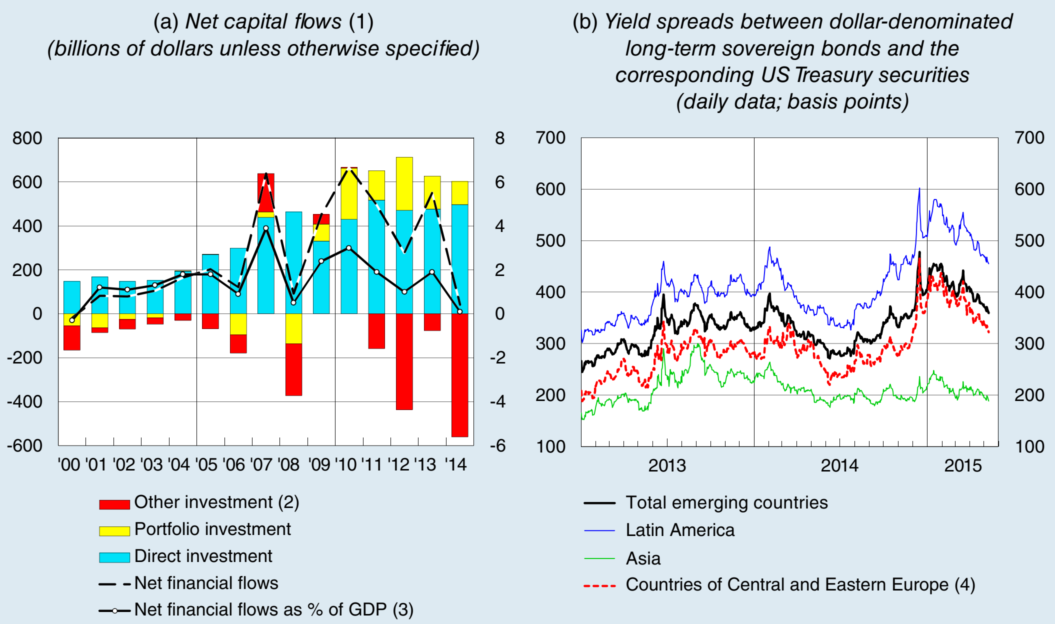
Low interest rates and abundant liquidity fuelled demand for risky assets. Since the beginning of 2014 share prices have risen by around 20 per cent in Japan and in the euro area, by 14 per cent in the United States, and by 5 per cent in the United Kingdom (Figure 1.5.b). The Japanese stock market has benefited, among other things, from equity fund purchases amounting to ¥3 trillion per year that the Bank of Japan is making as part of its quantitative easing programme, as well as from recent adjustment of the investment strategy of the main public pension fund, designed to increase its holdings of higher-yield assets at the expense of Japanese government bonds.

In the United States risk premiums on corporate bonds are still at historically low levels: in mid-May 2015 the yield spreads on investment-grade corporate bonds over government bonds were virtually unchanged from end-2013, at barely 1.8 percentage points; spreads on high-yield securities had widened by 60 basis points (to 4.6 percentage points), mainly reflecting perceptions of heightened risk on debt issued by companies in the energy sector, hit by the fall in oil prices.

Financial market conditions in the emerging economies instead worsened from the summer onwards; in particular, in countries with the most severe internal and external imbalances there was a resurgence of tensions linked both to global factors – the appreciation of the US dollar and the falling prices of oil and other commodities – and to country-specific vulnerabilities.

Figure 1.6

Capital flows and sovereign spreads in the emerging and developing countries



Sources: Based on IMF, Thomson Reuters Datastream and JP Morgan Chase Bank data.
(1) Balance between capital inflows and outflows; excludes changes in official reserves. – (2) Bank and commercial loans, currency deposits, other assets and liabilities. – (3) Right-hand scale. – (4) Includes Russia.

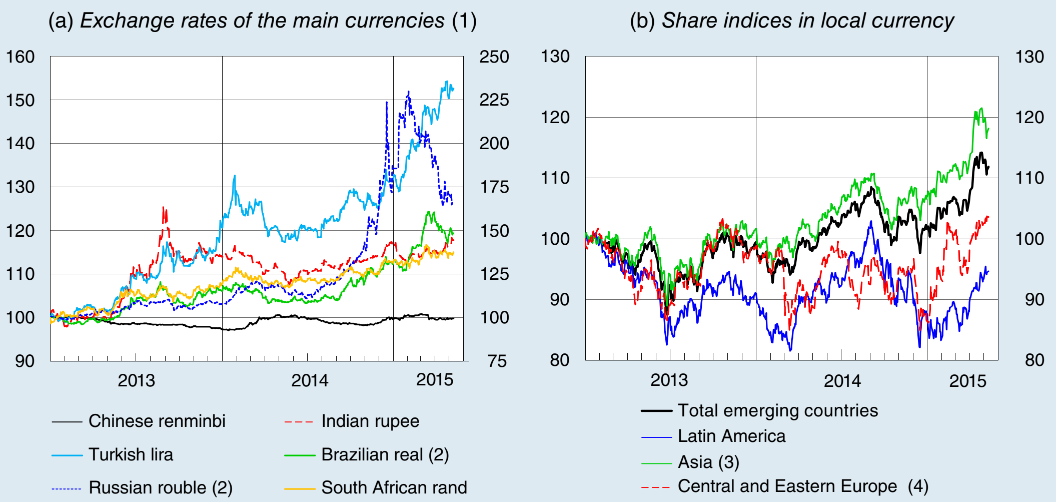
Net capital inflows to the emerging economies slowed sharply, declining to just over $40 billion for the year (Figure 1.6.a); capital outflows in the 'other investment' category of the balance of payments, which mainly includes bank transactions, increased from around $80 billion to $560 billion, most markedly for China and Russia; net portfolio investment inflows fell to just over $100 billion, from $150 billion, mostly owing to substantial disinvestment in Russia. After declining on average to 270 basis points in July, the yield spreads on dollar-denominated sovereign debt securities compared to

US Treasuries widened to over 400 basis points at the end of the year, the highest since 2011 (Figure 1.6.b), driven by those on Russian and Latin American debt.

The currencies of the emerging economies most vulnerable to external conditions have depreciated significantly against the dollar (the Brazilian real and the Turkish lira by around 20 per cent since the start of 2014, the rouble by over 35 per cent; Figure 1.7.a). The exchange rates of the Asian countries, mostly net importers of raw materials, recorded much smaller variations, as did those of the EU member countries in central and eastern Europe, which were stable against the euro until the end of the year (they have since begun to appreciate, especially the Polish zloty and Hungarian florin, gaining around 5 per cent).

Figure 1.7

Exchange rates and share indices of the emerging countries
(daily data; indices: average Jan. 2013=100)



Source: Thomson Reuters Datastream and Morgan Stanley.
(1) Exchange rates against the dollar. An increase in the index indicates a depreciation. – (2) Right-hand scale. – (3) Excludes Japan. – (4) Includes Russia.

There was a correction of share prices in September and October, but the overall rise since the start of 2014 has nevertheless exceeded 10 per cent (Figure 1.7.b); the Chinese market performed particularly well, with its index doubling, driven by the financial and real estate sectors, which benefited more than others from the expansionary measures taken by the People's Bank of China.

2. WORLD TRADE, COMMODITY PRICES AND PAYMENTS BALANCES

In 2014 the commodity markets were characterized by an abrupt fall in oil prices, which has few historical precedents. The fall can be ascribed to developments both in supply (a rapid increase in the production of unconventional crude oil in the United States and OPEC's decision in November not to reduce its own output) and in demand (the progressive weakening of global growth expected for 2014-15).

World trade expanded at a much slower pace than had been expected at the beginning of 2014, continuing to show less elasticity to output than in the pre-recession period. This decrease could prove persistent, since it can be attributed to the end of the one-off effects of structural shifts, one of which is the expansion of global value chains in the past two decades.

Balance-of-payments disequilibria remained stable in 2014, after diminishing considerably in recent years, but they continue to represent a risk for the global economy. The adjustments observed to date are due more to the steep fall in demand in the deficit countries than to any restructuring of expenditure on the part of those running current surpluses. The persistence of the positive or negative sign of the current accounts in the countries with the largest trade imbalances led to a further expansion of their net external creditor or debtor positions.

Regional financing mechanisms now play a more important part in the global financial support networks. On the other hand, no progress was made in negotiations to increase the IMF's resources while giving the emerging economies a greater role in its governance.

Commodity prices and markets

The price of oil. – After more than three years at over $100 a barrel, the price of oil plummeted in the second half of 2014 to under $50 a barrel last January.[1] The sharp fall was due to three factors: (a) the progressive lowering of expectations for demand in 2014 and 2015, reflecting more prudent assessments of growth in the main importing countries; (b) the rapid increase in production of light tight oil in North America; and (c) OPEC's decision not to intervene to support prices by reducing its own production, in contrast with the course of action taken in similar circumstances in the past (see the box 'The fall in the price of oil', *Economic Bulletin*, No. 1, 2015).

There was a substantial slowdown in the growth of global demand for oil in 2014, with an increase of only 0.6 million barrels a day (mb/d) compared with 2013, half the increase

[1] Average of WTI, Brent and Dubai grades, the three benchmarks for the global market.

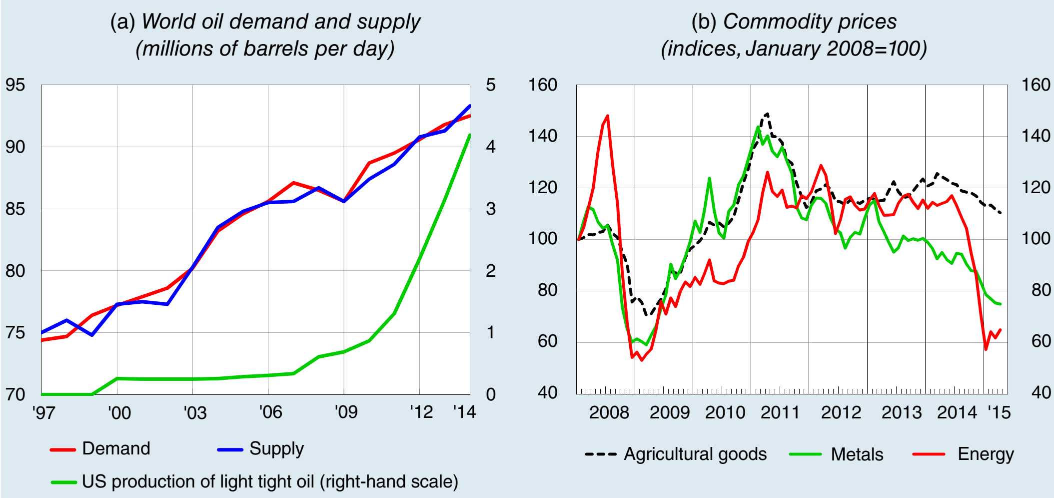
recorded in the preceding two years. Supply was much livelier with an increase of 2.1 mb/d over 2013, or 2.3 per cent, driven by the expanded production in North America (1.7 mb/d more than in 2013). As a result there was excess supply of about 1 mb/d (Figure 2.1.a), and stocks of crude oil reached very high levels both in the United States and in the other advanced countries and turned hesitantly downward only in late April and early May of this year.[2]

At the current juncture the expansionary effects of the fall in oil prices have been limited by two factors. In the first place, part of the decline reflects the weakness of global demand and therefore represents a response to lower economic growth, not an independent stimulus.[3] Second, by reinforcing the downward pressure on inflation where it was already low, it could fuel expectations of further declines and lead to an undesirable rise in real interest rates.[4] The IMF's revisions of growth forecasts for 2015 over the last 12 months were downward, on average, despite the expansionary boost in the oil-importing countries, mainly because of lower projections of potential growth for many emerging economies and the brake on economic activity that the price fall will itself constitute for the oil exporting countries.[5]

Other commodity prices. – The decline in non-oil commodity prices that began in 2011 continued in 2014. The overall year-on-year reduction of 4 per cent was determined by a fall in industrial metals prices that exceeded 10 per cent, with even greater drops recorded for iron ore and copper, which were affected in the second half of the year by the slowdown in demand from China, which now buys almost half of global metal production (compared with just over 10 per cent in 2000; Figure 2.1.b).

Figure 2.1

Oil demand and supply and commodity prices



Sources: Based on IMF, EIA and IEA data.

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[2] R. Cristadoro, V. Di Nino and L. Painelli, 'Più greggio per tutti: la rivoluzione *shale* negli USA e la reazione dell'OPEC', Banca d'Italia, Questioni di economia e finanza (Occasional Papers), forthcoming.

[3] According to the prevailing estimates, weak demand was responsible for between 20 and 40 per cent of the fall in crude oil prices between June and December.

[4] S. Neri and A. Notarpietro, 'Inflation, debt and the zero lower bound', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), No. 242, 2014.

[5] E. Di Stefano and D. Marconi, 'Assessing potential growth in emerging countries after the global financial crisis', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), No. 256, 2015.

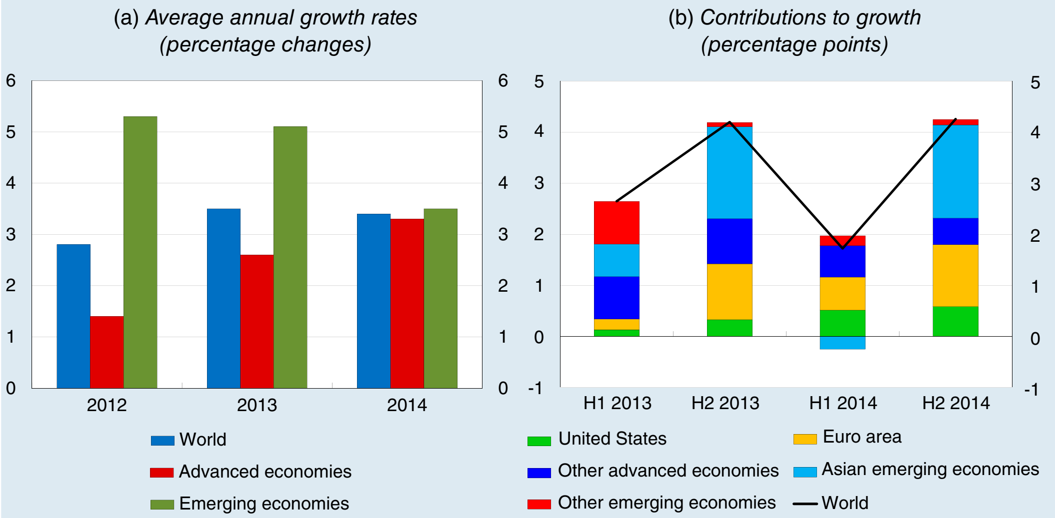
At the end of 2014 the prices of agricultural commodities were about 20 per cent below their 2011 peaks, and industrial metals were down more than 40 per cent. As with oil, the sizeable declines in prices are a consequence of massive investment in productive capacity and stockpiling induced by the high prices of the preceding years; exceptionally abundant harvests in many places around the world also contributed. The slowdown in demand then led to a glut, which is still driving down prices.

World trade

World trade in goods and services grew at a moderate pace in 2014 (3.4 per cent; Figure 2.2.a), well below the expectations of the international institutions expressed at the start of the year.[6] As in 2013, output grew only modestly in the first half of 2014, owing to the stagnation of trade in the Asia region, and accelerated in the second, fostered by the cyclical upturn in the advanced economies, in particular the United States, and by the strong recovery of China's foreign trade (Figure 2.2.b).

Figure 2.2

Volume of world trade in goods and services: main geographical areas



Sources: Based on IMF, CPB Netherlands Bureau for Economic Policy Analysis and OECD data.

Over a considerable period (1976-2011) the growth of imports was equal to around one and a half times that of global GDP; in the last three years, however, the annual increase of 3 per cent in trade did not differ from that in output. This reduction of elasticity, to which structural factors contribute, could turn out to be persistent (see the box 'The weakness of world trade and the role of global value chains').

6 Estimated at 4.5 per cent by the IMF (see *World Economic Outlook: Update*, January, 2014) and at 4.8 per cent by the OECD (see *Economic Outlook*, 94, 2013).

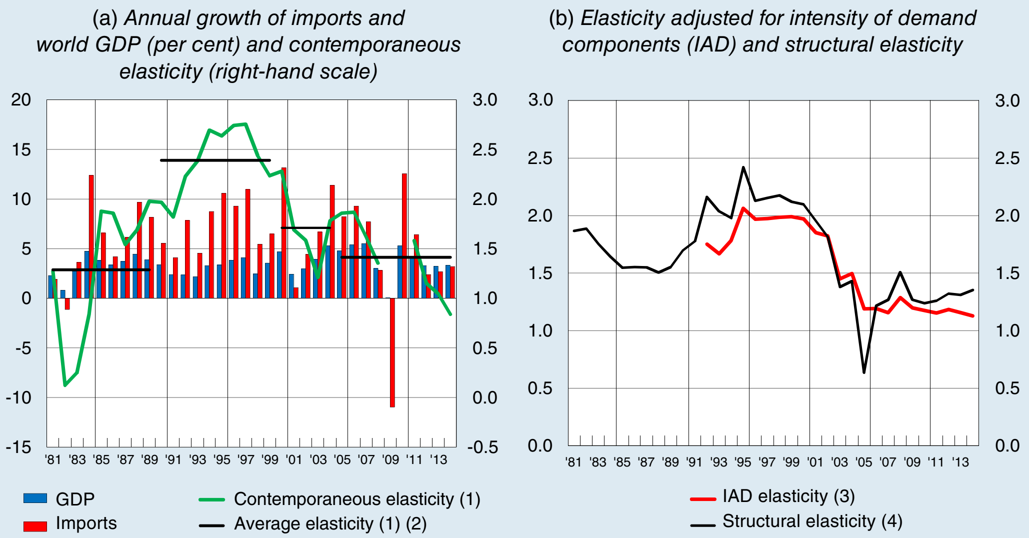
THE WEAKNESS OF WORLD TRADE AND THE ROLE OF GLOBAL VALUE CHAINS

The elasticity of imports to GDP has fallen from a value of more than 2 in the 1990s to values approaching 1 following the crisis (Figure A.a). Transitory factors account for part of this decline: output has stagnated in the economies where import elasticity and trade openness are historically higher, such as the euro area, while investment, which activates imports more than other components of demand, has been slow to recover.

However there is still a decline in elasticity, even taking into account the dynamics of the individual components of demand (consumption, investment and public spending), the geographical diversity of growth and other cyclical factors (Figure A.b).

Figure A

Elasticity of imports to world GDP



Sources: Based on IMF, OECD, NIESR and WIOD data.
(1) Right-hand scale. – (2) Average elasticity is calculated for the subperiods 1980-89, 1990-99, 2000-04, and 2005-14. – (3) The index is that proposed by M. Bussière, G. Callegari, F. Ghironi, G. Sestieri and N. Yamano, 'Estimating trade elasticities: demand composition and the trade collapse of 2008-2009', *American Economic Journal: Macroeconomics*, 5, 3, 2013, pp. 118-151. – (4) Structural elasticity is estimated for rolling 10-year periods ending in the reference year.

The important regional and multilateral trade agreements concluded in the 1990s and the development in the same years of international supply chains or global value chains (GVCs), which made for higher growth of trade in intermediate goods at a given level of output, caused an increase in elasticity during that decade. The essentially one-off effects of these structural transformations gradually dissipated, leading to a fall in elasticity after the turn of the century.

The contribution of GVCs can be estimated using the international input-output tables, which are only available from 1995 to 2011. These data allow us to isolate, in each country's exports, the portion of domestic value added absorbed by the country of first destination.[1] The remaining part of exports can be considered

[1] A. Borin and M. Mancini, 'Follow the value added: bilateral gross exports accounting', Banca d'Italia, Temi di Discussione (Working Papers), 1026, 2015.

a gauge of the weight of the GVCs and of the degree of the individual countries' involvement in global supply chains.[2] According to this methodology, the contribution of the growth of GVCs to the elasticity of imports to GDP, positive until about the middle of the 2000s, fell to nil after the crisis (Figure B.a). GVCs have developed around three poles: the euro area, the United States and China. However, the integration process within the GVCs of these 'global factories'[3] has not been consistent. In particular, China's participation in GVCs expanded rapidly in the years leading up to its accession to the WTO and then stabilized from the mid-2000s onwards, in contrast with the steadier trends for the euro area and the United States (Figure B.b).

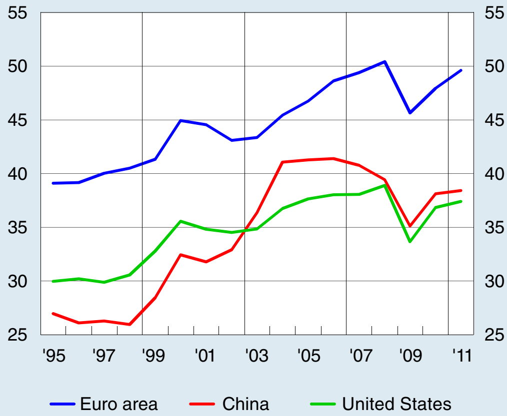
Figure B

Breakdown of elasticity and global value chains (GVCs)

(a) *Average elasticity of imports to GDP and contribution of diffusion of GVCs* (1)

	Average elasticity in period		Contribution of GVC diffusion		Residual
1996-2000	2.06	=	0.45	+	1.61
2001-2005	1.45	=	0.33	+	1.12
2006-2011	1.13	=	0.04	+	1.09

(b) *Euro area, US and China's integration into GVCs* (2)
(percentage points)



Sources: Based on IMF and WIOD data.
(1) Breakdown of the average elasticity observed in each period into the contribution made by the diffusion of global value chains and a residual. – (2) The overall degree of integration into global value chains for the euro area, the United States and China is measured as the ratio to total exports of exports net of the domestic value added absorbed by the country of first destination. For the euro area the indicator includes both intra- and extra-area trade.

The reduction in the residual part of elasticity, that which is not associated with the expansion of GVCs, presumably reflects the end of the impetus of the trade liberalizations of the 1990s (above all the Uruguay Round), whose effects already began to fade at the beginning of the 2000s.

[2] R. Cappariello and A. Felettigh, 'How does foreign demand activate domestic value added? A comparison among the largest euro-area economies', Banca d'Italia, Temi di Discussione (Working Papers), No. 1001, 2015.

[3] R. Baldwin, 'Trade and industrialisation after globalisation's 2nd unbundling: how building and joining a supply chain are different and why it matters', NBER Working Paper 17716, 2011.

Liberalization initiatives. – After the start of important trade negotiations in 2013, including the Translatlantic Trade and Investment Partnership between the United States and the European Union (see Annual Report for 2013, Chapter 3, 'World trade and payments balances'), in 2014 the various initiatives came to a standstill. This was mainly because of persistent divergences concerning the safeguarding of foreign investors, the defence of intellectual property rights, food security, and protective regimes in some sectors, in particular agriculture. The approval of a measure allowing the President of the United States powers of negotiation otherwise reserved to Congress (fast track) would remove an obstacle that has to date made it more difficult to reach an agreement.

Global imbalances

Global imbalances, measured as the sum of the absolute values of current account deficits and surpluses, remained stable in 2014 at 3.4 per cent of world GDP. Lower prices for energy products led to a further decline of 26 per cent in the surpluses of the oil-exporting countries (to $332 billion), while the continued deterioration of the terms of trade kept the other commodity exporters in deficit. For the second consecutive year the current account surplus of the euro area expanded significantly, driven by increases in Germany, Italy and Spain (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area'). The US deficit remained stable at 2.4 per cent of GDP. China's current account surplus rose from 1.9 to 2 per cent of GDP, as the massive 32 per cent increase in the trade surplus, which reached $464 billion, more than offset the further deterioration of the services balance.

Although global imbalances, measured by the current accounts deficits and surpluses, have diminished considerably in recent years compared with the period immediately preceding the 2008 crisis, they nevertheless remain a source of risk for the global economy.

For one thing, the imbalances may widen again in the future, since their decrease was due to the faster rise in domestic demand in the emerging economies in surplus and the drastic reduction of demand in the deficit countries, rather than to a recomposition of expenditure between domestically produced and imported goods and services in response to changes in relative prices and in the structure of the economies with the largest imbalances.[7]

Second, the net debtor and creditor positions increased further, both in absolute terms and in relation to global GDP, because even though they narrowed, the current account balances, which determine variations in the positions, did not change their signs: the countries with the largest current account surpluses and deficits before the crisis are still in the same positions in the world ranking. Accordingly a good number of countries, especially the emerging economies, remain dangerously exposed to sudden changes in appetite for risk on the financial markets and to increases in interest rates.

Global financial safety nets

The IMF, at its spring 2015 meetings in Washington, observed that financial, currency and geopolitical tensions and associated risks had intensified and require adequate safeguards.

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7 IMF, *World Economic Outlook*, October 2014, pp. 115-154.

In this context, a key factor in ensuring a response to possible financial, and consisting in and balance-of-payments crises remains the configuration of the global financial safety nets, consisting in the set of lending and insurance instruments of the international organizations, regional and bilateral financing arrangements and national currency reserves.

The IMF's capability for action is undermined by the difficulty in reaching agreement on governance reform. In 2014 a new regional financing arrangement was formed by Brazil, Russia, India, China and South Africa (the BRICS countries) together with the Asian Infrastructure Investment Bank, signalling the intention of the emerging countries, first and foremost China, to count more heavily in the international monetary system. The IMF nevertheless continues to play a central role in various ways: through its capacity for direct financial support, currently amounting to 520 billion special drawing rights (SDRs), including the resources made available by bilateral borrowing agreements; because assistance under several regional financing arrangements may require the approval by the IMF of a lending arrangement; and by the leadership it exercises in devising adjustment policies for countries in difficulty.

IMF resources and loans to members. – The Fund's resources ordinarily come from member country quotas, which are reviewed periodically. The 2010 reform (see Annual Report for 2012, Chapter 4, 'International economic cooperation') called for the doubling of subscribed capital, a substantial increase in the quotas of the emerging economies, and a reweighting of the Executive Board in their favour. This reform has not yet won ratification by the Congress of the United States.

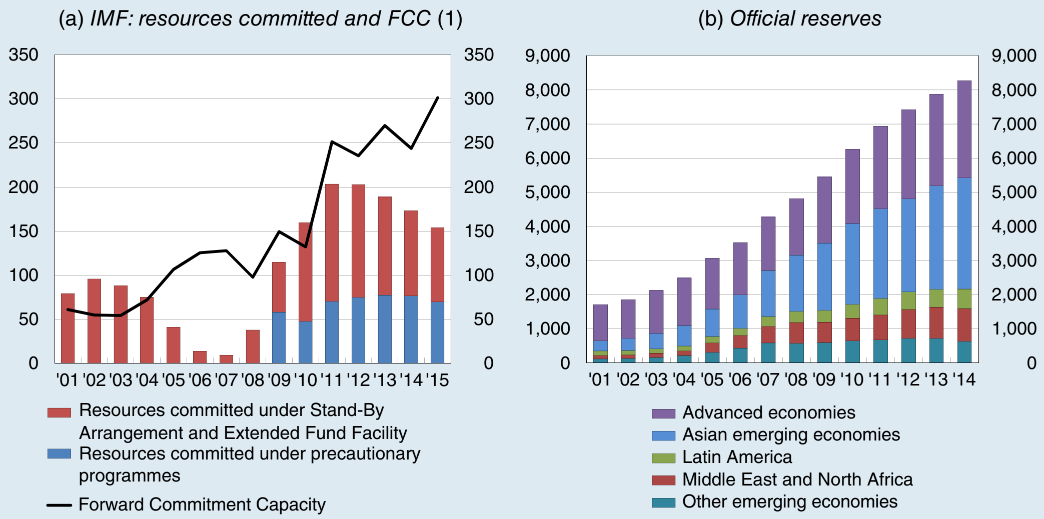
To cope with the potential increase in the demand for funds, in the last few years the IMF has procured additional temporary sources of finance: under the New Arrangements to Borrow (NAB) and bilateral loans (see Annual Report for 2013, Chapter 4, 'International economic cooperation'). At the end of April the IMF's forward commitment capacity – the amount of funds that it could potentially disburse over the next twelve months – was around SDR 301 billion, 14 per cent more than a year earlier. The resources allocated to assist member countries amounted to SDR 154 billion, 45 per cent of which going to four precautionary programmes (Figure 2.3.a). Until agreement on reform is reached, the IMF's resources will continue to depend on renewal of the NAB and the possible extension of bilateral loans, subscribed since the end of 2012 and limited to four years' duration (Italy's bilateral loan to the IMF amounts to €23.48 billion and can be extended until October 2016).

Regional financing arrangements. – The most important development in this area was the constitution, in July, of a contingent reserve arrangement (CRA) among the BRICS countries, with a financial commitment of $100 billion. The new arrangement flanks two other alternative regional financing arrangements, which have recently been reinforced, namely the European Stability Mechanism (ESM) (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area') and the Chiang Mai Initiative Multilateralization (CMIM), an agreement among the ASEAN countries, China, Japan and South Korea with $240 billion pledged. In any event the IMF is involved in these arrangements: in the case of the ESM, where such involvement is possible and appropriate; and in the CRA and the CMIM – to date never activated – if financing should exceed 30 per cent of a given country's maximum access limit.

Foreign exchange reserves. – Many countries, given the uncertainty over the adequacy of the multilateral and regional safety nets, continue to hold large stocks of foreign exchange reserves. At the end of 2014 total global currency reserves amounted to SDR 8,272 billion (Figure 2.3.b), of which SDR 5,424 billion was held by the emerging countries and SDR 2,664 billion by China alone. The emerging economies' stock of reserves increased by 4.5 per cent in 2014, less steeply than in previous years mainly because of reduced accumulation of reserves by the oil exporters and the outflow of reserves from Russia in operations to counter the depreciation of the rouble.

Figure 2.3

IMF resources and official reserves
(billions of SDRs; end-of-period balances)



Source: Based on IMF data.
(1) Includes both credit outstanding and undrawn balance. The FCC does not include resources made available by bilateral loans. For 2015 the data refer to 30 April.

3. MACROECONOMIC DEVELOPMENTS AND FISCAL POLICIES IN THE EURO AREA

The fragile recovery of the euro-area economy in 2014 was affected, among other factors, by the slower than expected growth of world trade. The signs of an upturn strengthened towards the end of the year and in the early part of 2015. Growth rate gaps narrowed but significant differences in cyclical conditions between countries remain.

Inflation has fallen far below the ECB Governing Council's definition of price stability. It was negative in December and has remained extraordinarily low even net of the most volatile components. Inflation expectations over the medium term have declined as well, for the first time since the launch of the monetary union, and are now well under 2 per cent.

The fiscal policy stance, after the adjustments made over the previous three years, was broadly neutral. Discussion continues over the evolution of European governance and the creation of a fiscal capacity, which could foster macroeconomic stabilization and help finance reforms.

Cyclical developments

Euro-area GDP returned to growth last year, increasing by 0.9 per cent (Figure 3.1.a), less than had been forecast. A contribution to economic activity came from the expansive monetary policy of the ECB (see Chapter 4, 'Monetary policy in the euro area'), especially in the second half of the year, and from the return to a broadly neutral fiscal stance after three years of budget adjustments.

Household spending rose by 1.0 per cent, partially recouping the contraction of 2012-13. Gross fixed investment also began to grow modestly, by 1.0 per cent, thanks to improved conditions for financing and firms' less pessimistic assessments of demand prospects. Investment is still low, however; at current prices it stabilized at 19.5 per cent of GDP, compared with 22.2 per cent in the decade before 2008. Construction expenditure continued to decline (by 0.2 per cent), though not as steeply as in the two previous years. It was affected among other things by the contraction in public investment, which settled at 2.7 per cent of GDP, low by historical standards and significantly lower than in the United States and Japan.

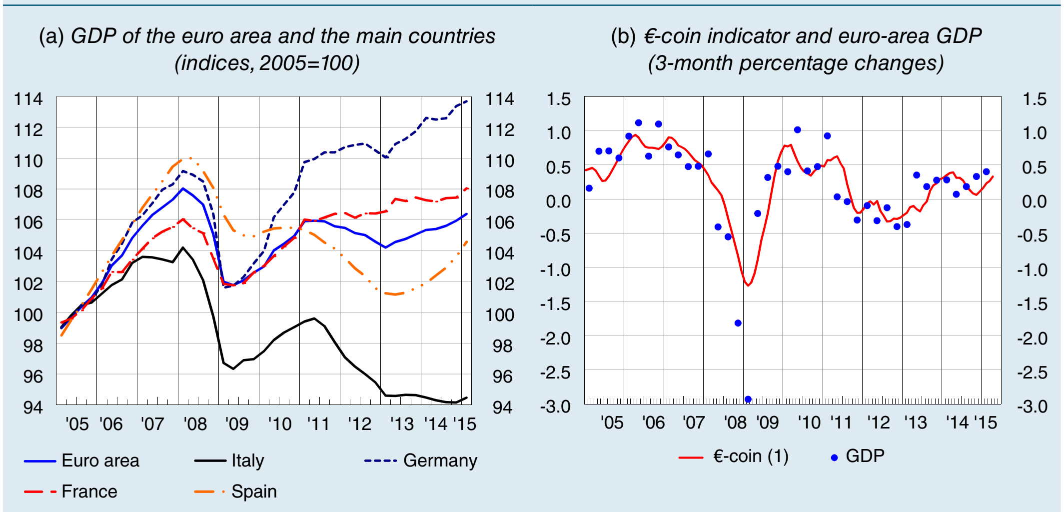
Despite the slight slowdown in world trade growth to 3.4 per cent, the euro area's exports expanded by 3.7 per cent in 2014, sustaining economic activity. In the second half of the year, they benefited from competitiveness gains. According to our estimates, the depreciation of the euro between mid-2014 and April 2015 (about 12 per cent in nominal effective terms), if it proves permanent, will increase the area's GDP by about 1 percentage point through 2016. Imports accelerated but the balance of trade improved, partly owing to the fall in the prices of energy imports.

The growth gaps between countries narrowed as tensions progressively eased and financial market fragmentation was attenuated. Net exports made a positive contribution to GDP in Germany (0.4 percentage points) and Italy (0.3 points), negative in France (-0.5) and Spain (-0.8). Consumption increased in all the main countries, but in substantial fashion only in Spain and Germany. The ratio of investment to GDP rose in Spain and was virtually stable in Germany, while continuing to decline in France and Italy. Property market performance was highly uneven, as a rise in prices in Spain, where they had been falling since 2008, and in Germany contrasted with further declines in France and Italy.

Euro-area GDP grew by 0.4 per cent in the first quarter of this year compared with the fourth quarter of 2014. While growth slowed in Germany, economic activity strengthened in France, Spain and also Italy, where it grew for the first time since the third quarter of 2013. The Bank of Italy's monthly €-coin indicator, which estimates current GDP growth net of its most volatile components, confirmed that activity had slackened in the summer of last year; it gained pace again towards the end of the year (Figure 3.1.b).[1] This April the index showed quarterly growth of 0.33 per cent, corresponding to over 1 per cent on an annual basis.

Figure 3.1

Euro-area GDP and €-coin



Sources: Bank of Italy, Eurostat and Istat.
(1) For details on the €-coin indicator see http://eurocoin.bancaditalia.it.

[1] The methodology used to develop the indicator is described in F. Altissimo, R. Cristadoro, M. Forni, M. Lippi and G. Veronese, 'New eurocoin: tracking economic growth in real time', *The Review of Economics and Statistics,* 92, 2010, pp. 1024-1034; also published in Banca d'Italia, Temi di Discussione (Working Papers), 631, 2007. Since May 2009 the updates are released monthly on the websites of the Bank of Italy and the CEPR.

Unemployment is one of the most critical aspects of the economic situation. The area-wide unemployment rate was again high in 2014 (11.6 per cent), though down marginally from the all-time peak recorded in 2013. After contracting for two years, employment recovered partially, with growth of 0.6 per cent, but there were still 4.5 million fewer persons in work than in 2008. Labour demand increased significantly in Germany and Spain and very modestly in France and Italy, in line with the divergent trends in output.

Prices and costs

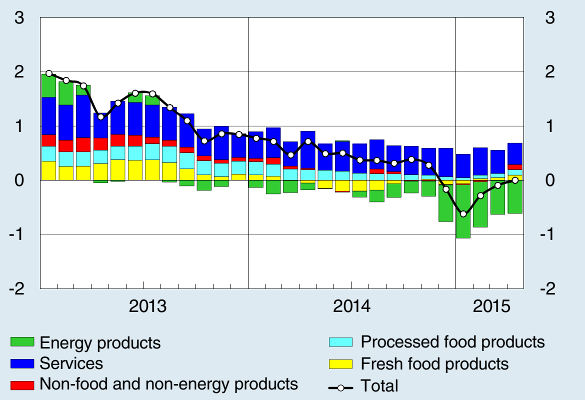
Inflation in the euro area, measured by the Harmonized Index of Consumer Prices, fell to 0.4 per cent year-on-year in 2014; in December the 12-month change in the index was negative (-0.2 per cent), and in January 2015 the rate was the lowest since the launch of the monetary union (-0.6 per cent). It subsequently rose and in April, according to preliminary data was practically nil.

The fall in the inflation rate cannot be ascribed solely to the very small increase in food prices (0.5 per cent in 2014) and the drop in energy prices (-1.9 per cent, as a consequence of the decrease in oil prices denominated in euros). Core inflation, measured by the HICP net of food and energy products, came down to its lowest level ever, 0.8 per cent, from 1.1 per cent in 2013 (Figure 3.2). Inflation was affected more than in the past[2] by the persistent weakness of demand, aggravated by near-zero nominal interest rates.[3] These developments have prompted a revision of expectations, including for the medium term[4] (see the box 'The risks of too low inflation over a prolonged period').

Figure 3.2

Inflation in the euro area and contributions of its components (1)

(monthly data; 12-month percentage changes and percentage points)



Sources: Based on Eurostat and ECB data.
(1) HICP. For April 2015, preliminary data.

Downward pressures on prices have arisen in practically all the countries of the euro area. This April the 12-month change in consumer prices was less than half a percentage point in all the main member countries and was negative in Italy and Spain.

2 M. Riggi and F. Venditti, 'Surprise! Euro area inflation has fallen', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 237, 2014.

3 A. Conti, S. Neri and A. Nobili, 'Why is inflation so low in the euro area?', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

4 S. Cecchetti, F. Natoli and L. Sigalotti, 'Tail comovement in option-implied inflation expectations as an indicator of anchoring', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

Unit labour costs for the entire economy rose by an average of 1.1 per cent last year, slightly less than the 1.4 per cent recorded in 2013 as a result of slower growth in hourly earnings (Table 3.1). However, hourly productivity gains slowed owing to the recovery in number of hours worked. Unit labour costs increased most sharply in Germany and France and more moderately in Italy, while declining Spain.

Table 3.1

Unit labour costs and their components in selected euro-area countries (1)
(percentage changes on previous year)

	Hourly labour costs		Hourly productivity						Unit labour costs	
					Value added (2)		Hours worked			
	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014
France	2.6	1.5	1.8	0.1	0.7	0.3	-1.1	0.2	0.8	1.4
Germany	2.6	1.7	0.4	0.0	0.1	1.5	-0.3	1.5	2.2	1.7
Italy	0.9	0.7	0.5	-0.5	-1.4	-0.3	-1.8	0.1	0.3	1.1
Portugal	3.5	-1.4	1.6	-1.1	-1.2	0.6	-2.7	1.7	1.9	-0.3
Spain	1.4	0.3	1.7	0.8	-1.2	1.5	-2.9	0.6	-0.4	-0.5
Euro area	2.1	1.2	0.7	0.1	-0.5	0.8	-1.2	0.6	1.4	1.1

Sources: Based on Eurostat data; for Italy, based on Istat data.
(1) On the basis of the number of hours worked. For France, annual percentage change based on raw quarterly data. – (2) Value added at base prices, chain-linked volumes, reference year 2010.

The analysts surveyed by Consensus Economics repeatedly revised their inflation forecasts for 2015 downwards, by a total of about 1.5 percentage points between the beginning of 2014 and February 2015, to reflect a slowdown in prices that was consistently more pronounced than they had expected. Similar indications are furnished by the inflation expectations implicit in financial markets[5] (see Chapter 4, 'Monetary policy in the euro area'). Only in recent months, following the launch of the Eurosystem's public sector securities purchase programme, have analysts begun to revise their forecasts upwards. The latest survey indicates that the inflation rate will be 0.1 per cent this year and 1.2 per cent next; it is not expected to approach 2 per cent, which would be in line with the official definition of price stability, until 2020. The ECB staff projections issued in March also revise the inflation estimate for 2016 upwards, assuming full implementation of the purchase programme, to 1.5 per cent from 1.3 per cent last December, notwithstanding the sharp fall in oil prices in the interim.

The financial markets

Financial market conditions in the euro area continued to improve in 2014. Fragmentation along national lines was further reduced, thanks above all to the Eurosystem's measures and the launch of Banking Union but also to advances in European economic governance and the progress of individual countries with reform.

[5] M. Miccoli and S. Neri, 'Inflation surprises and inflation expectations in the euro area', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 265, 2015; M. Casiraghi and M. Miccoli, 'Risk-adjusted forecasts of inflation', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

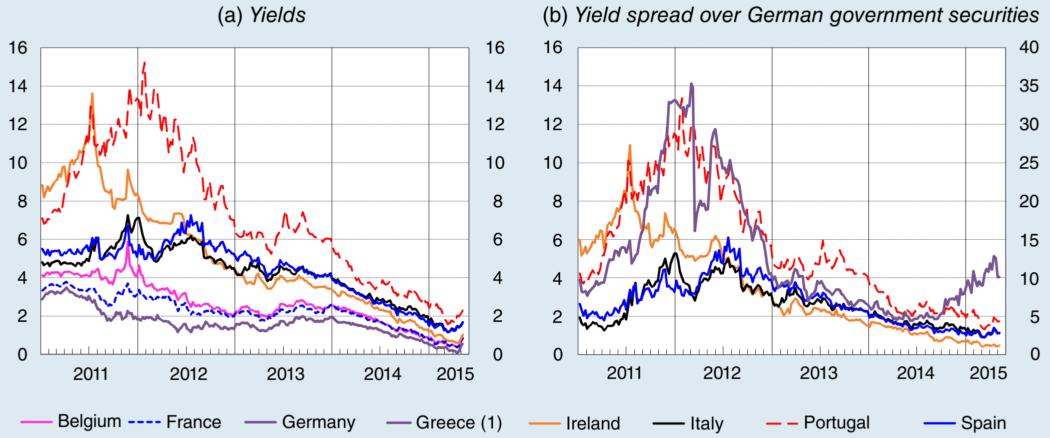
Financial asset prices were buoyed by the highly expansive stance of monetary policy. This countered the downward pressures in the second half of the year exerted by the temporary dip in expectations for more solid recovery and by the uncertainty generated by international factors such as geopolitical tensions and the pronounced fluctuations in oil prices.

The yields on government securities came down sharply in most euro-area countries in 2014, falling towards all-time lows (Figure 3.3.a). Factors in the substantial decline in yields on 'risk-free' long-term securities were the lowering of inflation expectations and, in the second half, also of expectations for economic growth, as well as the ECB's expansive monetary policy measures. In most of the countries heavily exposed to government securities tensions, sovereign risk premiums also diminished considerably (Figure 3.3.b).

Figure 3.3

Government securities yields and spreads

(weekly data; per cent and percentage points)



Source: Based on Bloomberg data.
(1) Right-hand scale.

The average return on euro-denominated investment grade corporate bonds declined to an historic low of 1.2 per cent at the end of the year, compared with 2.1 per cent a year earlier. The rates on high-yield bonds also continued to fall, although less sharply (from 4.9 to 4.6 per cent). The low interest rates led non-financial corporations to make very substantial bond issues, which outpaced redemptions and exceeded the previous year's placements.

The share price index for the main euro-area corporations rose by 2 per cent in 2014 but with significant volatility over the course of the year. Share prices, after gaining in the first half, were depressed by concerns about geopolitical tensions. Fears of the possible repercussions of the growing conflict between Russia and Ukraine resulted in more significant declines in euro-area stock markets than in the other principal markets. Since the end of the year, the tensions in Greece have also weighed on stock prices.

Euro-area financial market conditions continued to improve rapidly in the first four months of 2015, thanks above all to the Eurosystem's expanded asset purchase programme. The programme, announced on 22 January, had been widely expected, but its size and duration exceeded market expectations (see Chapter 4, 'Monetary policy in the euro area'). The rates on government securities continued to decline through mid-April, falling by an average of 0.4 percentage points in the euro-area countries to 0.6 per cent at ten-year maturities, while the share prices of the main listed corporations jumped by 20 per cent. Subsequently, there was a significant rise in the yields of long-term German government securities, which was transmitted to the other area countries as well. The rise appears to have reflected a moderate increase in inflation expectations, partly owing to higher oil prices, and technical factors, including a temporary increase in net issues on the primary market.

Fiscal policies

Budget outturns for 2014 and the prospects. – According to the latest estimates of the European Commission,[6] after the fiscal adjustment carried out in the three previous years, the euro area's fiscal policy stance (measured as the change in the cyclically adjusted primary budget balance) was practically neutral (with an improvement of nearly 0.2 percentage points) in 2014 and should remain so in 2015 (with a worsening of about the same amount). The stance of the major area economies is broadly uniform despite the differences in individual countries' cyclical positions and public finance conditions.

Average general government net borrowing in the euro-area countries diminished for the fifth consecutive year, from 2.9 to 2.4 per cent of GDP. The main contribution came from the 0.3 point improvement in the primary balance. A further reduction in the deficit, to 2.0 per cent of GDP, is forecast for 2015.

The area-wide ratio of public debt to GDP rose by 1 percentage point to 94.2 per cent, owing chiefly to the gap between the average cost of the debt (2.9 per cent) and nominal GDP growth (1.9 per cent). The debt ratio should diminish slightly this year.

The number of countries subject to excessive deficit procedures or at risk of non-compliance with the Stability and Growth Pact diminished. In 2014 the Council of the European Union closed the procedures that had been opened in 2009 for Austria, Belgium, the Netherlands and Slovakia. Of the eight countries for which procedures are still in course, Malta corrected its excessive deficit by the term set, and on 13 May 2015 the Commission recommended that the Council abrogate the procedure. In March the Council of the EU extended for two years, until 2017, the deadline for correction of the French deficit, taking into account the adverse cyclical conditions and the commitment to complete the reforms. This was the third extension from the original deadline of 2012.

In November, on the basis of draft budgetary plans for 2015, the Commission signalled risks of violation of the budget rules by seven countries in 2014-15 (Austria, Belgium, France, Italy, Malta, Portugal and Spain). Based on subsequent information, Finland was added to the list of countries subject to monitoring. In February 2015 the Commission judged that – in the light of such factors as substantial compliance with

[6] Unless otherwise indicated, the data here come from European Commission, 'Spring forecasts', May 2015. Reference is to the current euro area, with 19 members.

the preventive arm of the Pact,[7] the particularly adverse macroeconomic conditions and the governments' commitment to structural forms – the programmes of Belgium, Finland and Italy, which had already been deemed consistent with the deficit rule, were also consistent with the debt rule.[8] On 13 May the Commission updated its assessment of Finland, concluding that for the three years 2014-16 that country would not be in compliance with either the deficit or the debt rule.

Support to countries in difficulty. – The amount of new loans to euro-area countries in difficulty was considerably less than in the years immediately preceding. Loans for €18.9 billion were granted in 2014; the total since the start of 2010 is €407 billion (Table 3.2).

Table 3.2

Financial support to euro-area countries in difficulty (1)
(billions of euros)

	2010	2011	2012	2013	2014	Total to May 2015 (2)	Total support programme
Ireland	0.0	34.7	21.1	10.9	0.8	67.6	67.5
Portugal	–	34.0	27.5	10.0	5.2	76.6	78.0
Greece	31.5	41.5	109.9	32.0	11.7	215.7(3)	244.6
Spain	–	–	39.5	1.9	–	41.3	41.3
Cyprus	–	–	–	4.9	1.3	6.1	10.0
Total	**31.5**	**110.2**	**197.9**	**59.7**	**18.9**	**407.3**	**441.4**

Sources: For bilateral loans to Ireland, National Treasury Management Agency; for loans from EFSF, EFSM and ESM, those institutions' websites; for the first support programme for Greece, European Commission, 'The second economic adjustment programme for Greece', March 2012; for the IMF loans not part of that programme, press releases on the occasion of each disbursement.
(1) There may be discrepancies due to rounding or to variations in the exchange rate between the currency in which loans are denominated and the euro. – (2) Data updated to 15 May 2015. – (3) Takes into account the restitution to the EFSF in February 2015 of funds appropriated but not used (€10.9 billion). Until the programme is completed, Greece can use these resources for interventions in support of the banking system at the request of the ECB or the Single Supervisory Mechanism.

The support programmes for Ireland, Portugal and Spain have been completed. All in all, these three countries received loans equal respectively to 36, 44 and 4 per cent of their 2014 GDP. Ireland received its last support instalment in March 2014. In July Spain began repaying the loans, ahead of the agreed schedule. Portugal requested the closure of its programme in May 2014, forgoing the last tranche of assistance.

The Commission, in accord with the ECB, is responsible for post-programme surveillance over the three countries until they have repaid at least 75 per cent of the loans received from European countries and institutions. In addition, the European Stability Mechanism monitors non-compliance risks until full repayment of its loans and those of the European Financial Stability Facility.

[7] The preventive arm of the Stability and Growth Pact requires an improvement of 0.5 percentage points of GDP in the structural budget balance for countries that have not attained their medium-term objective. The correction is modulated according to the state of the economic cycle and the ratio of public debt to GDP in each country.

[8] Under the debt rule the difference between the debt ratio and the threshold of 60 per cent must be reduced by an average of one-twentieth per year for three years. Specific constraints defined in terms of variation of the structural balance are envisaged for a transition period of three years for the countries that were subject to the excessive deficit procedure in 2011.

The programme for Cyprus is scheduled to be terminated in 2016. In 2014, €1.3 billion was disbursed. So far loans worth €6.1 billion have been granted, equal to 35 per cent of the country's GDP in 2014, out of a total programme commitment of some €10 billion.

There is still great uncertainty about the outcome of the negotiations over the support programme for Greece, despite the appreciation expressed by the Eurogroup at its meeting of 11 May of the Greek government's willingness to speed up the talks. As far as the portion financed by European institutions is concerned, the programme was supposed to be terminated in 2014. At the request of the Greek government, in February an extension until 30 June was conceded to implement the measures envisaged, upon which the disbursement of additional funds is conditional. A two-month extension had already been granted in December. The delay in designing and carrying out the reforms, to be agreed with the institutions, was due in part to the Greek political elections in January and the resulting change of government. The payment of the last tranche of assistance by the EFSF and the transfer of the 2014 Eurosystem's profits on Greek securities under the Securities Markets Programme depend on the success of the negotiations. Overall, Greece has received assistance amounting to about 120 per cent of its 2014 GDP.

European governance

Last year saw further changes in European economic governance. As suggested in the annual growth survey[9] released in November 2014 as part of the European semester, for the first time the Commission published its assessments of budgetary policies and of macroeconomic imbalances together (see the box 'Macroeconomic imbalances in the European Union') and earlier in the year than had previously been the case. In January 2015 the Commission issued a guide interpreting the scope for flexibility envisaged by the Pact to reconcile the sustainability of the public finances with the need to support economic activity.[10] In particular, the communication spelled out how compliance assessments should take account of cyclical conditions in the individual countries, macroeconomic shocks to the entire area, and the efforts made or planned to foster growth through targeted reforms or the financing of specific investment programmes (see the box 'European budget rules and the objectives for Italy's public finances', *Economic Bulletin,* 1, 2015).

MACROECONOMIC IMBALANCES IN THE EUROPEAN UNION

The recent crisis has led to a series of reforms of European governance, including new mechanisms of multilateral surveillance.[1] In 2010 an annual Macroeconomic Imbalances Procedure for surveillance was introduced. On the basis of the economic reading of a scoreboard of macro-financial indicators, an Alert Mechanism Report identifies the countries that require closer examination, which are then subjected to an in-depth review that serves to develop

1 D. Franco and F. Zollino, 'Macreoeconomic imbalances in Europe: institutional progress and the challenges that remain', *Applied Economics,* 46, 6, 2014, pp. 589-602.

9 European Commission, 'Annual growth survey 2015', COM (2014) 902 final, 2014.

10 European Commission, 'Making the best use of the flexibility within the existing rules of the Stability and Growth Pact', COM (2015) 12 final, 2015.

country-specific recommendations for individual governments. In formulating its own national reform programme, to be updated yearly, each country must take account of the procedure and any recommendations. Government response to the latter will be assessed over the following year, with possible sanctions for repeated failure to take proper action.

The score for a country can range from stage 1 (no imbalances) to stage 5 (excessive imbalances that require specific monitoring and decisive policy action). In March 2015 the Commission released the in-depth reviews for the 16 countries identified by the Alert Mechanism Report as experiencing macroeconomic imbalances. As in 2014, Italy was classed in stage 5, along with Bulgaria, Croatia, France and Portugal. In the Commission's view the main sources of risk are high public debt and loss of competitiveness. However, alternative indicators suggest that the latter is more modest (see Chapter 9, 'Prices, costs and competitiveness'). The in-depth review appreciated the reduction of the tax wedge, the reforms of the labour market, the school system and the governance of cooperative banks, as well as the Government's proposals on competition. On the other hand, it criticized the uncertain implementation of the spending review, the delays in the privatization programme, and the inadequate gains in the efficiency of taxation and the public administration. The Commission's country-specific recommendations for 2015 focus on these issues, along with the urgent need to encourage a reduction in banks' non-performing loan assets and to strengthen active labour market policies.

The excessive imbalances of France (stage 5) were traced to deterioration in the balance of trade and loss of competitiveness, against a backdrop of high public debt and insufficient fiscal correction. Spain was upgraded to stage 4, as the Commission recognized the progress made on reform of the tax system, the public administration and the banking system. But high public, private, and foreign debt and the high rate of unemployment continue to be significant sources of vulnerability. For the first time Germany was classed in stage 3 (countries requiring decisive policy action and monitoring) by reason of the persistent large surplus on the current account of its balance of payments and its low level of investment. The Commission deemed Germany's public investment in infrastructure, education and research insufficient, and its progress in efficiency of the tax system inadequate. The inclusion of Germany on the list of countries with imbalances is also justified by the potential repercussions on the rest of the EU of the substantial excess of saving over investment in its largest economy.

Reflection continued on the issues raised by the European Council's 2012 report 'Towards a genuine Economic and Monetary Union'. One contribution was a note presented in February 2015 by the President of the Commission, together with the Presidents of the European Council, the Eurogroup and the ECB. Among other things, the discussion bears on the possibility of constituting a 'fiscal capacity' for the euro area, i.e. an autonomous power to raise resources for purposes of macroeconomic stabilization and the financing of reforms. Various alternatives for the creation of such a fiscal capacity are feasible. Proposals have been made, for instance, concerning unemployment benefits (see the box 'An unemployment scheme for the euro area') and for the partial centralization of pension schemes.[11] Fiscal capacity could be the first step towards a genuine fiscal union. Actually achieving such a union would require strengthening institutional arrangements, conferring the power to tax and to borrow on a single fiscal authority, and guaranteeing proper democratic legitimation of the joint decision-making process, including through partial renunciation of national sovereignty.

AN UNEMPLOYMENT SCHEME FOR THE EURO AREA

A recent publication of the Bank of Italy[1] examines the effects of a hypothetical cyclical stabilizer consisting in transfers commensurate with the expenditure that would be sustained by each country to finance notional unemployment benefits with minimum characteristics common to the entire euro area. National unemployment schemes would remain in force under the principle of subsidiarity. The contribution rates in individual member states could differ so as to equalize the funds received and the contributions paid by each over a span of years. Instituting a single contribution rate for the entire area would produce greater risk sharing, with some cross-national resource redistribution. The mechanism would operate non-discretionally and would increase the possibility of stabilizing the economic cycle by introducing an element of insurance among countries, which is currently envisaged only for extreme cases necessitating financial support.

The paper assesses the degree of stabilization that the mechanism posited would provide under alternative hypotheses concerning its funding and applying the same multipliers as those used by the European Commission in its projection exercises. Assuming national contribution rates entailing no resource redistribution over the medium term, during the period 2002-12 the mechanism would have furnished a degree of cyclical stabilization equal to about one seventh of that already permitted by the cyclical adjustment of the budget balance provided for by European fiscal rules. Hypothesizing a single area-wide contribution rate, the degree of stabilization doubles, with only very modest cross-national resource transfers. The largest contributor would finance the fund with an outlay of less than 0.1 per cent of its GDP. In this case the fund would make net resource transfers above all to Spain and Portugal. Since the financial flows are assumed proportional to a notional unemployment benefit, they would follow trends in involuntary terminations of payroll jobs. Accordingly, Italy, with its higher incidence of self-employment and long-term unemployment, would be one of the main net contributors, together with France and Germany. Furthermore, the direction of the flows varies with the period over which the simulation is conducted. For example, Italy would have been a net beneficiary in 2009-10, Germany in the five years preceding the Great Recession.

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1 A. Brandolini, F. Carta and F. D'Amuri, 'A feasible unemployment-based shock absorber for the euro area', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), No. 254, 2014.

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11 F. Balassone, S. Momigliano, M. Romanelli and P. Tommasino, 'Just round the corner? Pros, cons, and implementation issues of a fiscal union for the euro area', Bank of Italy, Questioni di Economia e Finanza (Occasional Papers), 245, 2014.

4. MONETARY POLICY IN THE EURO AREA

Last year, given slack economic activity, subdued money and credit dynamics, and exceptionally low actual and expected inflation, the Governing Council of the European Central Bank reduced official interest rates to their effective lower bound, i.e. the rate below which it does not intend to make any further cuts, conducted longer-term refinancing operations to stimulate credit supply and began to purchase private sector securities.

In January 2015, against a backdrop of further deterioration in the outlook for prices, the Council judged the prevailing degree of monetary stimulus as insufficient and decided to extend the purchase programme to public sector securities. Under the expanded asset purchase programme the Eurosystem will make monthly purchases amounting to €60 billion at least through September 2016 and in any case until there is a sustained adjustment in the path of inflation consistent with the objective of price stability.

The Council's decisions were based on mounting evidence that developments in aggregate demand had weighed heavily on the fall in inflation, on the particularly strong risk of the disanchoring of inflation expectations, and on the awareness of the severe costs of deflation. It is essential that the measures adopted be conducted with determination and carried out in full.

The Council's decisions have had wide-ranging effects on the financial markets. Those stemming from the Public Sector Purchase Programme were largely seen as early as November 2014, when the Council announced the start of preparatory work for its adoption. Looking ahead, both economic growth and inflation may be significantly boosted.

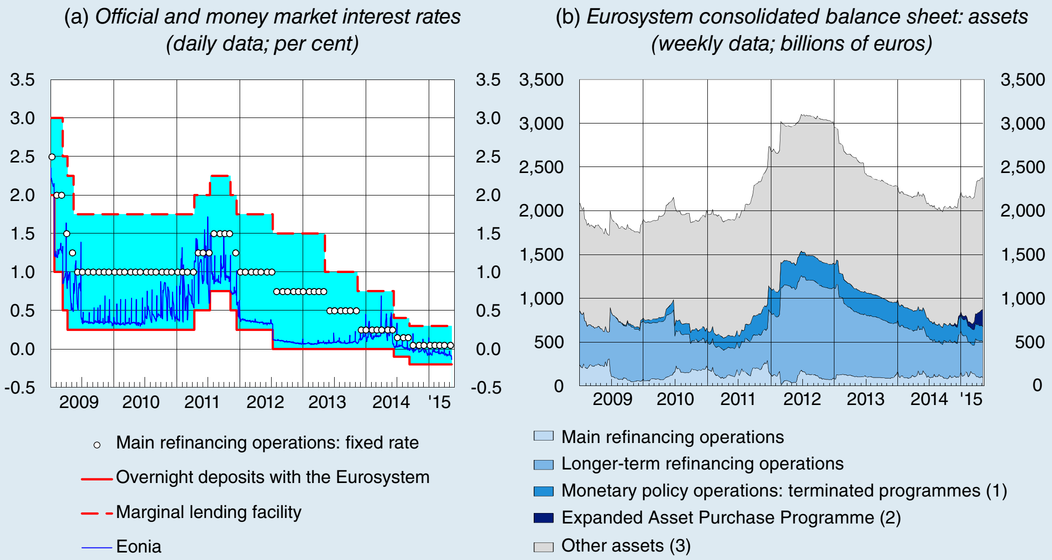
Monetary policy action

In the first part of 2014, the weakness of economic activity and money and credit growth in the euro area was accompanied by a sharper-than-expected slowdown in prices involving a broad range of index components and countries. Medium-term inflation expectations remained well below the ECB's definition of price stability (see the section 'Interest rates and the exchange rate of the euro' and Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area'). The Council cut its key policy rates in June and again in September and took measures to foster credit supply and economic growth by expanding the Eurosystem's balance sheet (Figure 4.1).

The rate on main refinancing operations was lowered to 0.05 per cent and that on the deposit facility to -0.20 per cent. The unprecedented decision to bring the latter down to negative levels – together with the suspension of the sterilization of the funds injected via the Securities Markets Programme – encouraged cross-border circulation of liquidity (see the box 'Liquidity developments following the monetary policy decisions of June 2014', *Financial Stability Report,* 2, 2014).

Figure 4.1

Official interest rates in the euro area and the Eurosystem's consolidated balance sheet



Sources: ECB and Thomson Reuters Datastream.
(1) Covered Bond Purchase Programmes (CBPP, CBPP2) and Securities Markets Programme (SMP). – (2) Covered Bond Purchase Programme 3 (CBPP3), Asset-Backed Securities Purchase Programme (ABSPP) and Public Sector Purchase Programme (PSPP). – (3) Marginal lending facility, gold and other assets denominated in euros and in foreign currency.

In June the Council decided to conduct targeted longer-term refinancing operations to supply banks with low-cost liquidity, conditional upon their expansion of lending to firms and households (see the box 'The monetary policy measures adopted in June 2014', *Economic Bulletin,* 3, 2014). In September it introduced private sector securities purchase programmes (see the section 'Monetary policy operations'). These decisions were transmitted to financial market conditions, favouring a reduction in the cost of credit and the depreciation of the euro.

Nevertheless, the inflation outlook worsened in the latter part of 2014. Price dynamics turned negative, and even long-term inflation expectations fell below the definition of price stability (see the box 'The risks of too low inflation over a prolonged period'). In January 2015, judging the monetary stimulus achieved to be insufficient, the Council extended its asset purchase programme to include securities issued by euro-area governments as well as several European public agencies and institutions (see the box 'The expanded asset purchase programme'). The risks of hypothetical losses on government securities are borne by the national central banks that make the purchases. This approach takes into account the concerns of some Council members that, under existing institutional arrangements, the programme might result in cross-country resource transfers not authorized by resolutions of the bodies empowered to make such decisions. However, this does not undermine the effectiveness of the programme, which depends on the size and timing of the purchases.

THE EXPANDED ASSET PURCHASE PROGRAMME

Under the expanded asset purchase programme the Eurosystem is expected to make monthly purchases of public and private sector securities worth €60 billion. Launched in March 2015, the programme will continue at least until September 2016 and in any case until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its definition of price stability. The Bank of Italy will buy about €130 billion in Italian government bonds; including ECB purchases, the total will come to €150 billion.[1]

The positive effects of the measure began to make themselves felt as early as last November, when the ECB Governing Council announced the start of preparatory work on the programme. The yields on euro-area government securities diminished, the euro depreciated, and inflation expectations, which had been declining since the start of 2013, turned back up in January (see the box 'The macroeconomic impact for Italy of the Eurosystem's expanded asset purchase programme', *Economic Bulletin*, 2, 2015).

The programme can stimulate economic growth and a rise in prices in the area. We estimate the potential impact on the Italian economy through the effect on interest rates and the exchange rate at 1.4 percentage points of GDP in the two years 2015-16 and just over half a point in inflation each year. Additional effects could emerge via portfolio rebalancing, the increase in wealth, and a boost to confidence and inflation expectations.[2]

1 'Nota di approfondimento sul programma di acquisto di titoli pubblici e privati dell'Eurosistema', update 15 April 2015, Banca d'Italia website.

2 P. Cova and G. Ferrero, 'The Eurosystem's asset purchase programmes for monetary policy purposes', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 270, 2015.

Interest rates and the exchange rate of the euro

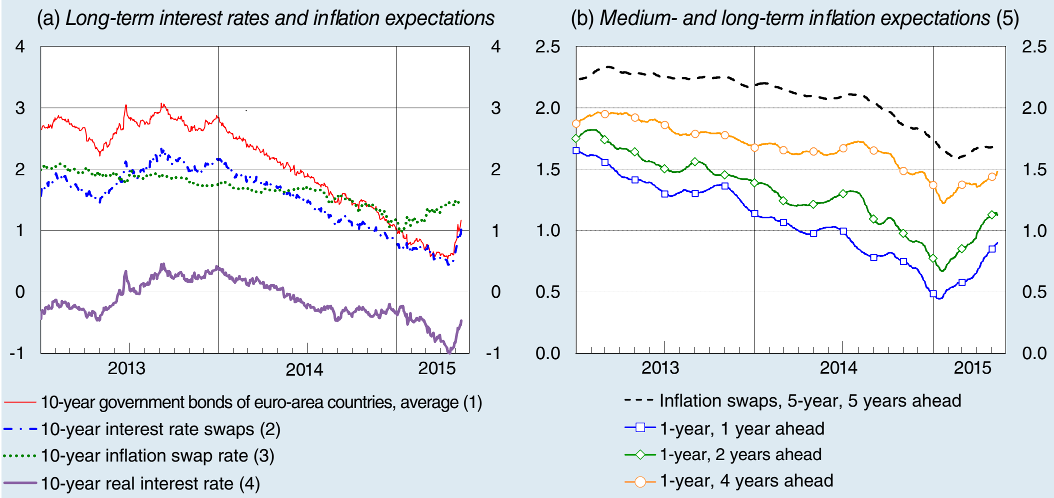
As a consequence of the lowering of the key policy rates and the increase of liquidity through the expanded asset purchase programme, the overnight rate (Eonia) and the three-month rate (Euribor) slipped below zero. These marginally negative interest rates did not result in market malfunctions or portfolio shifts towards cash.

Nominal long-term interest rates diminished progressively throughout 2014 and early 2015. In the second half of April they turned back up slightly, owing in part to a small pick-up in inflation expectations (see the section 'The financial markets' in Chapter 3). In mid-May nominal interest rates measured by ten-year swaps stood at 1.0 per cent, down from 2.2 per cent at the start of 2014 (Figure 4.2.a), and the average yield on government securities of that maturity in the main euro-area countries was 1.2 per cent, down from 2.8 per cent.

The fall in expected inflation steepened in the second half of 2014 (Figure 4.2.b), and even longer-term expectations have declined to well below the definition of price stability. At the start of 2015 the one-year expectations implied by inflation swaps, which include a risk component, were equal to about 0.5 per cent one year ahead, and five-year expectations five years ahead were down to about 1.5 per cent (see the box 'The risks of too low inflation over a prolonged period'). The Consensus Economics survey and the ECB's survey of professional forecasters also signalled falling medium- and long-term inflation expectations in the course of 2014. After the announcement of the expanded asset purchase programme, the decline halted and a gradual upturn began.

Figure 4.2

Long-term interest rates and inflation expectations in the euro area
(daily data; per cent)



Sources: Based on Bloomberg and Thomson Reuters Datastream data.
(1) Average yields on benchmark 10-year government bonds of Austria, Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal and Spain, weighted by GDP at constant 2014 prices. – (2) Fixed rate on 10-year interest rate swaps in euros. – (3) Fixed rate on 10-year euro-area inflation swaps. – (4) Fixed rate on 10-year interest rate swaps deflated by the fixed-rate on 10-year inflation swaps. – (5) Fixed rate implied by inflation swap contracts, 30-day moving average.

THE RISKS OF TOO LOW INFLATION OVER A PROLONGED PERIOD

The monetary policy decisions of the ECB Governing Council have been based on the growing body of evidence that trends in aggregate demand have significantly influenced the fall in inflation, on the particular importance of the risk of disanchoring inflation expectations and on the awareness that the cost of deflation or persistently low inflation will be very high. Analysis by the Bank of Italy contributed to these conclusions.

Empirical analyses using vector autoregressive models to decompose historical price series have shown that the protracted decline in economic activity has contributed substantially to the progressive decline in inflation over the past two years. In addition, the fall in oil prices has had a greater indirect effect on core inflation than during the financial crisis of 2008-09.[1]

[1] A. Conti, S. Neri and A. Nobili, 'Why is inflation so low in the euro area?', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

The risk that inflation expectations might become disanchored from rates compatible with the definition of price stability appeared to be particularly severe. The empirical evidence indicates that negative shocks to inflation are persistent.[2] Furthermore, when inflation stays below or above target for a prolonged period, the risk may be compounded by economic agents' revising their expectations for future inflation to take account of surprises registered in the past.[3] Financial instruments, such as inflation swaps, provide timely information for measuring inflation expectations and thus for assessing disanchoring risk, although one objection has been that measurements based on information drawn from financial instruments may be distorted by the presence of time-varying risk premiums. Analyses conducted by the Bank of Italy nevertheless confirm that even taking these premiums into account, in the course of 2014 medium- and long-term inflation expectations diverged from the ECB definition of price stability.[4] Another similar sign is the observation that more recently downward changes in short-term inflation expectations have been accompanied, as they had not been in the past, by comparable variations in longer-term expectations.[5]

It has also been argued that periods of negative price changes in the past have not necessarily entailed significant economic costs. However, this thesis would not appear to be sufficiently robust when: (a) inflation expectations are disanchored, initiating a deflationary spiral; (b) nominal interest rates are at their lower bound; and (c) the level of public and private debt is high. When prices go below the level predicted when the debt was contracted and nominal interest rates cannot go down, the real cost of debt service increases, tightening the financial constraints on households, firms, and government.[6]

Simulations using a macroeconomic model appear to confirm this conclusion. In the case of an aggregate supply shock that causes a fall in prices (such as a reduction in the price of energy), if nominal interest rates cannot go down and the level of debt is high, then the real interest rate will rise and the cost of debt service will increase. The outcome could be an amplification of the decline in inflation and a significant contraction in aggregate demand.[7]

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[2] F. Busetti, M. Caivano and L. Rodano, 'On the conditional distribution of euro area inflation forecasts', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

[3] F. Busetti, G. Ferrero, A. Gerali and A. Locarno, 'Deflationary shocks and de-anchoring of inflation expectations', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 252, 2014.

[4] M. Casiraghi and M. Miccoli, 'Risk-adjusted forecasts of inflation', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

[5] S. Cecchetti, F. Natoli and L. Sigalotti, 'Tail comovement in option-implied inflation expectations as an indicator of anchoring', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

[6] M. Casiraghi and G. Ferrero, 'Is deflation good or bad? Just mind the inflation gap', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 268, 2015.

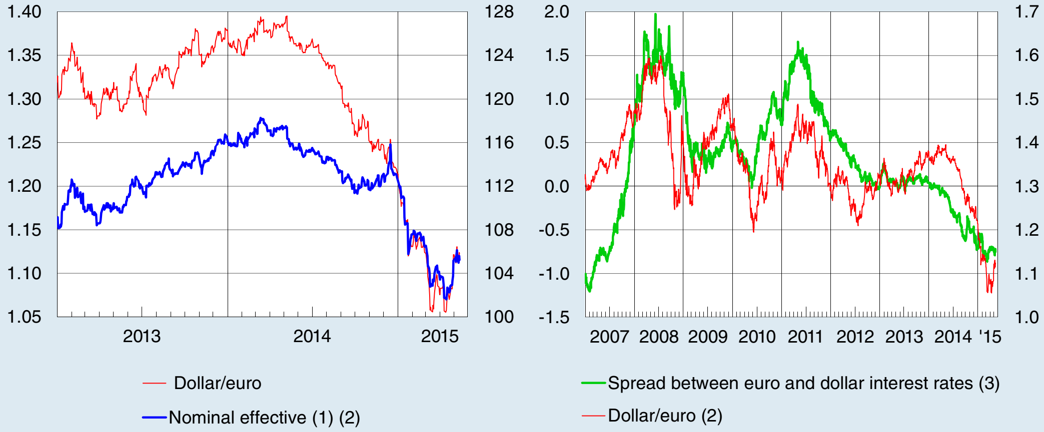
[7] S. Neri and A. Notarpietro, 'Inflation, debt and the zero lower bound', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 242, 2014.

The euro weakened progressively from the middle of the year onwards, reflecting the ECB's accommodative measures and the beginning of the gradual normalization of monetary conditions in other advanced countries (Figure 4.3). Between the start of last

June and mid-May of this year, the euro depreciated by 9 per cent in nominal effective terms and by 18 per cent against the dollar.

Figure 4.3

Exchange rates of the euro
(daily data)



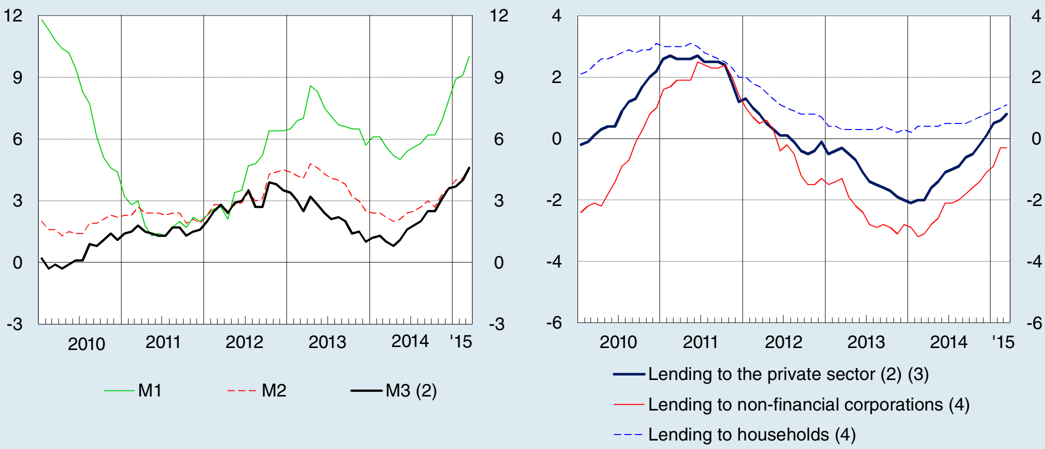
Sources: ECB and Thomson Reuters Datastream.
(1) Index: 1999 Q1=100. A rise in the index corresponds to an appreciation. – (2) Right-hand scale. – (3) Spread between fixed rate on 2-year interest rate swaps in euros and dollars; per cent.

Money and credit

As portfolios were adjusted towards more liquid assets in connection with the flattening of the term structure of interest rates, the twelve-month growth rate of M3 quickened in 2014 and the early months of 2015 to 4.6 per cent in March (Figure 4.4).

Figure 4.4

Money and credit aggregates in the euro area
(monthly data; 12-month percentage changes) (1)



Source: ECB.
(1) Changes calculated on end-of-month data adjusted for calendar effects. – (2) From June 2010 onwards the data do not include repos with central counterparties. – (3) Loans in euros and other currencies granted by monetary financial institutions. The data are adjusted for the accounting effects of securitizations. The private sector consists of households, non-profit institutions serving households, non-financial corporations, insurance companies and pension funds, non-money-market investment funds and other financial institutions. – (4) Loans in euros and other currencies granted by monetary financial institutions, adjusted for the accounting effects of securitizations.

The decline in bank lending to the private sector eased in 2014, coming to a halt in December, and by this March lending was 0.8 per cent greater than a year earlier. The improvement was due to an attenuation of the contraction in lending to non-financial corporations and a slight acceleration in lending to households.

Since the end of 2013 the average rates on new loans to firms and new mortgage loans to households have come down by nearly 1 percentage point to stand at 2.0 and 2.3 per cent respectively in March 2015.

According to the euro-area bank lending survey, in 2014 and the first quarter of this year lending benefited from a gradual relaxation of credit supply conditions. The survey on the access to credit of enterprises in the euro area found that access had eased chiefly for medium-sized and larger firms while remaining difficult for small businesses.

Monetary policy operations

Last year the Eurosystem continued to supply liquidity to the banking system through fixed-rate auctions with full allotment, both in its main refinancing operations and in the three-month longer-term operations. In June the Governing Council decided that this policy would remain in effect at least through December 2016.

During the first half of 2014 the excess liquidity in the banking system diminished, though remaining abundant. As market fragmentation along national lines decreased, banks made ample resort to the option of early repayment of the funds received via the three-year longer-term refinancing operations (see the Annual Report for 2011, Chapter 7, 'The single monetary policy'). Starting in September the liquidity repaid was largely offset by new funds obtained through targeted longer-term refinancing operations; in the three auctions to date, banks took a total of €310 billion, including some €90 billion disbursed to Bank of Italy counterparties.

Under its asset purchase programmes, by the end of April 2015 the Eurosystem had bought €6 billion worth of asset-backed securities and €75 billion worth of covered bank bonds.

By the end of April purchases under the expanded asset purchase programme, which began in March 2015 and includes public sector securities, amounted to €120 billion (of which €95 billion consisted in public securities, including €15 billion worth of Italian government bonds), in line with the objective of €60 billion a month. At that date the residual maturity of the public sector purchase programme portfolio, like that of the segment consisting in Italian government securities, was just over eight years. In order to maintain liquid and functional markets, the national central banks will make the bonds in this portfolio available for securities lending.

THE ITALIAN ECONOMY

5. OVERVIEW

The prolonged decline in Italy's GDP slowed in the course of 2014 and came to an end in the last quarter. Year on year, economic activity diminished by 0.4 per cent, bringing the cumulative loss since the onset of the Great Recession to almost 9 percentage points. The initial signs of a recovery in domestic demand emerged at the end of the year and were confirmed in the first quarter of 2015, sustaining GDP growth, which turned positive for the first time in nearly two years.

The main brake on growth in 2014 was falling investment (Table 5.1). Household spending continued its slow recovery, under way since mid-2013, with contributions coming both from the stabilization of purchasing power, thanks in part to the measures of income support for lower-paid workers that went into effect in May, and to increasing confidence in the general economic outlook for Italy. Exports rose sharply, boosted by the expansion of potential demand addressed to Italian enterprises and by gains in price competitiveness.

Table 5.1

Sources and uses of income in Italy

	Per cent of GDP in 2014 (volumes at previous-year prices)	2013			2014		
		Percentage changes		Contribution to GDP growth in % points (chain-linked volumes)	Percentage changes		Contribution to GDP growth in % points (chain-linked volumes)
		Chain-linked volumes	Deflators		Chain-linked volumes	Deflators	
Sources							
GDP	–	-1.7	1.4	–	-0.4	0.8	–
Imports of goods fob and services (1)	27.1	-2.3	-1.9	0.6	1.8	-2.5	-0.5
of which: goods	*21.8*	*-2.6*	*-2.3*	*0.6*	*1.7*	*-3.3*	*-0.4*
Uses							
National demand	97.4	-2.5	0.8	-2.5	-0.7	0.3	-0.7
Consumption of resident households (2)	61.2	-2.8	1.1	-1.7	0.3	0.2	0.2
Consumption of general government	19.5	-0.3	0.2	..	-0.9	0.6	-0.2
Gross fixed investment	16.9	-5.8	0.5	-1.1	-3.3	0.1	-0.6
plant, machinery, armaments, cultivated biological resources	*5.7*	*-5.5*	*0.1*	*-0.3*	*-2.5*	*-0.1*	*-0.1*
products of intellectual property	*2.6*	*-1.7*	*0.6*	*..*	*0.3*	*1.1*	*..*
construction	*8.7*	*-7.2*	*0.8*	*-0.7*	*-4.9*	*-0.1*	*-0.4*
Change in stocks (3)	–	–	–	0.4	–	–	-0.1
Exports of goods FOB and services (4)	29.7	0.5	0.1	0.1	2.7	-0.3	0.8
of which: goods	*24.2*	*0.7*	*-0.2*	*0.2*	*2.5*	*-0.4*	*0.6*
Net exports	–	–	–	0.8	–	–	0.3

Source: Istat, national accounts.
(1) Includes residents' expenditure abroad. – (2) Includes non-profit institutions serving households. – (3) Includes valuables. – (4) Includes non-residents' expenditure in Italy.

In October Istat revised the national accounts to comply with the new ESA 2010 standards, at the same time implementing EU agreements for the inclusion in value added of certain illegal activities. The outcome was an upward revision of GDP by about 4 percentage points. Gross fixed investment is now about 7 percentage points higher than in previous estimates, owing above all to the inclusion of research and development expenditure under investment.

The saving rate for the entire economy, measured as a ratio to gross national income, was 18.8 per cent in 2014, only marginally higher than in 2013 (Table 5.2). At the same time the surplus on current external transactions increased to 2 per cent of gross national income (compared with a 3.5 per cent deficit in 2010), while investment fell to 17 per cent, almost all of the decline being accounted for by private sector investment.

Table 5.2

Saving and gross investment in Italy
(per cent of gross national disposable income)

	Average 1981-1990	Average 1991-2000	Average 2001-2010	2010	2011	2012	2013	2014
Saving by general government	-6.6	-3.3	0.7	-0.5	-0.4	0.6	0.1	0.1
Saving by private sector	28.8	24.6	19.4	17.8	18.0	17.0	18.4	18.6
of which: consumer households (1)	*20.0*	*14.0*	*7.8*	*5.7*	*5.4*	*4.6*	*5.9*	*5.6*
Gross national saving	22.3	21.3	20.0	17.3	17.6	17.7	18.5	18.8
Gross investment	23.2	20.5	21.3	20.8	20.8	18.1	17.5	16.7
Memo:								
Balance on current transactions with rest of world	-0.9	0.9	-1.3	-3.5	-3.1	-0.4	0.9	2.0

Source: Based on Istat data.
(1) Includes non-profit institutions serving households.

After declining for two years labour input in the economy rose slightly in 2014. Larger and export-oriented firms increased the number of hours worked, while in the service sector the contraction of public employment was almost halted. The unemployment rate rose further to a yearly average of 12.7 per cent as a consequence of increased labour force participation. The rise in hourly labour costs in the private sector remained moderate.

Heterogeneity in firms' performance is significant and growing; the more innovative and export-oriented businesses have scored greater than average gains in sales. The economy as a whole, however, is weighed down by the large number of micro-enterprises, often inadequately organized and managed and with a financial structure in which equity capital makes only a limited contribution. This hampers one of the crucial factors in growth, namely innovation, which is less intense in Italy than in the other main advanced economies. A regulatory and institutional environment that is still not particularly business-friendly limits the possibility of reallocating resources to more productive uses.

There was a further widening of the growth gap between the South and the Centre North, where exporting firms better able to exploit the increase in foreign demand are more numerous. On average for the year construction employment continued to decline in all parts of the country; however, the total number of persons in work in the Centre and North increased by 0.8 per cent, while it fell by the same amount in the South. The unemployment rate rose by 1 percentage point in the South and by 0.4 points in the rest of the country to 20.7 and 9.4 per cent respectively. The gap is the widest it has been in a decade.

The restrictiveness of fiscal policy was attenuated, thanks among other things to the flexibility allowed by the European budget rules. Net borrowing was essentially unchanged in 2014, within the ceiling of 3 per cent of GDP, but the cyclically adjusted primary surplus diminished. To boost consumption and redistribute resources to the less well-off, the Government cut the tax wedge on lower-middle-income payroll earnings (financing it largely through spending cuts and temporary revenues, as well as by higher taxes on financial assets). The ratio of public debt to GDP rose by 3.6 percentage points to 132.1 per cent, owing above all to the payment of overdue general government commercial debts and financial support to members of the Monetary Union.

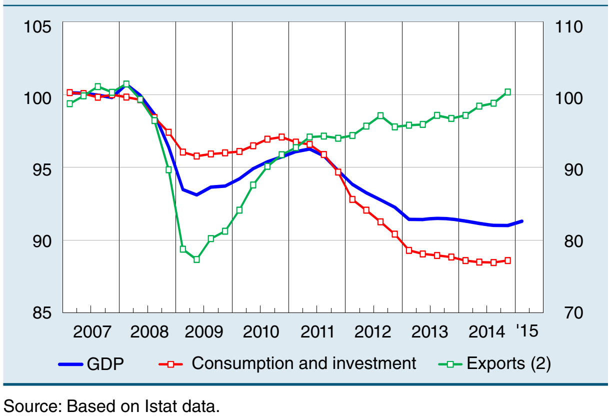
Consumer price inflation fell to a very low level, averaging 0.2 per cent for the year as a whole, as a result of the weak rise in the core components, given ample spare production capacity, and the new decline in oil prices. Some initial positive signs for the price outlook emerged from the business surveys conducted in the early months of 2015, reflecting the less anaemic prospects for demand.

Starting last summer the economic picture has offered signs of improvement, favoured by the gradual recovery in private and public consumption and the continuing stimulus from foreign demand. In the fourth quarter national demand, net of destocking, made a positive contribution to growth for the first time in nearly three years (Figure 5.1). The signs of recovery continued in the early months of 2015 as well, benefiting from the fall in oil prices, improving credit conditions and the depreciation of the euro. Istat's preliminary estimates put quarterly GDP growth in the first quarter at 0.3 per cent, owing above all to the upturn in manufacturing value added.

Figure 5.1

GDP and the main components of demand (1)

(quarterly data; indices, 2007=100)



Source: Based on Istat data.
Chain-linked volumes adjusted for seasonal and calendar effects. – (2) Right-hand scale.

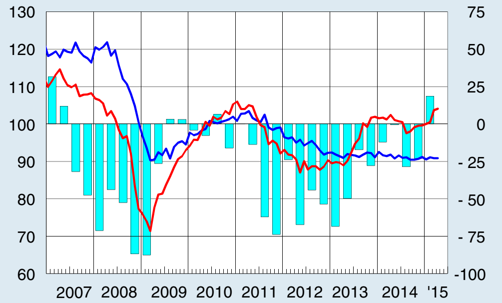
Even stronger signals stem from the sharp gain in household and business confidence, based chiefly on increasingly positive assessments of the general state of the economy, bolstered in part by the exceptionally relaxed monetary policy stance. The Ita-coin coincident indicator of the fundamental performance of the

Italian economy increased again in April, although it remained marginally negative. One risk in interpreting the data is the persistent difference between qualitative survey information and the quantitative data (Figure 5.2). This divergence could signal a gradual adjustment in the level of activity but might also reflect, as in the period from mid-2013 to the third quarter of 2014, a downward revision of firms' notion of 'normal' levels of output.[1]

Figure 5.2

Industrial production and business confidence

(monthly data)



Sources: Based on data from Istat, Terna and Bank of Italy.
(1) Balance of responses 'better' and 'worse' to the question in the Bank of Italy-*Il Sole 24 Ore* quarterly survey on the state of the economy reported in Survey on Inflation and Growth Expectations, March 2015, Supplements to the Statistical Bulletin, No. 18, 2015; the data refer to industrial firms only. – (2) Industrial production adjusted for seasonal and calendar effects; for April 2015, estimated data. – (3) Index, 2010=100. – (4) In June 2013 methodological changes were introduced to the sample and the survey techniques that make the data since then not directly comparable with the earlier data.

The quickening of economic activity could intensify this year and especially next, powered by a gradual recovery in investment, as business surveys suggest, and in consumption, fostered by the improving prospects for the labour market and the income support for low-paid employees, which has now been made permanent. The expansion will apparently be primarily cyclical, still benefiting from the effects on interest rates and the exchange rate deriving from the ECB's public securities purchase programme and the low price of oil, which should free resources for consumption and investment.

Banks and institutional investors benefited from abundant market liquidity and low interest rates. Institutional investors' funding was the highest in 15 years, permitting a significant increase in earnings, and banks' funding conditions continued to improve. The weakness of the economy cut into banks' earnings, and profitability was negative again, but their capital ratios strengthened thanks to capital increases in the course of the year. The improving economic outlook should favour a consolidation of the initial signals of an upturn in lending that emerged in the early months of 2015.

In 2014 the reform drive was stepped up in such fields as labour market regulation, corruption, and civil justice efficiency. Additional measures are being finalized, including the enabling act for tax reform and the reform of the school system. The full accomplishment of this extensive agenda of reforms, removing the obstacles that still hold back investment and consumption, is essential if the Italian economy is to emerge from its protracted recession on a durable basis. In this way potential output, after the severe losses suffered since 2008, could return to a sustained path of growth (see the box 'Italy's potential output and the output gap').

[1] A.M. Conti and C. Rondinelli, 'Easier said than done: the divergence between soft and hard data', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 258, 2015.

ITALY'S POTENTIAL OUTPUT AND THE OUTPUT GAP

The two recessions that struck the Italian economy between 2008 and 2013 resulted in an unprecedented contraction in economic activity amounting overall to nearly 9 percentage points of GDP. The plunge in actual output appears to have reduced potential output as well. We have estimated the impact of the crisis on potential GDP using different models and various types of data. Analyses based on a vector autoregressive model using macroeconomic and financial data have shown that potential GDP has declined by about 2 percentage points.[1]

A dynamic general equilibrium model finds a loss of comparable size as the consequence of financial shocks and fiscal consolidation. However, this model also assigns an important role to agents' expectations concerning the future course of the main variables, which means it is conceivable that in the future there could be a positive effect on potential output both from reforms designed to increase competition, especially in services, and from the consolidation of the public finances, which in the medium term could help to ease the tax burden. In the longer run this set of tax measures and reforms would expand output potential by about 3 percentage points.[2]

Despite the decline in output due to the steep fall in domestic demand in recent years there are still substantial unutilized resources, as measured by the output gap, i.e. the amount by which the actual output of the economy falls short of its potential output. Italy's output gap in 2014 was -4.2 per cent according to the latest estimates of the European Commission, -4.6 per cent according to the IMF, and -6 per cent according to the OECD. However, these estimates are subject to very considerable uncertainty in the measurement of production potential, heightened by the revisions of the data themselves. Using Bayesian averaging techniques to combine the results of four alternative methods, the 2014 output gap can be put in a range from -6.7 to -4.1 per cent.[3]

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1 V. Aprigliano and A.M. Conti, 'How Financial and Sovereign Risk Shocks Shape Potential Output in Italy', in *Gli effetti della crisi sul potenziale produttivo e sulla spesa delle famiglie in Italia*, Banca d'Italia, Seminari e convegni, Workshops and Conferences, 18, 2014, pp. 69-84.

2 A. Gerali, A. Locarno, A. Notarpietro and M. Pisani, 'Every Cloud has a Silver Lining. The Sovereign Crisis and Italian Potential Output', in *Gli effetti della crisi sul potenziale produttivo e sulla spesa delle famiglie in Italia*, Banca d'Italia, Seminari e convegni, Workshops and Conferences, 18, 2014, pp. 85-123.

3 The four methods are (a) production function, (b) structural VAR, (c) unobserved components model, and (d) time-varying autoregressive model. See A. Bassanetti, M. Caivano and A. Locarno, 'Modelling Italian potential output and the output gap', Banca d'Italia, Temi di Discussione (Working Papers), 771, 2010.

6. FIRMS

Value added decreased in 2014, chiefly in the construction industry but also, to a lesser extent, in manufacturing; it stagnated in the service sector. The contraction in investment slowed during the year before coming to a halt in the last quarter; corporate investment was again held back by the outlook for demand, which although improving was still weak and uncertain, and by large margins of spare capacity. The contraction in lending was not as sharp as in 2013 and affected above all the financially weakest firms; credit supply conditions improved gradually, mainly as a result of the reduction in interest rates.

The differences between firms, already significant by international standards, continued to widen. Results were once again better for exporting firms and for the most innovative and least indebted ones, typically medium-sized and large enterprises. Italy's productive structure features a large proportion of small firms that innovate less and have high levels of debt, making them less able to compete and constraining their financial choices.

The long recession has changed the productive system, with firms that are less profitable and have poor growth potential closing down and production inputs being reallocated to more efficient units. Banks' highly selective policies have led to a reduction in firms' borrowing and a shift in their financial structure towards a higher proportion of equity. However, this shift is still hindered by an institutional environment that is not business friendly.

Economic developments

Business demographics. – The net enterprise birth rate is picking up, in line with the economy. Although it increased in 2014 for the first time in three years (by 0.6 per cent), it is still below the pre-crisis level (1.4 per cent on average in 2003-07). The improvement is the result of a decrease in the death rate from 7.1 to 6.6 per cent (6.8 per cent on average in 2003-07) and a virtually stable birth rate of 7.2 per cent. The percentage of limited companies, which are organizationally more complex and have easier access to capital markets than other business forms, continued to rise, a trend under way for more than two decades.

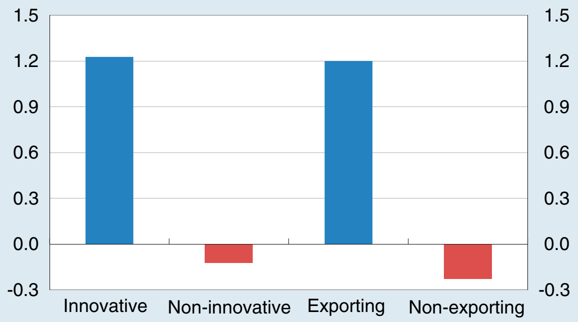
Value added and production. – As in the previous three years, the decline in value added was largest in the construction industry (-3.8 per cent), where activity was 32 per cent below the level of 2007. Supply decreased sharply in the energy sector as well. In manufacturing the contraction in value added slowed considerably overall (-0.4 per cent against -5.5 per cent in 2012-13) but there were marked differences from one sector to the other: a clear upturn in transport equipment and computers contrasted with a significant drop in electrical equipment and metals and metal products, while traditional 'made in Italy' products showed signs of improvement. From the autumn on, industrial production showed signs of recovery that persisted through the first quarter of this year.

In the service sector the decline in value added broke off during 2014, with a year-on-year gain of 0.1 per cent, against a drop of 0.8 per cent in 2013, mainly as a result of the sharp upturn in accommodation and catering services as tourist flows began to pick up, but also owing to the more modest improvement in the real-estate sector, probably in connection with the rise in the number of house sales (see Chapter 7, 'Households'). Meanwhile, value added basically stagnated in the transport industry and continued to contract in business and communication services. The performance of the latter sector reflected the persistently weak financial conditions of industrial firms, which account for the bulk of demand in Italy (as in France and Germany but unlike the United States).[1]

The survey run by the Bank of Italy's branches at the beginning of this year on 4,260 firms with 20 or more employees in non-construction industry and private non-financial services found that gross sales turnover increased by 0.3 per cent in real terms in 2014, recouping the drop recorded the year before. Performance differed considerably from firm to firm but, as in the previous three years, given the same size, sector and location, sales grew more in the case of innovative and exporting businesses (Figure 6.1).

Figure 6.1

Corporate strategies and sales turnover growth in 2014 (1)
(per cent)



Sources: Banca d'Italia, Survey of Industrial and Service Firms.
(1) Average change in sales turnover at constant prices based on firms of the same size, sector and location. (Non-)innovative firms are firms that did (not) spend on R&D in 2014; (non-)exporting firms are firms that generated more (less) than a third of total sales turnover on foreign markets in 2014.

Innovation. – Recent studies confirm that there is less innovative activity in Italy than in the other major advanced economies, especially in the private sector (see Chapter 11, *Relazione annuale sul 2012*, Banca d'Italia, 2013). The latest European survey on innovation indicates that the lag, especially marked in comparison with Germany, is more noticeable in the high-tech industries.[2] Italian firms have much less capability for in-house research and development and for cooperation with universities and other advanced training institutions. These tendencies are aggravated by the structure of Italy's productive system, such as its two-tier size structure (and large proportion of micro-enterprises), predominance of family-owned firms,[3] and financial structure

1 E. Viviano, 'The growth of the service sector and the demand for services', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

2 Eurostat, *Community Innovation Survey 2012*, 2015.

3 M. Bugamelli, L. Cannari, F. Lotti and S. Magri, 'Il gap innovativo del sistema produttivo italiano: radici e possibili rimedi', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 121, 2012.

overbalanced towards bank credit with a limited contribution of equity.[4] Moreover, Italian firms are less likely to adopt advanced technologies and tend to internationalize more by means of commercial exchanges and agreements than by foreign direct investment (see Chapter 10, 'External demand and the balance of payments'). All in all, this will affect the country's ability to recover its growth potential in the medium term.

Investment. – The decline in investment under way, with occasional interruptions, since the beginning of the economic crisis slowed in 2014 (Table 6.1) and in the last quarter of the year a slight growth was recorded. Overall, investment was down 30 per cent from 2007 and had fallen from 21.6 to 16.9 per cent of GDP. In the euro area as a whole the average contraction was about 15 per cent (7 per cent in France), while in Germany investment was almost 5 per cent higher than before the crisis.

Table 6.1

Fixed investment in Italy
(volumes at chain-linked prices unless otherwise specified; per cent)

	Per cent composition in 2014 (1) (volumes at previous year's prices)	Changes			Per cent of GDP (1) (volumes at previous year's prices)	
		2012	2013	2014	2000	2014
Construction	51.3	-9.3	-7.2	-4.9	9.8	8.7
Housing (2)	*27.1*	*-7.5*	*-6.8*	*-4.4*	*4.7*	*4.6*
Other (2)	*24.2*	*-11.2*	*-7.5*	*-5.6*	*5.1*	*4.1*
Cost of change of ownership	*3.9*	*-27.7*	*-7.0*	*-2.2*	*0.8*	*0.7*
Plant, machinery, arms and biological crops	33.4	-13.5	-5.5	-2.5	7.9	5.7
of which: *transport equipment*	*5.3*	*-28.0*	*4.7*	*-1.2*	*1.6*	*0.9*
Intellectual property	15.2	2.3	-1.7	0.3	2.5	2.6
Total gross fixed investment	**100.0**	**-9.3**	**-5.8**	**-3.3**	**20.2**	**16.9**
Total excluding housing	–	-9.9	-5.5	-3.0	15.4	12.3
Total excluding construction	–	-9.2	-4.4	-1.6	10.4	8.2

Source: Istat, national accounts.
(1) Rounding may cause discrepancies in totals. – (2) Includes costs of change of ownership.

In Italy the protracted decline in investment is due above all to the sharp contraction in current and expected demand, as well as to persistently large margins of idle capacity. Other, less important, contributory factors are tensions related to financing conditions and the uncertain outlook (see the box 'The determinants of the decline in investment').

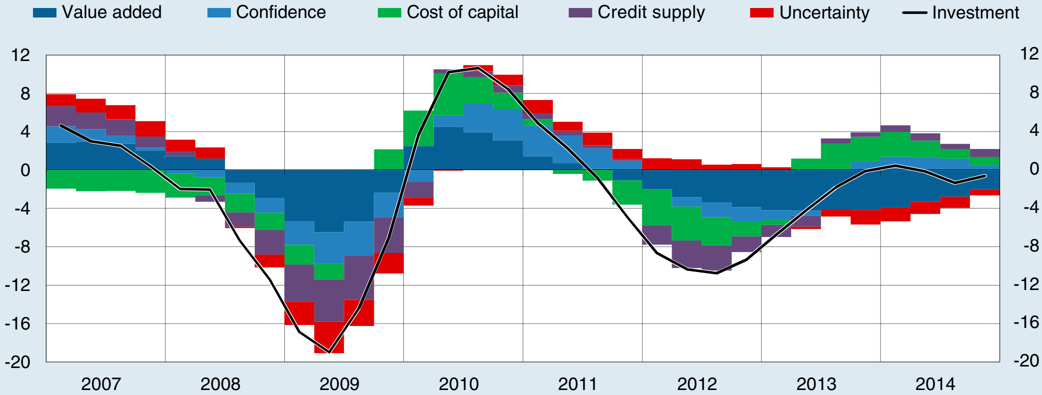
4 S. De Mitri, A. De Socio, P. Finaldi Russo and V. Nigro, 'Le microimprese in Italia: una prima analisi delle condizioni economiche e finanziarie', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 162, 2013.

THE DETERMINANTS OF THE DECLINE IN INVESTMENT

The sharp reduction in private sector investment in Italy during the financial crisis has been analysed at the aggregate[1] and corporate[2] level, linking investment decisions to demand conditions, firms uncertainty about the economic outlook, the user cost of capital (which depends on the level of real interest rates), and the restrictions on credit supply measured by the surveys.

Determinants of private sector investment, excluding construction

(quarterly data; percentage changes on year-earlier period and contributions)



Sources: Based on Bank of Italy and Istat data.

The figure reconstructs the contribution of the different components based on the aggregate model. Financial tensions aggravated the decline in capital goods accumulation at the start of both recessions. In recent months, persistently weak demand, proxied by value added and business confidence, is the main impediment to investment growth. Changes in the user cost of capital had a negative effect from the start of the sovereign debt crisis in summer 2011 but a positive one (amounting to almost 4 percentage points) over the last two years, owing to expansionary monetary policy measures. The constraints of credit supply account for about one third of the reduction in investment at the height of the crises in 2008-09 and 2012-13. However, their impact gradually faded as the financial markets returned to normal and the sovereign debt strains eased. In the present phase, capital accumulation is being held down by the still poor outlook for demand, despite some improvement, and remaining uncertainty about future economic developments. This uncertainty weighed down on investment in both recessions.

Company-level data, which offer an insight into differences in the behaviour of manufacturing firms, confirm that investment (as a ratio to the stock of capital) was lower, other conditions being equal, in the firms that found it harder to access credit and in those whose demand expectations were worse. The drop in firms' projected sales turnover, which was particularly sharp in 2009 and was only partly recouped in the following years, is the main driver of the reduction in the investment rate since

[1] F. Busetti, C. Giordano and G. Zevi, 'Main drivers of the recent decline in Italy's non-construction investment', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

[2] S. Bond, G. Rodano and N. Serrano-Velarde, 'Investment dynamics in Italy: financing constraints, demand and uncertainty', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

the beginning of the crisis. The increase in the share of firms experiencing difficulties accessing credit (from 2 per cent on average in 2003-07 to 10 per cent in 2008-13) took 0.3 percentage points off the overall investment rate, in line with previous findings.[3]

[3] F. Cingano, F. Manaresi and E. Sette, 'Does credit crunch investments down? New evidence on the real effects of the bank-lending channel', *Mo.Fi.R. Working Papers*, 91, 2013; E. Gaiotti, 'Credit availability and investment: lessons from the "Great Recession"', *European Economic Review*, 59, 2013, pp. 212-227.

Investment fell particularly sharply in the construction industry, especially the non-residential branch. The trend had already been under way before the financial crisis and worsened with the sovereign debt crisis, subtracting 3.1 percentage points from overall output growth since 2007; the prolonged reduction in spending on public works was a contributory factor. According to the survey of 566 construction firms conducted by the Bank of Italy's branches at the beginning of this year, the decline came almost to a halt last year and investment should be basically stationary this year as well.

The reduction in expenditure on machinery, equipment and transport equipment, which has eased considerably in the last two years, was particularly pronounced in private non-financial services, accounting for over half of the decrease in the rate of accumulation of these goods in the economy as a whole since the onset of the crisis. The negative contribution of industry was significantly smaller, even though the sector invests just under 50 per cent of the total, 14 percentage points more than in France or Germany.

Investment in intellectual property, which under the new ESA 2010 accounting standards includes spending on R&D, picked up slowly. Last year, 15 per cent of total capital accumulation related to intellectual property, about 4 percentage points higher than in 2007; this was due to a rise in expenditure in industry that limited the reduction in the economy as a whole to 1.4 per cent. The percentage was nonetheless lower than in Germany or France (by 3 and 9 percentage points respectively), where investment in intellectual property has risen by 14 and 24 per cent overall since the start of the recession.

According to the Bank of Italy's Survey of Industrial and Service Firms, last year the decrease in investment concerned mainly private non-financial services, especially firms with more than 200 employees (Table 6.2). In the non-construction industry it also affected only the largest firms (those with at least 500 employees), which had substantially increased their investment in 2013. In both sectors, small and medium-sized firms invested more than initially planned, mainly owing to unexpected changes in demand and reorganization.

Firms plan to step up investment in 2015, for the first time since the start of the sovereign debt crisis, to about the same extent in both industry and services. The planned increase is concentrated among large firms – half of it relating to investment projects by some ten major corporations – and should be especially marked among those reporting better expectations for sales turnover. Interviews with some business owners conducted by the Bank of Italy's branches indicate that investment is being buoyed by the improved macroeconomic outlook following the upturn in export demand and by highly expansionary monetary policy. In manufacturing a further contribution comes from the gradual recovery in capacity utilization, which had contracted sharply during the slump; firms project it will reach 76.6 per cent in 2015, against an average of 79.8 per cent in 2005-07.

Table 6.2

Gross fixed investment of firms according to Bank of Italy surveys
(percentage changes at 2014 prices unless otherwise specified) (1)

	Total	Number of employees				Capacity utilization (2) (3)		Change in sales turnover (2)	
		20 to 49	50 to 199	200 to 499	500 & over	low	high	low	high
Non-construction industry									
of which: manufacturing									
2014 outturn	*1.5*	*7.7*	*14.1*	*5.0*	*-8.1*	*-2.5*	*4.1*	*1.4*	*1.6*
realization rate (4)	*102.8*	*113.3*	*112.1*	*100.5*	*94.5*	*102.0*	*103.3*	*101.6*	*104.2*
2015 plan	*4.0*	*-7.4*	*-0.7*	*1.0*	*14.3*	*8.9*	*1.3*	*-2.5*	*9.4*
Outturn for 2014	0.9	7.5	10.9	1.4	-5.3	-1.5	3.0	0.0	2.1
Realization rate (4)	101.3	112.8	107.9	97.8	96.1	100.7	101.7	99.8	103.3
Planned investment for 2015	5.0	-6.0	1.0	2.3	12.1	7.4	4.1	1.9	9.3
Service sector (5)									
Outturn for 2014	-1.6	1.3	0.3	-3.6	-2.8	….	….	-4.0	0.9
Realization rate (4)	98.5	116.7	101.1	95.6	93.4	….	….	94.2	103.4
Planned investment for 2015	5.7	-3.8	3.4	-3.9	13.2	….	….	8.1	4.3
Total									
Outturn for 2014	-0.4	3.8	6.0	-1.0	-4.0	-1.5	3.0	-1.9	1.4
Planned investment for 2015	5.3	-4.8	2.0	-0.4	12.7	7.4	4.1	4.3	6.3

Source: Banca d'Italia, Survey of Industrial and Service Firms.
(1) Winsorized robust means of distributions of annual changes in investment. Investment is deflated using the individual deflators provided by the firms. – (2) Firms are divided according to whether they fall below (low) or above (high) the median, calculated separately for industry and services, relating to 2014 for the outturn and realization rate and relating to projections for 2015 for planned investment. – (3) Industrial firms only. – (4) Percentage ratio, at current prices, of realized investment to planned investment (recorded in last year's survey) for 2014. – (5) Private non-financial services.

Labour demand. – After declining for two years, labour utilization began to edge up. According to national accounts figures, total hours worked by payroll employees in the non-farm private sector rose by 0.3 per cent (see Chapter 8, 'The labour market'). The improvement varied from one branch to another and was generally associated with a shift towards more skill-intensive technologies and concentrated among the largest firms, which had seen a particularly sharp drop in hours worked in previous years.

The total labour demand of small firms is less subject to cyclical fluctuations as this group includes almost all new businesses, which grow faster than average during recessions but more slowly during expansions. In the medium term new businesses provide strong support for the growth of total employment: from 1991 to 2007 firms up to three years old created more than 50 per cent of new jobs while accounting for just 15 per cent of job destruction and the reduction in total employment.

However, new businesses have more difficulty growing in Italy than in the United States, limiting their potential favourable impact on employment. There is evidence that Italian firms are born smaller and grow more slowly and for less time, two years on average instead of ten.[5] This is probably due to a less business-friendly environment (see Chapter 12, 'The regulation of business activity and the institutional context').

Productivity. – As a result of the gap between the recovery in labour demand and the further decrease in value added, hourly productivity fell by 0.5 per cent in 2014, more sharply in manufacturing than in services. Last year's contraction was chiefly cyclical in nature, like the one recorded earlier during the recession. Signs of an upturn in productivity sustained by reallocation among firms had nonetheless emerged before the onset of the global crisis, albeit only in the manufacturing sector; the tendency was halted by the double-dip recession.

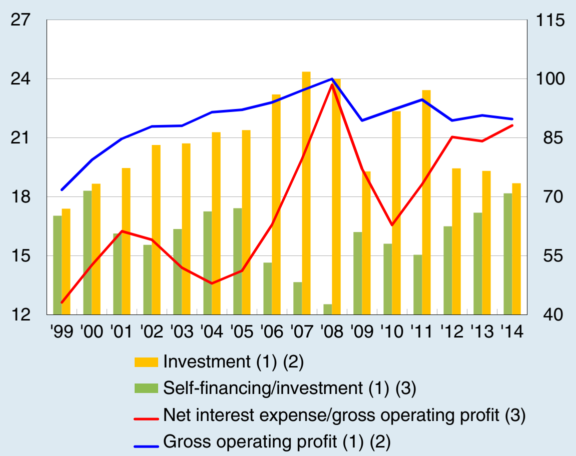
In the longer term, hourly productivity growth will remain slow, particularly in comparison with the other leading European countries. Manufacturing productivity gained 1.1 per cent per year in 2000-07 in Italy, against just under 4 per cent in France and Germany; between 2008 and 2014 the rate slowed to 0.6 per cent, compared with 1.6 per cent in France and 0.5 per cent in Germany. The figures indicate that the reallocation of resources towards more efficient firms, which provides the main support for productivity growth in most of the advanced economies, is less effective in Italy, partly because the legal and institutional order is less favourable to large-scale business activity.[6]

Competitiveness on the financial markets and in lending too can contribute to productivity growth. A recent study, focusing on the period 1996-2007, of the provinces where intervention by the authorities has improved the banking system's competitiveness has found, other circumstances being equal, a higher company birth rate, a higher five-year new business survival rate, and greater downsizing of existing small firms. In the same provinces, the workforce tends to be allocated more towards the most productive firms.[7]

Profitability and financial balance. – The gross operating profit of non-financial corporations

Figure 6.2

Profitability and coverage of investment
(per cent; indices)



Source: Based on Istat data.
(1) Right-hand scale. – (2) Indices, 2008=100. – (3) Net interest expense and self-financing are estimated on the basis of the national economic accounts of the non-financial corporations sector, 1995-2014.

5 F. Manaresi, 'Net employment growth by firm size and age in Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

6 D. Andrews and F. Cingano, 'Public policy and resource allocation: evidence from firms in OECD countries', *Economic Policy*, 29, 78, 2014, pp. 253-296; CompNet Task Force, 'Micro-based evidence of EU competitiveness. The CompNet database', ECB Working Papers Series, 1634, 2014.

7 F. Lotti and F. Manaresi, 'Finance and creative destruction: evidence for Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

decreased slightly in 2014, and is still 10 per cent lower than at the start of the crisis (Figure 6.2). Net interest expense continued to absorb a large part of operating income (21.6 per cent in 2014). According to the Survey of Industrial and Service Firms, the dispersion of individual economic results was still marked: among firms with at least 50 employees 67 per cent showed a profit, about 8 percentage points more than among small firms (9 points in 2013). A similar gap exists between exporting firms and those selling mainly to the domestic market.

Given the still very low level of investment, firms increasingly tapped internal resources for their requirements. Consequently, their financial balance, which had turned slightly positive in 2013 for the first time in fifteen years, further improved to 0.9 per cent of GDP. As a result of these tendencies liquidity increased by €12 billion (€15 billion in 2013; Table 6.3) and was particularly abundant among large firms.

Table 6.3

Financial assets and liabilities of firms (1)
(millions of euros and per cent)

	End-of-period stocks			Flows	
	2014	Percentage composition		2013	2014
		2013	2014		
ASSETS					
Cash and deposits	292,245	17.6	18.2	14,513	11,588
Securities	66,789	4.1	4.2	-5,531	123
of which: Italian public sector	*54,793*	*3.0*	*3.4*	*-4,750*	*4,515*
Shares and other equity	541,299	33.2	33.7	-3,024	19,826
Trade receivables	565,744	36.4	35.2	-38,333	-6,132
Other assets (2)	141,710	8.8	8.8	1,339	2,159
Total assets	**1,607,787**	**100.0**	**100.0**	**-31,036**	**27,564**
of which: external	*464,365*	*27.2*	*28.9*	*16,817*	*15,336*
LIABILITIES					
Financial debt	1,264,220	36.7	36.4	-31,388	-7,732
Bank loans	807,970	23.1	23.3	-44,374	-6,717
Other loans (3)	300,013	9.4	8.6	-9,770	-5,656
Securities	156,237	4.2	4.5	22,756	4,641
Shares and other equity	1,524,721	43.6	43.9	33,918	10,332
Trade payables	503,637	14.6	14.5	-28,576	-1,623
Other liabilities (4)	180,431	5.2	5.2	534	2,874
Total liabilities	**3,473,009**	**100.0**	**100.0**	**-25,511**	**3,851**
of which: external	*529,252*	*14.8*	*15.2*	*39,930*	*14,809*
BALANCE	**-1,865,222**			**-5,525**	**23,714**

Source: Bank of Italy, financial accounts.
(1) The data refer to the non-financial corporations sector. Rounding may cause discrepancies in totals. – (2) Short-term foreign claims, intra-group claims, insurance technical provisions, domestic derivatives and other minor items. – (3) Includes finance provided by leasing and factoring companies, intra-group loans and securitized loans. – (4) Postal current accounts, severance pay and pension provisions, domestic derivatives and other minor items.

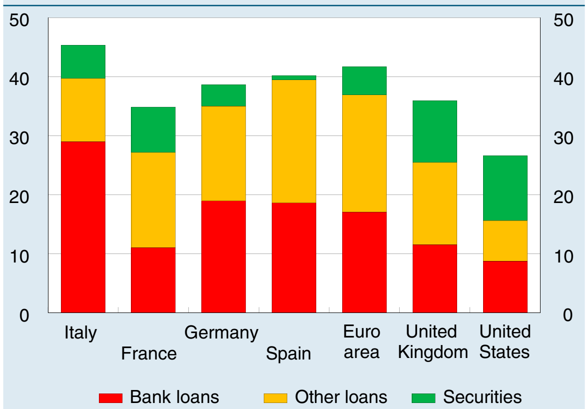
Financial developments

Debt. – Firms' financial debt decreased by further €8 billion (Table 6.3) in 2014, to 78 per cent of GDP. The last three years have seen major changes in firms' balance sheet structure. In this period leverage declined by about 4 percentage points, to

45.3 per cent, partly as a result of new equity inflows (see *Financial Stability Report*, 1, 2015). There were also significant changes in firms' financial debt: loans decreased by over €84 billion and there were substantial net bond issues of €41 billion. Although by international standards Italian firms' financial structure is more balanced, they still make less use of equity capital and rely more heavily on bank loans; the share of bonds is now in line with the euro-area average (Figure 6.3).

Figure 6.3

Leverage and composition of financial debt in 2014 (1)
(per cent)



Sources: Bank of Italy, ECB, Federal Reserve System – Board of Governors.
(1) Leverage is the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices.

Credit. – Credit granted to Italian firms by banks and financial companies continued to contract, albeit less sharply, in 2014 and again in early 2015, recording a twelve-month rate of decline of 1.8 per cent in March this year (Table 6.4). The fall was most pronounced in construction and real-estate services, mainly reflecting weak productive activity. The Survey of Industrial and Service Firms reports a decrease in the

Table 6.4

Lending to firms (1)
(end-of-period data; per cent)

	12-month percentage changes				Percentage composition
	2012	2013	2014	March 2015	March 2015
			Banks		
Branch of economic activity					
Manufacturing	-5.9	-6.1	-0.9	-0.6	21.6
Construction	-2.4	-4.5	-4.6	-4.2	15.6
Services	-2.4	-6.8	-2.4	-1.8	33.0
Real estate	-1.1	-3.2	-3.4	-2.5	11.8
Other	1.1	-5.1	3.0	-0.1	9.2
Size of firm					
Small (2)	-2.9	-3.9	-2.4	-2.5	17.3
Medium-sized and large	-2.0	-5.3	-1.9	-1.7	73.9
Total	**-2.2**	**-5.1**	**-2.0**	**-1.8**	**91.2**
			Financial companies		
Leasing	-2.6	-4.2	-3.8	-3.4	6.2
Factoring	3.9	-6.2	-4.1	4.8	1.8
Other	-9.4	4.4	2.1	3.8	0.8
Total	**-1.5**	**-4.2**	**-3.6**	**-1.1**	**8.8**
			Banks and financial companies		
Total	**-2.1**	**-5.0**	**-2.3**	**-1.8**	**100.0**

Sources: Supervisory reports.
(1) The data refer to non-financial corporations and producer households. Loans include repos and bad debts. The data for financial companies refer to intermediaries under Article 107 of the Consolidated Law on Banking. The data for March 2015 are provisional. – (2) Limited partnerships, general partnerships, informal partnerships, de facto companies and sole proprietorships with less than 20 workers.

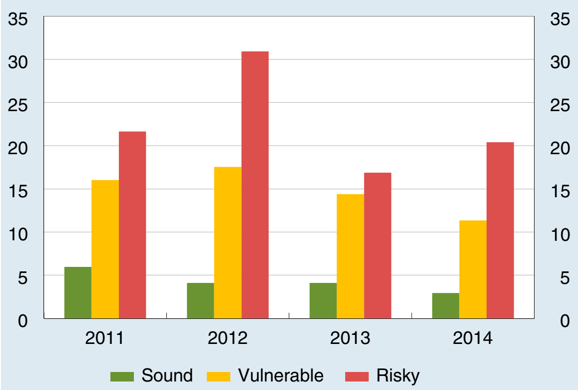
demand for credit, largely in connection with investment dynamics: the balance between the share of firms that increased their demand for credit and the share that reduced it narrowed in the second half of 2014 to 10 percentage points, one of the lowest levels since the start of the crisis.

Credit supply conditions gradually improved. After holding stable for two years, from February 2014 interest rates on new loans decreased by 120 basis points, to 2.3 per cent in March this year, reflecting the expansionary measures taken by the Eurosystem (see Chapter 4, 'Monetary policy in the euro area'). The decrease was larger for Italian firms, with the spread vis-à-vis German and French rates reduced to less than half the peak level recorded two years before.

The easing of lending standards during the year had different effects on firms. Data for a broad sample of limited companies show widely divergent trends in credit dynamics, with a still sharp contraction in the case of economically weaker and poorly capitalized firms but barely negative in the case of sounder businesses (see *Financial Stability Report*, 1, 2015). According to the Survey of Industrial and Service Firms, the share of firms reporting that they had not obtained some or all of the credit requested fell slightly but was still twice as high as in the five years before the crisis (8 against 4 per cent). The share of firms subject to credit rationing fell to 3 per cent for the sounder ones but rose to 20 per cent for those with a less well balanced financial situation (Figure 6.4). From 2011 to 2014 firms' leverage was the main impediment to banks' accepting new loan applications; difficulties in accessing credit were also greater among the less liquid firms. Furthermore, balance sheet conditions continued to affect the cost of credit: the spread between the median interest rates charged to the weakest and the soundest firms was again around 200 basis points.

Figure 6.4

Firms' access to credit by degree of riskiness (1)
(per cent)



Sources: Banca d'Italia, Survey of Industrial and Service Firms, and Cerved data.
(1) Percentage of firms reporting that they had received none or only some of the credit requested.

Despite lower interest rates, firms are still financially weak, as the ratio of new bad debts to outstanding loans in the first quarter of 2015 confirms (3.9 per cent). Accordingly, the measures taken to diminish the risk exposure of banks and increase borrowing opportunities for firms with good economic prospects appear particularly important (see the box 'Main financial support measures for firms').

MAIN FINANCIAL SUPPORT MEASURES FOR FIRMS

The productive system's financing and liquidity requirements continue to be served by a number of policy measures introduced or reinforced in the course of the crisis.[1] From 2009 to 2014, the financial resources provided to SMEs through the Guarantee Fund and Cassa depositi e prestiti (CDP) and by means of the partial suspension of loan repayments amounted to over €90 billion, equal to just under 10 per cent of disbursements of bank loans below €1 million.

Public loan guarantee schemes, which reduce the impact of firms' riskiness on bank balance sheets, play an especially important role in facilitating access to credit.[2] Italy's Guarantee Fund continued to be the main means of support for the financing of small firms in 2014, with the volume of loans activated since 2009 reaching €54 billion. It has been gradually strengthened, partly by increasing its endowment and partly by extending eligibility to additional categories of potential beneficiary. The requirements for obtaining a guarantee, calibrated to the firm's capitalization, profitability and liquidity, are designed to limit access to firms that do not present particular financial imbalances.

Over the last few years, CDP has broadened its operations to include measures in support of the economy, mainly indirectly by granting the banking system funds that are earmarked for financing firms. The participating banks retain full responsibility for selecting eligible borrowers and deciding lending terms. In recent years, CDP has gradually diversified the purposes of the funding and the beneficiary firms. Up to December last year the amount of finance allocated to SMEs totalled more than €15 billion, just over €1 billion of which under a new facility designed to help renew capital goods.

Several agreements on debt moratoria have been signed in recent years to ease temporary financial tensions. Since 2009 these measures have left €24 billion at the disposal of firms, two thirds of which in the first two years of operation. According to the survey conducted by the Bank of Italy's regional branches, from 2009 to 2014 regular repayment resumed on about half of the loans with instalments in arrears at the start of the moratorium. The impact of the measure has been reduced by the gradual introduction of more stringent eligibility requirements. A new agreement signed in March 2015 introduces some changes to the way the moratorium works, potentially increasing the cost for some firms: in fact, banks can apply an interest rate up to 75 basis points higher than the one stipulated in the original contract for loans with repayment difficulties that are not covered by the Guarantee Fund.

[1] L. Bartiloro, L. Carpinelli, P. Finaldi Russo and S. Pastorelli. 'L'accesso al credito in tempo di crisi: le misure di sostegno a imprese e famiglie', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 111, 2012.

[2] Public guarantee schemes have become popular worldwide in response to the financial tensions of recent years; OECD, *Financing SMEs and Entrepreneurs 2013. An OECD Scoreboard*, OECD Publishing, 2013.

Bonds. – Bond issuance was again substantial, given the favourable market conditions. Although gross issuance, including that of foreign subsidiaries, was lower than in 2013, it still amounted to €28 billion; a further €14 billion worth of securities was placed in the first quarter of this year. Access to the market has broadened, as confirmed by the rise in the number of issuers, particularly first-time issuers, which reached the highest levels of the past five years (152 and 97 respectively). Funding increased among small firms, which took advantage of the new rules on issues by unlisted firms (minibonds).

Equity. – Non-financial corporations took further steps to strengthen capital, with net inflows amounting to €10 billion, against €34 billion in 2013 (Table 6.3). According to balance sheet data for 2012-13 it was mainly the most profitable firms that increased capital, by reducing dividends. Additional equity capital was raised through IPOs, the number of which jumped to 23 in 2014, compared with an average of 7 in 2008-13, a trend that continued to gain impetus in the first quarter of this year. Most of the IPOs were made on the Alternative Investment Market, which has simplified listing procedures.

According to data published by the Italian Private Equity and Venture Capital Association (AIFI), investment by private equity firms was about the same as in 2013 (€3.5 billion) but involved fewer businesses (311 compared with 368). Financing of start-ups, mainly in high-tech sectors, diminished and the already wide gap with respect to the other leading countries widened further.

The allowance for corporate equity (ACE) introduced in 2011 is designed to foster firms' capitalization. Strengthening the measure by progressively increasing the rate for deductions of capital increases from taxable income, which was set at the end of 2013, should virtually eliminate the fiscal advantage of debt over equity.[8] Decree Law 91/2014, converted into Law 116/2014, further raised the allowance for a three-year period, subject to the approval of the European Commission, for firms listed on regulated markets or multilateral trading facilities. The law also offers a credit against the company's IRAP tax liability if the allowance cannot be used in full because of insufficient taxable income. According to the Survey of Industrial and Service Firms the ACE measure allowance benefited more than 10 per cent of the firms that decided to increase their equity capital in the period 2012-14; the percentage was even higher among large firms.

[8] Istat, *Rapporto annuale 2014. La situazione del Paese*, 2014.

7. HOUSEHOLDS

Consumer spending increased slightly on average last year for the first time since 2010, but it was still about 8 per cent below the 2007 level. Most of the increase was in purchases of durable goods, which were hardest hit by the double-dip recession as households reviewed their consumption patterns.

The decline in purchasing power ceased, thanks to the marginal improvement in labour market conditions and government transfers, as well as the fall in inflation. The ratio of wealth to disposable income stabilized, mainly because of the increase in the value of financial assets. The Bank of Italy's Survey of Household Income and Wealth for 2014 indicates that about 90 per cent of the tax credit for payroll workers with average to low earnings was spent, and the proportion of households reporting difficulty making ends meet decreased slightly. According to Istat's surveys, however, since 2007 the number of people living below the absolute poverty line has more than doubled, reaching 10 per cent in 2013.

Although the property market was still weak, the first signs of a recovery in sales appeared, with an increase in new mortgage loans after three years of sharp contraction.

Income and income distribution

Disposable income rose by 0.2 per cent at current prices; it was unchanged in real terms owing to the sharp reduction in inflation (Table 7.1; see Chapter 9, 'Prices, costs and competitiveness'). The rise in employees' income was almost entirely offset by the fall in that of self-employed workers (see Chapter 8 'The labour market'). Property income turned downwards again, especially rental and net interest income. General government supported households overall by increasing social benefits and making transfer payments. Starting in May, employees with gross annual income of between €8,000 and €26,000 began to benefit from the tax credit introduced by Decree Law 66/2014, which according to government estimates entailed a transfer of almost €7 billion, equal to 0.6 per cent of households' disposable income.

The tax credit raised the median net compensation of employees and slightly lowered the proportion of low-income workers,[1] which has risen considerably since 2008, owing among other things to the spread of involuntary part-time working (Figure 7.1.a; see last year's *Annual Report*). According to the preliminary findings of the Bank of Italy's Survey of Household Income and Wealth, some 5.5 million

[1] Those earning less than two-thirds of the median full-time salary.

Table 7.1

Gross disposable income and the propensity to save (1)
(at current prices, unless otherwise indicated)

	% of households' gross disposable income in 2014	2012	2013	2014
		Percentage changes		
Income from payroll employment	60.4	-1.1	-1.1	1.0
Income from payroll employment per standard labour unit	–	*0.6*	*0.8*	*0.6*
Income from self-employment (2)	25.9	-3.5	-0.5	-1.9
Income from self-employment per standard labour unit	–	*-2.8*	*1.2*	*-2.0*
Net property income (3)	22.3	-3.4	0.5	-2.6
Social benefits and other net transfers	32.9	2.2	2.1	3.2
of which: net social benefits	–	*1.8*	*2.2*	*2.7*
Net social security contributions (-)	23.0	-0.1	-0.7	0.7
of which: by employers	–	*-1.7*	*-1.2*	*0.5*
Current taxes on income and wealth (-)	18.5	5.0	-0.7	0.9
Gross disposable income	**100.0**	**-2.6**	**0.2**	**0.2**
in real terms (4)	–	-5.1	-0.9	..
in real terms, adjusted for expected inflation (4) (5)	–	-4.8	0.3	1.4
in real terms, adjusted for past inflation (4) (6)	–	-3.8	0.7	0.6
		Gross disposable income		
Average propensity to save (7)	**–**	**6.6**	**8.4**	**8.1**
calculated on income adjusted for expected inflation	–	3.8	6.8	7.8
calculated on income adjusted for past inflation	–	4.4	7.7	8.0

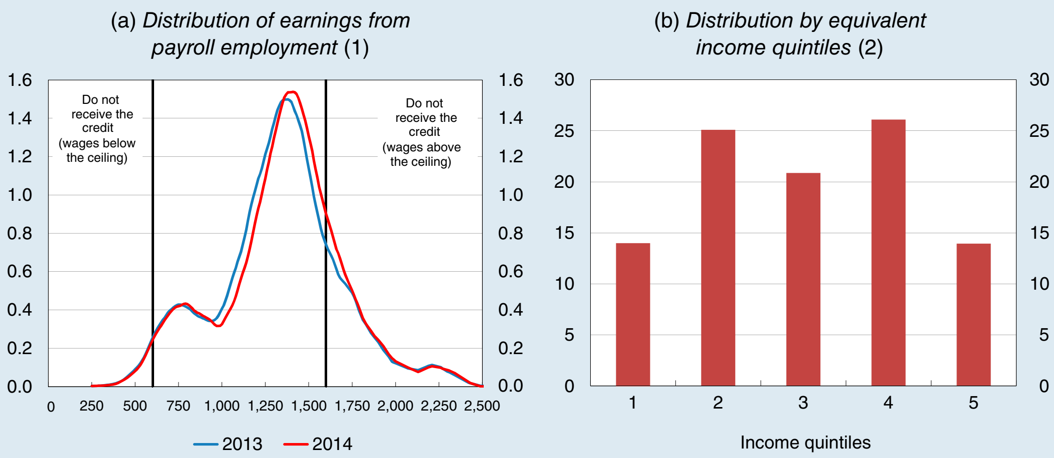
Sources: Calculations and estimates based on Istat and Bank of Italy data.
(1) Data refer to resident households and non-profit institutions serving households. – (2) Mixed income and income withdrawn by members of quasi-corporations. – (3) Gross operating profit (mainly rental income), net rents from land and intangible assets, actual net interest, dividends and other profits distributed by companies. – (4) Deflated using the resident household consumption deflator. – (5) Gross disposable income net of expected losses on net financial assets due to inflation (estimated on the basis of the Consensus Economics survey). – (6) Gross disposable income net of losses on net financial assets due to inflation calculated ex-post. – (7) Ratio of saving (gross of depreciation and net of changes in pension fund reserves) to gross disposable income.

households (a quarter of the total) benefited from the credit. Since many of the eligible workers belong to households that have other sources of income, the households in the bottom quintile of the distribution of equivalent income got less than 15 per cent of the total, and even some households in the top quintile obtained the credit (Figure 7.1.b). Resources specifically allocated to combating absolute poverty,[2] which affected around 10 per cent of the population in 2013 (4.1 per cent in 2007), were limited (an estimated €300 million in 2014 for the 'Social Card' and the experimentation of the 'Support for active inclusion' plan).

[2] Defined as households with insufficient resources to acquire essential goods and services.

Figure 7.1

Tax credit: effect on wages and distribution by equivalent income quintiles
(density and per cent)



Sources: Based on data from Istat labour force survey and Bank of Italy, Survey of Household Income and Wealth.
(1) Distribution of monthly wages of payroll workers, density estimated using the Kernel method, values on the vertical axis are multiplied by 1,000. Data refer to the second half of 2013 and of 2014. Sample of permanent payroll workers already employed in 2013; to eliminate composition effects, the distribution for 2014 is estimated holding constant the socio-demographic characteristics of workers (gender, age, educational qualification, geographical area, working hours). – (2) Provisional data for over 60 per cent of the sample. For each quintile of equivalent income, the height of the bar represents the share of the total transfer received by households. Amounts declared by the respondents.

Consumption

Italian households' consumption expenditure increased modestly over 2014 as a whole, the first gain since 2010 (Table 7.2), as the upturn that began in the summer of 2013 continued. The loss of purchasing power and the contraction in wealth halted. The recovery of consumption came as the propensity to save declined slightly and confidence improved.

Table 7.2

Households' expenditure
(chain-linked prices, unless otherwise indicated; percentage changes)

	% in 2014 (volumes at previous year prices)	2011	2012	2013	2014
Non-durable goods	32.0	-0.8	-4.4	-3.5	-0.6
of which: food and non-alcoholic beverages	*14.3*	*-0.8*	*-4.0*	*-3.4*	*0.1*
Semi-durable goods	9.1	2.2	-9.0	-4.8	-0.2
of which: clothing and footwear	*6.1*	*2.8*	*-7.9*	*-4.8*	*0.2*
Durable goods	6.5	-5.4	-10.6	-6.4	3.2
Services	52.4	1.2	-1.3	-1.4	0.7
of which: hotels and restaurants	*9.6*	*0.8*	*-1.0*	*-2.2*	*0.3*
education	*1.0*	*0.2*	*-1.6*	*-2.6*	*1.3*
Total domestic expenditure	**100.0**	**0.1**	**-3.8**	**-2.7**	**0.3**
Spending abroad by Italian residents	(1)	-2.3	-6.1	-1.3	7.2
Spending in Italy by non-residents	(1)	2.7	0.8	1.8	3.5
Total national expenditure	**–**	**..**	**-3.9**	**-2.9**	**0.3**
Memo:					
National consumption deflator	–	2.9	2.7	1.1	0.2

Source: Istat, National Accounts.
(1) Spending abroad by Italian residents and that in Italy by non-residents came to 1.7 per cent and 3.5 per cent respectively.

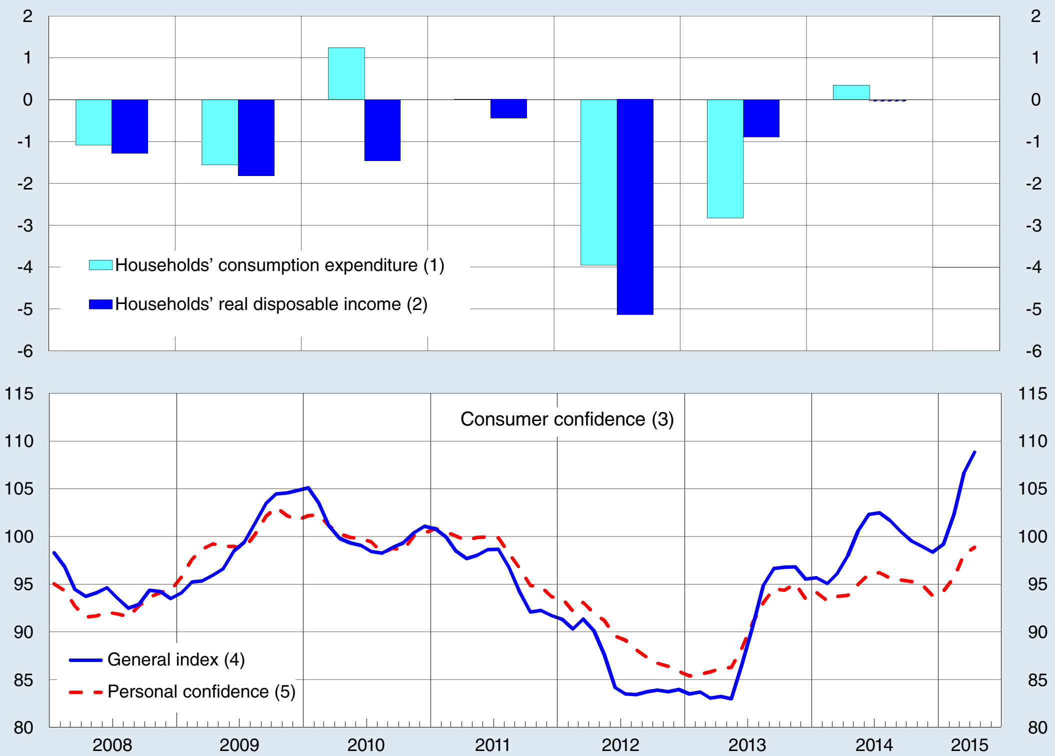
Spending on durable goods rose sharply, after falling more than 20 per cent between 2011 and 2013. New car registrations increased by around 4 per cent, growing for the first time in six years, but purchases of consumer durables for the home, such as furniture and household appliances, continued to decline, affected by the weakness of the property sector (see the section 'The housing market and borrowing'). Spending to meet basic needs, such as on healthcare and foodstuffs, began to expand again.

The gain in consumption ended the substantial contraction registered in the course of the double-dip recession (Figure 7.2), associated with a marked decline in disposable income and a shift in spending patterns (see the box 'The recession and household consumption'). Following the losses incurred during the most acute phases of the crisis, total wealth stabilized at almost eight times disposable income. Against this background the saving rate, which rose sharply in 2013, fell slightly to 8.1 per cent (Table 7.1); when expectations of less inflation-induced erosion of financial asset values are taken into account, however, the propensity to save actually increased. The preliminary results of the Bank of Italy's Survey of Household Income and Wealth indicate that about 90 per cent of the tax credit for payroll workers was spent, comparable to the

Figure 7.2

Consumption, real income and consumer confidence

(growth rates and indices)



Source: Based on Istat data.
(1) Consumption expenditure of households and non-profit institutions serving households; chain-linked volumes; percentage changes on the previous year. – (2) Real disposable income of households and non-profit institutions serving households, deflated using the consumption expenditure deflator for resident households. – (3) Indices, 2010=100; seasonally adjusted data; moving averages for the three months ending in the reference month. – (4) Obtained by calculating the balances between the percentages of replies indicating a situation that is improving or worsening in response to questions on: the general economic situation in (a) the past 12 months and (b) over the next 12 months; the respondents' personal economic situation in (c) the past 12 months and (d) over the next 12 months; the advisability of durable goods purchases (e); expected unemployment (f); the possibility (g) and advisability (h) of saving; households' financial situation (i). – (5) Average of the balances between the percentages of replies to (c), (d), (e), (g), (h) and (i).

average propensity to consume. The survey also found that a slightly smaller share of households reported difficulty making ends meet.[3]

THE RECESSION AND HOUSEHOLD CONSUMPTION

In the course of the recent double-dip recession Italian households significantly reduced their overall consumption, which is now around 8 per cent below the 2007 level; they also shifted their spending towards primary goods and services.[1] An increasing share of total expenditure went towards rent, services for the home and – for the youngest households only – food products, while the portion allocated to 'reducible' consumption items (transport, clothing and footwear, furniture and household appliances) decreased. Spending on non-essential items (accommodation and restaurants) increased only for the most affluent.

Aside from the sharp drop in income, the variation in the consumer basket reflected the contraction of household wealth.[2] Taking into account the changes in the relative prices of goods included in the household consumption basket, there is evidence that when income shrinks a larger share of total expenditure serves to satisfy basic needs that are not easily 'reduced' in the short term (such as rent).[3] Our estimates also show that one-off pay increments as a result of collective bargaining lead to increased spending only on clothing and footwear.[4]

The recovery in disposable income expected in the next few years could accordingly entail a reallocation of spending along the lines that prevailed before the recession. Looking ahead, household consumption should also benefit from the low prices of crude oil. According to our simulations, if the prices of oil products stabilize at the levels of December 2014, households stand to make fuel savings of €2.1 billion over the year as whole (80 euros per household); the poorest households would benefit less (see the box, 'The drop in oil prices and the structure of the energy sector').[5]

[1] C. Rondinelli, A. Bassanetti and E. Scoccianti, 'On the structure of Italian households' consumption patterns during the recent crises', in *Gli effetti della crisi sul potenziale produttivo e sulla spesa delle famiglie in Italia*, Banca d'Italia, Seminari e convegni, Workshops and Conferences, 18, 2014, pp. 124-157.

[2] M. L. Rodano and C. Rondinelli, 'The Italian household consumption: a comparison among recessions', in *Gli effetti della crisi sul potenziale produttivo e sulla spesa delle famiglie in Italia*, Banca d'Italia, Seminari e convegni, Workshops and Conferences, 18, 2014, pp. 158-185. See also the box 'Household consumption in recent recessions', in *Economic Bulletin*, 2, 2015.

[3] C. Rondinelli, 'Estimating demand elasticities in the recent crises', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

[4] E. Adamopoulou and R. Zizza, 'Accessorizing: the effect of union contract renewals on consumption', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

[5] I. Faiella and A. Mistretta, 'The impact of lower oil prices on energy expenditure and economic activity', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 279, 2015.

In line with the increase in spending, new consumer loans rose by 3.5 per cent following six years of contraction. Consequently, the stock of loans declined at a slower pace (see Table 7.5), in particular that of earmarked loans, which were fuelled by the upturn in durable goods purchases; another contributory factor was the end of a long phase of progressive tightening of lending standards.

[3] Share of households that responded 'with great difficulty' or 'with difficulty' to the question 'Is your household's income sufficient to see you through to the end of the month?'

In the first four months of 2015 the signs of recovery strengthened. Confidence improved further, especially concerning the future and the general economic situation, returning to levels close to those observed at the turn of the century; new car registrations were up by around 20 per cent from the all-time lows of the first four months of 2013. In the first quarter of 2015 new consumer loans expanded by 2.6 per cent compared with the first quarter of 2014.

Financial savings and wealth

Last year's decline in household saving was accompanied by reduced investment in real assets and increasing financial investment. Consumer and producer households' gross financial wealth increased, mainly as a result of the rise in the prices of financial assets; it remained at 3.6 times disposable income, above the euro-area average and below the levels of the United Kingdom and United States (Table 7.3). Real-estate wealth, by contrast, continued to decline, suffering from the drop in house prices. The ratio of net household wealth to disposable income was basically stable, in part owing to the reduction in household debt.

Investment in financial assets. – In 2014 net purchases of financial assets increased (Table 7.4). Net investment in financial assets reached 2.9 per cent of disposable income, still less than the average observed in the years preceding the crisis. Households continued to reorganize their portfolios, seeking higher returns as interest rates remained low: a substantial portion of bank bonds and government securities was replaced with managed assets such as investment fund units, especially Italian funds, and insurance products. However, there was no reduction in the share of wealth held in liquid assets (cash and deposits) for precautionary motives.

The housing market and borrowing

While down slightly from the peak of 2008, the share of home-owners in Italy remains high by international standards at nearly 75 per cent. Moreover, residential expenses are a major item in Italian households' budgets: as a share of total expenditure last year spending on dwelling services (actual and imputed rents, water and energy supplies) stabilized in nominal terms at just under 25 per cent, after increasing for a decade, above all during the two recessions.

The housing market. – Housing market demand was still weak in 2014, but there were some signs of improvement. The number of sales rose by 3.6 per cent, partly thanks to the reduction in property registration fees at the start of the year; nonetheless, sales remain around 40 per cent below the 2008 level (Figure 7.3).

As in other recessions, the recovery in property transactions has been slow to affect prices, which fell, for the third consecutive year, by 4.2 per cent. The decline slowed in the second half of 2014, but at the end of the year prices were 14.8 per cent below the peak of the summer of 2008. The factors that ordinarily affect house prices the most, such as disposable income and access to mortgages, improved in 2014, but not

Table 7.3

Composition of households' financial assets and liabilities (1)
(end-of-period stocks)

	Cash and deposits	Government securities and other bonds	Shares, equity holdings and investment fund units	*of which: investment funds*	Insurance and retirement provisions (2)	Financial assets	Financial liabilities (3)	*of which: financial debt*	*of which: mortgages*	Net financial wealth	Real wealth (4)
	Percentage shares of the total					**As a share of disposable income**					
Italy											
2013	31.4	16.6	29.8	*8.1*	19.2	3.48	0.83	*0.63*	*0.33*	2.65	5.24
2014	31.5	13.4	31.6	*9.7*	20.4	3.57	0.83	*0.63*	*0.33*	2.74	5.13
France											
2013	28.6	1.9	27.2	*6.9*	35.9	3.31	1.01	*0.86*	*0.64*	2.31	5.24
2014	28.4	1.7	26.9	*6.4*	36.2	3.36	1.00	*0.86*	*0.61*	2.36	....
Germany											
2013	39.3	4.3	18.9	*9.0*	36.8	2.74	0.86	*0.85*	*0.55*	1.88	3.57
2014	39.3	3.8	19.4	*9.5*	36.8	2.79	0.85	*0.85*	*0.56*	1.94	....
Spain											
2013	46.2	1.4	34.3	*9.5*	16.0	2.74	1.23	*1.15*	*0.88*	1.51	6.11
2014	42.9	1.2	37.5	*11.3*	16.2	2.87	1.18	*1.09*	*0.84*	1.69	6.12
Euro area											
2013	35.5	5.7	24.5	*7.4*	31.4	3.22	1.09	*0.98*	*0.61*	2.13	....
2014	35.0	4.9	24.8	*8.0*	32.6	3.30	1.07	*0.96*	*0.60*	2.23	....
United Kingdom											
2013	25.9	0.6	12.6	*3.5*	57.2	4.64	1.44	*1.35*	*0.93*	3.20	4.17
2014	23.9	0.8	12.7	*4.1*	59.2	5.14	1.46	*1.36*	*0.93*	3.68	....
United States (5)											
2013	13.1	5.8	45.7	*12.7*	32.5	5.19	1.10	*1.05*	*0.75*	4.09	1.82
2014	13.4	4.8	46.5	*13.1*	32.5	5.24	1.09	*1.04*	*0.72*	4.15	1.85

Sources: For Italy, Bank of Italy and Istat; for the other countries: Banco de España (Spain); ECB; Federal Reserve and Bureau of Economic Analysis (United States), OECD.
(1) Consumer and producer households and non-profit institutions serving households. The percentage composition of assets excludes some minor items. – (2) Insurance technical reserves, pension funds and severance pay and pension provisions. – (3) Financial debts and commercial debts and some minor items. – (4) Includes tangible assets (houses, land and other items) and intangible assets (patents, goodwill and other items). The data for Germany and the United Kingdom refer to 2012. – (5) Consumer households and non-profit institutions serving households.

Table 7.4

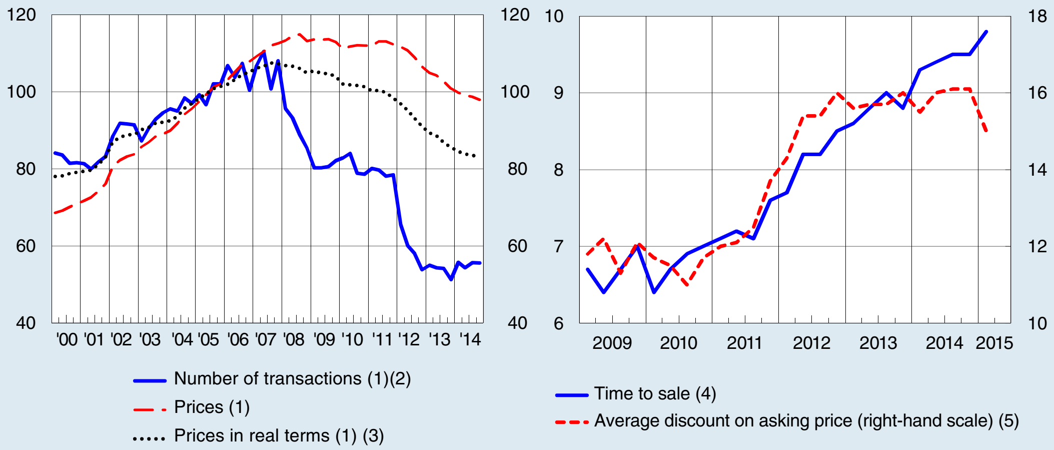
Households' financial assets and liabilities (1)
(millions of euros and per cent)

	End-of-period stocks			Flows	
	2014	Percentage composition 2013	Percentage composition 2014	2013	2014
ASSETS (2)					
Bank deposits (3)	1,076,729	27.3	27.4	16,390	28,140
Italian	1,046,129	26.5	26.6	16,216	27,957
Sight deposits	543,734	13.1	13.8	10,648	42,063
Other deposits	502,395	13.5	12.8	5,568	-14,106
Foreign	30,600	0.8	0.8	174	183
Debt securities	526,149	16.6	13.4	-78,111	-123,965
Italian	417,358	13.6	10.6	-62,878	-116,269
of which: issued by the public sector	*173,585*	*4.9*	*4.4*	*-23,165*	*-32,203*
issued by banks	*237,498*	*8.5*	*6.0*	*-40,128*	*-80,659*
Foreign	108,791	3.0	2.8	-15,233	-7,697
Investment fund units	380,184	8.1	9.7	27,817	56,530
Italian	203,018	4.2	5.2	9,247	33,147
Foreign	177,166	3.8	4.5	18,570	23,383
Shares and other equity	864,239	21.7	22.0	27,313	2,016
Italian	818,854	20.7	20.8	25,385	1,263
Foreign	45,385	1.1	1.2	1,927	753
Insurance, pension fund reserves and severance pay entitlements	803,845	19.2	20.4	22,407	53,341
of which: life insurance reserves	*518,867*	*11.9*	*13.2*	*18,625*	*46,399*
Other assets (4)	282,794	7.1	7.2	4,219	12,826
Total assets	**3,933,939**	**100.0**	**100.0**	**20,034**	**28,887**
LIABILITIES					
Short-term debt	58,795	6.4	6.4	-529	1,052
of which: to banks	*57,840*	*6.2*	*6.3*	*-230*	*1,498*
Medium- and long-term debt	634,042	69.7	69.2	-9,894	-7,112
of which: to banks	*538,832*	*59.4*	*58.8*	*-7,235*	*-6,995*
Other liabilities (5)	222,911	23.9	24.3	1,715	3,252
Total liabilities	**915,747**	**100.0**	**100.0**	**-8,708**	**-2,808**
BALANCE	**3,018,192**			**28,741**	**31,695**

Source: Bank of Italy, Financial accounts.
(1) Consumer households, producer households and non-profit institutions serving households. Rounding may cause discrepancies in totals. – (2) Individually managed portofolios are not shown; their assets are included under the individual investment instruments. – (3) Includes those of Cassa Depositi e Prestiti. – (4) Accounts receivable, Bancoposta current accounts, banknotes, coins and some minor items. – (5) Accounts payable, severance pay and pension provisions, and some minor items.

Figure 7.3

Residential property market



Sources: Based on data from Agenzia delle Entrate, Bank of Italy, Istat, Consulente immobiliare and the quarterly Italian Housing Market Survey. *Short-term outlook*, conducted jointly by Bank of Italy, Tecnoborsa and OMI.
(1) Quarterly data; index numbers, 2005=100. – (2) Adjusted for seasonal and calendar effects. – (3) House prices deflated using the consumer price index. (4) Measured in months. – (5) In per cent.

sufficiently to halt the price decline.[4] Prices continue to suffer from the large overhang of new dwellings, although this is being slowly reduced. The share of construction firms reporting a larger than 'normal' stock of unsold residential properties came down to 74.3 per cent last year, according to the survey conducted by the Bank of Italy's branches in the early months of 2015 on a sample of 566 builders.

The imbalance between supply and demand stopped worsening but is still significant. According to the quarterly Italian Housing Market Survey, the average discount on sales prices in the first quarter of 2015 diminished slightly, after remaining basically stable at high levels in 2014 (Figure 7.3, see Italian Household Market Survey. Short-term Outlook, April 2015, in Supplements to the Statistical Bulletin, 25, 2015). Since the end of last year the number of households visiting properties with a view to buying has also gone up, although average time to sale has continued to lengthen.

Loans for house purchase. – The contraction in mortgage loans, the largest component of household debt, slowed sharply and was down by just 0.3 per cent in the twelve months to March 2015; overall, credit to consumer households ceased to decline (Table 7.5). After three years of sharp contraction new mortgages recorded an annualized increase of over 10 per cent, although they were still less than loan repayments; in the first quarter of 2015 the trend continued, and annualized lending was up 15 per cent in March. New mortgage lending to persons under 35 years of age, who had been hardest hit by the earlier supply restrictions, also began to grow again, though at a slower pace. The upturn in lending was driven by demand, which was sustained by the improved prospects for the property market and better financing terms, especially lower costs.

[4] A. Nobili and F. Zollino, 'A structural model for the housing and credit markets in Italy', Banca d'Italia, Temi di discussione (Working Papers), 887, 2012.

Table 7.5

Lending to consumer households (1)
(end-of-period data; millions of euros and per cent)

	12-month percentage changes					Stocks at March 2015 (2)
	December 2012	December 2013	June 2014	December 2014	March 2015	
			Loans for house purchase			
Banks	0.1	-1.2	-1.1	-0.5	-0.3	341,072
			Consumer credit			
Banks	-0.9	-1.8	-0.3	-0.6	0.0	59,902
Financial companies	-1.5	-1.9	-1.7	0.3	-1.0	53,355
Banks and financial companies	**-1.2**	**-1.8**	**-1.0**	**-0.2**	**-0.5**	**113,257**
			Other loans (3)			
Banks	0.4	0.3	1.0	1.2	1.0	110,675
			Total loans			
Banks and financial companies	**-0.1**	**-1.0**	**-0.7**	**-0.1**	**-0.1**	**565,004**

Source: Supervisory reports.
(1) Loans include repos and bad debts. For March 2015, provisional data. – (2) Including securitized loans. – (3) Mainly current account overdrafts and loans other than those for the purchase, construction or restructuring of residential properties.

Since the end of 2013, the annual percentage rate of charge on new mortgage loans has fallen by almost 1 percentage point, to 2.9 per cent in March this year; households that already had mortgages also benefited, renegotiating their mortgages in greater numbers than in 2013 (see *Financial Stability Report*, 1, 2015). The drop in interest rates was greater for fixed rate mortgages, which fell by over a full percentage point to 3.4 per cent in March; variable rates came down by 0.8 points to 2.4 per cent. As a consequence fixed rate loans increased in proportion to total new mortgages, especially from mid-2014 onwards, rising to about 30 per cent this March. Floating rate mortgages still make up the bulk of new lending, however, owing among other things to expectations that the benchmark Euribor rate will remain stable.

According to the regional Bank Lending Survey conducted by the Bank of Italy's branches, loan to value ratios stopped falling and at the end of 2014 averaged 59 per cent. The share of outstanding mortgages that can be extended or temporarily suspended at no charge increased by around 1 percentage point, to almost 21 per cent (14.5 per cent by value).

Like the reports from banks, the quarterly Housing Market Survey also indicates that households are finding it easier to get mortgages: the share of estate agents citing difficulty in obtaining a mortgage as a major impediment to house sales fell to 30.9 per cent in March, the lowest level since the survey was first conducted in 2008. That same month the share of sales financed by mortgages rose to 65.2 per cent, from 60.9 per cent in 2013.

8. THE LABOUR MARKET

After two years of contraction, employment in Italy stopped falling last year, sustained chiefly by a recovery in fixed-term payroll jobs, driven in turn by labour demand from the more highly export-oriented firms. However, the unemployment rate rose to an all-time high, reflecting increased labour force participation induced by the lengthening of working life and the persistently poor economic situation of households.

High unemployment continued to weigh on the growth of contractual wages. The increases established by the collective bargaining agreements concluded in the first half of the year were aligned with expected inflation at the time of signing, which then proved to be an overestimate. The contracts signed in the second half provided for significantly smaller increments, especially in the industries in greatest difficulty.

The enabling act for labour market reform (the Jobs Act) was passed at the end of 2014, in some respects reinforcing the changes enacted in 2012. The first two delegated decrees, which went into effect in March 2015, extend potential eligibility for unemployment benefits to additional categories of workers and change the rules on dismissals, making outcomes more predictable. Thanks in part to specific temporary social security tax relief, the number of open-ended hirings increased sharply in the first quarter.

Employment and hours worked

After falling steeply for two years, the total number of hours worked edged up by 0.1 per cent in 2014, as measured by the national accounts (Table 8.1). Trends in labour input varied from sector to sector, but in the more labour-intensive industries the variation was generally positive. In construction there was a markedly slower fall in numbers of hours worked and persons employed. In manufacturing the number of hours worked rose substantially, most sharply in the sectors that benefited most from the increase in export demand (see Chapter 10, 'Foreign demand and the balance of

Table 8.1

Labour input in the Italian economy by sector (1)
(annual percentage changes)

	Persons in employment			Hours worked		
	2008-2010	2011-2013	2013-2014	2008-2010	2011-2013	2013-2014
Agriculture, forestry, fisheries	**-0.2**	**-2.6**	**1.4**	**-1.7**	**-2.9**	**2.2**
Industry excl. construction	**-4.1**	**-2.4**	**-0.2**	**-6.6**	**-3.6**	**0.9**
of which: manufacturing	*-4.3*	*-2.6*	*0.0*	*-7.0*	*-3.8*	*1.1*
Construction	**-1.4**	**-6.6**	**-4.5**	**-2.0**	**-10.0**	**-4.9**
Services	**-0.4**	**-0.1**	**0.5**	**-0.7**	**-0.9**	**0.3**
of which: primarily public (1)	*-0.7*	*-0.5*	*0.2*	*-0.6*	*-1.0*	*0.0*
Total	**-1.2**	**-1.0**	**0.1**	**-2.0**	**-2.2**	**0.1**
Employees	-1.1	-0.9	0.2	-2.3	-2.1	0.2
Self-employed	-1.2	-1.4	-0.2	-1.4	-2.3	-0.1

Source: Based on Istat, national accounts.
(1) Includes defence, compulsory social insurance, education, health and welfare.

payments'), reflecting an upturn in per capita working hours thanks to diminished recourse to wage supplementation (the number of hours authorized decreased by 7.5 per cent). After six years of decline the number of persons in work did not decrease, steadying at 14 per cent below the cyclical peak of 2008. In services the upturn in total hours worked was fuelled by an increase in the number of workers, which returned to growth also in the primarily public sector after contracting by more than 100,000 over the previous five years. The decrease in general government staff eased from 1.9 to 1.3 per cent, presumably reflecting the relaxation of the public sector hiring freeze in effect since 2008 (see Chapter 15, 'The public administration'); the increase in employment in education and healthcare accelerated to 0.8 per cent.

The sectoral divergences affected trends in male and female employment. Men's employment, which had been declining in recent years, ceased contracting, in line with labour demand in industry. Women's employment gained 0.6 per cent, fuelled as in 2008-13 by increasing female participation in the labour market and the greater concentration of women workers in services.

The shift towards payroll employment continued; its growth, driven in the past two years by the recovery in labour demand at the largest firms (see Chapter 6, 'Firms'), offset the slight decline in self-employment, which was in any case more moderate than in the previous two years, owing in part to the exhaustion of the effects of the limitations on quasi-employee positions introduced in 2012, which had produced a rapid decline in the number of continuous collaboration contracts (see *Annual Report for 2013*, Chapter 10, 'The labour market').

The expansion of payrolls consisted chiefly in fixed-term employment (a gain of 3.6 per cent after the fall of 5.9 per cent in 2013), which is more responsive to signs of cyclical improvement, especially given the still uncertain prospects for economic recovery[1] (see Chapter 5, 'Overview'). One contributory factor was the changes introduced by Decree Laws 76/2013 and 34/2014, which broadened the possibilities for using this type of contract (see the section 'Labour market regulations and industrial relations'). For the first time since 2009 the number of open-ended positions also increased, albeit marginally (0.1 per cent), reflecting the upturn in hirings (0.6 per cent; Figure 8.1). The steady decline in hirings since 2009 and the reduction in per capita hours worked thanks to wage supplementation benefits and other forms of short-time working had enabled firms to spread the adjustment of staff size to declining demand over a period of years without intensifying the termination of open-ended positions, which remained broadly constant.

Open-ended hiring ceased to grow in the fourth quarter, presumably because firms elected to wait for the tax and social security relief scheduled for the early months of 2015 under the Stability Law (Law 190/2014; see Chapter 11, 'The public finances') and the new rules on dismissals laid down by the enabling act on the labour market (Law 183/214, known as the Jobs Act); see the section 'Labour market regulations and industrial relations'). It expanded again in the first few months of the new year, in part involving persons already employed under other types of contract.

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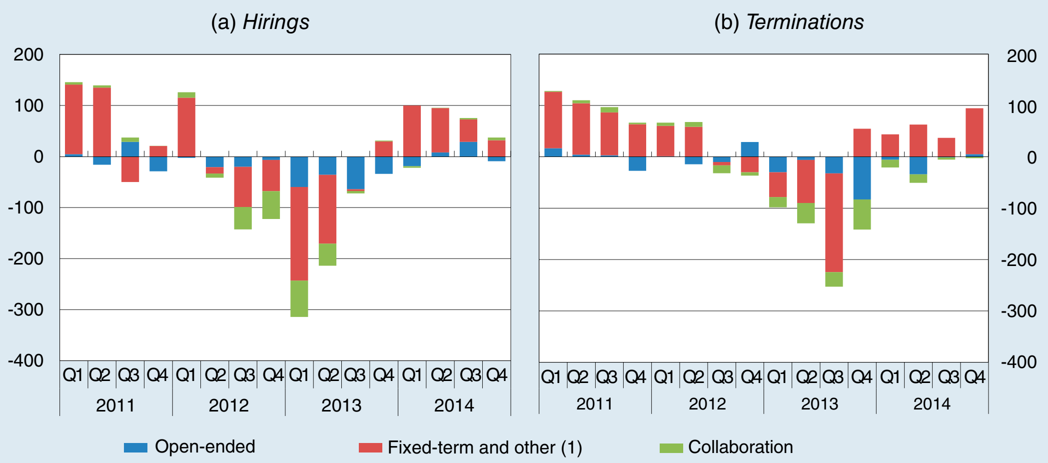
1 F. Colonna and G. Giupponi, 'Why do firms hire on a fixed-term basis? Evidence on the "buffer stocks hypothesis" from the longitudinal sample CICO', Banca d'Italia, Questioni di Economic e Finanza (Occasional Papers), forthcoming.

Figure 8.1

Hirings and terminations by type of employment contract
(changes on corresponding period of previous year; thousands of contracts)



Source: Ministero del Lavoro, *Sistema informatico per le Comunicazioni obbligatorie*.
(1) 'Other' comprises: training/work contracts (general government only), first job insertion contracts, fixed-term and open-ended temporary agency contracts, open-ended and fixed-term jobs on call, self-employment in entertainment, interim employment (general government only), and apprenticeship.

Labour supply and unemployment

The unemployment rate hit a new high of 12.7 per cent overall, and the youth unemployment rate (for persons under 25) rose to 42.7 per cent, the highest on record since 1977, when this statistic was first calculated. The number of unemployed persons almost doubled between 2008 and 2014, from under 1.7 million to 3.2 million (Table 8.2).

Between 2008 and 2011 the number of job seekers increased by slightly less than the number of jobs lost, by about 400,000 and over 500,000 respectively (Figure 8.2). During that period a reduction in the labour force as discouraged workers left the job market had curbed the unemployment rate, which rose only to 8.4 per cent from the low of 6.1 per cent in 2007. But between 2011 and 2014, when another 300,000 jobs were lost, the number of job seekers increased by over a million, owing in part to the substantial expansion of the labour force.

Among young people aged 15-24 the participation rate, which had been diminishing for twenty years as a consequence of increased secondary school and university attendance, remained stable at 27.1 per cent. The worsening finances of households and increasing tuition fees discouraged enrolments and prompted those already enrolled to complete their degree courses more quickly.[2] The share of young people not in employment, education or training yet not seeking work declined to 11.9 per cent, still higher than before 2008. In the 35-44 age group the marginal rise in the participation rate was driven by a drop of over 10 per cent in the number of women engaged exclusively in family care and housekeeping.

[2] E. Adamopoulous and G.M. Tanzi, 'Academic performance and the great recession', Banca d'Italia, Temi di Discussione (Working Papers), 970, 2014.

Table 8.2

Labour supply in 2014
(thousands of persons and per cent)

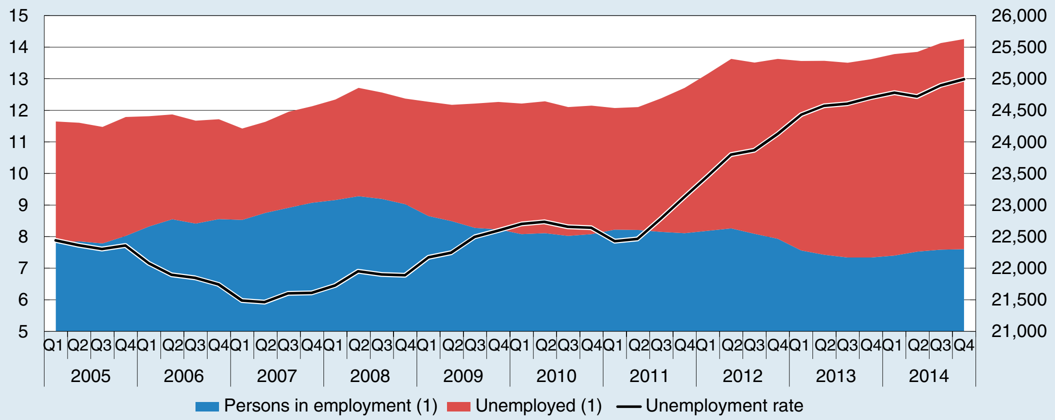
	Aged 15-34		Aged 35-54		Aged 55 +		Total	
	Thou-sands of persons (1)	% change 2013-2014 (2)	Thou-sands of persons (1)	% change 2013-2014 (2)	Thou-sands of persons (1)	% change 2013-2014 (2)	Thou-sands of persons (1)	% change 2013-2014 (2)
Labour force	**6,663**	**-1.2**	**14,665**	**0.1**	**4,187**	**8.5**	**25,515**	**1.0**
Men	*3,754*	*-1.3*	*8,359*	*-0.3*	*2,574*	*7.0*	*14,687*	*0.7*
Women	*2,908*	*-1.0*	*6,306*	*0.5*	*1,614*	*10.8*	*10,828*	*1.5*
Total employment	**5,035**	**-2.9**	**13,266**	**-0.6**	**3,978**	**8.8**	**22,279**	**0.4**
Men	*2,877*	*-2.9*	*7,636*	*-0.7*	*2,432*	*7.6*	*12,945*	*0.2*
Women	*2,158*	*-2.8*	*5,630*	*-0.5*	*1,546*	*10.6*	*9,334*	*0.6*
Job seekers	**1,627**	**4.5**	**1,399**	**7.0**	**210**	**2.9**	**3,236**	**5.5**
Men	*877*	*4.5*	*723*	*4.8*	*142*	*-2.1*	*1,742*	*4.0*
Women	*750*	*4.5*	*676*	*9.4*	*68*	*15.2*	*1,494*	*7.2*
Unemployment rate	**24.4**	**1.3**	**9.5**	**0.6**	**5.0**	**-0.3**	**12.7**	**0.5**
Men	*23.4*	*1.3*	*8.6*	*0.4*	*5.5*	*-0.5*	*11.9*	*0.4*
Women	*25.8*	*1.4*	*10.7*	*0.9*	*4.2*	*0.2*	*13.8*	*0.7*

Source: Based on Istat, labour force surveys.
(1) For rates, per cent. – (2) For rates, changes in percentage points.

The labour force participation of older workers, finally, was affected by Decree Law 201/2011, which raised the retirement age. The share of workers older than 50 retiring each year fell from 10 per cent in 2010 to 5 per cent in 2014. Greater participation increases the economy's production potential;[3] in the short term, however, the unexpected drop in labour force exits by older workers, coming moreover during a recession, may have held back normal turnover and thus slowed the flow of new employment entries.

Figure 8.2

Unemployment in the recession
(per cent; thousands of persons)



Source: Based on Istat, labour force surveys.
(1) Right-hand scale.

3 Ad hoc team of ESCB, 'Comparisons and contrasts of the impact of the crisis on euro area labour markets', European Central Bank, Occasional Paper Series, 159, 2015.

Despite the modest upturn in hirings, there was a further increase last year in the number of the long-term unemployed, who now account for over 60 per cent of all job seekers, compared with 45.2 per cent in 2008. The lengthening of the average duration of unemployment through the course of the cyclical downswing was virtually uniform across occupations.[4] That is, it did not stem from any sharpening misalignment between workers' skills and those needed by firms such as to block a recovery in employment.

The widening gap between labour demand and supply continued to curb wage increments under collective bargaining.[5] Multi-year contracts, moreover, limit the possibility of adapting hourly labour costs to cyclical developments after the agreement is signed. The renewals concluded in the first half of last year were aligned with expected inflation at the time, providing for average annual raises of about 2 per cent. However, the subsequent brusque slowdown in prices produced a rise in real contractual wages in the industries involved (see Chapter 9, 'Prices, costs and competitiveness'). The lower inflation expectations were promptly factored into the new collective bargaining agreements reached in the second half of the year, especially in the industries worst hit by the slump.

According to a survey conducted by the Bank of Italy together with other Eurosystem central banks in the Wage Dynamics Network, 14 per cent of Italian firms with 20 or more workers froze or cut wages between 2010 and 2013. The adjustment was sharper at the more human-capital-intensive firms, which curbed labour costs while retaining their more highly skilled staff.[6]

Labour costs will be held down by the measures enacted in 2014 to narrow the tax wedge. The Stability Law for 2015 excludes staff expenses for permanent employees from the regional tax on productive activities and provides for a 36-month exemption from employer social security contributions on new open-ended hires in 2015 (see Chapter 11, 'The public finances'). A further, indirect curb on labour costs may stem from the tax credit for lower-income employees enacted by Decree Law 66/2014 (see Chapter 7, 'Households').

Labour market regulations and industrial relations

Continuing the line taken by previous governments, the Jobs Act institutes comprehensive labour market reform involving employment relationships, unemployment insurance, active labour market policies, and the provisions for reconciliation of occupational needs with those of family care and personal life. On 4 March 2015 the Government enacted the first two delegated decrees under the Act, one on unemployment benefits and one on dismissals.

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4 A. Rosolia, 'The Italian labour market after the great crisis', *Gli effetti della crisi sul potenziale produttivo e sulla spesa delle famiglie in Italia*, Banca d'Italia, Seminari e convegni, Workshops and Conferences, 18, 2014, pp. 186-213.

5 A. Rosolia, 'On the response of Italian wages to the unemployment rate', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

6 F. D'Amuri, S. Fabiani, R. Sabbatini, R. Tartaglia Polcini, F. Venditti, E. Viviano and R. Zizza, 'Italy: evidence from the wage dynamics network', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

Legislative Decree 22/2015 extends eligibility for unemployment benefits. It institutes a new social insurance benefit for employment (*Nuova prestazione di assicurazione sociale per l'impiego*, NASpI), combining two pre-existing programmes (ASpI and mini-ASpI) introduced by the 2012 reform; it eases the eligibility requirements for the benefits and links their potential duration to the length of employment during the previous four years. The decree also introduces an experimental unemployment subsidy, which varies according to the household's economic situation, for jobless workers whose NASpI benefits have expired. To encourage job search and retraining, dismissed workers may request vouchers for employment agency services in seeking work or for training. Active labour policy measures, which will include the creation of a national employment agency, are deferred to a later decree and could suffer the delays that have limited the effectiveness of the European youth guarantee scheme.[7]

Legislative Decree 23/2015 introduces new regulations on the dismissal of workers hired on permanent contracts from 7 March 2015 onwards. The remedy of reinstatement in the case of illegitimate dismissal is circumscribed still more narrowly than in the 2012 reform; the amount of monetary compensation is specified and made commensurate with seniority; and the employer is now allowed to offer a tax-exempt, conciliatory indemnity smaller than that to which the dismissed worker would be entitled in the case of a favourable ruling, acceptance of which precludes legal action against the dismissal and invalidates any legal action already initiated. These measures reduce uncertainty over the cost to employers in the event of dismissal and may favour broader use of open-ended contracts, fostering a shift towards stabler employment relationships.

A third decree, approved on a preliminary basis by the Council of Ministers, codifies the regulations governing the various forms of employment contract. The rules on fixed-term jobs, already extensively liberalized, following Law 92/2012 (the Fornero reform), by Decree Laws 76/2013 and 34/2014, should remain substantially unchanged; instead, further intervention in respect of quasi-employee contracts is envisaged. In addition, new regulations governing job descriptions and work rules are expected to allow employers greater discretion in this field, thereby broadening the scope for reorganization and renegotiation and fostering company-level agreements in derogation from the national contract.

Employers and unions maintained their commitment to reforming industrial relations, tackling the specific problems that have so far limited company-level and local-level bargaining.[8] At the start of 2014 a codified text on union representation harmonized the contents of earlier agreements between employer and labour organizations. It provides for measuring the representativeness of the various trade unions with a view to majority endorsement of contracts that are binding for all signatories. The measurement criteria have not yet been finalized; moreover, the agreement is effective only within its specific perimeter of application, namely the signatory parties.

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[7] For an analysis of the diffusion and operation of the youth guarantee schemes in Italian regions, see the forthcoming regional reports in Banca d'Italia, Economie Regionali series.

[8] F. D'Amuri and C. Giorgiantonio, 'Diffusion and outlook of firm-level bargaining in Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 221, 2014.

9. PRICES, COSTS AND COMPETITIVENESS

Downward pressures on prices, which were present throughout the euro area, also affected the Italian economy. Inflation turned negative in the summer owing not only to food and energy prices but also to weak demand, which affected the core components more than in the past. The drop in inflation shaped price expectations, which diminished and only showed signs of a slight increase after the launch of the Eurosystem's expanded asset purchase programme at the beginning of 2015.

Wage increases slowed. The deceleration was less rapid than that of consumer prices, which was largely unexpected and therefore not envisaged in earlier labour contracts. The content of the upcoming contract renewals will depend, among other things, on how inflation expectations change.

Italy's price competitiveness has improved in recent months, mainly as a result of the depreciation of the euro. It has held virtually stable since the beginning of monetary union, while that of France and Germany has improved and that of Spain has diminished.

Prices

The twelve-month rate of consumer price inflation as measured by the HICP came down to an average of 0.2 per cent in 2014, the lowest level since the time series began in 1987 (Table 9.1). It slowed over the course of the year, turning negative at -0.1 per

Table 9.1

Consumer prices

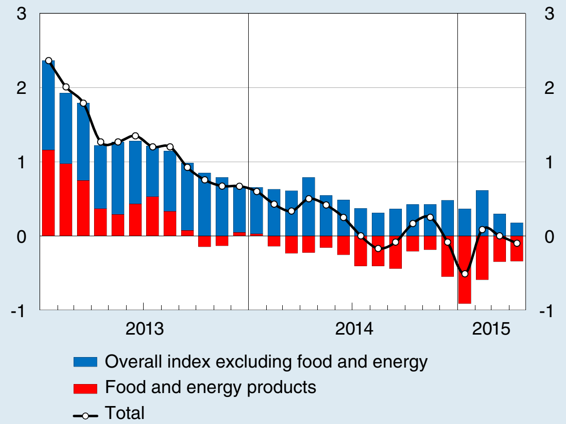
	Percentage changes on previous year		Percentage weights
	2013	2014	2014
HICP	**1.3**	**0.2**	**100.0**
Unprocessed food	2.7	-0.7	8.4
Processed food	1.5	0.5	12.3
Energy products	-0.2	-3.0	9.1
Non-food and non-energy products	0.6	0.5	27.7
Services	1.6	0.8	42.5
Unregulated goods and services	1.0	0.2	89.8
Regulated goods and services	3.1	0.5	10.2
Overall index excluding food and energy	1.3	0.7	70.2

Source: Based on Istat data.

cent in the third quarter (Figure 9.1). The decline in energy prices intensified to -3.0 per cent year-on-year, while the rate of food price increases fell to nil from 2.0 per cent. Even excluding these components, core inflation fell to historically low levels.

Figure 9.1

Inflation in Italy and contributions of the main components (1)
(monthly data; 12-month percentage changes and percentage points)



Source: Based on Eurostat data.
(1) HICP.

The ample margins of idle capacity continued to exert downward pressure on prices, more so than in previous recessions.[1] Changes in expectations and in firms' pricing policies may have contributed, the latter also reflecting almost three years of virtually uninterrupted recession and structural modifications entailing more frequent reductions in list prices (see the box 'Changes in firms' pricing policies during the recession').

CHANGES IN FIRMS' PRICING POLICIES DURING THE RECESSION

A recent study designed to assess the flexibility of prices in Italy and its evolution over the years has analysed a large sample of prices of individual goods and services recorded monthly by Istat for the consumer price indices.[1]

The study has found increased flexibility in recent years. The percentage of products whose list prices are altered in any one month (which is an indicator of the frequency of price changes) averaged about 15 per cent in 2006-13, 6 percentage points more than in 1996-2001.[2] The prices of energy products change almost monthly; those of services are on average stable for just under one year. Over the years, price reductions in particular have become more frequent (from 3.5 to 6.2 per cent each month). The difference is considerable, above all in the case of services, and the size of the price changes also tends to be greater than in the past.

Part of the trend is attributable to the increasing market share of large retailers, but the deep and prolonged recession has also had an impact on the

[1] S. Fabiani and M. Porqueddu, 'Changing prices … changing times: evidence for Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

[2] S. Fabiani, A. Gattulli, R. Sabbatini and G. Veronese, 'Consumer price setting in Italy', *Giornale degli economisti e annali di economia*, 65, 2006, pp. 31-74.

[1] M. Riggi and F. Venditti, 'Surprise! Euro area inflation has fallen', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 237, 2014.

mechanism of price changes. For non-food and non-energy products, this impact has been in the form of larger and more frequent downward adjustments and smaller price rises. For services, both the frequency and the size of price increases have diminished.

The weakening of price dynamics affected expectations (see the box 'The risks of too low inflation over a prolonged period'). The analysts surveyed by Consensus Economics revised their 2015 inflation forecasts downwards from 1.3 per cent at the beginning of 2014 to -0.1 per cent in February this year; since then their expectations have edged back upwards, to +0.1 per cent in May, with the start of the Eurosystem's public securities purchase programme. Professional forecasters estimate that inflation will stay low in 2016, at 0.9 per cent. The firms interviewed in March for the Bank of Italy-*Il Sole-24 Ore* survey expected price inflation to be around 1.2 per cent over a three-to-five-year horizon (see 'Indagine sulle aspettative di inflazione e crescita. Marzo 2015', in Supplementi al Bollettino Statistico, No. 18, 2015, forthcoming in English in Supplements to the Statistical Bulletin).

Labour costs

Hourly earnings in the entire economy, which had been slowing since the start of the sovereign debt crisis, were again held down by the sharp deceleration in the private sector. As in 2013, actual earnings increased less than contractual pay, which itself slowed considerably. The contribution of the non-contractual components of wages was nil.

Earnings nonetheless increased more than prices. The pay rises envisaged in labour contracts signed up to the middle of 2014 were based on the HICP forecasts available at the time, which proved to be higher than the inflation outturn[2] (see Chapter 8, 'The labour market').

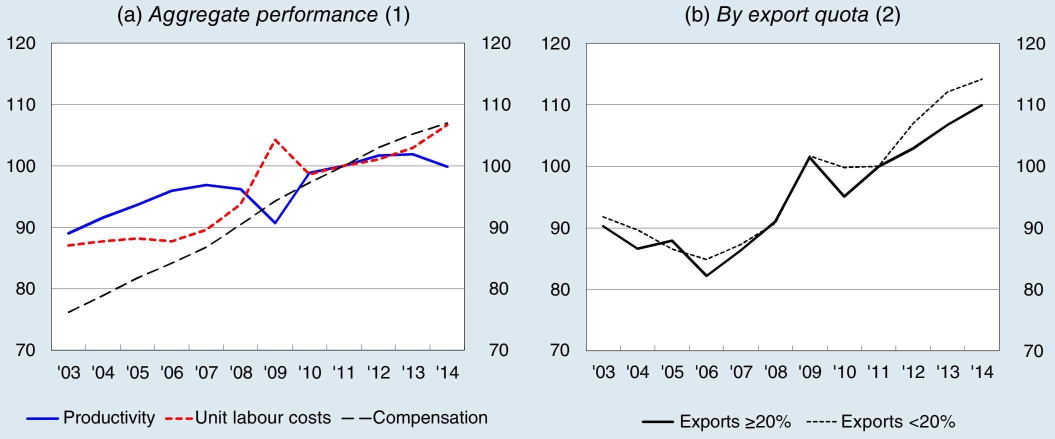
Unit labour costs in the private sector rose by 1.6 per cent, a faster rate than in 2013 owing to the cyclical contraction in value added per hour worked (see Chapter 6, 'Firms'). The upturn was particularly large in industry, where the rate of increase jumped from 1.9 to 3.6 per cent (Figure 9.2.a). Since the beginning of the sovereign debt crisis, unit labour costs in industry have risen by about 7 per cent, the same as in Germany (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area') where productivity has instead increased, albeit less than earnings. In France and Spain unit labour costs have risen at a slower pace, mainly owing to the better performance of productivity, achieved, particularly in Spain, by sharply reducing labour input.

There were considerable differences in the growth of unit labour costs between exporting and non-exporting firms, however. According to the Bank of Italy's Survey of Industrial and Service Firms, since 2011 unit labour costs have risen faster in the

[2] Wage agreements signed in the first six months of 2014 explained 0.1 percentage points of the rate of increase in real earnings, which went from 0.4 to 0.9 per cent.

Figure 9.2

Unit labour costs in industry
(indices, 2011=100)



Sources: Based on data from Bank of Italy, Survey of Industrial and Service Firms and Istat, national accounts.
(1) Productivity calculated as the ratio of value added at factor prices, chain-linked volumes, to hours worked; unit labour costs are measured as the ratio of the hourly compensation of employees to productivity. – (2) Firms classified according to their propensity to export (at least 20 per cent of sales turnover; less than 20 per cent of sales turnover). The indicator of unit labour costs is the difference between the rate of increase in hourly compensation and the rate of increase in total sales turnover at constant prices per hour worked.

industrial firms that rely chiefly on domestic demand than in export-oriented firms, whose productivity increased more sharply thanks to the growth of demand (Figure 9.2.b).

The cost of energy and other intermediate goods

Producer prices of goods sold on the domestic market fell by 1.8 per cent on average in 2014. Contributory factors were the decline in energy prices and, to a lesser extent, in food prices. Crude oil prices have a greater impact on the energy price index in Italy than in France and Germany, although this has lessened as a result of profound changes in the structure of our energy sector (see the box 'The drop in oil prices and the structure of the energy sector').

THE DROP IN OIL PRICES AND THE STRUCTURE OF THE ENERGY SECTOR

The decrease in the price of oil translates, for countries that depend on oil imports, into lower spending on energy, freeing up resources that households and firms can allocate to consumption and investment.

The contribution of oil to Italy's energy balance has diminished considerably in recent decades. At the beginning of the 1970s oil accounted for almost 75 per cent of primary energy consumption, while the share is now about a third of that figure, mostly concentrated in the transport sector.

The role of oil prices as a benchmark for the wholesale prices of other energy products has also diminished, partly owing to the liberalization of markets at the beginning of this millennium. The price of natural gas is increasingly determined by the price quotes at the main European hubs, which depend on supply and demand,

and is no longer anchored to the price of oil. The price of electricity has generally followed the gas market and has been influenced by the recent development of renewable energy sources, which contributed 43 per cent to electricity production in 2014, up from 18 per cent in 2004, while refined oil and gas products accounted for 2 and 34 per cent respectively, against 16 and 43 per cent in 2004. Renewable energy sources receive an increasing amount of incentives, which topped €13 billion in 2014, more than twice as much as in 2011. They accounted for slightly less than a quarter of the electricity expenditure of the typical user, compared with just over a tenth in 2011.

The weight of energy commodity costs in the retail prices of energy products has decreased with time, partly because of the growing incidence of tax and related charges (infrastructure costs and financing of renewable energy). In 2014 the cost of the raw material represented 45 per cent of the final price of electricity and about 40 per cent of that of fuel and natural gas, against 53, 44 and 39 per cent respectively in 2011.

It is estimated, based on data from sample surveys,[1] that if prices of oil products stabilize at their December 2014 levels, households could save about €2.1 billion on fuel expenditure over the whole of this year (equal to about €80 per household). The saving would be less for the least well-off households, which often do not possess a vehicle. Instead, all households would benefit from the reduced cost of transport, which would amount to about €500 million assuming the reduction was passed on entirely to users. In the case of firms, according to some recent reconstructions of energy expenditure,[2] a decrease of 10 to 15 per cent in the prices of oil derivatives would raise sales turnover by a further €650 million or so (equal to a 0.9 per cent decrease in labour costs) and investment growth by €27 million.

1 I. Faiella and A. Mistretta, 'Gli effetti delle riduzioni delle quotazioni del greggio sulla spesa energetica e sull'attività economica', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 279, 2015.

2 I. Faiella and A. Mistretta, 'Spesa energetica e competitività delle imprese italiane', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 214, 2014.

Non-energy intermediate goods also exerted downward pressure on firms' costs, although less strongly. Producer prices of these goods fell by about 0.5 per cent on average in 2014, about the same as in 2013. Considering imported intermediate inputs, the decrease comes to almost 2 per cent, against 2.9 per cent in 2013.

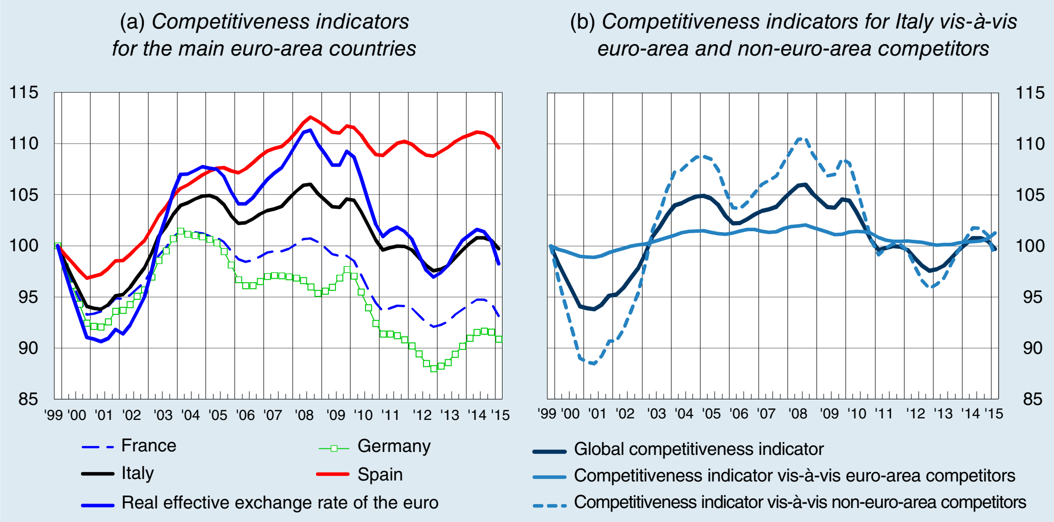
Price competitiveness

The depreciation of the euro, which was particularly sharp in the first quarter of 2015, led to a rapid improvement in the competitiveness indicators based on producer prices compared with the end of 2014, with gains of between 3 and 4 per cent for the four leading euro-area countries.

Considering the whole period of the European Monetary Union, from 1999 to 2014, competitiveness on international markets, again based on producer prices,

Figure 9.3

Competitiveness indicators for the main euro-area countries and real effective exchange rate of the euro (1)
(indices, Q4 1999=100; 4-quarter moving average)



Sources: Bank of Italy and, for the real effective exchange rate of the euro, ECB.
(1) Based on producer prices of manufactures. An increase indicates a loss of competitiveness. The competitiveness indicators are calculated vis-à-vis 61 competitor countries (including members of the euro area). The figure for the last quarter is partly estimated. The real effective exchange rate of the euro is calculated by the ECB vis-à-vis 20 competitor countries outside the euro area.

improved for French and German firms, mainly as a result of trade with other euro-area countries (Figure 9.3.a).[3] That of Spanish firms instead deteriorated significantly. Italy's price competitiveness was at the same level in 2014 as at the start of the monetary union. Italy's cumulative loss of competitiveness with respect to France and, above all, Germany is much wider when measured using the ECB's indicators based on unit labour costs. However, empirical analysis has shown that in the case of Italy indicators based on prices, including producer prices, offer a better explanation of the performance of goods exports than those based on unit labour costs, which are distorted by globalization.[4]

The prices of Italian manufactures have moved in line with the euro-area average, so that Italy's competitiveness with respect to the area economies as a whole has remained stable (Figure 9.3.b).

[3] A. Felettigh, C. Giordano, G. Oddo and V. Romano, 'Reassessing price-competitiveness indicators of the four largest euro-area countries and of their main trading partners', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 280, 2015.

[4] C. Giordano and F. Zollino, 'Exploring price and non-price determinants of trade flows in the largest euro-area countries', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 233, 2014.

10. FOREIGN DEMAND AND THE BALANCE OF PAYMENTS

In 2014 the current account of Italy's balance of payments continued to improve. The overall correction, equal to over 5 percentage points of GDP with respect to the low point of 2010, was only partly due to cyclical or temporary factors. Considering the size of the output gap and the elasticity of exports and imports, we can conclude that about half the adjustment was structural in nature; a contribution came from the gain in goods exports, which have grown more than demand in the outlet markets. However, the smaller size of firms in Italy than in other European countries remains an obstacle to greater penetration of foreign markets.

Capital inflows strengthened; foreign purchases of Italian portfolio securities, including government bonds, confirm renewed investor confidence in Italy. Consequently the Bank of Italy's TARGET2 net liabilities decreased further, albeit with fluctuations related to the Treasury's securities issues and banks' recourse to ECB refinancing.

Exports and imports

Exports. – In 2014 the growth of exports of goods and services accelerated to 2.7 per cent in volume terms, regaining momentum especially in the second half of the year.

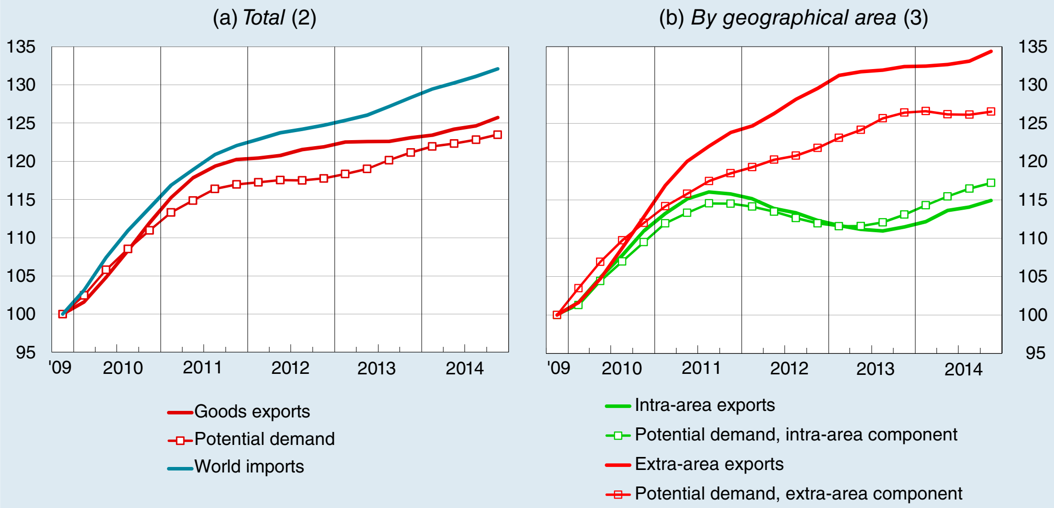
After being badly hit by the collapse of international trade during the global crisis, from 2010 onwards goods exports outpaced potential demand in Italy's outlet markets. In these five years export performance was particularly strong in markets outside the euro area, where growth benefited from the recovery of price competitiveness (Figure 10.1). Instead, slack demand from the euro-area countries acted as a brake, given the importance of these economies for Italy's exports.

In Italy, unlike other European countries where exports are mainly attributable to just a few large corporations, medium-sized firms also make a significant contribution to the total (almost 30 per cent).[1] The high proportion of small and medium-sized companies in Italian industry nonetheless remains a weak point, because firm size is a key factor in the capacity for commercial penetration of foreign markets, which is measured by the percentage of exporting firms in a country, market shares, the number of foreign markets reached and how distant they are. Since the turn of the

[1] A. Berthou, E. Dhyne, M. Bugamelli, A M. Cazacu, C. V. Demian, P. Harasztosi, T. Lalinsky, J. Meriküll, F. Oropallo and A. C. Soares, 'Assessing European firms' exports and productivity distributions: the CompNet trade module', ECB, Working Paper Series, 1788, 2015.

Figure 10.1

Goods export volumes, potential foreign demand and world goods imports (1)
(4-quarter moving averages; indices, Q4 2009=100)



Sources: Based on data from Istat, IMF and CPB Netherlands Bureau for Economic Policy Analysis.
(1) Seasonally adjusted. – (2) Goods exports, national accounts. Potential demand is calculated as the weighted average of the imports by volume of Italy's trading partners, weighted by their shares of Italian exports by value. – (3) The breakdown of goods exports into intra- and extra-euro-area is estimated, beginning with the aggregate national accounts datum, on the basis of foreign trade data and the prices of industrial products sold abroad.

century, in fact, exporting firms with under 50 employees have failed to keep pace with their larger counterparts.

According to national accounts statistics, goods exports increased by 2.5 per cent in 2014. This was driven by sales of machinery, motor vehicles and other transport equipment; sales of clothing and leather goods also continued to expand at higher-than-average rates.[2] The shrinkage of exports of refined petroleum products, metal products and electronic equipment continued.

In 2014 exports to the euro area and other EU countries returned to growth, while the expansion of sales to non-EU countries came to a halt, despite the positive contribution of exports to the United States and East Asia. Geopolitical tensions were reflected in a sharp drop in exports to Russia, whose share of Italian exports was in any case already very small, less than 3 per cent (see the box 'The economic repercussions of the crisis in Ukraine').

Imports. – After falling sharply for two years, imports of goods and services grew by 1.8 per cent in 2014. The upturn in the goods sector was broad-based, excluding only commodities and oil products, sectors in which declining import volumes were accompanied by sharply falling purchase prices.

[2] The geo-sectoral analysis of foreign trade data is still reliable for the interpretation of the national accounts, although the new accounting standards (ESA 2010) introduced a gap between the two sources because of the different treatment of goods crossing borders for processing in third countries; L. Bracci, S. Fabiani and A. Felettigh, 'Trading processing for goods: a different view from the past on Italian trade flows?', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

The current and capital accounts

In 2014 the Bank of Italy adopted the IMF's new standards for its balance of payments reporting.[3] The goods account now includes the amounts relating to certain illegal transactions and the net proceeds from merchanting; the impact of these items is small (around 0.5 per cent for exports and 0.3 per cent for imports). Instead, goods that cross the border for processing without change of ownership are no longer recorded as goods trade but entered in the services account as processing for third parties, which is one of the ways in which firms participate in global value chains (see the box 'Italy's participation in global value chains').

ITALY'S PARTICIPATION IN GLOBAL VALUE CHAINS

The international fragmentation of production and the expansion of multinational corporations have profoundly changed the way goods and services are produced and exchanged. Exports are now less important as a gauge of a country's global competitive position and access to outlet markets. An increase in exports may in fact bring only a small change in domestic value added if exports embody an increasing amount of imported value added. What is more, intermediate goods cross a country's national borders several times, artificially swelling foreign trade flows owing to double counting. As a result of this international fragmentation of production, exports may also be stimulated by the final demand of a different country from that of first destination of the goods and services sold abroad. Lastly, foreign markets are served increasingly by multinationals whose production is carried out locally through subsidiaries.

Global input-output tables have recently become available, and a suitable methodology for the breakdown of exports into their component parts (domestic and imported value added and double counting) has been developed, providing new tools for the analysis of value added flows between countries, from their creation up to final consumption.[1]

Based on this information, it is estimated that between 1999 and 2011 the portion of Italian exports embodying domestic value added fell by about 10 percentage points to 72.7 per cent (see the table). About two thirds of this decline reflects the increased proportion of imported value added, indicating that Italian companies are increasingly using inputs produced abroad, and one third is due to the increase in double counting with the increased complexity of the production chains in which Italy participates. Although the overall index measuring Italy's participation in global value chains has risen (last line of the table), in 2011 it was still below that of the other leading euro-area economies. Germany in particular is part of more complex global chains, mainly because of its specialization in motor vehicles and the organizational

[1] R. Cappariello and A. Felettigh, 'How does foreign demand activate domestic value added? A comparison among the largest euro-area economies', Banca d'Italia, Temi di Discussione (Working Papers), 1001, 2015.

[3] IMF, *Balance of Payments and International Investment Position Manual*, 6th ed., 2009 (BPM6); see the box 'The new international accounting standards for external transactions and investment positions', *Economic Bulletin*, 4, 2014.

Breakdown of value added in Italian goods and services exports (1)
(per cent of total exports)

	1999	2007	2009	2011
Total exports	**100.0**	**100.0**	**100.0**	**100.0**
Domestic value added	**82.1**	**74.6**	**78.4**	**72.7**
Absorbed by final foreign demand	81.1	73.6	77.6	71.9
Activated by the final demand of country of first destination	72.9	64.6	69.4	63.7
Exported as a final good	39.7	33.2	37.6	32.7
Exported as an intermediate good	33.2	31.4	31.8	31.0
Re-exported by the country of first destination for final consumption in third countries (A)	8.2	9.0	8.2	8.2
Re-imported into Italy (B)	1.0	1.0	0.8	0.8
Imported value added (C)	**14.3**	**18.8**	**16.8**	**20.5**
Double-counting component (D)	**3.6**	**6.6**	**4.7**	**6.8**
Index of participation in global value chains (A+B+C+D)	*27.1*	*35.4*	*30.6*	*36.3*

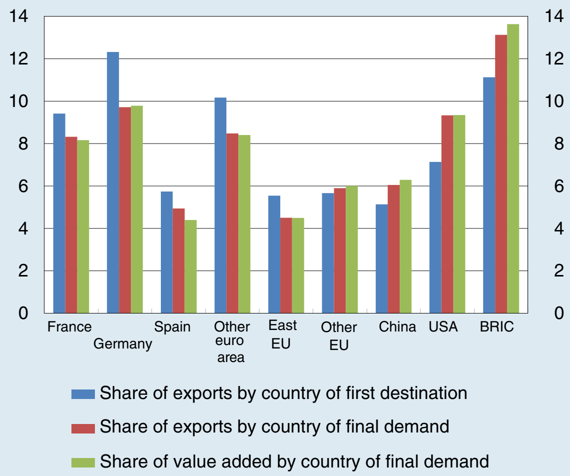
Source: R. Cappariello and A. Felettigh, 2015.
(1) Excluding tourism.

choices of companies working in this field: while benefiting from highly integrated cross-border production, especially with the countries of eastern Europe, German car manufacturers tend to keep the final assembly stage at home.[2]

The breakdown by country of final demand reveals that for Italy the role of the EU economies is significantly smaller than is suggested by the traditional export analysis based on country of first destination (Figure A). This depends on the considerable weight of regional production chains

Figure A

Shares of exports and value added exported by Italy according to country of first destination and country of final demand
(billions of US dollars)



Source: R. Cappariello and A. Felettigh, 2015.

[2] J. Amador, R. Cappariello and R. Stehter, 'Global value chains: a view from the euro area', *Asian Economic Journal*, 29, 2, 2015, pp.1-22

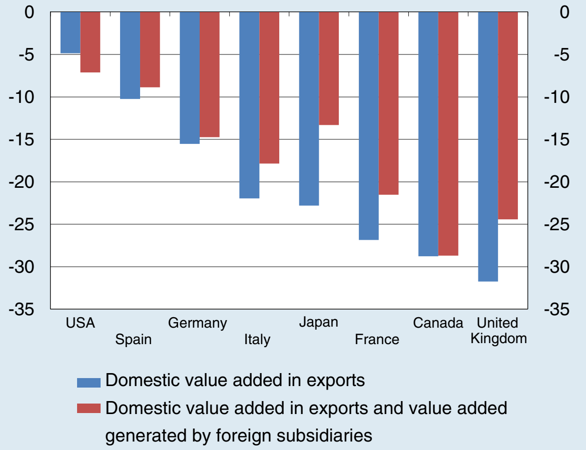
within the EU, which generate substantial trade in inputs for the production of goods for final consumption outside the EU.[3]

The indicators of the value added embodied in exports, together with a new database on foreign subsidiaries in a large number of countries, will allow us to measure and directly compare the two ways in which firms meet demand from abroad (exports and direct investment).[4] Foreign demand can indeed stimulate both the value added embodied in exports and that produced by foreign subsidiaries. The share of total value added destined for foreign markets evolves differently from the share measured by exports alone (Figure B). For Italy the loss of world market share is attenuated when account is taken of the activity of firms located abroad, not just directly exported value added (by the first gauge the share declined by 18 per cent between 2004 and 2011, by the second by 22 per cent). The extent of the improvement is even greater for Japan, France and the United Kingdom.

Figure B

Changes in market share of value added destined to serve foreign markets between 2004 and 2011

(percentage changes; current prices and exchange rates)



Source: S. Federico, 'How does multinational production affect the measurement of competitiveness?', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

3 A. Borin and M. Mancini, 'Follow the value added: Bilateral gross export accounting', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

4 S. Federico, 'How does multinational production affect the measurement of competitiveness?', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

The current account surplus rose to nearly 2 per cent of GDP in 2014, continuing the improvement that began in 2011 (Table 10.1). The year-on-year increase involved all the components except services (Figure 10.2), the greatest contribution coming from the goods surplus, which rose to more than 3 per cent of GDP. The sharp reduction in purchases of energy commodities, equally affecting oil and natural gas, resulted in a decrease in Italy's total imports from the main suppliers, i.e. the OPEC countries and Russia. In particular there was a fall in the domestic consumption of the petrochemical industry, while the demand for fuel remained more or less unchanged.

The goods balance was 4.4 percentage points of GDP better than the low point of 2010 (Figure 10.2). The adjustment of the external accounts was only due in part to cyclical and temporary factors, such as the weakness of domestic demand, which slowed Italy's imports, and the end of subsidies for photovoltaics, which in 2010-11 had spurred imports of solar panels. The data indicate that about half of the adjustment is structural, reflecting among other things Italian exporters' enhanced capacity to

Table 10.1

Balance of payments
(balances in billions of euros, except as indicated)

	2010	2011	2012	2013	2014
Current account	**-55.7**	**-50.4**	**-6.9**	**15.0**	**30.9**
per cent of GDP	*-3.5*	*-3.1*	*-0.4*	*0.9*	*1.9*
Goods	-21.7	-18.6	16.8	36.1	49.5
Non-energy products (1)	27.6	39.5	76.3	87.6	90.1
Energy products (1)	-49.3	-58.1	-59.5	-51.5	-40.7
Services	-9.2	-6.2	-0.1	1.4	0.5
of which: Transport	*-8.5*	*-8.7*	*-8.2*	*-7.9*	*-8.3*
of which: Travel	*8.8*	*10.3*	*11.5*	*12.8*	*12.5*
Primary income	-4.8	-6.4	-4.1	-4.4	-2.3
Secondary income	-20.0	-19.3	-19.5	-18.1	-16.6
Capital account	**..**	**1.0**	**4.0**	**0.2**	**3.4**
Financial account (2)	**-87.7**	**-69.1**	**-14.8**	**11.3**	**50.2**
Direct investment	16.1	12.3	5.3	3.6	9.0
Portfolio investment	42.5	9.7	-25.9	-14.6	-4.5
Financial derivatives	5.0	-7.3	5.8	3.0	-3.6
Other investment	-152.3	-84.8	-1.5	17.7	50.2
Change in official reserves	1.0	0.9	1.5	1.5	-1.0
Errors and omissions	-32.1	-19.7	-11.8	-3.8	15.9

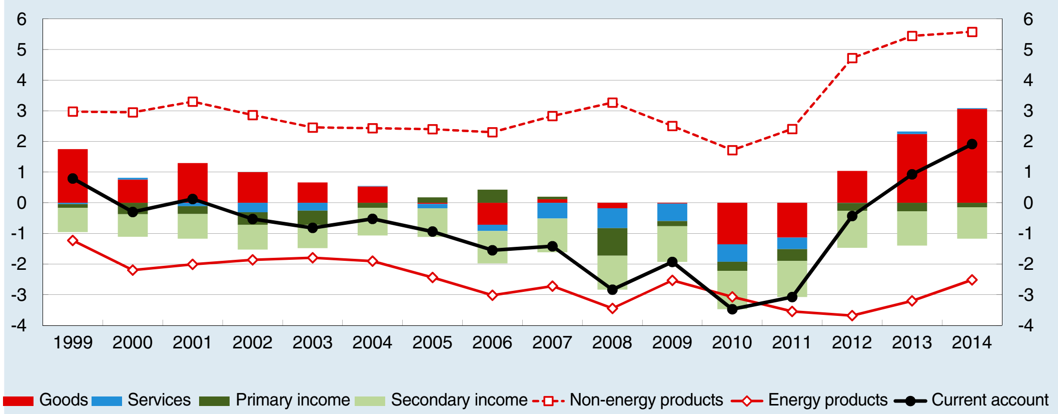
Source: For GDP, Istat.
(1) Based on Istat foreign trade data. – (2) The sign convention that traditionally governed the financial account was discontinued with the adoption of the IMF's BPM6: as was already the case on the liabilities side, now on the asset side too positive values indicate an increase and negative values a decrease. Therefore, a positive balance indicates a net increase in assets, a negative balance a net increase in liabilities.

keep pace with growing demand (see the box 'The cyclically adjusted current account balance').

A significant contribution to the correction of the balance of trade in goods between 2010 and 2014 came from the increase in exports outside the European Union, in particular to the United States and to the OPEC countries, with which Italy recorded its first trade surplus since these statistics began to be gathered in 1970. The

Figure 10.2

The balance on current account and its components
(per cent of GDP)



Sources: For GDP, Istat; for the breakdown between energy and non-energy products, based on Istat foreign trade data.

THE CYCLICALLY ADJUSTED CURRENT ACCOUNT BALANCE

The available estimates indicate that Italy's external accounts have come back into balance, even excluding cyclical and temporary factors. According to the European Commission's methodology, which adjusts the current account as a function of the domestic output gap and the average gap of partner countries, the GDP elasticity of imports and exports, and their ratio to GDP,[1] This suggests that in 2014 Italy's current account balance, adjusted for the effects of the economic cycle, showed a surplus 0.7 per cent of GDP, after a deficit of 0.1 per cent in 2013. In 2015 it is expected to improve further to 1.4 per cent.

These evaluations are subject to wide margins of uncertainty since they depend on the output gap estimate. However, even taking the low end of the range of the Bank of Italy's estimates of the output gap (see the box 'Italy's potential output and the output gap'), the structural balance calculated according to this approach would be practically in equilibrium.

The IMF's analyses result in similar estimates: in 2013 (last year available) the balance adjusted for the economic cycle and for fluctuations in commodity prices shows a surplus of 0.3 per cent of GDP.

1 For more details on this methodology, see M. Salto and A. Turrini, 'Comparing alternative methodologies for real exchange rate assessment', European Commission, Economic Papers, 427, 2010.

balance vis-à-vis EU countries turned positive, roughly half the total improvement stemming from the reduction of the deficit with Germany.

In the services account, Italians' spending on tourism returned to growth after years of stagnation; the increase was greater than that in households' domestic consumption. Foreign tourists' spending in Italy continued to increase, gaining 5 per cent. The travel balance remained in surplus. Processing services for third parties generated a surplus, driven by relatively high-tech products (pharmaceuticals, chemicals and refined petroleum products) and not fully offset by a deficit in low-tech sectors.

There was a significant reduction of more than €2 billion in the primary income deficit, as a result of the performance of investment income. The deficit on secondary income continued to depend chiefly on public transfers with EU institutions; the fall in immigrants' remittances almost came to a halt.

The marked expansion of more than €3 billion in the capital account surplus in 2014 was due largely to the absence of non-recurring factors that had been present in 2013, such as the purchase of CO_2 emission rights.

The financial account

In 2014 cross-border financial transactions returned rapidly to levels very close to those prevailing before the sovereign debt crisis in Europe.

Non-residents made net purchases of Italian portfolio securities amounting to nearly €100 billion, mainly government bonds (€59 billion, mostly with maturities beyond a year, compared with less than €14 billion in 2013) and other debt instruments, including Italian bank issues; equity investments were concentrated in the banking sector. Direct investment inflows remained at around 1 per cent of GDP, modest by European standards.

Italian residents purchased foreign assets amounting to €123 billion, mainly portfolio securities (about €93 billion). Direct investment, consisting mostly in equity purchases and reinvested earnings, contributed €20 billion to the total, according to preliminary data.[4]

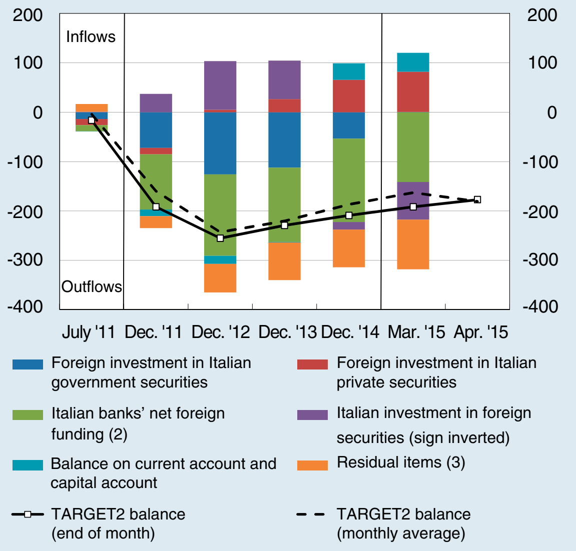
There were substantial purchases (more than €65 billion) of foreign investment fund units, equivalent to about half the net funds raised by the Italian managed asset industry in 2014 (see Chapter 13 'Banks and institutional investors'). For the most part the purchases were made by insurance companies and pension and investment funds, but one third was accounted for directly by savers themselves. Non-bank financial companies also invested in debt securities (€23 billion, mostly at maturities beyond one year). Italian banks increased their deposits with foreign counterparties by more than €6 billion.

Almost half of the improvement in the balance on 'other investment' (deposits, loans and trade receivables) was due to the reduction of €20 billion in the Bank of Italy's debtor position in the TARGET2 payment system. The improvement was favoured by the current account surplus and inflows of foreign capital for investment in public and private Italian securities. Resident banks' net funding on the international interbank market continued to decline, but more moderately than in the recent past (Figure 10.3).[5]

The TARGET2 balance continued to improve in the early months of 2015 (by nearly €32 billion at the end of April), albeit with fluctuations related to the Treasury's securities issues and Italian banks' recourse to ECB refinancing, which tends to replace more costly sources of funding. Foreign purchases of Italian government bonds continued (€54 billion in the first quarter).

Figure 10.3

TARGET2 balance and its counterparts (1)
(billions of euros; cumulative flows from July 2011)



(1) Breakdown of the balance based on the accounting identity of the balance of payments. – (2) Including funds intermediated by resident central counterparties. – (3) Foreign direct investment, financial derivatives, other investment, errors and omissions.

[4] The figure will be revised in the autumn once the data from direct reporting surveys has been acquired, whose impact is usually concentrated on direct investment.

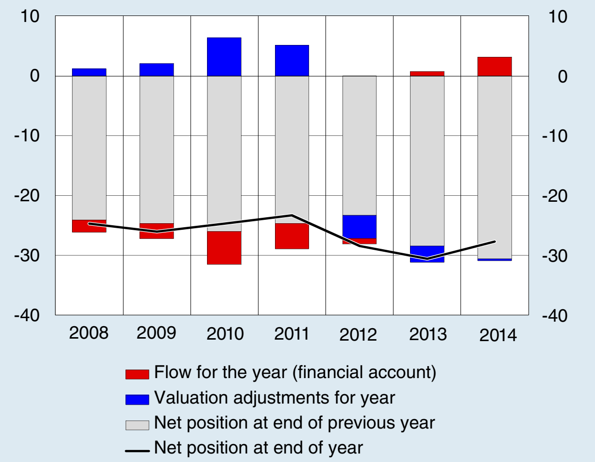
[5] Funding includes repos intermediated by resident central counterparties.

The net international investment position

Figure 10.4

Net international investment position

(per cent of GDP)



Source: For GDP, Istat.

At the end of 2014 Italy's net external debtor position amounted to €447.9 billion (27.7 per cent of GDP), almost 3 percentage points less than a year earlier (Figure 10.4). The improvement was due to the surplus on current account, while valuation adjustments had a negative impact of €5.4 billion, as the increase on the liability side outweighed that on the asset side. Over half the increment in liabilities consisted in the increase in the market value of Italian government securities held by non-residents due to the decline in interest rates; the revaluation of gold and other official reserves contributed €12.6 billion on the asset side.

At the end of 2013 Italians' undeclared portfolio assets lodged abroad probably amounted to some €120 billion, about the same as in 2012. Including bank deposits as well, the underestimation of total financial assets held abroad should be put at between 9 and 10 percentage points of GDP.[6]

Italy's net international investment position remains safely below the alert threshold of 35 per cent of GDP set by the European Commission for its excessive imbalance procedure (see the box 'Macroeconomic imbalances in the European Union'), and the medium-term outlook points to a steady improvement thanks to the current account surplus (see *Economic Bulletin,* 1, 2015). The depreciation of the euro in early 2015, in particular vis-à-vis the dollar and the Swiss franc, should also have a positive impact insofar as foreign-currency-denominated financial assets far outweigh the corresponding liabilities.

6 Update to 2013 of the findings of V. Pellegrini and E. Tosti, 'In search of lost capital: an estimation of undeclared portfolio assets', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 131, 2012.

11. THE PUBLIC FINANCES

In a difficult macroeconomic situation, fiscal policy was substantially neutral last year. Within the constraints imposed by European budgetary rules, the Government adopted deficit-neutral measures to support the economy. In particular, the tax wedge was reduced for payroll workers with mid-to-low earnings. Despite the continuing recession, Italy's general government deficit remained stable at around 3 per cent of GDP. As nominal output stagnated, the debt-to-GDP ratio rose; about a third of the increase was attributable to the measures for the payment of overdue general government commercial debts and financial support to other euro-area countries.

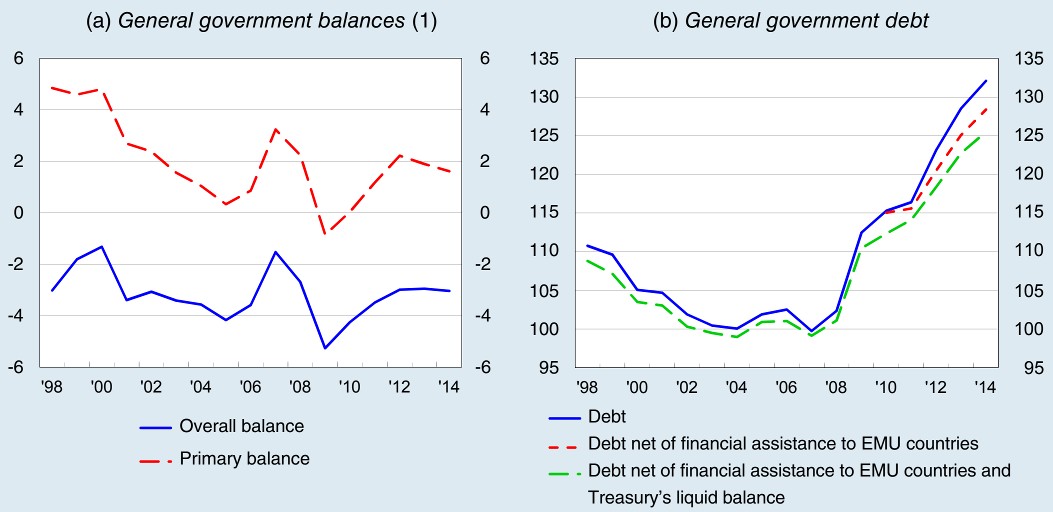
The Government's Economic and Financial Document (EFD) for 2015 indicates that Italy's fiscal stance will remain broadly neutral: reduced interest expense will nevertheless lead to a slight improvement in the structural balance.

The public finances in 2014

Net borrowing edged marginally up from 2.9 to 3.0 per cent of GDP last year (Figure 11.1), as the decline in the primary surplus from 1.9 to 1.6 per cent was almost completely offset by the 0.2-point reduction in interest expenditure to 4.7 per cent of GDP.

Figure 11.1

Public finance indicators
(per cent of GDP)



Source: For net borrowing and primary surplus, Istat.
(1) A negative balance indicates a deficit (net borrowing); a positive balance indicates a surplus (net saving).

Local government helped to contain net borrowing, turning in a slightly positive balance (it had been nil in 2013). Net of transfers from other public entities, their revenue rose by about 1 percentage point, while expenditure contracted by 1.4 per cent (see the sections 'Revenue' and 'Expenditure').

While economic activity slowed, the fiscal stance was broadly neutral. The latest estimates of the European Commission indicate that the structural deficit (excluding cyclical effects and temporary measures) remained unchanged at just under 1 per cent of GDP, following the substantial reduction over the previous two years (amounting to a total of 2.4 percentage points, of which 2.0 points in 2012). The temporary interruption of convergence on the medium-term objective (namely structural budget balance) is in keeping with the preventive arm of the Stability and Growth Pact, which does not require any budget adjustment for countries that have an output gap larger than 4 per cent of GDP, as Italy did in 2014.

The public debt ratio rose to 132.1 per cent of GDP (see the section 'General government debt').

Budgetary policy in 2014. – The EFD update of September 2013 estimated net borrowing on a current legislation basis in 2014 at 2.3 per cent of GDP (Table 11.1), and the Government planned to increase it by 0.2 points in order to fund increased capital spending. Nevertheless, as the result of earlier measures the structural budget balance was

Table 11.1

Public finance objectives, estimates and outturn for the year 2014
(billions of euros and per cent of GDP)

	General government				Memorandum items:			
	Net borrowing	Primary surplus	Change in structural balance	Debt	Real GDP growth rate (%) 2014	Privatiza-tion receipts 2014	Net borrowing 2013	Structural deficit 2013
Objectives								
September 2013 (1) (2)		....	....	2,128.8	....	....	....	....
per cent of GDP	2.5	2.9	0.1	132.8	1.0	0.5	3.0	0.4
April 2014 (1) (3)	....	....	....	2,141.5	....	....	47,321	....
per cent of GDP	2.6	2.6	0.2	134.9	0.8	0.7	3.0	0.8
September 2014 (4)	....	....	....	2,140.6	....	....	45,358	....
per cent of GDP	3.0	1.7	-0.3	131.6	-0.3	0.3	2.8	0.7
Estimates								
September 2013 (1) (2)	37.3	48.8	....	....	....	....	48,723	....
per cent of GDP	2.3	3.0	0.4	133.2	1.0	....	3.1	0.5
April 2014 (1) (3)	41.9	40.7	....	2,141.5	....	....	47,321	....
per cent of GDP	2.6	2.6	....	134.9	0.8	....	3.0	0.8
September 2014 (4)	49.2	27.5	....	....	....	....	45,358	....
per cent of GDP	3.0	1.7	-0.3	131.7	-0.3	....	2.8	0.9
Outturn (5)	**49.1**	**26.1**	**....**	**2,134.9**	**....**	**3.3**	**47,455**	**....**
per cent of GDP	3.0	1.6	0.0	132.1	-0.4	0.2	2.9	0.7

(1) Data presented according to the statistical rules of ESA 95; starting September 2014 the planning documents use the ESA 2010 rules. – (2) Economic and Financial Document (EFD) update, 2013. – (3) EFD 2014. – (4) EFD update, 2014. – (5) Net borrowing, primary surplus and GDP growth are based on Istat data; the change in structural balance in 2014 and structural deficit in 2013 are from EFD 2015.

projected to improve slightly (by 0.1 per cent of GDP), but much less than was required by European budget rules and Italian law (at least 0.5 points). This strategy took advantage of the flexibility allowed by the investment clause of the Stability and Growth Pact.

Although the Commission later ruled out the applicability of the investment clause (see Chapter 13, 'The public finances', in last year's Annual Report), the Stability Law for 2014 enacted the programmes set out in the 2013 EFD update, deferring to subsequent measures the procurement of the additional resources needed to increase the structural adjustment for 2014. Specifically, the budget law appropriated €3.2 billion for additional net capital expenditure; furthermore, current spending was increased by €1.5 billion and revenue by €2.2 billion. The revenue increase stemmed chiefly from changes in the taxation of financial and insurance companies and an increase in stamp duties; at the same time the tax wedge on lower-middle-income employees was reduced and the tax deduction under the allowance for corporate equity increased; real estate taxation was revised.

With the publication of the EFD in April 2014, the Government slightly raised its estimate of net borrowing for the year to 2.6 per cent of GDP. In the new planning framework, the reduction of the structural deficit (by 0.2 percentage points) was still less than required by the European budget rules. The Government justified the decision not to increase the adjustment on the grounds of the persistent weakness of economic activity (in particular Italy's substantial output gap[1] and firms' liquidity difficulties) and the launch of an ambitious reform programme that would significantly benefit the public finances in the medium term. Under the strengthened procedure required by the law enacting the constitutional principle of budget balance, Parliament authorized the consequent deviation from the path of convergence towards the medium-term objective.

While retaining the final balance targets set forth in the EDF, the Government immediately passed Decree Law 66/2014, converted with amendments into Law 89/2014, to finance a further reduction in the tax wedge for lower-middle-income employees, partly in order to support demand (see Chapter 13, 'The public finances', in last year's Annual Report and Chapter 7, 'Households', in this year's). The tax cut concerned only the remaining months of the year, but the Government announced that it would make it permanent with the next Stability Law. Overall, the decree engendered a budget recomposition in which tax cuts worth €7.4 billion and additional spending of €0.2 billion were offset chiefly (60 per cent) by revenue increases, mostly temporary, and partly by expenditure reductions.

Still in June 2014, the EU Council, on the Commission's proposal, recommended that Italy reinforce its structural budget adjustment for the year. The particular adversity of the cyclical situation did not emerge until November, when the Commission estimated the output gap at more than 4 per cent of GDP,[2] which relieves countries of the fiscal adjustment obligation. As a consequence, in assessing Italy's draft budgetary plan for 2015 the Commission, even while estimating that the structural balance would worsen, found no violation of the preventive arm of the Stability and Growth Pact in 2014.

1 The EDF put the output gap at 3.6 per cent of GDP, the same as the Commission's estimate (see European Commission, Spring forecasts, May 2014).

2 European Commission, Autumn forecasts, November 2014.

Budget plans and outturns. – The budget outturn for 2014 was less favourable than originally planned. The divergence was mainly due to the worse than expected performance of the economy (see the box 'The 2012 programme for a balanced budget and the dynamics of expenditure').

The original plan set out at the start of the budget session in the autumn of 2013 was to increase the primary surplus by 0.5 percentage points of GDP in 2014, while real GDP was projected to expand by 1.0 per cent. The actual outturn showed a contraction of 0.3 points in the primary surplus and of 0.4 per cent in GDP. The divergence was due in part to the changeover in September 2014 from the ESA 95 to the ESA 2010 national accounts framework. In particular, increased spending estimated at 0.2 per cent of GDP derived from the new accounting treatment of tax credits against deferred tax assets. Interest expenditure turned out to be 0.7 points of GDP less than expected; in addition, the changeover to ESA 2010 had an effect, worth 0.2 points, by excluding the flows associated with derivatives transactions.

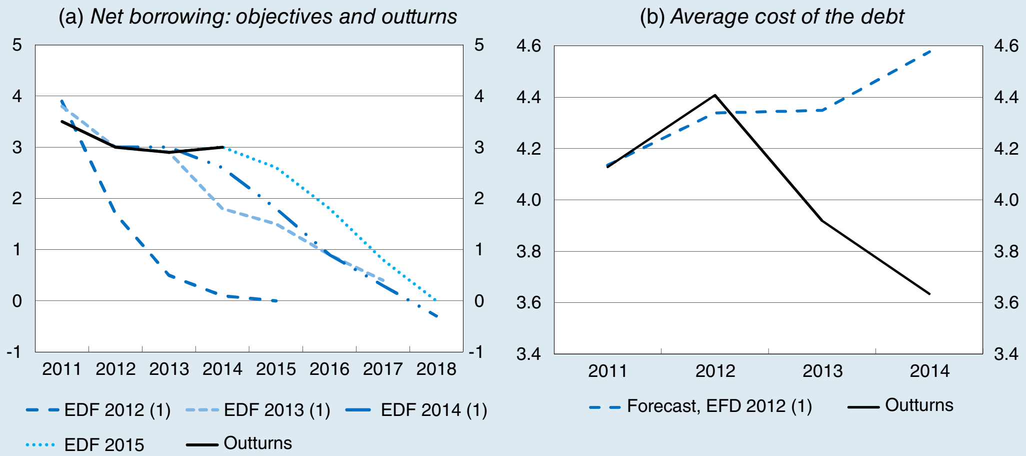
The difference between objectives and results is ample also with respect to the programmes set out in the April 2014 EFD, when the severity of the economic downturn was not yet clear. But the estimates given in the EFD update in September were broadly on target as regards both the final balance and revenue and expenditure trends.

THE BALANCED BUDGET TARGET IN THE 2012 PROGRAMME AND THE DYNAMICS OF EXPENDITURE

The 2012 Economic and Financial Document (EFD), taking account of the budget measures enacted in the second half of 2011, forecast a rapid reduction in net borrowing, with approximate budget balance in nominal terms as early as 2014 (Figure A.a). It projected a growing primary surplus that would reach 5.5 per cent of GDP that year.

Figure A

Net borrowing and the average cost of the debt
(per cent of GDP)



(1) Data according to the ESA 1995 accounting framework; the cost of the debt is net of interest flows in connection with derivatives.

These objectives were not attained. After net borrowing had been brought below the 3 per cent limit already in 2012 it then remained more or less constant, and the primary surplus in 2014 was 3.9 percentage points less than had been projected in 2012. For net borrowing, the gap was smaller because interest expenditure was 0.9 points less than forecast (Figure A.b).

The failure to hit the primary surplus target can be blamed on the recession of 2012-14. In April 2012 the projection had been for substantially unchanged GDP in real terms and nominal growth of 5.7 per cent; instead, the outturns were contractions of 4.8 and 1.4 per cent respectively. On the basis of the standard elasticity of the budget to GDP, it is estimated that the lower growth cut the primary surplus by 3-3.5 points with respect to expectations.

Above all, the recession affected revenue dynamics. In contrast with many past occasions, this time the failure to attain the objectives was not due to any significant slippage of primary spending or its current component.[1] The 2012 EFD projected average growth of 0.7 per cent for both aggregates over the three years, while the outturn showed average rates of 1.0 per cent for total and 1.3 per cent for current primary spending.

However, allowing for several unexpected, extraordinary factors that increased spending during the period, these gaps are erased. First of all, the protracted recession pushed unemployment benefits well above the amount forecast in the spring of 2012;[2] moreover, it also increased the likelihood of a situation arising whereby, since 2012 under Law 14/2012 firms can convert certain deferred tax assets into tax credits – the consequent cost to the Treasury was entered as increased expenditure amounting to €6.3 billion in 2014. Second, spending dynamics were also affected by (a) the tax credit for lower-income employees, entered in the accounts as an increase in expenditure, and (b) the new accounting treatment of municipal waste disposal management, resulting in an annual increase estimated at around €1 billion in both revenue and expenditure starting in 2013. Net of these provisions, which were not factored into the estimates made in 2012, the rise in total primary expenditure was actually less than planned, while the gap relating to current expenditure was negligible.

Extending the analysis back beyond the last three years, we see that since 2009 the measures to curb spending have reduced the rate of expenditure growth considerably compared with the past (Figure B.a). In the decade before the economic and financial crisis, primary expenditure and its current component grew by over 4 per cent per year nominally and around 2 per cent in real terms. In the last five years, on the other hand, nominal growth has averaged 0.4 per cent for total and 1.2 per cent for current primary expenditure. In real terms, total primary expenditure has

1 M.R. Marino, S. Momigliano and P. Rizza, 'A structural analysis of Italy's fiscal policies after joining the monetary union: Are we learning from our past?' *Public Finance and Management*, 8, 3, 2008, pp. 451-501; F. Balassone, S. Momigliano and P. Rizza, 'Italy: medium-term fiscal planning and frequent government changes' in P. Mauro, ed., *Chipping away at public debt,* Wiley, Hoboken, NJ, 2011, pp. 153-76.

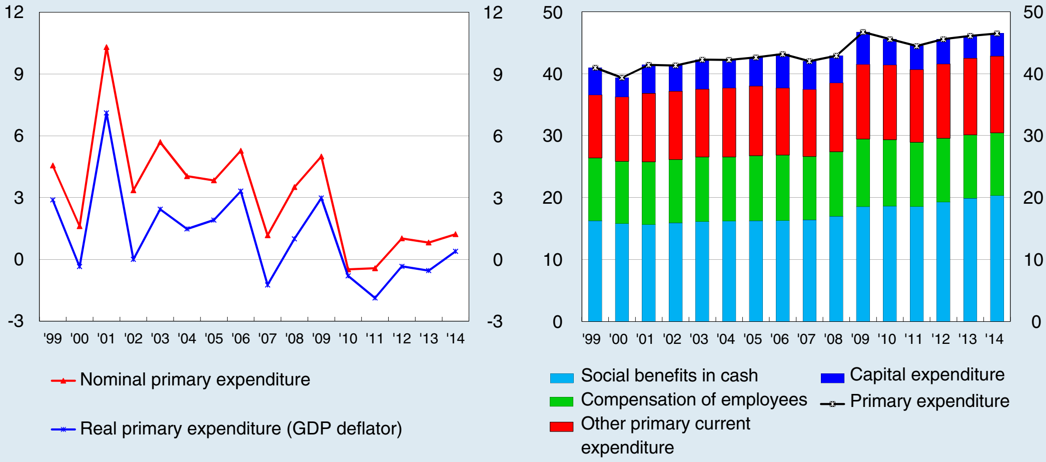
2 Lacking detailed data, the increase in unemployment-related outlays with respect to projections is estimated at €3 billion. This conservative estimate assumes that the sharp rise in disbursements in 2012 was fully forecast in the 2012 EFD and that despite the forecast of a modest decline in unemployment in 2013 and 2014, expenditure held constant through the period.

Figure B

Primary expenditure: dynamics and composition

(a) *Dynamics of primary expenditure (growth rates)*

(b) *Composition of primary expenditure (per cent of GDP)*



been reduced by about half a point per year, while current primary spending has remained basically unchanged. The ratio of primary spending to GDP has held at its 2009 level; the ratios of compensation of employees and capital spending to GDP have come down significantly, while that of social benefits has risen (Figure B.b).

Revenue

General government revenue increased by 0.6 per cent in 2014 to €777.2 billion or 48.1 per cent of GDP. If both the tax credit for low- and middle-income employees and that for firms against deferred tax assets are counted as decreases in revenue, receipts can be estimated to have fallen by 0.7 per cent.[3]

The ratio of tax and social security contributions to GDP came to 43.5 per cent, about the same as in the last two years. Reclassifying as above, the ratio would have diminished by 0.6 percentage points. Social contributions increased by 0.5 per cent to €216.4 billion. Tax revenue rose by 0.4 per cent, in parallel with nominal GDP. The increase was due almost exclusively to local government revenue, which amounted to 6.6 per cent of GDP (Figure 11.2), while central government tax revenue was broadly unchanged.

Treasury tax receipts were held down by declines in revenue from direct taxes and capital taxes. Direct taxes were affected by the fall of €29.4 billion or 19.0 per cent in corporate tax receipts (IRES), owing in part to the particularly large frontloaded payment that had been required at the end of 2013, especially for banks and insurance companies. An opposite effect derived from the one-off tax on the revaluation of equity

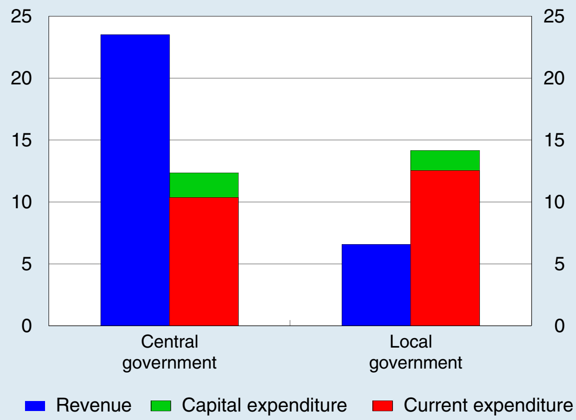
3 According to ESA 2010, these credits are entered entirely as increased expenditure by general government. But they are hybrid in nature. As a rule they result in a decrease in tax revenue because they reduce the taxpayer's liability; only if the liability is smaller than the credit do they give rise to a transfer to the taxpayer.

in the Bank of Italy (€1.8 billion) and the increase in the substitute tax on income from financial assets, partly as a result of the rise in tax rates enacted by Decree Law 66/2014 (see Relazione annuale sul 2013, 'Appendice', section entitled 'Principali provvedimenti in materia economica. La finanza pubblica: Imposte dirette'). Personal income tax receipts were stable at around €150 billion; this figure does not count the effect of the tax credit for mid-to-low-income employees. Capital tax receipts declined from €4.1 billion to €1.3 billion, reflecting the contraction in the revenue generated by the substitute tax on the alignment of fiscal and book values.

Figure 11.2

Tax revenue and primary expenditure by sub-sector, 2014 (1)

(per cent of GDP)



Source: Based on Istat data.
(1) Expenditure net of transfers to public entities.

The Treasury's indirect tax receipts increased, thanks to the rise in VAT receipts, which went up by 3.8 per cent to €90.9 billion as a result of the hike in the ordinary rate from 21 to 22 per cent in October 2013 and tax payments in connection with the settlement of overdue general government commercial debts (see the box 'General government commercial debts'). Excise tax receipts increased, as did stamp duties, owing in part to the raising of the rate on financial instruments from 1.5 to 2 per mille (see Relazione annuale sul 2013, 'Appendice', section entitled 'Principali provvedimenti in materia economica. La finanza pubblica: Imposte indirette').

The increase in local government tax revenue was driven by the introduction of a tax on municipal services (Tassa sui servizi indivisibili, TASI), which brought in €4.6 billion (see the box 'Local taxes on home ownership: redistributive aspects'), and also by local personal income surtaxes, which increased by 4.3 per cent to €15.4 billion. However, property tax (IMU) receipts dropped by 3.3 per cent to €16.1 billion,[4] and above all receipts from the regional tax on productive activities (IRAP) fell by 4.8 per cent to €30.4 billion. The latter reflected the lowering of the base rate enacted by Decree Law 66/2014 (which affected payments on account made in 2014 but was then abrogated by the Stability Law for 2015; see Relazione annuale sul 2014, 'Appendice', section entitled 'Principali provvedimenti in materia economica. La finanza pubblica: Finanza decentrata'). Local governments further raised the rates on the main taxes under their jurisdiction, except for IRAP (Figure 11.3).

Italy's tax and social contribution burden in the international context. – Italy's overall tax and social contribution burden is still heavy by international standards. Even reclassifying the tax credits mentioned above as decreases in revenue, there remains

[4] The receipts from this tax in 2013 mainly involved properties that are not primary residences or luxury homes; only a small amount (€0.4 billion) came from the so-called 'mini-IMU' on non-luxury primary residences. In 2014 IMU on this class of properties was abrogated.

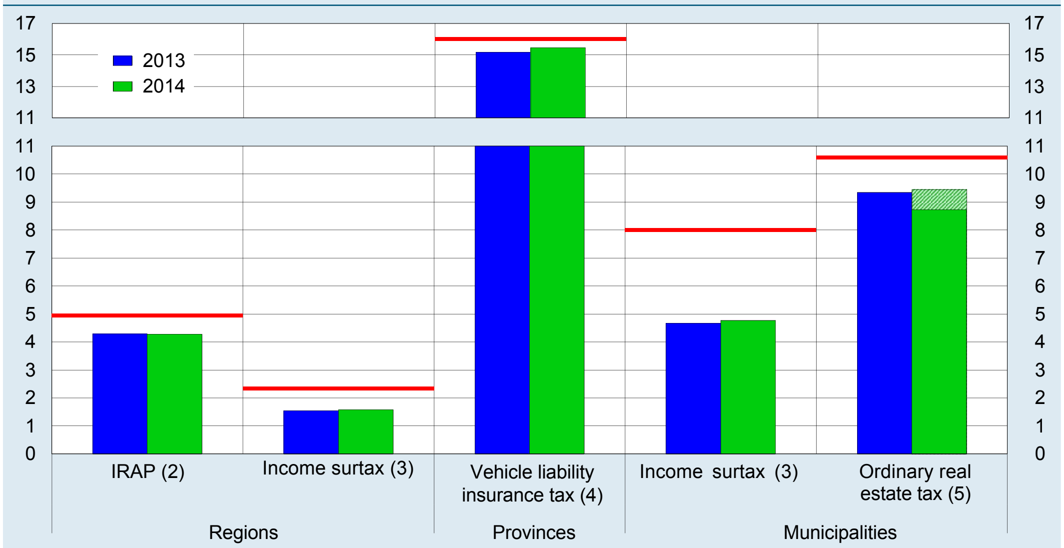
a difference of 1.7 percentage points of GDP with respect to the euro-area average,[5] representing in any case a reduction of 0.8 points compared with 2013.

As regards employee earnings, the OECD has estimated that for payroll workers with gross earnings equal to two thirds of the average – who benefited from the tax credit introduced in May 2014 – the tax wedge was reduced significantly in the year, from 44.9 to 42.4 per cent for a single worker with no dependents and from 29.0 to

Figure 11.3

Main local tax rates (1)

(per cent; for municipal taxes, per mille)



Sources: Based on data from Ministry of Economy and Finance (MEF), local government acts, and Ivass.
(1) The red line represents the legal ceiling for each tax. – (2) The rate is calculated as the average of the sectoral rates, weighted by each sector's share of the total tax base of private sector parties based on tax returns. – (3) Averages obtained by weighting the rate applied by each region with its share of the tax base according to income tax returns; for ease of reading, the municipal income surtax is given per mille, not per cent. – (4) Average obtained by weighting the rate applied by each province with its share of motor vehicle liability insurance premiums. – (5) Taxes on property other than the primary residence; the rate for 2013 corresponds to the average of IMU rates on such properties, weighted by tax bases taken from MEF data; the rate for 2014 corresponds to the sum of the average rates of IMU and TASI (the cross-hatched area).

26.9 per cent for one with two dependent children. The gap with the rest of the euro area was also narrowed, by about 2.5 percentage points in both cases.[6] For workers with approximately average earnings, ineligible for the credit, the tax wedge increased marginally, from 47.9 to 48.2 per cent for a single worker and from 38.5 to 39.0 per cent for a married worker with two dependent children. The difference from the rest of the area was essentially unchanged by comparison with 2013 at 5.5 percentage points for the former type of worker and just over 7 points for the latter.

The Stability Law for 2015 introduces social contribution relief and IRAP relief in respect of permanent employees, which should favour a broader, more generalized reduction of the tax wedge on labour over the next three years. However, the contribution relief applies only to permanent hirings in 2015 and is to be phased out starting in 2018 (see Chapter 8, 'The labour market').

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5 Based on European Commission data (Spring forecasts, May 2015).

6 OECD, *Taxing Wages*, 2015. The OECD dataset does not include Cyprus, Latvia and Malta, and for Italy it excludes IRAP.

LOCAL TAXES ON HOME OWNERSHIP: REDISTRIBUTIVE ASPECTS

Italy's home ownership taxes have been modified repeatedly over the past three years. A capital tax on primary residences[1] was reintroduced in 2012 and designated IMU (municipal property tax), essentially abrogated in 2013, and reinstated, de facto, in 2014 as TASI (municipal services tax). The TASI, like its predecessor, is a municipal tax on the cadastral value assigned to the property. The rate (a base rate of 1 per mille, compared with 4 per mille for IMU) is set by the municipalities, which also determine the amount of any tax deductions (whereas for IMU deductions were fixed at national level and municipalities could increase them within certain limits).

Property taxation has substantial redistributive effects.[2] Here we examine the impact of taxation of the primary residence, based on data from the Bank of Italy's 2012 Survey of Household Income and Wealth and municipal resolutions setting rates and tax deductions. The sample covers about 5,800 Italian households who own their primary residences.

The analysis finds that the transition from IMU in 2012 to TASI in 2014 lowered the effective tax rate from 2.3 to 1.9 per mille. The reduction was the result of two opposing factors: the decrease in the average statutory rate from 4.3 to 2.1 per mille and the reduction in the average deduction from about €230 to €25. The net effect differed by household type. For those in the bottom two quintiles of the primary residence cadastral value, the effect of the smaller deduction prevailed, resulting in a higher effective tax rate; for those in the upper quintiles, the effect of the lower statutory rate was greater, resulting in a diminution in tax liability, the amount of which increases with the tax base (see the figure, panel a).

For the same sample of households we estimate the redistributive effects of two possible modifications to the property tax. Scenario A posits a larger tax deduction, set as a fixed amount at national level and equal to €230, the IMU average in 2012. Scenario B posits, in addition to the deduction, the alignment of the tax base with the market value of properties (as declared by the householders interviewed for the survey). In both scenarios the municipal tax rate is set in such a way as to keep municipal revenue the same as with TASI.[3] Since the tax base differs between the two scenarios (cadastral value in the first, market value in the second), for purposes of homogeneous comparison households are ranked by equivalent net income.

By comparison with TASI, Scenario A would produce a fiscal benefit that decreases progressively from the bottom through the third income quintile, while the fourth and fifth quintiles, especially the latter, would face a tax increase (figure, panel b). Scenario B would result in even more pronounced redistribution. The

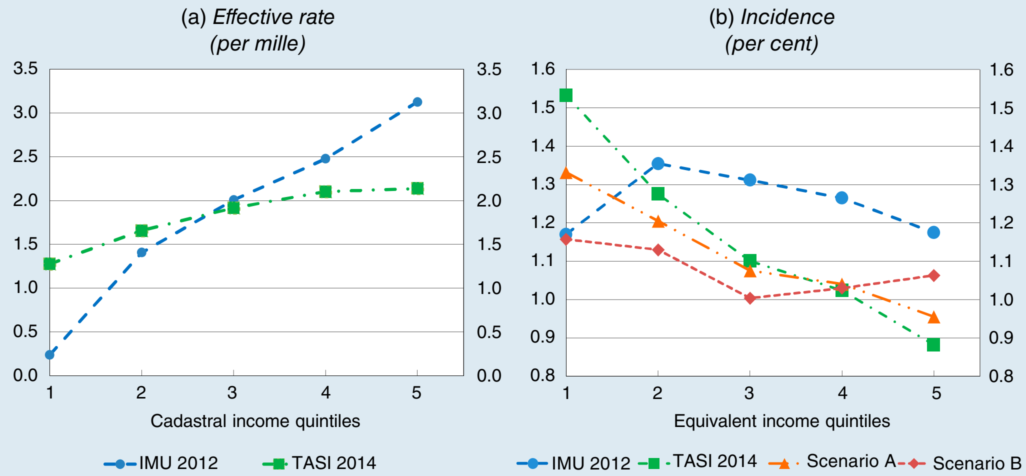
1 Here and throughout the reference is to taxes on non-luxury primary residences.

2 Home ownership taxes play a leading role in local public finance because they are considered an efficient way to finance local government. For a broader analysis, see G. Messina and M. Savegnago, 'A prova di acronimo: I tributi locali sulla casa in Italia', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 250, 2014.

3 In Scenario B, lower rates are posited in the municipalities where the property revaluation is greater (i.e. where the gap between market value and cadastral value is larger).

revaluation of the tax base would penalize above all the top quintile, whose homes display the greatest gap between market value and today's TASI tax base.

Taxes on the primary residence: income redistribution effects



Sources: Based on Bank of Italy data and municipal resolutions.

As for business income, according to Eurostat data the legal tax rate in Italy was 7 percentage points higher than the average for the other countries of the euro area in 2014, remaining about the same as in Germany, France and Spain. The allowance for corporate equity introduced in 2011 brings a gradual reduction in actual tax rates and can cut taxes sharply for new firms or significant increases in equity.

Expenditure

The spending curbs introduced in past years continued to have effect in 2014 (see the box 'The balanced budget target in the 2012 programme and the dynamics of expenditure'). General government outlays increased by 0.8 per cent to 51.1 per cent of GDP, and net of interest payments they rose by 1.2 per cent, to €751.1 billion. Reclassifying the tax credits as discussed above (see the section on 'Revenue'), primary expenditure is estimated to have been practically unchanged from 2013.

Primary current expenditure was pushed up by increasing social benefits in cash, which rose by 2.7 per cent to €328.3 billion, largely reflecting the payment of the tax credit to lower-middle-income employees. Intermediate consumption and social benefits in kind rose marginally, by a total of 0.6 per cent to €134.1 billion, while compensation of employees diminished for the fourth consecutive year, coming down by 0.6 per cent to €163.9 billion, reflecting hiring restrictions and the freeze on contract renewals.

Capital expenditure rose by 1.4 per cent, but if tax credits against deferred tax assets are excluded from transfers to firms, it declined by 5.6 per cent. Gross fixed investment, net of property disposals, came down by 7.0 per cent. The decline was accounted for entirely by local authorities, which account for more than half of this aggregate, and was due in part to the conclusion of the payments of overdue commercial debts that had been made in 2013. Local government investment was down by nearly a third from its 2009 peak.

Interest payments contracted by 3.5 per cent to €75.2 billion, as the increase in the debt was more than offset by the decline from 3.9 to 3.6 per cent in its average cost (see the section 'The government securities market' in Chapter 14).

Healthcare spending. – A significant portion of primary current expenditure, just under 30 per cent (Figure 11.2), is accounted for by local authorities. The most important component is healthcare, which is administered by the regional governments.

Healthcare spending came to 6.9 per cent of GDP in 2014, roughly the same as the euro-area average. After three years of steady decrease, outlays rose by 0.9 per cent to €111 billion. The increase was smaller than that in health appropriations. It was driven by intermediate consumption, which rose by 3.5 per cent to €29.6 billion in healthcare while contracting in the rest of the public sector. The rise in healthcare expenditure also reflected an increase in social benefits in kind, which went up by 0.8 per cent to €39.7 billion. Compensation of employees, by contrast, continued to diminish, falling 0.7 per cent to €35.5 billion.

The adjustment plans for the regions running substantial healthcare deficits have proven effective in containing expenditure. During the first adjustment planning cycle, 2007-09, the regions concerned (Liguria, Lazio, Abruzzo, Molise, Campania, Calabria, Sicily and Sardinia) significantly slowed the rise in their spending to 1.5 per cent per year on average, compared with 3.8 per cent in those regions in 2004-06 and 4.1 per cent in the rest of the country in 2007-09. The adjustment was strengthened in the second cycle (2010-12). The regions involved (Piedmont, Lazio, Abruzzo, Molise, Campania, Calabria, Puglia and Sicily) actually reduced their healthcare spending by 0.6 per cent per year on average, against a modest rise of 1.1 per cent in the other regions. These same regions are still implementing operational programmes (which have followed the adjustment plans; more details are available in the reports in the Bank of Italy's 'Regional Economies' series).

For the regions subject to the adjustment plans, the spending curbs resulted in a decline in the number of hospital beds (by 3.2 per cent per year on average in 2007-09 and 3.6 per cent in 2010-12) and in staffing (by 2.2 per cent per year on average in both periods). In the rest of Italy the contraction was more apparent from 2010 onwards and was less sharp.

There is some evidence that the adjustment plans have not worsened the quality of healthcare. In the second adjustment planning cycle, the Ministry of Health's assessments of observance of minimum healthcare standards[7] and the indicators of the outcomes of the main hospital services developed by the national agency for regional health services improved overall in the regions involved (thanks among other things

7 For its assessment the Ministry assigns a score to each region. In the regions subjected to the adjustment plans, the gap with respect to the top score diminished, on average, from 60 per cent in 2009 to 40 per cent in 2012. For the other regions the gap narrowed from 35 to 30 per cent.

to stepped-up monitoring of service quality) and the gap with respect to the rest of the country was reduced. The level of healthcare services in the regions subject to the adjustment plans nevertheless remains lower on average than in the other regions, as is shown by the persistence of substantial patient movements between regions.

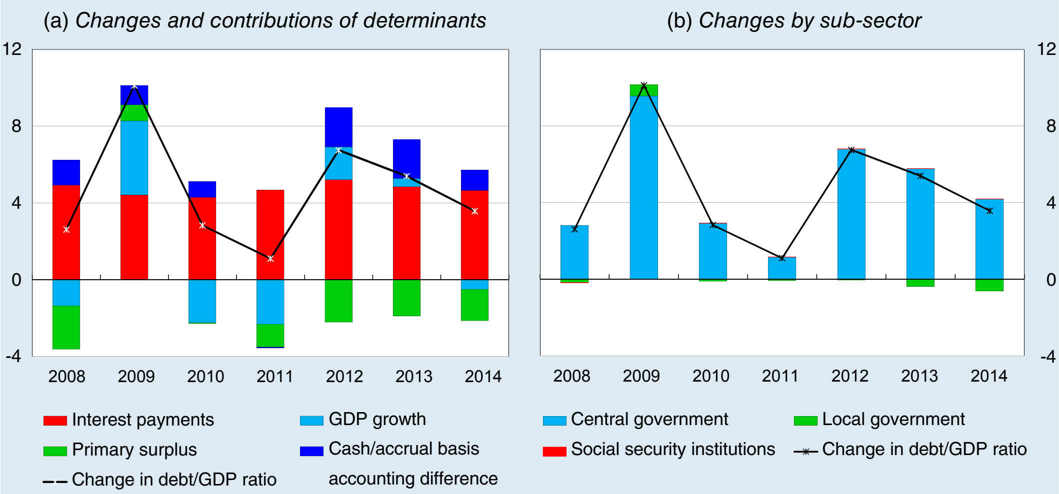
General government debt

Debt dynamics. – The ratio of general government debt to GDP rose by 3.6 percentage points to 132.1 per cent in 2014 (Figure 11.4). The gap between the average cost of the debt and nominal GDP growth (the latter was essentially nil) increased the ratio by 4.1 points; other factors not considered in calculating net borrowing increased the ratio by 1.1 points, while the primary surplus reduced the ratio by 1.6 points.

The most important factors increasing the debt but not net borrowing were the growth in the Treasury's liquid balance (0.5 percentage points of GDP), the reduction

Figure 11.4

General government debt
(per cent of GDP)



of current commercial debts (0.4 points; see the box 'General government commercial debts'), financial support to euro-area countries (0.3 points), and the flows generated by financial derivatives (0.2 points).[8] By contrast, the placement of new bond issues at above-par prices on average held the debt down by about 0.4 percentage points.

Central government debt increased by 4.2 points to 126.0 per cent of GDP, owing in part to loans by the Ministry of Economy and Finance to regional, provincial and municipal governments for the payment of overdue commercial debts (amounting to about 0.7 points). The ratio of local government debt to GDP decreased for the fifth

8 The debt was also increased (by 0.1 point of GDP) by the reclassification as loans of the market value of two interest rate swaps resulting from the exercise of two swaptions, as European statistical rules require.

consecutive year, falling to 6.1 per cent. Including financial liabilities to other general government bodies (which are consolidated in calculating overall general government debt), local government debt remained broadly unchanged at 8.6 per cent of GDP.

The debt ratio jumped by 32.4 percentage points between 2008 and 2014. The cumulative primary surplus of 8.3 points was absorbed by financial transactions (chiefly support to other euro-area countries, the payment of overdue commercial debts and the increase in the Treasury's liquid balance). Given the substantial stagnation of nominal GDP, the rise in the debt ratio corresponded to cumulative interest payments over the period.

The average residual maturity of government securities and that of the overall debt held essentially stable in 2014 at 6.3 and 6.8 years respectively. However, the duration of government securities, which takes the coupon component into account, lengthened from 5.0 to 5.6 years. The share of inflation-indexed securities rose from 11.8 to 12.8 per cent, owing mainly to two new BTP Italia issues.

Other liabilities and guarantees. – Calculated according to the European rules, the public debt does not include some types of liability, such as commercial payables (except those transferred to financial intermediaries without recourse), derivatives and – in that they represent contingent liabilities – general government guarantees in favour of third parties.

Commercial payables were reduced as a consequence of the measures regarding the payment of overdue general government commercial debts (see the box 'General government commercial debts'). However, net liabilities in derivatives, at market values, increased from 1.8 to 2.5 per cent of GDP, mainly as a result of the trend in the yield curve, given that the Ministry of Economy and Finance's debt management strategy aims above all to protect public finances against possible rises in rates. In 2014 general government guarantees in favour of third parties were more than halved, from over 6 per cent of GDP in 2013 to 2.7 per cent last year, owing above all to the reduction in guarantees in favour of the financial sector.

GENERAL GOVERNMENT COMMERCIAL DEBTS

Legislation. – In 2013 and 2014 a sum of around €50 billion was allocated mainly to accelerate the payment of 'certain, liquid and collectable' general government commercial debts outstanding at the end of 2012. According to official monitoring, it can be estimated that, thanks to the measures adopted, firms received more than €10 billion during 2014, compared with about €19 billion in 2013. Moreover, monitoring mechanisms and penalties were introduced to encourage public entities to bring their payment times into line with those required under the EU Late Payment Directive (generally 30-60 days), and the transfer to the financial system of claims on general government, with State guarantees, was facilitated.

Estimated commercial debts. – Our estimates show that total general government commercial debt decreased from about €75 billion at the end of 2013 to just over €70 billion at the end of 2014, a reduction of approximately 5 per cent. This is a fairly rough estimate due to the survey nature of some data. It is given by the sum of two components: a) commercial debts assigned without recourse to financial intermediaries, as recorded in supervisory reports; and b) commercial debts still on firms' balance sheets, estimated using the Bank of Italy's business surveys.

The estimates published by Eurostat, based on data provided by national statistics offices under the excessive deficit procedure, show that at the end of 2014 commercial payables in Italy stood at more than €49 billion – equal to 3.1 per cent of GDP (3.5 per cent in 2013) – the highest amount among the EU countries. With respect to ours, these estimates exclude debts assigned to financial intermediaries without recourse and consider only current expenditure. Taking different definitions into account, during 2013-2014 the decline in commercial debts in our estimates appears broadly consistent with the €13.6 billion estimated by Istat.

Average payment times. – According to our business surveys, the average payment times of general government were below 160 days in 2014, down from 180 days in 2013. This was mainly due to the reduction in the average delay with respect to contractual payment times (which stand at around 65 days). According to the *European Payment Report 2015*, Italian general government payment times, estimated at 144 days, were still longer than those in the other countries surveyed (e.g. more than 120 days longer than in Germany).

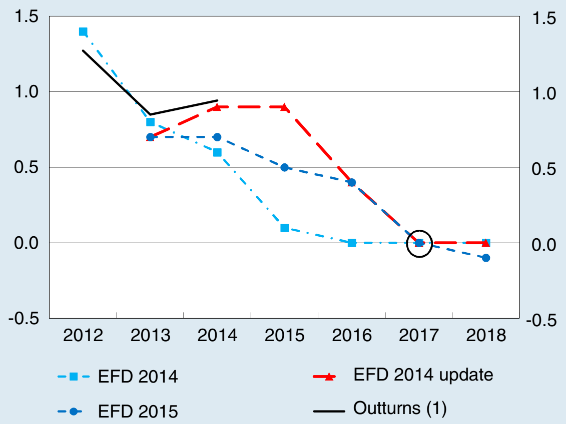
The new rule that general government can only pay suppliers who submit their bills electronically (e-invoices) could make an important contribution to keeping payment times down and increasing the transparency of public finances. For ministries, tax offices and social security agencies, this requirement has been in force since June 2014; for the rest of the public administration it came into effect on 31 March 2015.

The outlook

In April 2014, assuming a significant economic upturn in the course of the year, the Government planned to have the structural budget broadly in balance in 2015, with a structural adjustment equal to half a point of GDP (Figure 11.5). The planning framework lowered net borrowing – projected at 2.0 per cent on a current legislation basis – to 1.8 per cent, a reduction of 0.8 points from the 2.6 per cent forecast for 2014.

Figure 11.5

Structural deficit: objectives and outturns
(per cent of GDP)



(1) European Commission, Spring forecasts, May 2015.

In the autumn EFD update the Government revised its growth projections for both 2014 and 2015 downwards. The public finance framework, which also incorporated the transition to ESA

2010, changed accordingly, and the net borrowing projection for 2015 on a current legislation basis was raised from 2.0 to 2.2 per cent of GDP. The Government then decided on expansive measures amounting to 0.4 per cent of GDP (about €6 billion), setting a net borrowing target of 2.6 per cent. By comparison with the April planning framework the achievement of structural budget balance was postponed (from 2015 to 2017), as was the start on reducing the debt ratio (from 2015 to 2016).

The expansive measures of the 2015 Stability Law also included tax relief amounting to some €11 billion to reduce the tax wedge on labour, among other things by making permanent the tax credit for mid-to-low-income workers that had been enacted in April. Overall, reclassifying the credit as a reduction in revenue, the budget decreased revenue by €7 billion and expenditure by €1 billion by comparison with current legislation. According to the official estimates, the effect on the deficit was projected to be practically nil in 2016 and marginally restrictive in 2017.[9]

The Draft Budgetary Plan released in October estimated that in spite of the expansive measures the structural balance would be improved in 2015 by 0.3 points of GDP. The Government intended to make full use of the flexibility allowed by the European budgetary rules. In the face of adverse macroeconomic conditions and the plan of structural reforms it had pledged to carry out rapidly, it planned a smaller structural adjustment than that required by the preventive arm of the Stability and Growth Pact (at least 0.5 points) or the debt rule (2.2 percentage points under the constraints in effect during the transitional period of application).[10]

In its examination of Italy's programmes, on 28 November the Commission noted the risk of non-compliance but postponed its assessment for several months in order to take account of the definitive text of the Stability Law and of the progress made on structural reforms (see the box 'European budget rules and the objectives for Italy's public finances', *Economic Bulletin*, 1, 2015). On 27 February it recommended against opening an excessive deficit procedure for non-compliance with the debt rule, citing the so-called relevant factors (in particular the adverse macroeconomic situation, including low inflation, and the commitment to carry out a broad reform programme). The decision also took account of Italy's compliance with the preventive arm of the Pact in the light of the communication of January 2015, whereby the Commission had specified the size of the budget adjustments required on the basis of countries' cyclical condition.[11] In the case of Italy, given that the Commission estimated the output gap at between 3 and 4 per cent of GDP in 2015, the adjustment required amounted to 0.25 percentage points, in line with the 0.3-point improvement projected by the Government and the Commission at the time.

In April, on the basis of interest rate developments and more favourable growth prospects, the EFD revised the estimates for the public finances in 2015-18 on a current legislation basis and extended them to 2019, lowering the deficit by 0.1 percentage

9 Ragioneria generale dello Stato, 'La manovra di finanza pubblica per il 2015', February 2015.

10 The adjustment required in 2015 by the debt rule was especially large because it was augmented by the failure to make adjustments in 2013 and 2014 (see *Nota di aggiornamento del DEF 2014* (2014 EFD update), Section III.4, 'La regola del debito').

11 European Commission communication, 'Making the best use of the flexibility within the rules of the Stability and Growth Pact', COM(2015), 12 final, 2015.

point in 2015 (to 2.5 per cent of GDP), 0.4 points in 2016 (to 1.4 per cent) and 0.6 points in 2017 (to 0.2 per cent). Nevertheless, the Government maintained the net borrowing targets set at the end of 2014, envisaging measures that would increase the deficit by an amount practically equal to the projected improvement on a current legislation basis. These measures were intended to strengthen the enactment and implementation of the reforms in 2015 and, in combination with spending reductions, to avoid in 2016 the indirect tax increases provided for by the safeguard clauses. The structural deficit reduction was projected at 0.2 points in 2015, against the 0.3 points planned by the Government in the autumn. For 2016 the structural improvement was estimated at a tenth of a point, instead of the minimum requirement of half a point under the Stability and Growth Pact, by reason of the cyclical situation and the level of the public debt. The difference is due to recourse to the flexibility clause in relation to structural reforms, as specified in the Commission communication cited above. In any case, the projection of structural budget balance in 2017 was confirmed.

At the end of April the Constitutional Court overturned the suspension, in 2012 and 2013, of the cost-of-living indexation of pensions larger than three times the minimum, a measure enacted at the end of 2011. The Government has now approved a decree law for the partial indexation, decreasing with the pension amount, of pensions up to six times the minimum. Based on the data now available, the cost of back benefits should come to about €2 billion in 2015; once the measure is fully phased in, the annual cost should be limited (about €0.5 billion).

In its country-specific recommendations of 13 May, for Italy the Commission acknowledged the margin of flexibility provided by the clause on structural reforms, asking the Government to ensure a structural budget adjustment of 0.25 points of GDP in 2015 and 0.1 point in 2016. The Commission further observed that by its current legislation estimates the structural balance would worsen by 0.2 points in 2016, in contrast with the Italian Government's projection of a 0.5-point improvement. About one third of the discrepancy reflects the Commission's exclusion of the revenue provided for by the safeguard clause in the Stability Law for 2014, insofar as the relevant measures have not yet been finalized.

12. BUSINESS ACTIVITY REGULATION AND THE INSTITUTIONAL ENVIRONMENT

Business activity in Italy is affected by a poor regulatory framework and by the institutional context, notably an ineffective public administration (see Chapter 15, 'The public administration'), a slow civil justice system and widespread corruption. A reallocation of resources is essential in order to exit the long recession, but it is hampered by the heavy regulation of some markets, inefficient corporate crisis management systems and poorly developed financial markets.

The reform process that had begun three years earlier proceeded in 2014. In addition to measures relating to the labour market (see Chapter 8, 'The labour market'), a few aspects of company law were changed to make it easier for firms to obtain funding on the financial markets. Reforms were made to the civil justice system to reduce the number of disputes and speed up proceedings. Efforts to combat corruption were stepped up by strengthening the powers of the National Anticorruption Authority (NAA). Product market regulation, which had undergone sweeping reforms in the preceding three years, again came to the fore when the annual law on competition was submitted for approval.

Some effects of the reforms are now becoming apparent: there is greater openness to competition and a smaller backlog of court cases. The impact on economic activity has been weakened not only by persistent delays in passing the relative enabling laws, but also by the adverse cyclical phase and low inflation. Bankruptcy legislation still functions inadequately, affecting both the winding up of insolvent firms and the restructuring of financially distressed firms.

Competition and market regulation

The OECD indicators for 2013 show that between 2008 and 2013 many branches of Italy's service sector became more open to competition thanks to measures introduced above all in 2011 and 2012 (see Chapter 9, 'The productive economy and the reforms', *Annual Report for 2013*). The effects on economic growth, however, have been limited so far by the adverse economic climate and low inflation (see the box 'Competition reform and macroeconomic developments').

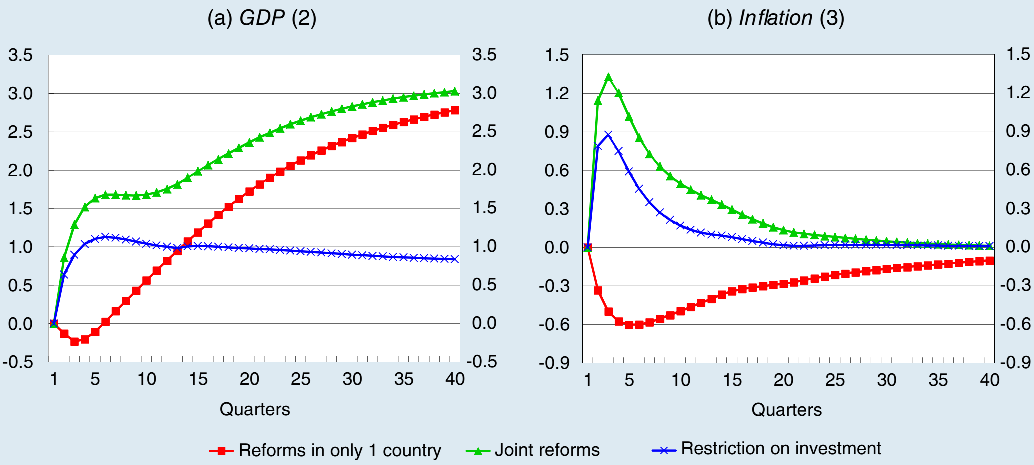
In February this year the Government, implementing Law 99/2009 for the first time, presented the annual bill on competition, containing some of the recommendations

COMPETITION REFORM AND MACROECONOMIC DEVELOPMENTS

Stronger competition in product markets has long-term positive effects on economic activity. A reduction in firms' profit margins, and in the prices of the relevant goods and services, boosts final and intermediate demand, with a knock-on effect for other sectors. Expectations of these positive effects can influence consumption and investment behaviour, causing them to be brought forward. But the way the effects eventually unfold is subject to much uncertainty. This will depend, above all, on how measures to foster competition are implemented, on how likely they are to be permanent, and on how elastic investment in physical capital is to expectations of higher activity in the long term.

In the short term, for these effects to occur demand must be sustained at the same time. In the current macroeconomic context, in which there are limits on the decrease in nominal interest rates, downward pressures on prices from increased competition could translate into a rise in real interest rates. This might cause consumption and investment decisions to be postponed, to the point where economic activity declines.

Effects of an increase in competitiveness (1)



(1) The simulation posits a reduction of 10 percentage points over a period of 5 years in the mark-up of the service sector. – (2) Percentage deviation from the base simulation. – (3) Annualized deviation from the base simulation in percentage points.

Simulations using a dynamic general equilibrium model of the euro area[1] suggest that, with falling prices and limits on the reduction of nominal interest rates, reforms designed to improve competitiveness that are enacted by only one euro-area country could have a limited impact on economic activity during the first two years. The positive effects of expectations of an increase in long-term economic activity would be offset by the negative effects of the rise in real interest rates following the decrease in prices. Thus, enacting an expansionary monetary policy and adopting measures to increase competitiveness are complementary in the short term.

Reforms enacted simultaneously by the euro-area countries could have more pronounced effects on economic activity and a positive impact on prices even in the short term. This happens when the measures taken not only foster a gradual increase in the supply of goods and services, but also exert sufficiently expansionary pressure

[1] A. Gerali, A. Notarpietro and M. Pisani, 'Structural reforms and zero lower bound in a monetary union', Banca d'Italia, Temi di Discussione (Working Papers), 1002, 2015.

on aggregate demand in the short-to-medium term, mainly through an increase in investment and exports. However, when firms' capacity to invest is limited – e.g. by restrictions on access to credit – aggregate demand would increase less, greatly reducing the overall impact of the reforms on economic activity and on prices compared with the case in which investment responds immediately.

set out in the Italian Competition Authority's weekly bulletin No. 27 of July 2014.[1] The sectors concerned are insurance, telephone and banking services, fuel distribution and legal services.

The regulation of business activity

Company law and corporate governance. – Between 2000 and 2014 the number of non-financial companies listed on the stock exchange rose from 190 to 248. Compared with the other euro-area countries, however, few Italian firms issue shares: at the end of 2014 the stock market capitalization of non-financial firms amounted to 19.3 per cent of GDP in Italy, 35.2 per cent in Spain, 41.8 per cent in Germany and 62.5 per cent in France.

The measures adopted last year (Decree Law 91/2014, converted by Law 116/2014) aimed to encourage recourse to channels of financing other than bank loans by offering tax and regulatory incentives for stock market listing (see the box 'The new rules on lending to firms by non-bank intermediaries', *Financial Stability Report*, 2, 2014). Unlisted companies are allowed to issue multiple voting shares, with the option to keep them in the event of subsequent listing. These shares waive the principle of 'one share – one vote' and allow the issuer to retain control with a limited financial outlay. In Italy, where company ownership is concentrated and family businesses are widespread (see Chapter 6, 'Firms'), this system can help to overcome misgivings about listing. It does have repercussions on the cost of capital, but issuers can limit these by reinforcing the safeguards for minority shareholders at the time of listing.

A similar scheme is also available for listed companies, linked to the length of time shareholders have held their shares. To encourage shareholders to take a more active part in the company over the long term, additional voting rights can be granted to those who had been registered for at least two years. Given the unwillingness of institutional investors to make use of an additional voting right, such a scheme would probably be used mainly by major shareholders, thus further reducing the chance of take-over bids.

Bankruptcy law. – Lengthy proceedings and the uncertain outcome of corporate crises cause a build-up of non-performing loans in banks' balance sheets, eroding their capacity to lend (see Chapter 13 'Banks and institutional investors'). Insolvency proceedings (bankruptcies and debt restructuring agreements) have increased significantly during the economic crisis.

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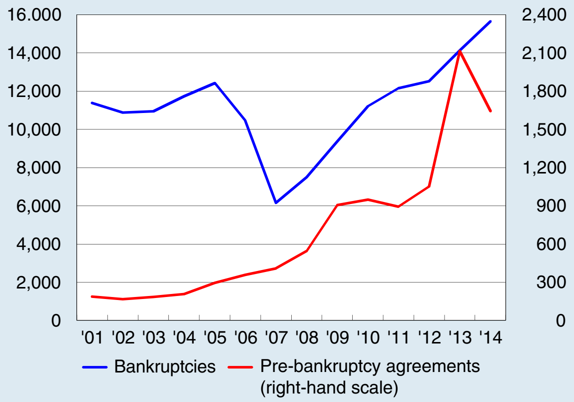
1 Available in Italian at *http://www.agcm.it.*

The number of bankruptcy proceedings opened each year has been rising since 2007, after a dip following the 2006 reform, which had, among other things, also restricted the scope of the procedures (Figure 12.1). Reducing the duration of procedures was one of the goals of the reform, but this does not appear to have been achieved. Based on data from the Cerved group's companies register, just 49.1 per cent of insolvency proceedings begun in 2007-08 were concluded within six years, against 48.4 per cent in 2001-02. There continue to be significant geographical differences too, with 53.3 per cent of proceedings coming to a close within six years in the North, 50.2 per cent in the Centre and 41.0 per cent in the South. This failure to shorten the process may be due in part to the difficulty of selling off assets, which the long recession has aggravated.

Figure 12.1

Incoming insolvency proceedings (1)
(number)



Sources: Based on Cerved group and Infocamere data.
(1) Pre-bankruptcy agreements comprise proposals accompanied by a debt restructuring plan.

After the reform of insolvency procedures in 2005 – aiming to facilitate early intervention for companies in financial crisis and ensure business continuity – use of the *concordato preventivo* (proposal for arrangement with creditors filed by the debtor) increased compared with bankruptcy proceedings (Figure 12.1). The introduction in 2012 of the *concordato con riserva* (which allows an anticipation of the debtor's Court protection while preparing the proposal for arrangement) and the partial amendments of 2013 initially encouraged such pre-bankruptcy agreements and then limited them. The results of company restructurings may also have been affected by the economic difficulties. In most cases where composition with creditors is applied for the company never recovers to become fully operational again: only 4 per cent of those filing a pre-bankruptcy agreement in 2006-07 were producing a profit six years later.[2] An alternative route to crisis resolution as part of pre-bankruptcy agreements is to sell off all or part of the company.

A committee of experts has recently been set up within the Ministry of Justice to draw up proposals for the reform of insolvency law.

The institutional environment

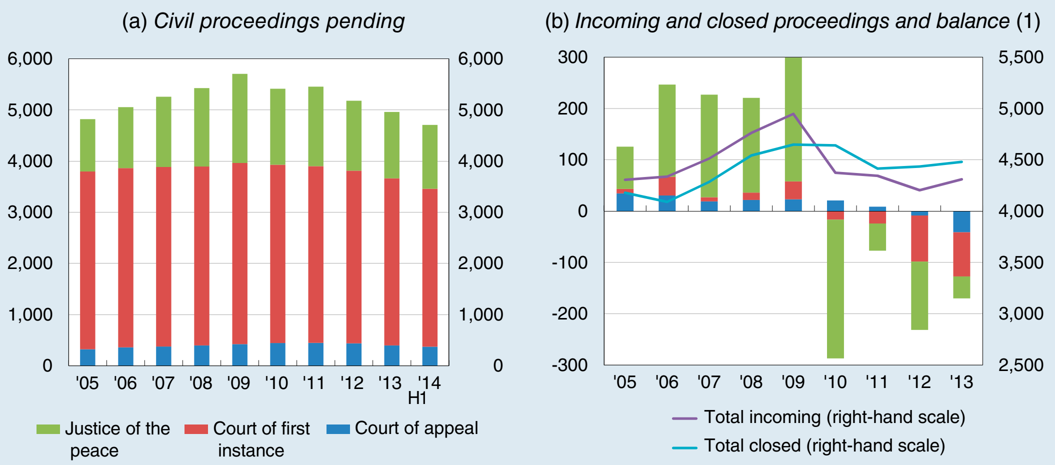
Civil justice. – The reform process begun in 2011 was taken forwards with the passing of Decree Law 132/2014, converted by Law 162/2014. In order to reduce litigation two new out-of-court dispute settlement procedures were introduced:

[2] C. Castelli, M. Micucci, G. Rodano and G. Romano, 'Il concordato preventivo in Italia: una valutazione delle riforme e del suo utilizzo', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

assisted negotiation and the possibility for parties to request that pending first instance or appeal court cases be referred to an arbitration panel. Frivolous litigation has been discouraged by raising the interest rate applicable to pending legal proceedings, and the system of awarding legal fees and expenses has been altered. To accelerate civil proceedings, the judge can, during the taking of evidence, order that a case brought as ordinary proceedings be converted into summary proceedings, involving a simplified and fast-track procedure. In enforcement proceedings, court bailiffs are authorized to search electronic databases for attachable assets.

Figure 12.2

Civil justice: change in stocks and flows of court proceedings
(thousands of proceedings)



Source: Based on Ministry of Justice data.
(1) Balance of incoming and closed proceedings by category of court.

The effects of the reforms are beginning to be visible. From the end-2009 peak of more than 5,700,000 cases to 30 June 2014 the number of pending cases fell by 18 per cent. The workload of justices of the peace decreased more (28 per cent) than that of the first instance courts (13 per cent) or appellate courts (12 per cent), although the latter accounted for a significant part of the reduction above all in 2012-13 (Figure 12.2).

The main cause of the drop in the number of pending cases is the decline in inflow, thanks above all to the measures taken in recent years concerning specific types of procedure, notably appeals against administrative sanctions and in matters of social security and petitions for compensation for excessive delays in the judicial process.

Proceedings remain nonetheless lengthy and there continue to be significant differences between courts. On average 28 per cent of cases in the first instance courts have been pending for more than three years, ranging from 4 per cent in the most virtuous court to 64 per cent in the least efficient one.[3] Further progress will depend on the improvements made to the incentives for all the actors involved in the functioning of the judicial system and on the reorganization of the courts now under way, consisting

[3] See *https://webstat.giustizia.it/_layouts/15/start.aspx#/Analisi%20e%20ricerche/forms/performance.*

in streamlining the local judicial administration system, developing IT systems, and carrying out programmes to reduce the backlog of cases.

Corruption. – International indicators based on perception surveys point to a high degree of corruption in Italy. Although there may be distortions, these indicators nonetheless offer some useful comparisons. According to the Corruption Perception Index developed by Transparency International, Italy is one of the EU countries with the highest level of corruption, alongside Bulgaria, Greece and Romania. The World Bank's Control of Corruption indicator paints a similar picture.

PROBLEMS WITH THE SUBJECTIVE MEASUREMENT OF CORRUPTION

The lack of data on the true extent of corruption has led to the use of measures based on perception of the phenomenon. Although such indicators may suffer from distortions due to their subjective nature and to other context-related factors, they are widely used in the economic literature, especially for international comparisons.

The Survey of Household Income and Wealth conducted by the Bank of Italy contains a set of questions designed to measure each respondent's (about 1,800 in total) assessment of the likelihood of corruption and of this being discovered and punished. The answers are used to draw up indicators of corruption and of confidence in counter-measures based on the interviewees' perceptions expressed as subjective probabilities ranging from 0 to 100. According to the results, the perception of corruption is much more widespread in the South of Italy, although counter-measures are judged to be slightly more effective than in the other regions.

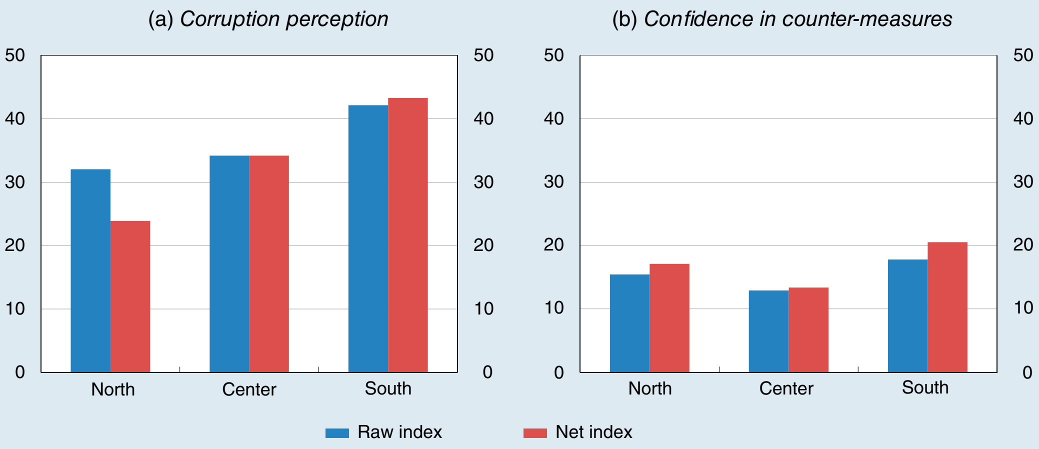
We have recently carried out a study to assess whether and how far these measures are influenced by the media, checking if the respondents' answers reflect the number of news items concerning corruption appearing on the front page of 30 online newspapers on the day of the interview.[1]

We find that one additional news item on corruption, equal to 8.4 per cent of the daily average of items recorded, increases the perception of corruption by 0.2 percentage points (equal to about 1 per cent of the average) and reduces confidence in counter-measures by 0.6 points (about 1 per cent of the average).

The media have a greater impact on the perception of corruption in the North of Italy. Not counting this effect increases the difference between North and South by about 9 percentage points, from 10.1 to 19.4 per cent (figure, panel a). Instead, the influence that media attention has on confidence in counter-measures is more evenly distributed around the country; factoring in the distortions attributable to the media, the gap between North and South increases by about 1 percentage point, from 2.4 to 3.4 per cent (figure, panel b).

[1] L. Rizzica and M. Tonello, 'Exposure to media and corruption perception', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

Corruption perception indexes: comparison of measures including (raw) and excluding (net) media influence
(per cent)



Source: Based on data from the Survey of Household Income and Wealth.
(1) The corruption perception index records each interviewee's assessment (from 0 to 100) of the likelihood that a public official will ask for cash, a favour or a gift in exchange for a service. The index of confidence in counter-measures records the likelihood (from 0 to 100) that a corrupt official will serve a prison sentence if discovered. For each macro-area the 'raw' indicators represent the average value of the probability assessed by the interviewees; the 'net' indicators are obtained by subtracting from the average value of the 'raw' indicators the sum of the coefficient of the ordinary least squares estimate of the impact of media attention on the perception of corruption and the average number of news items on corruption published in the macro-areas in the observation period.

Objective measures, based on data on judicial and investigative activity, as well as perception-based measures indicate that corruption is more widespread in the South of Italy than in the Centre and North. This gap remains even when distortions in the measurements are factored in (see the box 'Distortions in the subjective measures of corruption').

Since 2012, anti-corruption action has been strengthened with the passage of Law 190/2012, combining penal sanctions with preventive action. The adoption of the enacting provisions is still under way: in April this year the NAA approved a set of guidelines on whistleblowing in the public administration.

Decree Law 90/2014, converted by Law 114/2014, contains measures to fight corruption in public contracts. The NAA's role has been extended by granting it the power to appoint a special administrator for firms assigned public works contracts that are under investigation for 'offences against the public administration' and by transferring to it the powers of the former supervisory authority for public contracts. It is now compulsory to notify the NAA of any major changes occurring during the performance of a contract.

The draft enabling law for the transposition of the European directives issued in 2014 regarding public procurement and the award of concession contracts will greatly simplify the relevant regulations. Taken together with the NAA's market regulation powers, this could make the tender evaluation and contract award process less susceptible to corruption, which the present complexity favours.

Widespread corruption is aggravated by the presence of criminal organizations, which have moved beyond their traditional areas of operation. Corruption and organized crime cause distortions in the allocation of resources, diminish the effectiveness of policy action, and hinder development.[4]

[4] G. Barone and G. Narciso, 'Organized crime and business subsidies: where does the money go?', *Journal of Urban Economics*, 86, 2015, pp. 98-110; G. Barone and S. Mocetti, 'Natural disasters, growth and institutions: a tale of two earthquakes', *Journal of Urban Economics*, 84, 2014, pp. 52-66; P. Pinotti, 'The economic costs of organized crime: evidence from southern Italy', *Economic Journal*, forthcoming.

13. BANKS AND INSTITUTIONAL INVESTORS

In 2014 and the early months of 2015, the activity of banks and institutional investors benefited from abundant market liquidity and low interest rates. The very low cost of both wholesale and retail funding allowed the banks to reduce their recourse to Eurosystem refinancing significantly. In 2014 institutional investors raised €110 billion, the largest amount in fifteen years, taking advantage of savers' search for higher yields. The risks of a prolonged period of low interest rates remain modest both for Italian banks and institutional investors alike, thanks to the good matching of duration and yields between assets and liabilities (see *Financial Stability Report*, 1, 2015).

The lack of economic recovery has continued to penalize banks severely. Lending declined and credit quality worsened last year, though less than in 2013. However, some signs of improvement have appeared, faint as yet in the case of credit quality but clearer as regards the trend in lending. The progressive easing of credit supply conditions, reported by opinion surveys since mid-2014, continued in the first few months of 2015, and the gradual recovery in credit is also indicated by an increase in new loans to households and, since the start of 2015, to firms as well.

Banks' net profits were again negative, but their capitalization strengthened thanks to capital increases made in the first part of the year. Profitability was also negative for the other credit intermediaries. Bank and branch closings continued with a view to efficiency. However, both administrative and labour costs increased slightly, owing in part to early retirement incentives.

The profits of all categories of institutional investors increased considerably, driven by the strong performance of funding.

The comprehensive assessment of the largest euro-area banks was conducted in 2014, preparatory to the launch of the Single Supervisory Mechanism. The results for the Italian banks were positive on the whole, helping to make balance sheets more transparent and bolstering market confidence. The banks at which shortfalls were detected presented capital strengthening plans. The Bank of Italy, as part of the Supervisory Board, is monitoring their implementation (see *Relazione sulla gestione e sulle attività della Banca d'Italia,* 2014).

BANKS

The structure of the Italian banking industry

Italy has a total of 663 banks, of which 150 belong to 75 banking groups and 365 are mutual banks. The Italian banking industry is of relatively modest size by international standards, with total financial assets equal to 2.6 times GDP in 2014, as against 3.1 in the euro area and Germany and 4.0 in France. The main groups too are comparatively small. The degree of banking concentration in Italy – measured by the share of assets held by the five largest banks, equal to 40 per cent in 2013 – is intermediate among the large European countries.[1]

The industry's structure is changing under the impact of both the crisis that has reduced the number of banks and made it necessary to curb operating expenses and also in response to technical progress, which has widened the range of distribution channels. The number of banks active in Italy fell by 17 per cent between 2008 and 2014, above all owing to troubled and less efficient intermediaries leaving the market. Special administration procedures were begun for 12 banks in 2014 (7 mutual banks and 5 limited banks, 2 of which belonged to groups whose parent company was already under special administration). Liquidation procedures were activated for 2 other mutual banks.

Between 2008 and 2014 the number of bank employees was reduced by 17,900 (5.6 per cent) and the number of branches by 3,400 (9 per cent). The downsizing was much greater for the five largest groups, which also significantly reduced their market shares during the period. Distribution channels that exploit new technologies (Internet, mobile and phone banking) are increasingly being used. During these years the number of bank customers with access to distance services increased by 65 per cent to about 25 million, and the proportion of credit transfers executed online rose by over 20 percentage points to 43 per cent.

The decline in profits and the need to comply with the new, higher capital requirements have spurred the drive for efficiency. The recent reform of cooperative banks increases their ability to attract capital. The protocol signed by the Ministry of Economy and Finance with the association of savings banks and savings bank foundations will encourage greater diversification of investments. The federation of mutual banks is considering reforms which, among other things by providing for membership in proper banking groups, should foster greater integration and access, when necessary, to the capital market.

Assets

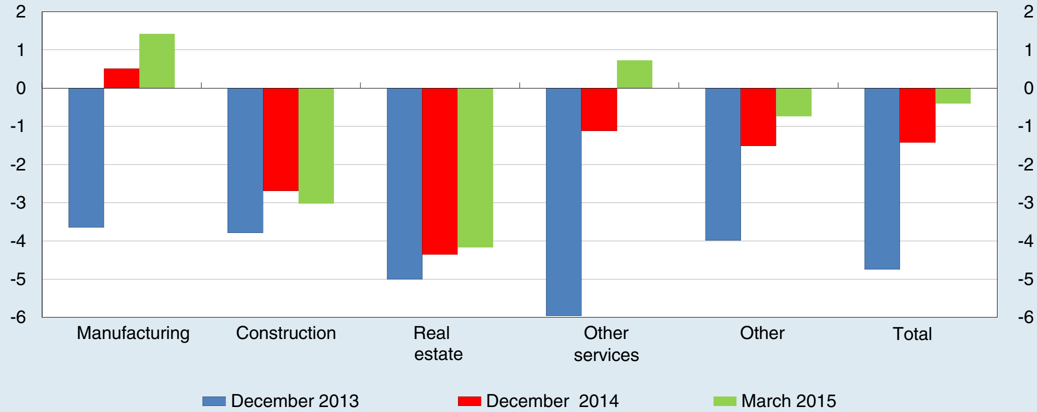
Lending. – Lending to Italian residents by banks operating in Italy continued to decrease in 2014, although less steeply than in 2013, diminishing by 0.7 per cent. Lending to households more or less stabilized. New mortgage lending returned to growth, increasing by 11.0 per cent, driven by the decline in interest rates to near the levels of 2010 (see Chapter 7, 'Households'), while lending to firms declined again, though much more moderately than in 2013 (2.0 as against 5.1 per cent), owing above all to still weak credit demand and firms' balance sheet conditions (see Chapter 6, 'Firms'). The Eurosystem's quarterly bank lending survey reported the progressive easing of supply conditions in the course of the year, especially for the less risky firms. The improvement continued in the first quarter of 2015, and banks expected the tendency to be maintained in the months to come and to be flanked by an upturn in demand. In the first quarter new loans to firms were nearly 13 per cent above their 2014 average.

[1] ECB, *Banking Structures Report*, 2014. The data are not calculated on a consolidated basis.

Credit dynamics were much more favourable for the borrower firms that were not saddled with non-performing loans. In the manufacturing sector financing to such firms increased by 0.5 per cent in 2014 after falling by 3.6 per cent the previous year, while in non-real-estate services it decreased only marginally (Figure 13.1). The recovery in credit gathered momentum in the early months of 2015 for firms in both sectors.

Figure 13.1

Bank lending to firms without non-performing loans (1)
(percentage change in the 12 months ending in the reference month)

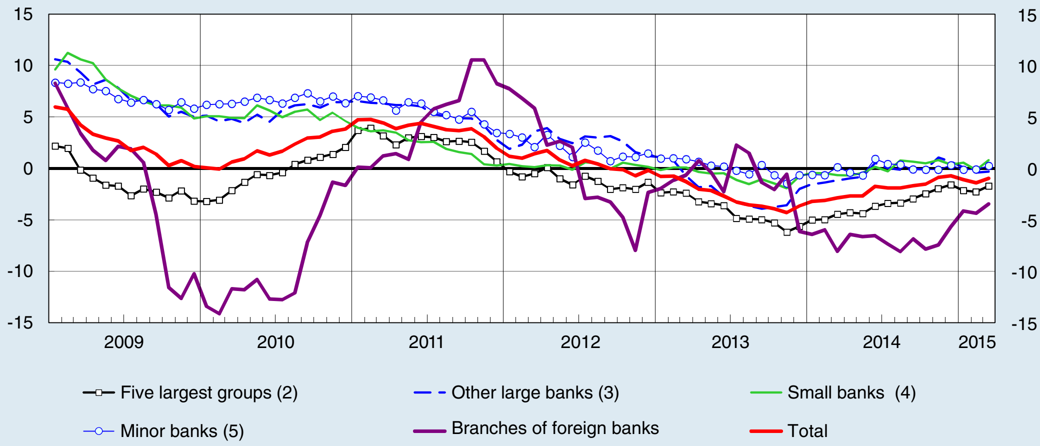


Source: Central Credit Register.
(1) Loans to firms that in the 12 months considered had only performing loans. The sectors are classified according to NACE 2007.

Lending by the top five groups and the branches of foreign banks continued to diminish, albeit more moderately than in 2013. Loans granted by other categories of bank increased slightly (Figure 13.2)

Figure 13.2

Bank lending by bank size (1)
(monthly data; 12-month percentage changes)



Source: Supervisory reports.
(1) The data for March 2015 are provisional. Loans include repos and bad debts. Banks are classified according to the composition of banking groups at March 2015 and to unconsolidated total assets at December 2008. Percentage changes are calculated net of the effects of securitizations, value adjustments, reclassifications and other variations not due to transactions. – (2) Banks belonging to the groups Banco Popolare, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, Unione di Banche Italiane and UniCredit. – (3) Groups and independent banks with total assets of between €21,532 million and €182,052 million. – (4) Groups and independent banks with total assets of between €3,626 million and €21,531 million. – (5) Groups and independent banks with total assets of less than €3,626 million.

The divergence between credit trends at banks of different sizes depends on both supply and demand factors. The smaller banks mostly adhere to a relationship lending model based on direct contact with borrowers, which provides greater incentive to safeguard long-term relationships. Furthermore, a good part of these banks' borrowers are small and medium-sized enterprises, which have little alternative to bank credit as a source of finance. By contrast, in recent years larger firms, which receive a significant portion of the larger banks' lending, have replaced a considerable amount with bond issues.

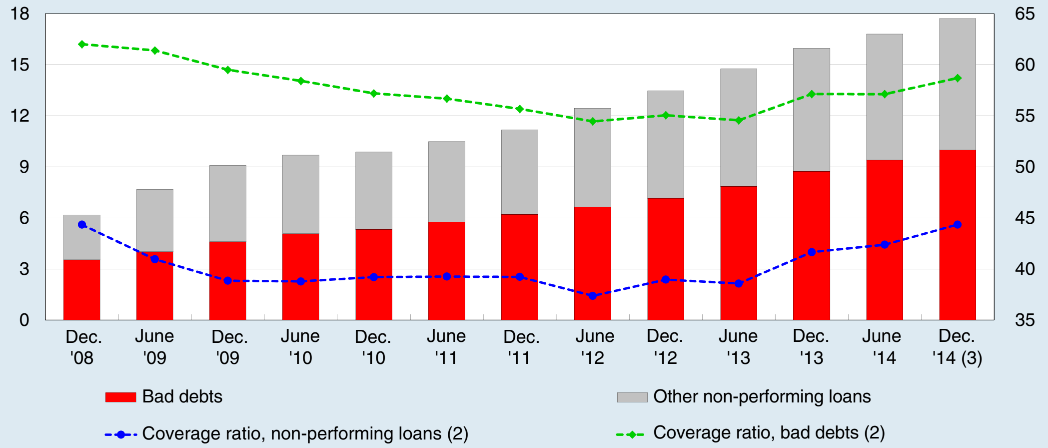
Loan quality. – The new bad debt rate was 2.6 per cent on average in 2014, 0.3 points less than in 2013, and the new non-performing loan rate was 4.9 per cent, down from 5.6 per cent. The situation worsened in the fourth quarter owing to the protraction of the cyclical downturn. A contributing factor, as on the occasion of past inspections, was the entry into the accounts of the fifteen largest banks – all at once – of the results of the asset quality review (see *Financial Stability Report*, 2, 2014).

In the first quarter of 2015 the seasonally adjusted annualized new bad debt rate came down to 2.4 per cent, 0.3 points better than in the previous quarter.

While non-performing loans rose to 17.7 per cent of total outstanding loans in December 2014, the coverage ratio, i.e. the ratio of loan loss provisions to gross exposures, rose by 2.7 points to 44.4 per cent (Figure 13.3).

Figure 13.3

Credit quality of Italian banks and groups:
incidence of non-performing loans and coverage ratio (1)
(per cent)



Sources: Consolidated supervisory reports for groups, individual reports for banks not belonging to groups.
(1) Including groups and banks controlled by foreign banks. Incidence is calculated in relation to banks' exposure gross of provisions. The coverage ratio is the ratio of loss provisions to the corresponding gross exposure. – (2) Right-hand scale. – (3) Provisional data.

The large amount of non-performing loans on the books depends in part on the time to credit recovery, which is significantly longer in Italy than abroad (see Chapter 12, 'Business regulation and the institutional context'). The limited development of a private market for bad loans, which is reflected in the small volume of bad debt transfers and securitizations (only about €5 billion worth of exposures removed from banks' balance sheets in 2014) remains an obstacle to reabsorbing the effects of the crisis. Measures to create incentives for the reduction of bad debts are under study (see the box 'A special purpose company for the purchase of Italian banks' bad debts', *Financial Stability Report*, 1, 2015).

Holdings of securities. – The banks' securities portfolio diminished by 0.4 per cent in 2014. The share of total assets accounted for by government securities edged up from 9.8 to 10.2 per cent, mainly because of the rise in the value of their existing bond portfolio as yields declined. Net purchases were practically nil, compared with substantial net purchases in 2012-13, owing in part to the large spread in risk-adjusted yields between government securities and loans to households and firms (see the box 'Banks' recent purchases of Italian general government securities', *Financial Stability Report,* 6, 2013).

The falling yields on government bonds, one factor in which is the public sector purchase programme recently launched by the Eurosystem (see Chapter 4, 'Monetary policy in the euro area'), and the prospective reduction in credit risk should restore a positive spread between expected yields and so favour the gradual substitution of loans for securities.

Funding

Banks' total funding contracted by 2.2 per cent last year, following the 3.4 per cent drop of 2013. Net of Eurosystem refinancing, the decline was smaller (0.6 per cent). The average cost of funds diminished in the course of the year, thanks in part to quantitative easing by the ECB, to stand at 0.9 per cent in December, 30 basis points lower than at the end of 2013 and extremely low by historical standards. Retail funding increased slightly, by 0.3 per cent, in 2014, as 6.1 per cent growth in deposits more than offset the 21.4 per cent drop in bonds held by households. Among deposits, current accounts expanded while fixed-term deposits and customer repos diminished. The shifting composition of funding among the various instruments reflects both banks' supply strategy of keeping down funding costs and also, presumably, savers' need to maintain holdings of liquidity against increasing investment in the more risky financial instruments (see Chapter 7, 'Households').

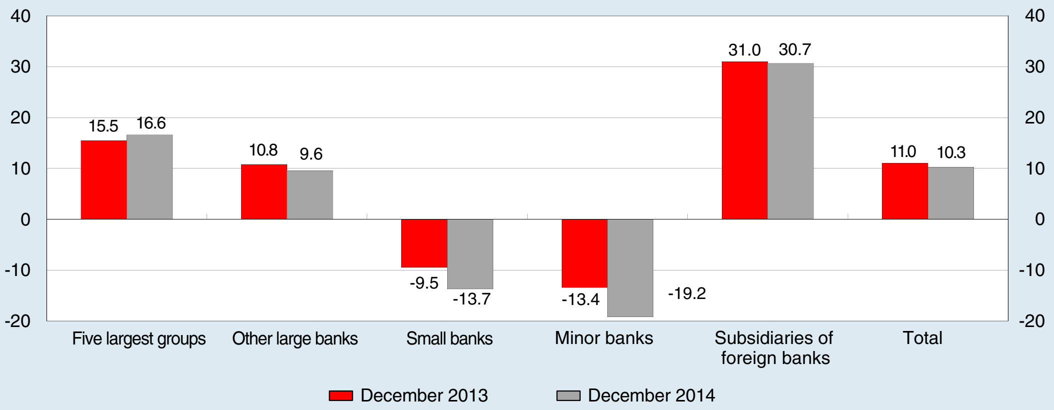
Wholesale funding contracted by 3.0 per cent, although the pace of the decline slowed in the second half of the year. Cross-border interbank funding fell by 6.7 per cent, while bond issues placed with institutional investors gained 4.0 per cent thanks to favourable financial market conditions.

The increased incidence of retail funding, together with a diminution in lending, helped to narrow the funding gap, i.e. the portion of lending not financed by retail funding, even at the banks that did not reduce their lending (Figure 13.4; see *Financial Stability Report*, 1, 2015).

Recourse to Eurosystem refinancing decreased progressively and was down 18.8 per cent on the previous year. New funds obtained through targeted longer-term refinancing operations (see Chapter 4, 'Monetary policy in the euro area') offset the reimbursement of three-year refinancing operations only in part.

Figure 13.4

Italian banks' funding gap (1)
(per cent)



Source: Supervisory reports.
(1) Difference between loans to residents and retail funding (residents' deposits and bonds placed with households) as a ratio to loans to residents. Excludes Cassa Depositi e Prestiti and branches of foreign banks.

In the first three months of 2015 the decline in funding eased further, to 0.6 per cent, and net of liabilities to the Eurosystem funding expanded by 1.5 per cent. Retail and wholesale funding both increased; all the wholesale components gained, including deposits by non-residents, which went up for the first time since July 2011.

Capital and profitability

Profitability. – The return on equity of Italian banks and banking groups, net of goodwill impairments, was negative again in 2014 at -0.2 per cent, representing a slight improvement from the loss of 0.9 per cent in 2013 (Figure 13.5). Profitability was undermined by substantial loan loss provisions, which absorbed virtually all their operating profit.

Net interest income increased by 1.0 per cent, as the shrinkage in the volume of lending was more than offset by the shift in funding towards less costly sources, which resulted in a widening of unit margins. Non-interest income diminished slightly, by 1.0 per cent. Net fee income rose by 4.7 per cent thanks to the recovery of the asset management industry, while the proceeds from trading activity and from the disposal of financial holdings (which were especially large in 2013) declined. Gross income remained broadly unchanged.

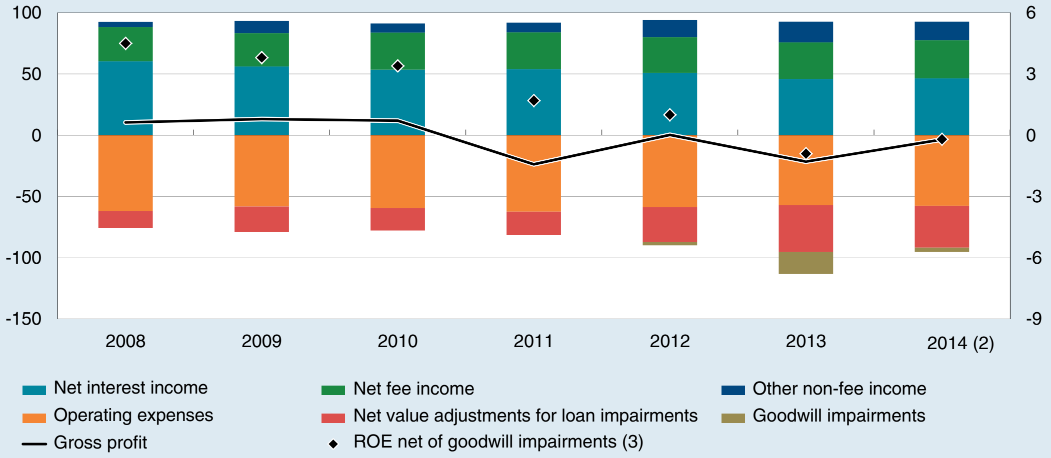
After two years of reduction, operating expenses rose marginally, by 0.6 per cent, owing in part to the costs incurred by some large groups to encourage early retirement of staff. The recently renewed collective bargaining agreement for the industry will help to curb staff costs over the next few years.

The cost cutting measures undertaken in the years following the global financial crisis enabled the banking system as a whole to blunt the impact of the recession on profitability (see the box 'Asset composition and profitability of the main euro-area banks').

Figure 13.5

Main profit and loss items of Italian banks and groups (1)

(billions of euros; per cent)



Sources: Consolidated supervisory reports for banking groups, individual reports for non-group banks.
(1) Provisional data. – (2) Right-hand scale.

ASSET COMPOSITION AND PROFITABILITY OF THE MAIN EURO-AREA BANKS

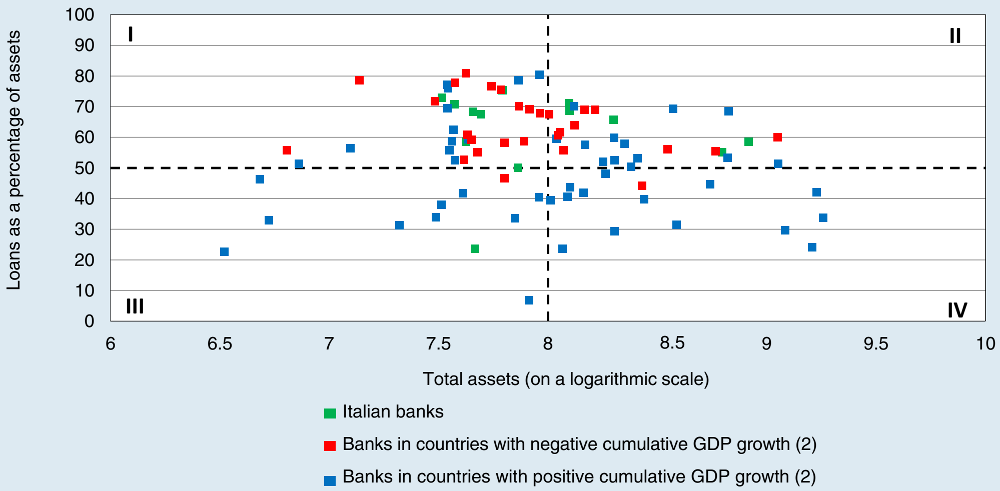
Since November 2014, with the start of the Single Supervisory Mechanism, the main euro-area banks have been supervised by the ECB. The banks involved are very diverse both in terms of size and core business. The figure below shows the total assets (on a logarithmic scale) and the share of loans other than interbank lending for a sample of 90 banks for which there is public data on the composition of their assets.[1] The 13 Italian groups are almost all placed in the upper part of the figure (quadrants I and II), i.e. among those for which lending accounts for at least 50 per cent of assets. Most of the 14 Spanish banks have the same characteristics as the Italian intermediaries; nearly half of the 7 French and 19 German banks can be found in quadrant IV, which contains large banks with a low ratio of loans to total assets. The data collected and published by the European Banking Authority (EBA) on exposure to credit risk also show that banks specializing in lending to customers have a greater exposure in their country of origin and to the business sector - characteristics that are particularly noticeable among the Italian banks.

A comparison of these banks' profitability between 2006 and 2013 must take account of the different kinds of operations conducted and the cyclical conditions of the economies in which they are located. In 2006-07 banks specialized in traditional lending activities had higher profits than the others; from 2008 they saw a more marked fall in profitability. For banks located in countries with negative cumulative GDP growth from 2007 to 2013 the decline was even greater, largely because of higher loan loss adjustments. In the last two years the

[1] The sample includes 90 of the 123 significant banks; only parent banks of groups resident in the euro-area were included. Consolidated data were used.

Figure

Distribution by assets and share of loans in the balance sheet (1)



Source: Based on SNL Financial, data referring to 2013.
(1) The vertical dotted line corresponds to the median line. – (2) The cumulative GDP growth was calculated between 2007 e il 2013.

gap in profitability between banks has mainly been due to differences in national economic performance. Even in countries where the situation was less adverse (including France, Germany and most of the countries of northern Europe), banks specialized in lending no longer report the higher profitability they enjoyed before the recession. Profits have declined for all banks, regardless of their main type of activity, and they are now only marginally positive.

Capital. – The new capital requirements for banks went into effect in 2014, transposing the Basel III standards into European Union regulations. The new rules are significantly more stringent as regards both the quantity and the quality of the capital that banks must hold against their risk exposures. Compliance will be phased in. The rules adopted in Italy, which immediately applied the minimum capital ratios of the new regime, provide for a transitional period for the aggregates deducted from supervisory capital that will end, in practice, in 2018.

At the end of the year the banking system's highest quality capital (common equity tier 1), calculated by the transitional rules phased in for 2014, came to 11.8 per cent of risk-weighted assets. Capital increases worth some €11 billion were effected in the first half of the year, so that the losses recorded did not result in a decrease in capital. If the final rules had been applied, the system's fully loaded CET1 ratio would have averaged 11.3 per cent.

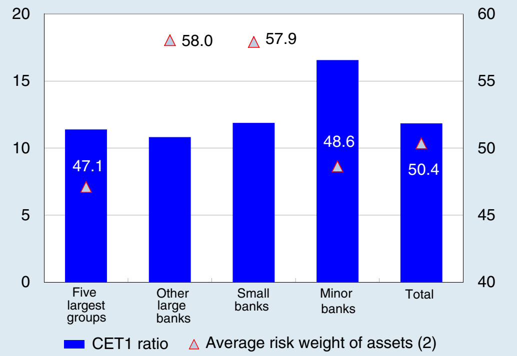
Banks' capital adequacy differs according to size class. At the end of the year the CET1 ratio of the largest groups was 11.4 per cent, slightly less than the system-wide average. That of minor banks was 16.6 per cent, remaining well above the average (Figure 13.6). Nevertheless, since the start of the crisis the difference in capitalization between the minor banks and the system average has diminished; as gauged by the CET1 ratio, the differential came down from 7.1 percentage points in 2007 to 5.5 points in 2010 and 4.7 in 2014. One factor was the decline in profitability, which is the minor banks' chief source of capital strengthening.

Italian banks' leverage continues to be low by international standards, reflecting a business model oriented towards traditional credit intermediation, hence a relatively higher risk weight of assets. The latest available data for comparison, for June 2014, put the average leverage of the major Italian banking groups (the ratio of tier 1 capital to unweighted risk assets) at 5.0 per cent. The average for the large, internationally active European banks was 3.9 per cent and for smaller European banks, 4.9 per cent.

Figure13.6

CET1 ratio and average risk asset weight of Italian banks and groups (1)

(per cent; December 2014)



Sources: Consolidated supervisory reports for banking groups, individual reports for non-group banks.
(1) Average risk weight is the ratio of risk-weighted assets to unweighted assets; for size classes of banks, see the footnotes to Figure 13.2. – (2) Right-hand scale.

NON-BANK CREDIT INTERMEDIARIES AND LOAN GUARANTEE CONSORTIUMS

Lending by non-bank intermediaries,[2] including those belonging to banking groups, declined by 2.9 per cent last year, following a 3.7 per cent drop in 2013. Credit quality worsened further. In the main business areas (leasing, factoring and consumer credit) the incidence of non-performing loans (bad debts, sub-standard loans, restructured loans, overdue loans and breaches of overdraft limits) rose by 1 percentage point to 16.7 per cent of outstanding exposures at the end of the year; for leasing companies it reached 23.7 per cent.

For the entire sector, profitability was negative again, but the losses were much smaller than in 2013 (€353 million as against €1.7 billion). Supervisory capital increased by €0.5 billion, bringing the total capital ratio to 11.5 per cent, nearly twice the minimum requirement of 6 per cent.

The guarantees extended by mutual loan guarantee consortiums entered in the special register decreased by 4.1 per cent in 2014 to €13.9 billion. As a result they had less recourse to second-level guarantees from the Guarantee Fund for Small and Medium-sized Enterprises. Non-performing exposures rose to 27.8 per cent of the total. The deterioration was reflected in an increase in loss provisions, which impacted on earnings; the sector made total losses of €86 million for the year. The decline in their business resulted in a reduction in capital requirements, enabling the consortiums to raise their total capital ratio from 14.4 to 15.1 per cent.

[2] Intermediaries entered in the special register provided for in the Consolidated Law on Banking, save for mutual loan guarantee consortiums, which are treated separately.

INSTITUTIONAL INVESTORS

Funding. – Italian institutional investors raised €111 billion in 2014, more than twice as much as the previous year (Table 13.1 and Figure 13.7.a), recouping a good part of the €265 billion decrease recorded between 2006 and 2012. Inflows of this magnitude had not been achieved since the late 1990s, when the industry was in the initial stage of development.

Table 13.1

Italian institutional investors: net funding and assets under management
(millions of euros and per cent)

	Net flows		End-of-period stocks			
					Percentage composition	
	2013	2014 (1)	2013	2014 (1)	2013	2014 (1)
Investment funds (2)	16,330	40,043	205,539	250,578	14.3	15.2
Insurance companies (3)	29,675	57,540	514,372	576,637	35.9	35.0
Pension funds (4)	4,324	4,731	74,689	83,620	5.2	5.0
Individually managed portfolios	22,677	25,269	639,229	738,044	44.6	44.8
Total	**73,003**	**127,583**	**1,433,829**	**1,648,879**	**100.0**	**100.0**
Consolidated total (5)	**49,685**	**111,060**	**1,085,764**	**1,248,683**	**–**	**–**
per cent of GDP	*3.1*	*6.9*	*67.5*	*77.3*	–	–
Memo						
Foreign investment funds (6)	35,245	59,227	389,604	477,550	–	–
of which:						
operated by Italian intermediaries (7)	*15,607*	*30,721*	*232,780*	*277,543*	–	–

Sources: Based on data from Bank of Italy, Ivass, Covip and Assogestioni.
(1) Provisional. – (2) Italian investment funds and SICAVs. – (3) Net insurance flows are premiums less surrenders and benefits. For end-of-period stocks, technical provisions net of reinsurance reserves. Excludes Italian branches of EU insurance companies and includes Italian branches of non-EU insurance companies. – (4) For end-of-period stocks, balance sheet assets. Excludes insurance mathematical reserves relating to pre-existing funds. – (5) Net of investments in Italian collective investment undertakings by the other categories of intermediary, investments of insurance companies and pension funds in portfolios managed on an individual basis by asset management companies, and the technical provisions of insurance companies deriving from the management of open pension funds. – (6) Foreign open-end investment funds. Stocks and net funding refer to the value of the units respectively held and subscribed by Italian investors. – (7) Investment funds operated by management companies established in Luxembourg or Ireland.

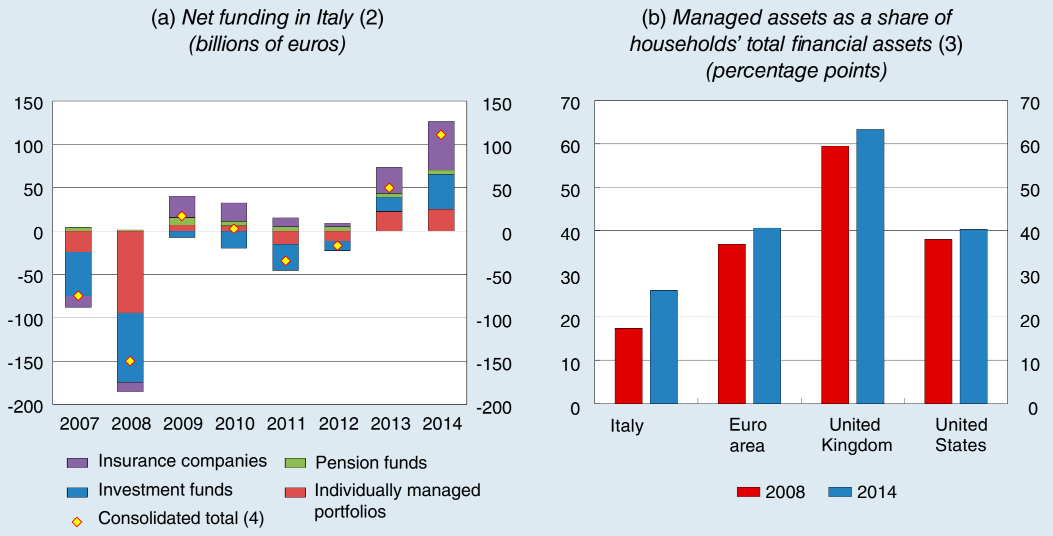
The protracted period of low interest rates led households to shift a part of their financial resources into asset management products. Banks, given their own moderate funding needs and a policy of supporting fee income, favoured this portfolio recomposition: 62 per cent of life insurance premiums and 80 per cent of the resources going to investment funds were raised through bank and post office branches, compared with 60 and 70 per cent, respectively, in 2013.

All the main sectors raised substantial funds. Inflows to investment funds, insurance policies and individual portfolio management services came to €40 billion, €58 billion and €25 billion, respectively.[3] Contributions to pension funds, which tend to be more stable, determined as they are by long-term saving choices, amounted to €5 billion, about the same as in 2013.

[3] These sectoral funding figures include flows from other institutional investors. The sectoral data and the consolidated total are given in Table 13.1.

Figure 13.7

Institutional investors: net funding and assets (1)



Sources: For panel (a), Bank of Italy, Ivass and Covip; for panel (b), Bank of Italy, ECB, OECD, Bureau of Economic Analysis and Federal Reserve.
(1) For 2014, provisional data. – (2) The flows for each sector are gross of funds raised from other institutional investors; for investment funds, only Italian funds. – (3) For the euro area, 17 member countries. For the United States, the pension fund aggregate refers to private, state and local funds and excludes federal retirement plans. Includes also foreign funds held by residents. Excludes money market funds. – (4) See the notes to Table 13.1.

For the most part, savers invested in funds specializing in medium- and long-term securities, preferring these to lower risk, lower yield products such as money market funds. In the insurance sector, there was a significant increase in unit-linked policies, although most new funds continue to flow to traditional policies offering minimum guaranteed returns.

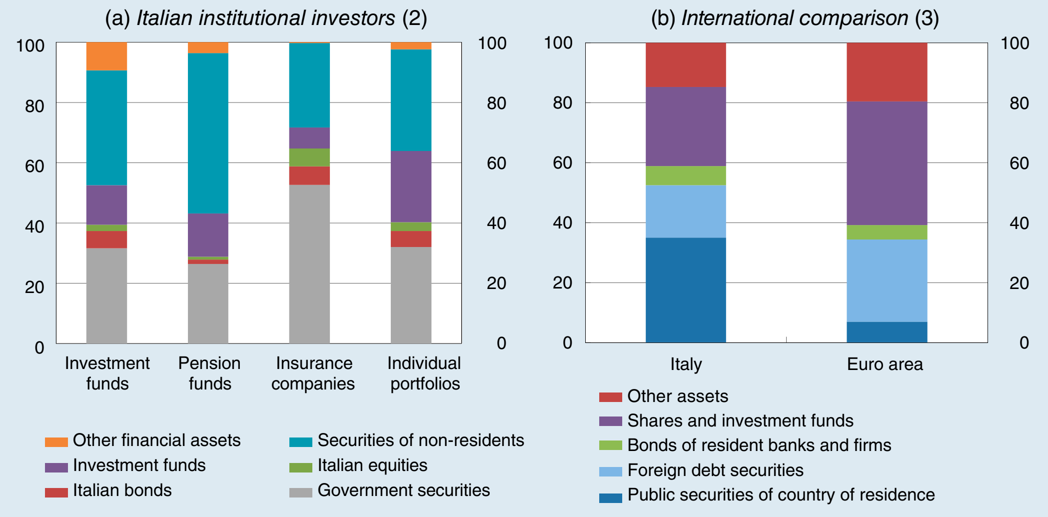
The portion of household financial assets entrusted to asset management institutions rose to 26 per cent. Since the all-time low in 2008, the share has risen by 9 percentage points, of which 4 points are due to investment funds and 4 to insurance policies (Figure 13.7.b). Italy's asset management industry remains small by international standards, but in recent years its growth has outpaced that of the other main countries.

Investment. – Assets under management by institutional investors amounted to €1,250 billion at the end of 2014, equal to 77 per cent of GDP. For the most part the funds were invested in listed securities with high credit ratings, and maturities were broadly in line with those of balance sheet liabilities in such a way as to contain credit and interest rate risk (see the box 'The EIOPA stress test for the risk of low interest rates', *Financial Stability Report,* 1, 2015).

A large share of portfolio assets often consists of investment in investors' home countries, mainly owing to the difficulty of evaluating the risks of foreign borrowers and the preference for assets denominated in the same currency as liabilities. In Italy, given the small number of listed firms and, more generally, the relatively undiversified capital market, domestic investment is concentrated above all on the public sector. Government securities account for about 35 per cent of the assets of Italian institutional investors, compared with under 10 per cent for comparable institutions in the euro area (Figure 13.8.b). Direct financing of the private sector in the form of shares, bonds and loans is relatively modest, by contrast: these instruments account for 19 per cent of financial assets in Italy against 25 per cent in the area as a whole.

Figure13.8

Main financial assets of institutional investors in 2014 (1)
(percentage shares)



Sources: For panel (a), Bank of Italy, Ivass and Covip; for panel (b), ECB.
(1) Provisional data. Assets at book value. – (2) Excludes social security institutions; for insurance companies, includes investments covering technical provisions; for investment funds, only harmonized Italian funds; among pension funds instituted prior to the 1993 reform, only independent funds and employer operated funds for which data on asset composition are available. – (3) Includes social security institutions; for insurance companies, includes investments covering technical provisions and shareholders' equity; for investment funds, Italian open-end and closed-end funds.

A number of legislative and regulatory measures have been enacted recently to encourage diversification of investors' assets and the sources of financing to the economy. In December 2013 the scope for insurance companies and pension funds to invest in minibonds issued by unlisted companies was broadened;[4] in June 2014 insurance companies, pension funds and special purpose vehicles were allowed to lend to firms[5] (see *Financial Stability Report*, 1 and 2, 2014); and in September the quantitative limits to pension fund investments were simplified.[6]

For the time being investment in unlisted securities and other illiquid assets is minimal and the reform's effect will presumably be gradual. In the future, portfolio diversification should be encouraged by the search for higher yields than those offered by traditional investment products, but it could be discouraged by the new Solvency II regime for the insurance industry, which institutes capital requirements based on counterparty risk starting 1 January 2016.

[4] Decree Law 145/2013, converted into Law 9/2014.

[5] Decree Law 91/2014 (the 'competitiveness' decree), converted into Law 116/2014. The secondary legislation for the insurance industry was approved in October 2014, that for investment funds, transposing the AIFM Directive, in April 2015.

[6] Ministerial Decree 166/2014.

The low propensity to invest in private sector securities also depends on the features of the asset management industry. For one thing, many insurance companies and pension funds are too small to build up the expertise needed to select investments and control risks. And reserved investment funds, to which institutional investors can entrust the tasks of selection and monitoring, are still relatively undeveloped. Closed-end real estate funds, including private equity and private debt funds, had total assets of €9 billion, just 1 per cent of the assets of all investment funds marketed in Italy.

A number of funds for investment in private debt issued by small and medium-sized enterprises were created in 2014 and the early months of 2015. By the end of March Italian asset management companies had founded 24 such funds, 18 of them operational, and others had been promoted by foreign managers. It is estimated that their total funding target exceeds €5 billion; at the end of March the capital raised by the funds that were already operational amounted to about €2 billion, subscribed mainly by banks and secondarily by insurance companies and pension funds. Fondo Italiano di Investimento has now instituted a fund of funds specializing in private debt fund units, with capital subscribed by Cassa Depositi e Prestiti. The presence in the market of an asset management institution with a well-established reputation could foster the development of this segment.

European integration of the investment fund market. – The expansion of supply has been spurred by regulatory harmonization at European level, in particular by the UCITS4 and AIFM directives, which instituted the European passport for open-end and alternative fund management companies. In recent years the presence in Italy of investment funds sponsored by foreign groups has increased substantially. Their share of the total assets of Italian open-end funds has risen to 32 per cent, from 17 per cent in 2008. A regulation was enacted in 2014 introducing a new category of closed-end funds, designated 'European long-term investment funds'. Integration of the fund market may help to spur competition and to make the industry more efficient, with greater product diversification, lower costs for investors, and better resource management.

This tendency may be furthered by the opening, in 2014, of the ETFplus segment of Borsa Italiana to listing of open-end investment funds. At the end of April 2015, 26 funds, sponsored by two management companies, were listed. The possibility of buying and selling units on the stock exchange broadens the range of distribution channels and may help to reduce placement costs and make the Italian market more accessible to new entrants.

The Capital Markets Union. – In February 2015 the European Commission presented, as part of the Capital Markets Union project, an ambitious set of proposals to broaden European firms' access to finance.[7] The Commission's initiatives can support portfolio diversification by institutional investors through the development of markets and financial instruments, such as securitization and the private placements market,[8]

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[7] European Commission, Green Paper, 'Building a Capital Markets Union', COM(2015)63 final, 2015.

[8] N. Branzoli and G. Guazzarotti, 'Il mercato dei *private placement* per il finanziamento delle imprese', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 262, 2015.

and funds specializing in private sector assets. The asset management industry can also benefit from initiatives to improve access to credit and balance sheet data concerning small and medium-sized enterprises.

Profitability. – The expansion of assets under management continued to support the profitability of institutional investors last year. Insurance companies' ROE remained high (9.2 per cent in the life and 9.3 per cent in the non-life branch) and their solvency ratios were again well above the regulatory minimums (see *Financial Stability Report*, 1, 2015). The performance of asset management companies was positive, overall, although results varied with the business segment: while the profits of asset managers of open-end funds and individual portfolios increased by 22 per cent, thanks to the growth in fees, those of real estate and private equity fund management companies continued to decline, owing in the former case to the weak housing market and in the latter to difficulty in attracting funds from institutional investors. The ratio of supervisory capital to the overall capital requirement of the asset management companies declined from 6.0 to 5.2 per cent owing to the more than proportional increase in the requirement.

14. THE MONEY AND FINANCIAL MARKETS

Conditions on the Italian financial markets have been improving since mid-2012 following the most acute phase of the sovereign debt crisis. Increasingly relaxed conditions reflected not only the subsidence of fears about the solidity of the monetary union, but also the progressively more expansionary stance of monetary policy, as well as the start of government security purchases by the Eurosystem.

Interest rates on Italian government bonds and spreads with respect to Germany dropped noticeably at all maturities.

The fragmentation of the euro-area financial markets along national lines continued to diminish. The risk premiums on bonds issued by Italian companies and banks fell markedly.

In 2014 as a whole stock prices were basically unchanged, but rallied strongly in early 2015.

There is a persistently high risk, however, of disorderly portfolio shifts, as shown by the fluctuations in financial asset prices after the Russia-Ukraine crisis, uncertainty over the situation in Greece, and the conflicts in the Middle East.

The launch of the asset purchase programme did not lead to any reduction in the availability of Italian government securities or in the overall liquidity of their secondary market. The implementation of the programme has been designed to avoid price distortions and permit the orderly functioning of the markets.

The money market

In 2014 conditions in the Italian money market continued to reflect the abundant supply of liquidity provided to banks by the Eurosystem.

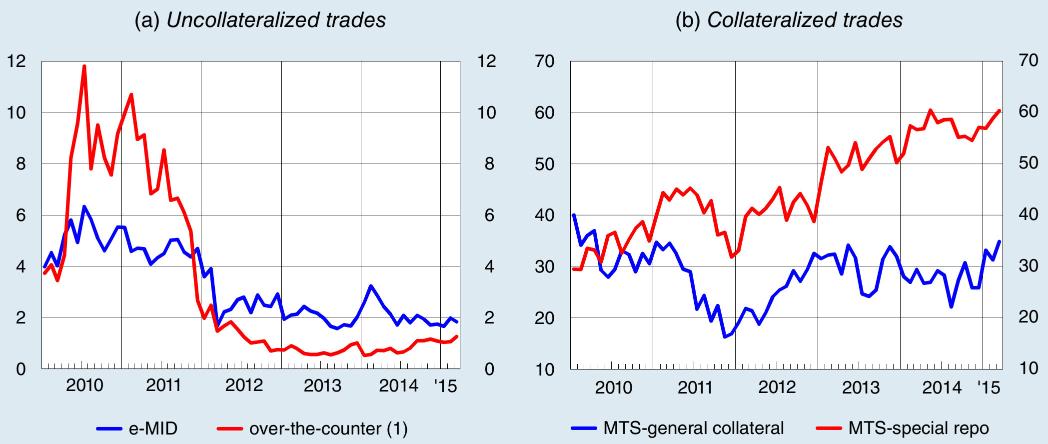
The volume of trading in unsecured interbank deposits on both the e-MID electronic and over-the-counter markets remained thin (Figure 14.1.a); trading in collateralized deposits via the MTS General Collateral repo market also contracted slightly (Figure 14.1.b).

After the official rates were lowered in September, the average cost of funding on Italy's money market declined to below zero, in line with the negative interest rates recorded in the other euro-area money markets.

Figure 14.1

Trading on the money market

(monthly averages of daily data; billions of euros)



Sources: Based on data from e-MID SIM S.p.A., MTS S.p.A. and TARGET2-Bank of Italy.
(1) Uncollateralized money market trades with maturities of up to one week between Italian banks belonging to different groups; estimates based on TARGET2-Bank of Italy data.

Public sector securities

Supply and demand. – In 2014 net issues of Italian public sector securities declined to €67 billion, from €81 billion in 2013; the stock of public sector securities outstanding rose to 111.1 per cent of GDP, partly reflecting low growth in nominal output.

Foreign investors showed renewed interest in Italian government securities, attracted by the relatively high yields and considerably lower risks perceived thanks to the dissipation of fears of a break-up of the single currency bloc and the determination of the Italian government to implement reforms. The share of Italian government securities held by non-residents rose to 29 per cent from 27 per cent a year earlier.[1] Net purchases by Italian banks were instead virtually nil.

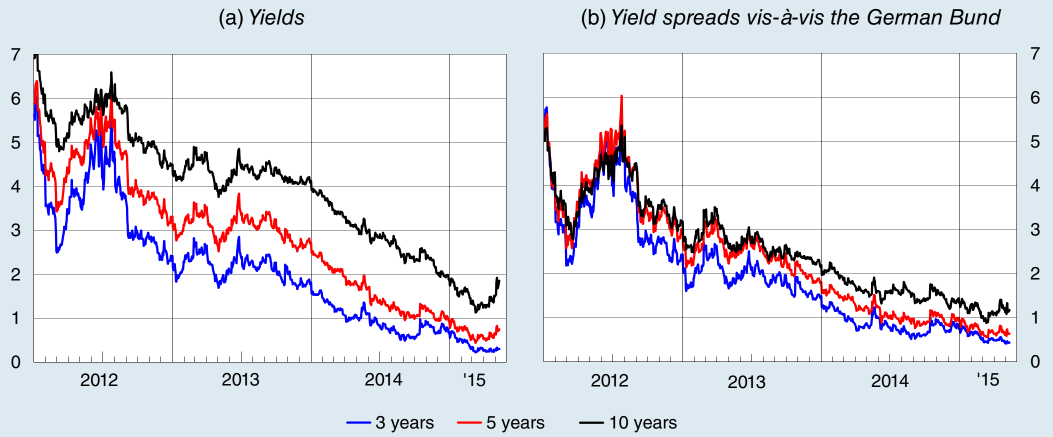
Yields. – Italian government securities benefited from the steady improvement in the euro-area sovereign debt markets (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area'). In early 2014 prices were supported by massive capital outflows from emerging countries seeking investment opportunities with a lower risk profile and relatively high yields; in the second half of the year they benefited from expectations of further expansionary measures by the ECB, notwithstanding the heightened volatility due to the more uncertain global macroeconomic outlook and the political tensions in Greece.

In 2014 as a whole the interest rates on Italian government securities declined at all maturities and in particular on ten-year bonds (by 2.2 percentage points, to 1.9 per cent

[1] Excluding the securities held by the Eurosystem (except for the Bank of Italy) as part of the Securities Markets Programme and those in investment funds and individually managed portfolios registered abroad but belonging to Italian investors.

Figure 14.2

Yields and yield spreads on BTPs at different maturities
(daily data; percentage points)



Source: Based on Bloomberg data.

last December; Figure 14.2.a). The ten-year interest rate spread with respect to Germany narrowed from 220 to 140 basis points (Figure 14.2.b). The decline in yields and in risk premiums on Italian government securities continued in the first four months of 2015, reflecting first the anticipation and then the start of purchases of public sector securities by the Eurosystem. By 20 April, the rate on ten-year BTPs and the spread vis-à-vis the corresponding German Bunds came to 1.5 and 1.4 per cent respectively. Subsequently, there was a significant increase in long-term rates that affected Italian and German government securities almost equally; this appeared to be due both to an initial, modest increase in inflation expectations and to technical factors, such as the closure of several speculative positions and expectations that a number of euro-area countries would make relatively high net issues of government securities in May.

Trading in the secondary market. – On the secondary market in Italian government securities liquidity conditions were mostly relaxed, marking an improvement on 2013. The volume of average daily trading on the MTS Cash market and on the BondVision platform was much higher than in 2013 (Figure 14.3.a). The bid-ask spread for BTPs stayed at very low levels (Figure 14.3.b), helping to keep down liquidity risk premiums on Italian government securities.[2]

Special repo trading on the MTS market intensified (Figure 14.1.b). The average cost of these transactions, measured by the difference between interest rates on the general collateral repo market and those on the special repo market continued to be modest in the first four months of 2015 as well, a sign that to date the Eurosystem's public sector securities purchase programme has not had any adverse effect on either the availability of securities for repo transactions or on the overall liquidity in the secondary market.

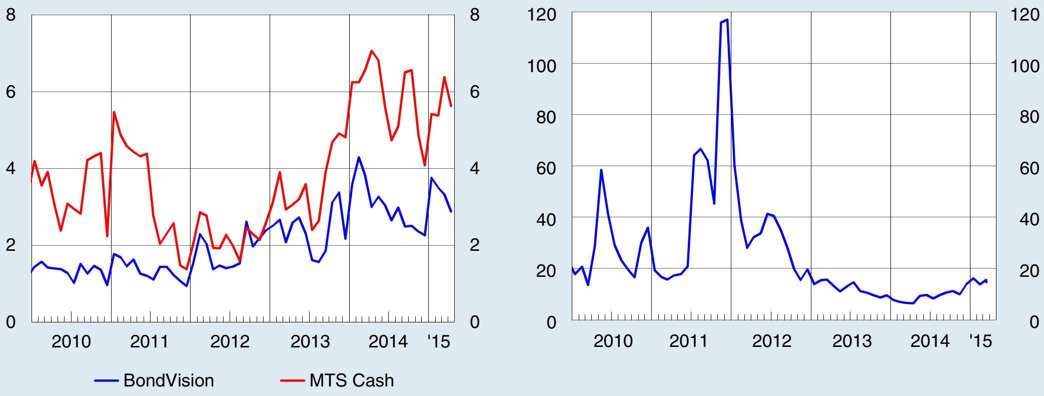
[2] M. Pericoli and M. Taboga, 'Decomposing euro area sovereign spreads: credit, liquidity and convenience', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

Figure 14.3

Trading in the secondary market in government securities

(a) *Volume of trading*
(monthly averages of daily data; billions of euros)

(b) *Bid-ask spread on BTPs*
(monthly averages of daily data; basis points)



Source: Based on MTS S.p.A. data.

Corporate bonds and bank bonds

Issuance. – In 2014 developments in Italy's primary market in both corporate and bank bonds were comparable with those observed overall in the other euro-area countries.

Non-financial Italian corporations continued to make net positive bond issues (Table 14.1), though they did slightly reduce gross placements on the international markets (to €21 billion, from €25 billion in 2013). This led to a further increase in the share of bonds in total corporate financial debt and a greater diversification of firms' sources of borrowing (see Chapter 6, 'Firms').

Net bond issuance by Italian banks was instead still markedly negative, mainly owing to the high volume of redemptions and the large contraction in retail placements (in a context characterized throughout the euro area by the replacement of bonds with bank deposits among the sources of bank funding (see Chapter 13, 'Banks and institutional investors'). Wholesale placements on international markets by Italian

Table 14.1

Medium- and long-term bonds of Italian banks and firms (1)
(nominal values; millions of euros)

	Net issues (2)			Stocks			*Per cent of GDP*
	2012	2013	2014	2012	2013	2014	2014
Banks	83,153	-80,297	-152,993	956,739	875,792	724,310	*45*
Other financial corporations	-5,706	-17,075	-16,729	231,882	214,759	198,181	*12*
Non-financial corporations	-12,926	22,756	4,637	101,288	123,728	130,859	*8*
Total	90,373	**-74,616**	-165,085	**1,289,909**	1,214,279	1,053,350	***65***

(1) The nationality and sector refer to the issuer and not to its parent company. Refers only to securities with a maturity at issue of more than one year. The data differ from those previously published owing to the adoption of the new ESA 2010 accounting standards. – (2) Difference between the nominal values of issues and redemptions.

banking groups did, however, remain more or less stable (at €35 billion against €36 billion in 2013).

Yields. – There was also a sharp fall in the yields of bonds issued by Italian banks and non-financial corporations, benefiting from both a generalized decline of yields on euro-denominated securities (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area') and a greater reduction in credit risk premiums than that observed on average in the other euro-area countries. The latter reflected the gradual

FRAGMENTATION OF THE EURO-AREA BANK AND CORPORATE BOND MARKET

One of the most lasting consequences of the global financial crisis and subsequent sovereign debt tensions has been the fragmentation of the euro-area financial markets along national lines. From the summer of 2007 to that of 2012, marked differences between countries appeared in the funding conditions for banks, firms and households, indicating an interruption in the process of financial integration, generated by fears for the cohesion of the euro area and divergent macroeconomic trends (see *Financial Stability Report*, 4, 2012).

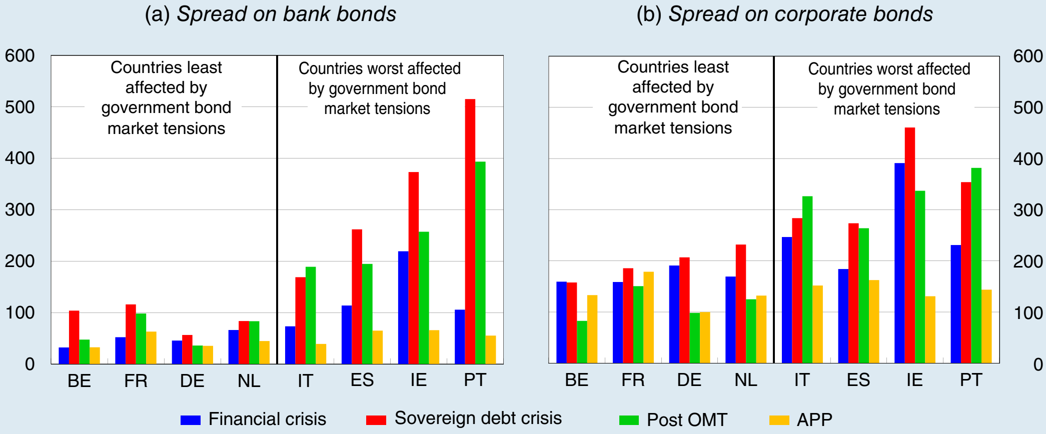
One indicator of funding conditions for private companies is the spread on a risk-free rate (the interest rate on similar swap contracts) that they are prepared to pay to place their bonds on the international market (see the figure). The dispersion of bond spreads across the euro-area countries peaked at the height of the sovereign debt crisis before falling back. Some of this dispersion was due to differences in the underlying determinants of the spreads, such as the individual issuer's credit risk. However, econometric estimates relating to Italian, German and other euro-area countries' bonds suggest that, even adjusting for issuer and security characteristics, the cost of borrowing in 2014 for bond issuers in the countries worst hit by the sovereign debt crisis was still higher than for German issuers (see the box 'The fragmentation of euro-area financial markets', *Financial Stability Report*, 1, 2014).

Financial fragmentation in the euro area diminished considerably from the summer of 2012 following the introduction by the ECB of Outright Monetary Transactions (OMT) and other unconventional monetary policy measures designed to maintain a single euro monetary policy and ensure that its transmission mechanism functioned correctly. Spreads quickly narrowed, including for Italian banks and firms, although after the introduction of OMT they were on average wider than during the sovereign debt crisis (see the figure). This was because many bank bonds were issued in the early stages of the crisis, when spreads were still fairly small, whereas after the OMT firms made huge placements with large spreads. The launch of the Banking Union has been another major factor in reducing the geographical fragmentation of euro-area financial markets. A further contribution may have come from advances in the European construction in terms of fiscal and economic integration and the progress made by individual countries in introducing measures to restore growth potential.

At the turn of this year the intra-area dispersion of the spread on private sector bonds was enormously reduced. The start of the ECB's expanded asset purchase

Figure

Spread at issue on bank and corporate bonds (1) (2)



Sources: Based on data from Bloomberg, Capital IQ, Dealogic and Thomson Reuters Datastream.
(1) Average value of asset swap spreads at issue, in basis points, on bonds (placed on the international market) issued by banks or firms whose parent company is located in the country indicated on the horizontal axis, in the period indicated. The periods of time are: financial crisis, from 2007 Q3 to 2010 Q2; sovereign debt crisis, from 2010 Q3 to 2012 Q2; post OMT, from 2012 Q3 (when they were introduced) to 2013 Q3; APP, from 2014 Q4 (increase in expectations that the ECB would expand its asset purchase programme to public securities, later announced in January 2015 as the Expanded Asset Purchase Programme, APP) to 2015 Q1. – (2) Legend: BE=Belgium; DE=Germany; ES=Spain; FR=France; IE=Ireland; IT=Italy; NL=Netherlands; PT=Portugal.

programme (APP) revived the prospects for growth and hence very likely improved investors' perceptions of the creditworthiness of banks and firms, confirmed the Monetary Union's cohesion, and encouraged risk-taking. Going forward, these developments will help to increase the flow of credit to banks and firms in the euro area, including in the countries most exposed to sovereign debt tensions.

easing of financial market fragmentation in the euro area along national lines (see the box, 'Fragmentation of the bank and corporate bond market in the euro area').

For a sample of investment grade securities with a large float, in 2014 the spread [3] on the bonds of Italian non-financial corporations narrowed by 0.5 percentage points, to 1.0 per cent. That on the bonds of the leading Italian banks fell by 0.8 percentage points, to 1.4 per cent; the decline in sovereign risk premiums was one contributory factor.[4]

The equity market

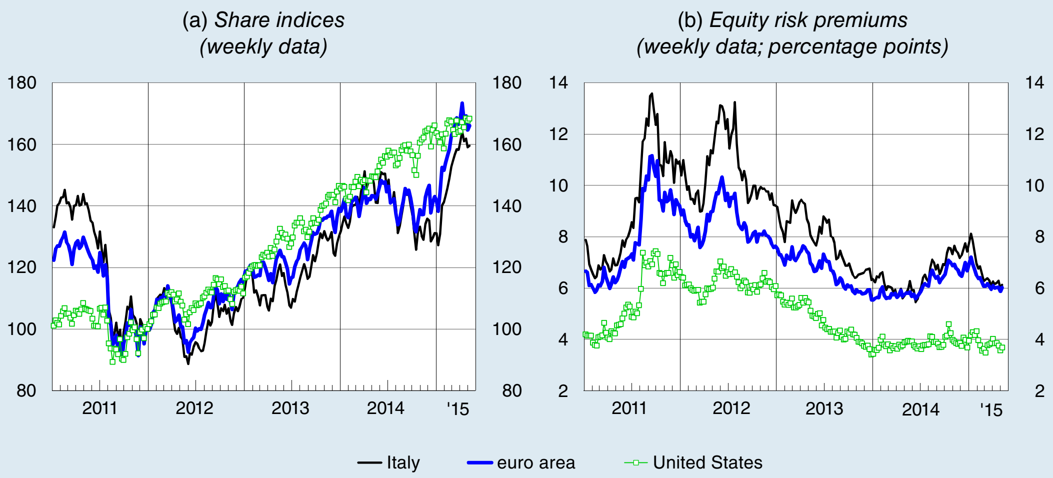
Share prices and trading. – At the end of 2014 the Italian stock exchange index was unchanged with respect to end-2013 (Figure 14.4.a), while the share prices of the main listed euro-area corporations recorded a slight gain of 2 per cent.

[3] Defined as the average spreads with respect to a basket of French and German government securities.

[4] J. Li and G. Zinna, 'How much of bank credit risk is sovereign risk? Evidence from the Eurozone', Banca d'Italia, Temi di Discussione (Working Papers), 990, 2014.

Figure 14.4

Equity markets



Source: Based on Datastream data.

Two opposing effects were at work in the Italian stock market: on the one hand, share prices were supported by the progressive narrowing of yields on the bonds reputed to be safest, such as the German Bund; on the other, prices were penalized by the increased risk premiums demanded by investors (Figure 14.4.b), most of all in the second half of the year as geopolitical tensions heightened and clouds were cast on the timing of the cyclical recovery in the euro area and the political crisis in Greece. Developments in the current and expected earnings of listed companies had no significant impact on share prices: the profits recorded in 2014 were unchanged overall from 2013, but the expectations for growth in the next few years remained high.

In the first four months of 2015 the Italian stock exchange index gained 21 per cent, higher than the increase of 16 per cent recorded in the euro area as a whole. The gain was mostly attributable to the new asset purchase programme launched by the ECB.

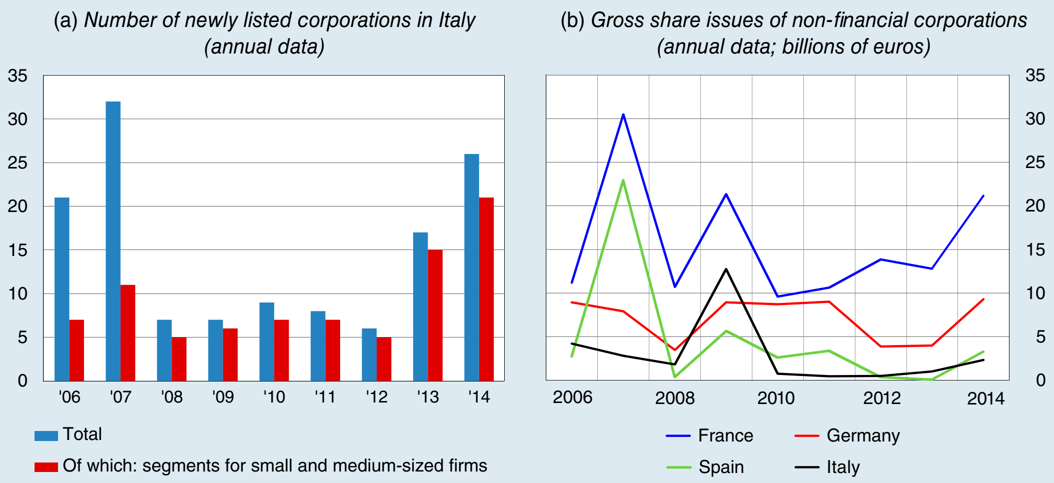
Supply and demand. – In 2014 gross issuance of equity capital on the stock markets increased both in Italy and in the rest of the euro area.

The number of initial public offerings on the Italian stock market increased significantly last year, from 17 in 2013 to 26 in 2014 (Figure 14.5.a), and the value of the shares placed in these IPOs came to €2.9 billion, as against €1.2 billion in 2013. Like last year, most IPOs were in the segment for small and medium-sized firms (the AIM Italia-MAC alternative capital market). In the first four months of 2015 this segment expanded further: five more companies joined, bringing to 64 the total number of those listed.

Notwithstanding the recent recovery, the volume of IPOs was small throughout the euro area, both by international standards and compared with pre-crisis levels: increased

Figure 14.5

IPOs and gross share issues of non-financial corporations



Source: Based on Borsa Italiana and ECB data.

access of firms, especially small and medium-sized firms, to the stock markets is one of the main pillars of the Capital Markets Union pursued by the European Union.[5]

Last year capital increases by listed companies expanded considerably, by around €11 billion compared with just €1 billion in 2013. Funding was mainly linked to bank recapitalizations but non-financial corporations also increased their recourse to the stock market: the value of gross share issues by these corporations increased both in Italy and in the main euro-area countries (Figure 14.5.b).

As a share of GDP, Italian corporations' total capitalization rose from 29 to 30 per cent. At the end of 2014 in the other major advanced economies this share was much larger: 52 per cent in Germany, 74 per cent in France, 140 per cent in the United States and 139 per cent in the United Kingdom.

Market infrastructure

In 2014 and in the first quarter of 2015 the further improvement in the conditions on Italian financial markets led to a rise in the volume of transactions handled by the central depository Monte Titoli and the central counterparty Cassa di Compensazione e Garanzia SpA (CC&G).

The average daily volume of transactions recorded in the Express II securities settlement system operated by Monte Titoli increased (Figure 14.6.a), mainly owing to the high volume of repo trading in Italian government securities. The percentage of fails (transactions not settled owing to non-delivery of the securities within the prescribed time limit) remained within the norm (Figure 14.6.a).

[5] European Commission's Green Paper, 'Building a Capital Markets Union', COM (2015) 63 final, 2015, European IPO Task Force, EU IPO Report, 2015.

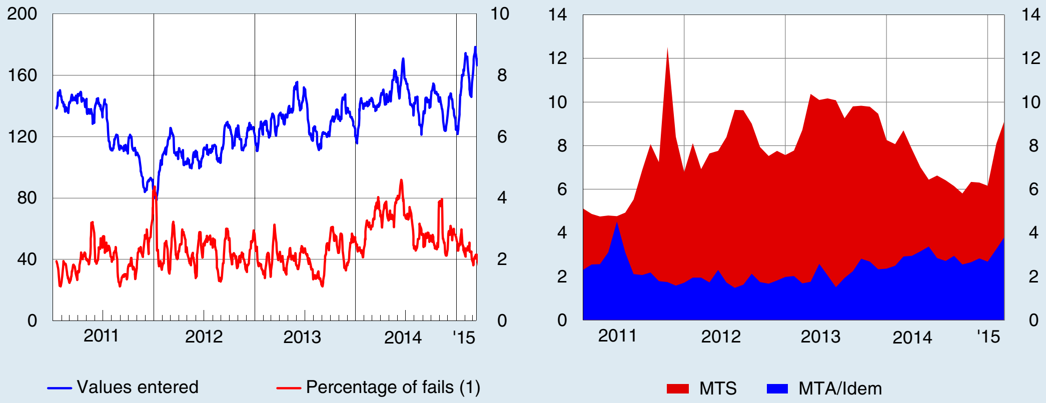
The overall amount of guarantees demanded of members by the CC&G increased for the equity, repo and derivatives markets; for government securities it rose markedly in the early months of 2015, after declining in 2014 (Figure 14.6.b). Part of the reason for the decline was the gradual downward revision of the margins applied by the CC&G to Italian government securities, made possible by the improvement in the conditions of the sovereign debt markets.

Figure 14.6

Market infrastructures

(a) *Monte Titoli: value of the orders entered and percentage of fails (10-day moving averages; billions of euros and percentage points)*

(b) *Cassa di compensazione e garanzia: value of the initial margins deposited (monthly averages of daily data; billions of euros)*



Source: Based on data from Cassa di Compensazione e Garanzia SpA and Monte Titoli SpA.
(1) Right-hand scale.

15 THE PUBLIC ADMINISTRATION

Improving the quality of public administration can give an important boost to the economy: recent experience in Italy has shown that initiatives to reduce red tape can have positive effects for companies.

World Bank indicators show that public administration in Italy is less effective than in other leading economies. However, the situation is very uneven: an indicator relating to business licences issued by Italy's municipal authorities shows that the South of Italy has a not insignificant share of virtuous government agencies despite underperforming overall compared with the Centre and North. Over time, regulation has become increasingly unwieldy and there are still delays in the approval of implementing measures, which causes uncertainty, although significant progress was made in 2014.

Problem areas include: 1) legislative and administrative decentralization – because it is not always clear where responsibility lies; 2) the failure to attract talent in the public sector, where career paths do not adequately reward skills and merit and recruitment procedures are not always sufficiently selective and conducted in ways that increase uncertainty about job security; 3) the effectiveness of performance appraisal systems for organizations and individuals; and 4) limited availability and use of information technology in user services.

The public administration and economic growth: Italy lags behind

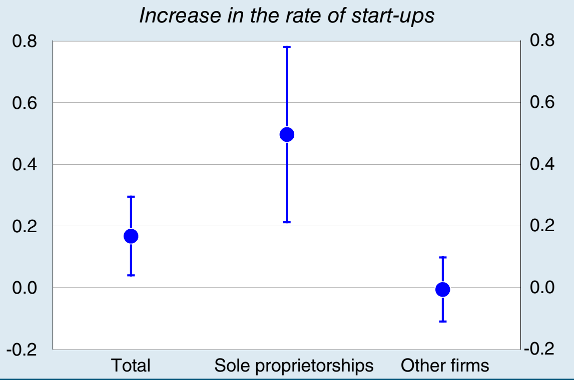
The quality and speed of public decision making, the stability and certainty of rules and the bureaucratic and administrative burdens that businesses must bear, affect their start-up and running costs, influence investment decisions and the capacity of the system to attract foreign firms, and affect the correct functioning of the markets and the reallocation of resources (see Chapter 6, 'Firms'). Our estimates show that some of the measures adopted in the past to reduce red tape and to simplify business start-up regulations have had positive effects on the number of new firms (see the box 'Start-up costs and firm dynamics').

START-UP COSTS AND FIRM DYNAMICS

A comparison of firm demographic measures by sector of activity in Italy's municipalities before and after the reform of the Point of Single Contact one-stop business service centre (SUAP) established by Law 133/2008 and Presidential Decree 160/2010, makes it possible to assess the effects of the reduction in administrative red tape and the simplification of the rules for starting and conducting business activities on the entry rate of new firms.[1]

The SUAP reform has raised the entry rate by 0.2 percentage points, mostly sole proprietorships and firms in the private services and construction sectors (see the figure). The new entries are not pursuing marginal or short-lived initiatives: following the reform the survival rate at one year has also risen by around 0.2 percentage points. The effects are more evident in Southern Italy where, with respect to the previous situation, the reform's impact may have been greater.

Effects of lower start-up costs on firm dynamics (1)
(percentage points)



Source: Based on Infocamere data.
(1) The data are taken from the Company Register and refer to the period from Q1-2011 to Q2-2014. The measures are constructed with reference to the four quarters before and after the reform's implementation in each municipality, confined to those that had launched it by Q2-2012 at the latest (6,870 municipalities, or about 86 per cent of the total). The sectors considered are private services, manufacturing and construction; professional services are excluded. The estimates are based on a total of 156,288 observations resulting from the combination municipality-economic sector.

[1] M. Amici, S. Giacomelli, F. Manaresi and M. Tonello, 'Red tape reduction and firm entry: evidence from an Italian reform', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

Firms' opinions, as recorded in the Bank of Italy's survey of industrial and non-financial service firms, point to significant difficulties in dealing with the public administration. The two aspects that hold back businesses the most are the excessive requirements for obtaining a new licence (considered very significant by 54.4 per cent of respondents) and the highly changeable nature of the regulations (45.2 per cent).

These perceptions are confirmed by Italy's low position in international rankings of how well the public administration functions. For example, Italy ranks 25th and 22nd out of 28 EU member countries in the World Bank measures 'Dealing with construction permits' and 'Government effectiveness' respectively.[1]

Measuring the public administration's effectiveness in issuing business permits shows a delay of about 33 per cent for municipalities in the South of Italy compared with the Centre and North. The significant share of virtuous administrations also in the South (34 per cent of municipalities fall into this group against 53 per cent of those in the Centre and North), however, confirms the large degree of variation in each area. In general better performance is associated with the use of more advanced technological infrastructure and the availability of more highly-skilled personnel; the impact of contextual variables is less clear. There is a high correlation in performance

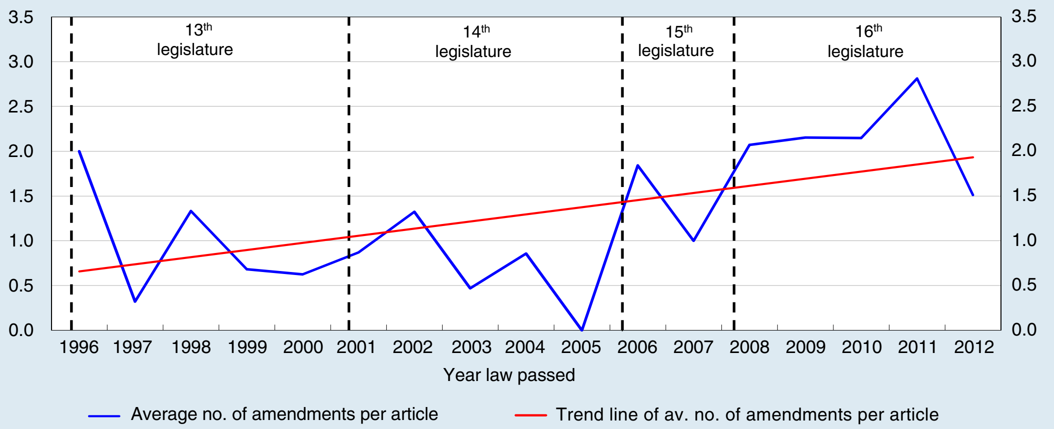
[1] See http://www.doingbusiness.org/data/exploretopics/dealing-with-construction-permits; http://info.worldbank.org/governance/wgi/index.aspx#home.

between the various areas of public administration, for example between the granting of permits and measures of the perceived quality of some services for users.[2]

It is not easy to define an optimal degree of change in the regulations over time: on the one hand, stability aids familiarity and application; on the other, change meets the need to adapt to new scenarios or general preferences. However, there is clearly a problem with changes that are not only frequent but which come about through successive interventions in the same legislative text. An indirect indicator of the case in question is given in Figure 15.1 which shows the increase in the degree of stratification of employment law in Italy in the period 1996-2014.

Figure 15.1

Stratification of employment legislation (1)



Source: Based on data from the State Printing Works and Mint.
(1) Primary legislation (Laws, Decree Laws, and Legislative Decrees) dealing with employment, passed from 1996-2014. The indicator measures, for each year, the average number of amendments per article within two years of its approval.

In the last year, uncertainty caused by delays in the approval of implementing measures was reduced: between February 2014 and May 2015 the amount of pending measures included in the legislation passed by the two preceding governments was reduced by about two thirds. Nonetheless in May 2015, some 29 per cent of the measures originally contemplated had not yet become law. At the same date, about 64 per cent of the regulations past their approval deadline relating to the present government had been passed – an improvement compared with the past.[3] The time needed for the passage of secondary legislation doubles on average when more than one public authority is involved. An analysis of 210 measures in the period November 2011-April 2013 shows that the average delay with respect to the approval deadline was 102 days when only one authority was involved but rose to 225 when there were two or more authorities involved.

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[2] S. Giacomelli and M. Tonelli, 'Measuring the performance of local governments: evidence from mystery calls', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming. The indicators of the effectiveness of public administration in relation to the granting of permits draw on the results of the survey of the *Points of Single Contact* conducted in 2013 by Infocamere on behalf of the Ministry of Economic Development; those on the quality of public services are inferred from Istat, Multipurpose Survey on Households. Aspects of daily life, 2013.

[3] See http://www.programmagoverno.gov.it.

Some of the difficulties in the running of Italian public authorities stem from unwieldy institutional arrangements arising from legislative and administrative decentralization, the lack of appeal of public sector employment, partly as a result of changes in recruitment policies, the introduction of performance appraisal systems for departments and senior managers, and delays in developing information technologies.

Institutional arrangements: tiers of governance and coordination

The Bassanini reforms (Law 59/1997 and subsequent implementing legislative decrees) and the constitutional reform of 2001 led to a radical legislative and administrative devolution of institutional arrangements and governance. Involving local entities more closely in the exercise of some functions, among other things without any precise definition of the financial autonomy of lower-level public entities,[4] led to a duplication of competencies, creating uncertainty for both public and private operators.

The regional governments (the 'Regions') were also jointly assigned competence for areas that had significant effects outside the region too, such as energy production and distribution or major communication networks. Furthermore, some legislative powers dealing with one area of competence were divided between the State and the Regions, as in the case of mandatory social security, for which the State remained responsible, and supplementary social security, which was classified among the areas of joint competence. Partly for this reason, there was an increase in litigation between the State and the Regions, which more than doubled after the reform came into force (115 judgments on average issued each year during the period 2003-2014 compared with an average of 50 per year in the period 1996-1999) and which has still not stabilized (the peak, 197 judgments, dates from 2012). Overall, there is evidence that the division of legislative competencies introduced in 2001 led to confusion over powers and made coordination difficult, with consequent delays and obstacles to administrative action.[5]

The constitutional reform bill before Parliament re-centralizes existing arrangements and strengthens the coordination tools, in particular by reassigning exclusive power to the State over numerous areas currently attributed to both State and Regions. The reform proposal does not, however, address the problem of the division of competencies for the award and execution of public contracts and the regulation of local public services, two important areas for the economy that have generated some legal uncertainty.[6]

Administrative decentralization was not accompanied by a thorough, nationwide review of the local government network, which could facilitate economies of scale and

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4 D. Franco, G. Messina and S. Zotteri, 'Fiscal decentralisation in Italy: an unfinished agenda', *Wirtschaftspolitische Blätter*, 4, 2004, pp. 467-481.

5 C. Giorgiantonio, 'Principio di sussidiarità e istanze centripete: 13 anni di applicazione del nuovo Titolo V', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

6 F. Decarolis and C. Giorgiantonio, 'Local public procurement regulations: the case of Italy', *International Review of Law and Economics,* forthcoming.

greater uniformity of action. This network, comprising just over 8,000 municipalities, about 70 per cent of which with a population of under 5,000 inhabitants, has hardly changed in more than 50 years. Since 2008 a series of measures has obliged the Regions to rationalize the network of Mountain Communities and to enforce the obligation for small municipalities to group together to carry out core functions. As at 31 March 2015 the 81 Mountain Communities and the 464 Inter-Municipal Unions already working or at an advanced stage of preparation had managed to group together only 48.6 per cent of all Municipalities (21.6 per cent weighted by population). In the leading EU countries, the average population of municipalities is larger on average, or there is a higher percentage of those that have grouped together (e.g. in Germany and France in 2012, respectively 65.0 per cent and 96.2 per cent of municipalities formed part of entities equivalent to Italy's Inter-Municipal Unions; in Spain in 2010 76 per cent of municipalities were part of Consortia).

Initiatives for the reform of some peripheral decentralized state entities have also intensified since 2008. Nevertheless, the comparison between these areas in 2007 and the current situation does not show any substantial change.[7]

The services conference, which is the main tool for coordinating the work of central and local entities working on the same administrative procedure, enjoyed only limited success. Despite twelve different legislative changes in twenty-five years to the original text of Article 14 of Law 241/1990, the services conference has not yet found a stable and effective configuration.

The review of central and peripheral government organization is included in the public administration reform bill being examined by Parliament.

Public sector employment

According to the EU Labour Force Survey, compared with the leading economies, in 2012 the average age of Italian public sector employees was 46.5 years (1.5 years older than in Spain and 4 years older than in France, Germany and the United Kingdom)[8] and they had been in service longer. This reflects both the traditional characteristics of Italian public sector employment, in particular the greater separation of the public and private sectors, and the freezes on hiring in the last fifteen years which, according to data published by the State Accounting Office, have led to a reduction of 8.7 per cent in staff numbers between 2001 and 2013 (10.7 per cent excluding the health and education sectors).

State Accounting Office data show that the percentage of fixed-term contracts out of all public sector employment contracts, which peaked at 13.5 per cent in 2006, had fallen to 9.2 per cent by 2013 (11.4 per cent and 7.8 per cent respectively, excluding health and education). These results also reflect periodic measures to give permanent contracts to precarious workers – in the period 2007-2013 these accounted

[7] Istat, *Atlante di geografia statistica e amministrativa*, 2009.

[8] The gap compared with the private sector was also greater in Italy than in the other countries considered, while if we exclude workers in the health and education sectors the results are less dissimilar.

for 12.8 per cent of all new permanent hires (25.1 per cent not counting health and education). Fixed-term contracts are still the most common form of hiring.[9]

Based on the results of the survey conducted by the OECD's Programme for the International Assessment of Adult Competencies (PIAAC), in 2012 Italian public sector employees were the lowest ranking of the member countries tested on literacy and numeracy. Compared with the other main EU countries, the lag is only partly accounted for by the generally lower level of skills of the adult population. The proportion of public sector employees with at least a university degree is also smaller by comparison with other countries: the gap, in this instance, is attributable to the lower share of university graduates in the population generally.

Working conditions in the public sector and related recruitment and career policies make it more difficult to attract, select and retain the best candidates.

Traditional public competitions are less common, in part following the hiring freeze, and this has increased the use of less stringent recruitment procedures and hence uncertainty about job security. There is evidence that this has made employment in the public sector less appealing, especially for the more talented candidates with better job prospects (see the box 'Choosing to work in the public sector: the role of precarious employment').

CHOOSING TO WORK IN THE PUBLIC SECTOR: THE ROLE OF PRECARIOUS EMPLOYMENT

Differences in employment conditions and entry to the public and private sectors can influence workers' choices and workforce composition in the two sectors.

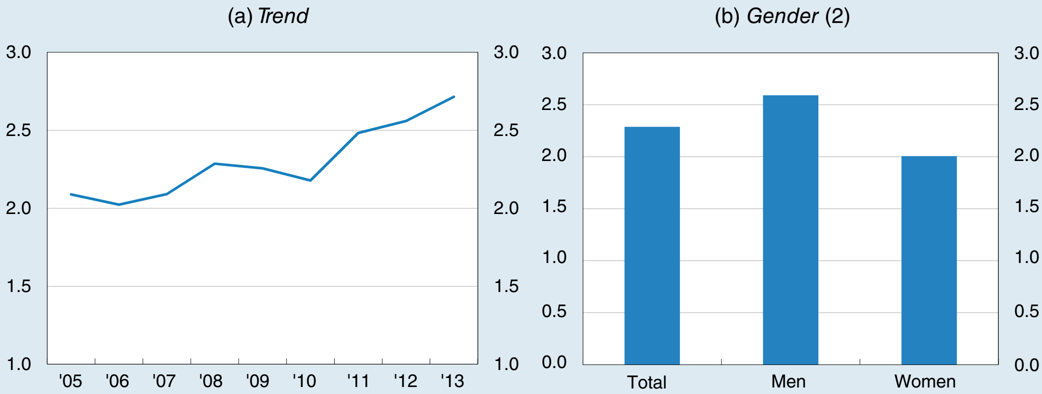
Using data from Istat's labour force surveys in the years 2005-2013, we assessed the effects of expectations of securing permanent employment on workers' moving, according to ability, between the public and private sectors. In particular, we assessed their impact on the most competent workers opting to: (a) take a job in the public sector; (b) move to the private sector, if they were on a temporary contract in the public sector.[1]

The analysis uses measures of workers' expectations based on observations of new hires and of permanent contracts granted in the public and private sectors in the previous four quarters. Ability is instead gauged by the length of time it takes workers to obtain their university degrees. This measure produces better scores on average among private sector workers; moreover, the ability gap with respect to public sector workers has also widened in recent years (see the figure, Panel a) and is greater for men than women (Panel b).

1 L. Rizzica, 'The use of fixed-term contracts and the (adverse) selection of public sector workers', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

9 Based on data from Istat's labour force survey, our estimates show that in 2013 fixed-term contracts were given to more than 4 out of 5 new hires; or 3 out of 4 if we exclude health and education.

Ability gap between the private and public sectors (1)
(percentage points)



Source: Based on Istat data, labour force surveys, 2005-2013.
(1) Ability is measured by calculating the inverse of the delay in obtaining a university degree for individual workers with respect to the minimum delay observed among workers with equivalent educational qualifications and age. The gap between the public and private sectors is equal to the difference between the average scores of the ability measure in the two sectors. – (2) Averages for the period 2005-2013.

Analysing worker flows between the two sectors, it is estimated that the likelihood of the most skilled workers choosing the public sector declines as the relative risk of being hired on a fixed-term contract and its average expected length increase. Among the precarious workers in the public sector instead, as expectations of being made permanent decline, the probability that the most skilled workers move to the private sector increases in the South and decreases in the Centre and North.

Career paths do not appear to reward merit and skills. Calculations based on data from Istat's labour force survey for the period 2009-2014 show that in the public sector the growth in hourly pay is more closely linked to length of service than in the private sector. The pay gap between a university graduate and a less well qualified employee is, however, smaller in the public sector (20 per cent) than in the private sector (about 26 per cent). Estimates based on PIAAC data on workers aged 35-54 years show that in the public sector in Italy, in terms of hourly wages the return on skills actually possessed is less than half the average for the countries participating in the survey; the gap between the private and public sectors is 8 percentage points, compared with 3.6 percentage points on average in the countries considered.

Management and performance appraisals

An essential factor in any organization's performance is the quality of its management and practices.

In public administration it is necessary to balance the need, on the one hand, to safeguard the continuity and impartiality of its work and, on the other, to ensure that government policies are implemented. This equilibrium is achieved in different ways in different countries: in Italy, following the reforms introduced over the past two decades, it has been achieved through: a) temporary posts (with automatic termination of office for managers when the government changes); b) political appointment, renewal and revocation of top positions (with the possibility of bringing in external candidates); c) the linking of the confirmation of a post (and the payment of any bonuses) to performance appraisals, and the involvement of independent bodies, as a guarantee.

The smooth running of this system has been hampered by failures in the performance measurement and appraisal systems. In 2014 the National Anti-Corruption Authority signalled a general flattening of appraisal scores at the higher levels as regards senior managers at Italian ministries and reported that the level of achievement of strategic objectives in this group was close to 100 per cent.[10] Calculations based on a sample of regional managers show that the main determinant of pay is actually the manager's age, while other characteristics such as having a postgraduate degree, language skills or work experience abroad, do not have any noticeable effect.

A new draft enabling law is currently before Parliament, which aims simultaneously to limit the discretion of the political leadership in appointing top managers (by requiring prior or subsequent approval by an independent committee) and to introduce career paths for managers that are more merit-based and competitive. Measures to encourage the mobility of managers within the public sector and towards the private sector are also being considered.

Decree Law 90/2014 (converted into Law 114/2014) also authorized the government to enact a specific regulation to reorganize performance measurement and appraisals. The guiding principles are: simplification of compliance burdens for the public administration; progressively linking the performance management cycle to budget planning; review of the rules of the independent appraisal bodies; and interaction with the internal control system. These principles address serious shortcomings in the existing legislative framework. As a result the implementation of the enabling law may also provide the opportunity to resolve some of the current difficulties, including the lack of a properly defined internal audit structure.[11]

The effectiveness of appraisal systems is closely linked to their ability to take into account the specific characteristics of different sectors, to avoid excessive formalities and to increase external accountability. Empowerment of managers would be improved by the preparation and publication of comparative appraisals, when it is possible to measure and compare individual performances; in other cases empowerment would be encouraged by institutionalizing systematic and methodologically robust public policy appraisal systems. The experience of countries with a more well-established tradition of measuring performance suggests that the key conditions for success are: independent appraisal bodies, transparent procedures, the availability of informational support and adequate resources, and a broad range of expertise.

Information technology

The effective use of information technology increases the levels of internal efficiency in government and improves the quality of the services provided. Italy lags behind

[10] ANAC, *Relazione sulla performance delle amministrazioni centrali 2012,* 2014.

[11] A. Peta, 'I controlli interni della Pubblica amministrazione: criticità e prospettive evolutive', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

in the development of information technology to serve the public administration. According to the European Commission's composite index that measures the progress of the European Digital Agenda, in 2014 Italy was ranked twenty-fifth among the 28 member countries.

The level of IT utilization is heavily tilted in favour of internal management activities and general communications, while the provision of digital services for users is less well developed. Nevertheless, there have been some notable exceptions, such as tax services. In 2012 only 36.7 per cent of local governments allowed users to submit forms electronically and only 19.1 per cent made it possible to conduct the entire process online.[12] Payment by credit card was only accepted by 25 per cent of local governments (12, 35, and 32 per cent in the South, Centre and North respectively).[13]

The development of information technology has been hindered by the piecemeal nature of the initiatives taken and the lack of measures to integrate administrations.[14] The 2014-2020 Strategy for Digital Growth addresses these issues.[15] The benefits of introducing IT procedures were also held back by the lack of both a simultaneous simplification of existing processes and any rationalization and reorganization of present structures.

[12] 'Le tecnologie dell'informazione e della comunicazione nella Pubblica amministrazione locale: anno 2012', Istat, *Statistics report*, 2013.

[13] *L'informatizzazione nelle amministrazioni locali*, Banca d'Italia, 2013.

[14] C. M. Arpaia, P. Ferro, W. Giuzio, G. Ivaldi and D. Monacelli, 'L'e-government in Italia: situazione attuale, problemi e prospettive', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

[15] Presidenza del Consiglio dei Ministri, *Strategia per la crescita digitale 2014-2020*, 2015.

THE BANK OF ITALY'S ANNUAL ACCOUNTS

16. MANAGEMENT REPORT AND ANNUAL ACCOUNTS[1]

The Bank of Italy's annual accounts consist of the balance sheet, the profit and loss account and the notes to the accounts. Amounts are in euros in the official accounts and in thousands of euros in the tables of the notes. The accounts are accompanied by the management report.

The draft annual accounts are transmitted to the Ministry of Economy and Finance under Article 117 of Royal Decree 204/1910 (Consolidated Law on the Bank of Issue).

The annual accounts are audited by an independent auditing company selected in accordance with and for the purposes of Article 27 of the Statute of the European System of Central Banks (ESCB). The auditing company appointed for the years 2010-15 is PricewaterhouseCoopers, which won the public tender announced by the Bank in 2009.

Information on the functions, governance and administration of the Bank can be found on its website (*www.bancaditalia.it*).

MANAGEMENT REPORT

Summary of the annual accounts

The monetary policy operations undertaken by the Eurosystem reduced the size of the national central banks' balance sheets and operating profits in 2014.

The Bank of Italy closed the year 2014 with a net profit of €2,998 million, compared with €3,035 million in 2013. The gross profit before tax and transfers to the provision for general risks was equal to €5,957 million (€6,862 million in 2013). Taxes for the year amounted to €1,159 million.

The balance sheet total at the end of 2014 amounted to €530,623 million, €23,784 million less than in 2013 (Table 16.1).

The change in total balance sheet assets was due above all to the decrease in lending to euro-area credit institutions, offset in part by the increase in intra-Eurosystem claims and in the value of the gold reserves.

[1] This abridged English version of the Bank's annual accounts does not contain all the information required by law in the Italian version, nor does it include the audit report issued by PricewaterhouseCoopers. The full Italian version can be found on the Bank of Italy's website (www.bancaditalia.it).

Table 16.1

Main balance sheet aggregates (1)
(millions of euros)

	31.12.2014	%	31.12.2013	%	31.12.2012	%	31.12.2011	%	31.12.2010	%
Gold	77,865	14.7	68,677	12.4	99,417	16.3	95,924	17.8	83,197	25.0
Foreign currency assets	40,510	7.6	37,720	6.8	41,185	6.7	40,911	7.6	37,789	11.3
Lending to euro-area credit institutions	194,522	36.7	235,869	42.5	271,784	44.6	209,995	39.0	47,635	14.3
Securities held for monetary policy purposes	35,486	6.7	37,572	6.8	44,525	7.3	43,056	8.0	18,079	5.4
Portfolio of financial assets	141,711	26.7	140,289	25.3	128,601	21.1	129,455	24.0	123,047	37.0
Intra-Eurosystem position	29,502	5.5	20,086	3.6	10,804	1.8	7,199	1.3	10,898	3.3
Other assets	11,027	2.1	14,194	2.6	13,657	2.2	12,438	2.3	12,316	3.7
Total assets	**530,623**		**554,407**		**609,973**		**538,978**		**332,961**	
Banknotes in circulation	164,527	31.0	157,541	28.4	149,948	24.6	146,010	27.1	138,324	41.5
Liabilities to euro-area credit institutions	15,436	2.9	20,789	3.7	27,665	4.5	33,878	6.3	22,741	6.8
General government deposits	7,859	1.5	27,117	4.9	33,802	5.5	23,529	4.4	42,488	12.8
Intra-Eurosystem position	208,576	39.3	228,382	41.2	253,799	41.6	198,453	36.8	7,093	2.1
Foreign currency liabilities	8,230	1.6	7,758	1.4	8,047	1.3	8,355	1.5	8,236	2.5
Other liabilities	7,577	1.4	8,697	1.6	3,386	0.6	4,652	0.9	4,958	1.5
Provisions	24,923	4.7	23,359	4.2	21,317	3.5	18,223	3.4	16,913	5.1
Revaluation accounts	66,200	12.5	54,191	9.8	86,900	14.3	83,004	15.4	70,206	21.1
Capital, reserves and net profit	27,295	5.1	26,573	4.8	25,109	4.1	22,874	4.2	22,002	6.6
Total liabilities	**530,623**		**554,407**		**609,973**		**538,978**		**332,961**	

Main profit and loss account aggregates (2)
(millions of euros)

	2014	2013	2012	2011	2010
Net interest income	6,406	6,728	6,602	4,501	3,845
Net result of the pooling of monetary income	221	557	1,315	590	613
Income from equity shares and participating interests	402	552	200	248	360
Realized gains/losses arising from financial operations	792	1,095	750	505	387
Write-downs	-96	-357	-28	-471	-214
Other net income	180	102	72	119	57
Operating expense and other costs	-1,948	-1,815	-1,838	-1,862	-1,921
Gross profit	**5,957**	**6,862**	**7,073**	**3,630**	**3,127**
Transfer to the provision for general risks	-1,800	-2,183	-2,645	-1,400	-1,350
Taxes on income for the year and productive activities	-1,159	-1,644	-1,927	-1,101	-925
Net profit	**2,998**	**3,035**	**2,501**	**1,129**	**852**

(1) The balance sheet is reclassified as follows: *Foreign currency assets* include the securities and other assets denominated in foreign currency (Items 2 and 3 on the asset side); the *Portfolio of financial assets* includes bonds, equity shares and other participating interests, and other assets denominated in euros and foreign currency allocated to Items 4, 6, 7.2, 8 and 11.2 on the asset side. It also includes the participating interest in the ECB (Item 9.1); the *Intra-Eurosystem position* includes net claims (liabilities) vis-à-vis the Eurosystem (Items 9.2, 9.3 and 9.4 on the asset side; Items 9.1, 9.2 and 9.3 on the liability side). *Foreign currency liabilities* include the liabilities denominated in foreign currency (Items 6, 7 and 8 on the liability side). The *Provisions* include the provisions for general risks, the provisions for specific risks and the staff-related provisions (Items 12 and 14 on the liability side). – (2) The profit and loss account is reclassified as follows: *Net interest income* includes interest income and interest expense under Items 1 and 6.1 of the profit and loss account; *Income from equity shares and participating interests* includes dividends and income from ETFs and shares/units of UCITS (Items 4, 6.2 and 6.5); *Realized gains/losses arising from financial operations* and *Write-downs* include income and expense under Items 2.1, 2.2, and 6.4; *Other net income* includes the amounts under Items 3, 7, 8 and 11; *Operating expense and other costs* include the costs under Item 9, while *Transfer to the provision for general risks* refers to the allocations under Item 2.3.

The value of refinancing operations decreased from €235,869 million to €194,522 million. Longer-term refinancing operations (LTROs) declined by €44,930 million owing to the early repayment of the two three-year LTROs conducted in 2011 and 2012; new targeted longer-term refinancing operations (TLTROs) were launched. Main refinancing operations increased by €3,583 million.

The redemption of securities purchased under the Securities Markets Programme (SMP) led to a decrease in the Bank's portfolio of securities held for monetary policy purposes as well, which was reduced by €2,086 million.

By contrast, a positive contribution came from increases of (a) €9,188 million in the value of the gold reserves due entirely to the rise in the metal's price; (b) €2,790 million in the value of foreign currency assets due to the appreciation of the main currencies against the euro; and (c) €9,416 million in the Bank's net position with the Eurosystem, entirely as a result of the rise in claims related to the allocation of euro banknotes.

On the liability side, there was a reduction in the Bank's debit balance with the TARGET2 payment system, part of its intra-Eurosystem liabilities (-€19,806 million). At the end of 2014 the latter amounted to €208,576 million, equal to 39 per cent of total liabilities (41 per cent at the end of 2013).

There was a decrease in the deposits of general government (-€19,258 million), partly owing to the less favourable terms of remuneration set by the ECB, and in banks' deposits (-€5,353 million). On the other hand, revaluation accounts increased by €12,009 million, mainly as a result of the increase in the value of gold and foreign currency assets, and the Bank's share of banknotes in circulation rose by €6,986 million.

The reduction in the Bank's balance sheet assets and in interest rates was reflected in the profit and loss account.

Net interest income declined by €322 million, owing above all to the contraction in income from securities held for monetary policy purposes. The reduction in interest income from refinancing operations was almost entirely offset by that in interest expense on intra-Eurosystem balances.

The net result for the Bank of the pooling of monetary income decreased from €557 million to €221 million, reflecting the lower amount of monetary income generated in the whole Eurosystem (see *Seigniorage and monetary circulation*).

Profit on trading, which had benefited last year from the transfer of the shareholding in Assicurazioni Generali SpA to Fondo Strategico Italiano, decreased by €303 million. There was also a €150 million decrease in income from equity shares and participating interests, mainly owing to the smaller dividend allocated by the ECB.

Operating expenses and other costs increased by €133 million as a result of larger allocations to the staff pension and severance pay fund (+€147 million) in connection with the updating of the demographic tables used to compute the actuarial reserves. There was an increase in administrative expenses associated with the asset quality review required by the ECB for the launching of the Single Supervisory Mechanism

(SSM). Excluding these one-off expenses, total operating costs diminished, partly owing to the reduction in depreciation allowances following the Bank's transfer of its portfolio of rental properties to the wholly-owned company Società Italiana di Iniziative Edilizie e Fondiarie SpA (SIDIEF), continuing the downward trend under way in recent years.

The decline in gross profit was partly offset by the decrease of €261 million in write-downs and the increase of €78 million in other net income.

The provision for general risks, which covers the Bank's overall exposure to risk, was funded to the tune of €1,800 million in view of the prospective increase in the size of the balance sheet and the progressive exposure to the risks attached to the programmes of public and private sector securities purchases launched by the Eurosystem in October 2014 (see *Post-balance-sheet events*).

Taxes for the year amounted to €1,159 million (€1,644 million in 2013). The decrease was due in part to the absence of the 8.5 per cent corporate surtax levied only in 2013.

Out of the net profit of €2,998 million, a total of €749 million was allocated to the statutory reserves and the shareholders were assigned a dividend of €340 million; €1,909 million was transferred to the State (see *Proposals for the Board of Directors*).

Post-balance-sheet events

As of 1 January 2015, following Lithuania's entry into the euro area, the Bank of Italy's share in the ECB's capital, considering only the Eurosystem countries, decreased from 17.5923 to 17.4890 per cent. This capital key is used to settle financial transactions between the Bank and the other Eurosystem central banks, such as the distribution of the ECB's net profit and the pooling of monetary income.

At its meeting of 22 January 2015 the ECB's Governing Council announced it would expand the asset purchase programme launched towards the close of 2014 to include public sector securities and those issued by European institutions. Purchases of the latter began in March 2015 (see *Monetary policy operations*). At the end of April the book value of the securities purchased by the Bank as part of the programme totalled €26.5 billion.

In conformity with the monetary policy guidelines issued by the ECB, Law 190/2014 requires the Ministry of Economy and Finance to transfer its account, i.e. the fund for the amortization of government securities, from the Bank to Cassa Depositi e Prestiti. The transfer took place, as instructed by the Ministry, in the first week of 2015.

At its meeting of 30 March 2015, the Bank's Board of Directors approved the reorganization plan for the branch network to be carried out over the next three years. The largest branches will take on additional responsibilities, three detached divisions of banking supervision will be incorporated in the nearest branch, and 19 branches with reduced operation will be closed.

Disclosure of relations with subsidiary and associate companies

The Bank of Italy is the sole shareholder in Società Italiana di Iniziative Edilizie e Fondiarie (SIDIEF), a real estate company whose main activity is the management and rental of properties owned by the Bank.

With effect from 1 January 2014 the Bank transferred to SIDIEF the entirety of its real estate portfolio consisting of 69 mainly residential properties. The operation, which was carried out at book value, was settled by means of an increase of €421 million in SIDIEF's capital and reserves, entirely paid in by the Bank.

The Bank's role with respect to the subsidiary is one of direction and coordination, principally regarding its corporate strategy, but it does not interfere in areas of operational autonomy.

In 2014 the Bank sold its controlling interest in Bonifiche Ferraresi SpA to a group of entrepreneurs and institutional investors. The price paid for the shareholding, which amounted to 60.37 per cent of the capital, was €104 million. The Bank of Italy has kept an interest of less than 2 per cent purely as a financial investment.

At the end of 2014 the Bank held a 20 per cent interest in Fondo Strategico Italiano (see 'Notes on the items of the balance sheet' – *Securities portfolio*). It has no other economic, capital or financial ties with the Fondo other than those connected with the shareholding.

Monetary policy operations

In 2014 the monetary policy auctions were again conducted at fixed rates with full allotment. In June 2014 the Governing Council of the ECB announced that this system would remain in place as long as necessary and in any case until the end of 2016. On the same occasion it decided to halt the operations to sterilize the liquidity injected through the Securities Market Programme.

Also in June, in order to enhance the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy, the Governing Council announced a series of TLTROs to be conducted quarterly over a period of two years. Two such operations were carried out in September and December, allowing counterparties to borrow up to 7 per cent of the total amount of their loans to the private sector at 30 April 2014. A further six operations are scheduled between March 2015 and June 2016. All the TLTROs will mature in September 2018 and the interest rate will remain fixed for the entire duration of each operation. For the remaining TLTROs, the 10 basis point spread over the rate on main refinancing operations that applied to the first two operations will be removed.

On two occasions, in June and September, the Governing Council reduced the interest rates on monetary policy operations, bringing that on the deposit facility into negative territory. The negative rate will also apply to deposits in excess of the reserve requirement and to some accounts held with Eurosystem national central banks, including government deposits above a given threshold (see 'Notes on the items of the balance sheet' – *Liabilities to general government and other counterparties*).

The Governing Council continued to issue forward guidance on interest rates during the year, communicating that it intended to keep them at a low level for an extended period of time, given the expectations of low inflation. At the end of the year the rates on main and marginal refinancing operations and on deposits with the central bank reached 0.05, 0.30 and -0.20 per cent respectively, the lowest levels on record.

At the end of 2014, the volume of funds provided by the Eurosystem through its refinancing operations was down to €630.3 billion, from €752.3 billion a year earlier. The share of LTROs, including TLTROs, was virtually unchanged at 75 per cent, compared with 78 per cent a year earlier. At the end of 2014, of €1,018.7 billion of funds initially allocated, repayments of the three-year operations conducted between the end of 2011 and the beginning of 2012 amounted to €808.7 billion at Eurosystem level; Italian counterparties repaid €167.9 billion of the €254.7 billion granted.

The Eurosystem's exposure to Italian counterparties amounted to €195 billion at the end of 2014, some €41 billion less than a year earlier. As a share of the total exposure it was practically unchanged at about 31 per cent.

The unconventional monetary policy measures designed to support lending to the real economy include two new securities purchase programmes launched towards the end of 2014: the Asset-Backed Securities Purchase Programme (ABSPP) – which to date has only entailed purchases by the ECB – and the Covered Bond Purchase Programme (CBPP3). Both programmes are designed to support specific segments of the market in order to enhance the functioning of the monetary policy transmission mechanism and foster the supply of credit.

In view of the urgent need to combat deflationary expectations, the Governing Council announced at its meeting on 22 January 2015 that it would further expand the asset purchase programme to include euro-denominated securities and bonds issued by euro-area central governments, agencies and European institutions (Expanded Asset Purchase Programme, APP). The new programme consists of monthly purchases (encompassing both covered bonds and asset-backed securities) amounting to about €60 billion, which will be made at least until September 2016 and in any case until there is a sustained adjustment in the path of inflation that is consistent with the aim of price stability.

At 31 December 2014 the book value of the securities held by the Bank for monetary policy purposes was €35.5 billion. The decrease with respect to the end of 2013 was due to repayments at maturity, mainly of purchases under the SMP, which were only partly offset by the new purchases of covered bonds.

Table 16.2

Securities held for monetary policy purposes
(millions of euros)

	31.12.2014	31.12.2013
Government securities (SMP)	23,403	28,621
CBPP1	5,396	6,693
CBPP2	2,035	2,258
CBPP3	4,652	–
Total	**35,486**	**37,572**

In accordance with the decisions of the Governing Council of the ECB, the securities acquired under the three Covered Bond Purchase Programmes and the Securities Markets Programme were valued at amortized cost subject to impairment.

The annual impairment tests conducted at the level of the Eurosystem showed no evidence of losses (see 'Notes on the items of the balance sheet' – *Monetary policy operations*).

Financial resources

Ownership of the country's official reserves (gold and claims on non-euro-area residents in foreign currency) is assigned by law to the Bank of Italy. Management of the reserves makes it possible to service the Italian Republic's foreign currency debt and meet its commitments to international organizations such as the International Monetary Fund. In addition, since the nation's official reserves are an integral part of the Eurosystem's reserves, their overall level and proper management help to safeguard its credibility. The foreign currency reserves are managed with the aim of guaranteeing high levels of liquidity and security, while also seeking to maximize the long-term expected yield. The Bank also manages a part of the reserves transferred to the ECB in accordance with the guidelines laid down by the Governing Council.

The item *Gold and net foreign currency assets*, the composition of which is shown in Table 16.3, includes the official reserves plus other claims on euro-area residents denominated in foreign currency held by the Bank, net of foreign currency liabilities.

Table 16.3

Gold and net foreign currency assets (1)
(millions of euros)

	31.12.2014	31.12.2013
Gold	77,865	68,677
US dollars	19,789	16,932 (2)
Pounds sterling	3,305	3,045
Japanese yen	3,761	4,200
Australian dollars	1,344	1,246
Chinese renminbi	85	–
Other currencies	6	5
Net assets vis-à-vis the IMF (including SDRs)	3,989	4,534
Total	**110,144**	**98,639**

(1) Valued at market exchange rates and prices. The reserves do not include financial assets (ETFs and shares/units of UCITS) denominated in foreign currency representing the investment of ordinary and extraordinary reserves, provisions and other capital funds, as they constitute a separate foreign currency position. – (2) Includes €73 million of temporary operations in dollars as part of an agreement between the ECB and the Federal Reserve to offer short-term liquidity in dollars to the banking system.

At 31 December 2014, gold and net foreign currency assets were worth €110.1 billion, compared with €98.6 billion a year earlier. The increase was due above all to the rise in the price of gold (up by 13.38 per cent, leading to an increase of €9.2 billion in the value of the stock) and, to a lesser extent, to the appreciation of the main foreign currencies in the Bank's portfolio. At the end of 2014 the composition of net foreign currency assets, excluding Special Drawing Rights, showed an increase in investments in dollars (from 66.5 to 70 per cent), basically no change in those in sterling (11.7 per cent) and Australian dollars (4.7 per cent), but a decrease in the proportion of assets in yen (from 16.6 to 13.3 per cent). In 2014 the Bank purchased Chinese renminbi for the first time, which accounted for 0.3 per cent of the total portfolio at the end of the year.

The Bank also holds a financial portfolio containing, among other, investments of provisions, reserves and the pension and severance pay provision. In compliance with the ban on the monetary financing of member states and euro-area public institutions, the securities of such issuers are not acquired at issue. Investments in shares of banks and insurance companies are excluded.

Table 16.4

Composition of the financial portfolio
(millions of euros)

	31.12.2014	31.12.2013
Government securities	122,544	117,380
Other bonds	3,182	2,953
Equity shares and other participating interests	6,707	6,246
ETFs and shares/units of UCITS	2,987	3,302
Total	**135,420**	**129,881**

At the end of 2014, the book value of the portfolio was €135.4 billion (€129.9 billion in 2013). The portfolio was invested mainly in bonds, especially Italian and other euro-area government securities. The part invested in equities consisted primarily of shares listed in the euro area. In 2014 the Bank completed the process of rebalancing its portfolio of Italian listed shares with a view to achieving greater diversification, replicating market indices and limiting reputation risk by avoiding ownership of large shareholdings in individual companies. The Bank's shareholdings in individual listed Italian companies are aligned around a threshold level of 0.5 per cent of their capital and the range of investments has been broadened to include all companies with stock market capitalization of over €500 million.

The bulk of the portfolio (86 per cent) consists of securities held to maturity and is therefore valued at amortized cost subject to impairment. If all listed financial instruments were valued at end-of-year market prices, the portfolio would be worth €152.7 billion.

The Bank also manages the investments of the defined-contribution pension fund for staff hired since 28 April 1993. Its investments and earmarked funding contributions are included in the Bank's balance sheet. The fund constitutes a separate asset for administrative and accounting purposes. Investments are made observing benchmarks. At 31 December 2014 the fund's total assets and liabilities in the Bank's balance sheet amounted to €353 million. Returns on assets and exposure to risk are measured daily.

Financial risks

Monetary policy operations. – The national central banks share the risks attached to securities acquired under the SMP, ABSPP and CBPP3 according to their share in the ECB's capital key. In the case of the other securities purchased under the APP, the NCBs assume the risk for public sector securities, while there is a system of risk sharing for securities issued by European institutions. This also applies to public sector securities acquired by the ECB as a result of the NCBs' share in its capital. In general, the risks attached to refinancing operations are shared.

According to the ESCB Statute, all lending operations with banks conducted by the Eurosystem must be backed by adequate collateral in the form of the transfer of ownership or pledging of eligible financial assets. The measures to control risk introduced by the ECB Governing Council are designed to protect the Eurosystem NCBs from the risk of financial loss when such assets are realized should a counterparty prove unable to meet repayments.

These risks are mitigated and managed according to rules laid down by the Eurosystem, which set out strict requirements for the credit rating of assets used as collateral and provide for the daily evaluation of collateral and the adoption of appropriate control measures, such as haircuts and variation margins.

In 2014, extensive collateral availability was maintained, compatibly with the rule on the assets eligible in lending operations, in order to help meet the banks' demand for liquidity and at the same time limit the Eurosystem's risk exposure.

The overall riskiness of refinancing operations diminished with the decrease in outstanding loans as a result of early repayments of three-year LTROs conducted in late 2011 and early 2012. However, the average duration of financing was increased during 2014 as a result of the first two TLTROs.

The Eurosystem's risk exposure associated with securities purchased for monetary policy purposes also decreased owing to repayments at maturity; the effect of this was only partly offset by the launch of the new CBPP3. The risks attached to covered bond purchases were limited by specific eligibility criteria as in the case of ABS, which for the time being are only purchased by the ECB.

Foreign currency reserves and the financial portfolio. – The Bank of Italy manages on an integrated basis the financial risks attached to monetary policy operations and to other financial assets and liabilities, consisting in particular of the foreign currency reserves and the financial portfolio, and takes account of the links between the various risk factors. It also monitors the liquidity risk of the foreign currency reserves and the operational risks associated with its overall activities. The optimum composition of financial investments is established taking account of all the main identifiable sources of risk over the medium-to-long term.

For the control of overall risks the Bank uses a prudential measure of risk exposure based on an estimate of low-probability high-impact losses, i.e. entailing a large expected shortfall. The measure was developed within the Eurosystem and takes account of the diversification of market and credit risk.

As well as controlling aggregate risk exposure, the Bank also monitors individual positions. Most of its euro-denominated bond portfolio is held to maturity, while the equity component consists predominantly of temporary investments. For the control of financial risk the Bank takes account of both fixed assets and trading stock. The exposure to market risk[2] is monitored on the basis of several indicators: the elasticity of the bond portfolio to interest rate fluctuations (duration); the maximum potential loss estimated over a year for the long-term and short-term components (structural VaR and cyclical VaR) and separately for the various classes of financial assets and portfolios; and the decrease in value of the portfolio in the event of highly adverse but low-probability market developments.

The exchange rate risk for non-euro-denominated assets included in the financial portfolio is hedged through foreign exchange forward sales.

The Bank controls and limits risk not only by means of continuous monitoring but in the case of credit risk by rigorously selecting investment instruments and counterparties based on a prior assessment of credit ratings and market information. It also sets category and individual exposure limits that are monitored daily.

The liquidity of the financial instruments invested in is normally very high. The liquidity risk of the foreign currency reserves is managed by applying extremely prudent criteria in the selection of financial instruments and counterparties, and by placing tight restrictions on the maturity of bank deposits, bank paper, and commercial paper, as well as on acquisitions of individual issues.

At the end of 2014 the overall exposure to financial risk, measured using the new method that combines market and credit risk, was assessed as less than at the end of 2013 owing to the smaller size of the balance sheet and reduced credit risk. The exposure to interest rate risk, measured separately, also diminished, mainly for the portfolio of euro-denominated bonds and securities purchased for monetary policy purposes. The overall duration of the bond component was basically unchanged for Italian government securities and those of other euro-area countries and for the portfolio of supranational securities, but increased for securities indexed to euro-area inflation. Over the year the duration of foreign currency reserves was virtually stable, while that of the monetary policy portfolio decreased with the progressive redemption of the securities.

In the future, however, the Bank's balance sheet is set to expand and risk exposure to increase progressively with the programmes of public and private sector securities purchases that the Eurosystem began to roll out last October.

Seigniorage and monetary circulation

Seigniorage is the aggregate income that the central banks earn from the issue of banknotes.

In the Eurosystem, seigniorage is included in the broad definition of monetary income, i.e. the net revenue that the national central banks obtain from the assets held against monetary liabilities, mainly consisting of banknotes and credit institutions'

[2] Market risk includes exchange rate risk, the risk of fluctuations in the price of gold (commodity risk) and equities, and interest rate risk associated with movements in the yield curve of individual markets.

deposits. With the adoption of the euro and the single monetary policy the total monetary income generated by the Eurosystem NCBs is distributed among them according to their share in the ECB's capital. Consequently, every year each of the NCBs calculates its monetary income as laid down in the rules established by the Governing Council; this is then pooled with the ECB for redistribution among NCBs according to the capital key (see 'Notes on the items of the profit and loss account' – *Net result of the pooling of monetary income*).

The monetary income of the Bank of Italy contributes, together with the other income from its investments (including of capital and provisions) to the net profit for the year.

At the end of the year the total value of banknotes put into circulation by the Bank was €142.2 billion (14 per cent of the Eurosystem total), down 1.7 per cent from the end of 2013 (€144.7 billion). The amount recorded in the accounts (€164.5 billion) represented the 16.2 per cent share of total Eurosystem circulation notionally assigned to the Bank of Italy.

The Bank contributes, via its banknote printing facility, to meeting the Eurosystem's demand for banknotes and participates in the development of the new series. It is also involved in drafting common guidelines for the quality of the notes in circulation and measures against counterfeiting.

In 2014, a total of 1,162 million banknotes were produced, in denominations of €10 and €20 for the second series and of €50 for the first series. This was basically in line with projected production and with actual production in 2011-12. It represents a decrease of 15 per cent compared with 2013, when the Bank's printing facility produced the largest volume of euro notes since the introduction of the single currency in 2002. A combination of factors was responsible, including the start of production of the new €20 note and the pilot run of the new €50 note. In addition, the Bank's printing facility, as R&D main test-print centre for the Eurosystem, began experimenting a series of innovative technical solutions, including new security features for large-denomination notes of the second series. Although the share of production assigned to the Bank in 2015 (997.2 million notes) will be less than in 2014 (1,477.8 million), volumes will still be high at around 1.2 billion notes, owing to the mismatch between the allocation of the new denominations and the actual start of their production.

In 2014, investments were limited to strictly essential projects in view of the need to align the printing facility's production capacity with medium-term forecasts for euro banknote demand, the application of the ECB's guidelines on the new production system – which include the strategic objective of designing a system of joint purchase by NCBs equipped with printing facilities – and, above all, the commitment to limit production costs.

The Bank's branches put 2.7 billion banknotes into circulation during the year, for a total value of €91.1 billion. The return flow to the Bank amounted to 2.5 billion banknotes, worth €93.6 billion. Some 2.5 billion notes were checked and 0.8 billion were withdrawn from circulation. An automatic planning procedure for banknote transport to the branches, designed to improve distribution efficiency, is now in the final stages of development.

Human, logistical and IT resources

Human resources. – At 31 December 2014 the Bank had 7,078 employees: 4,510 working at Head Office and 2,568 at branch offices. Managers and officers accounted for respectively 8.7 and 20.9 per cent of the personnel. The staff's average age was 48.8 years and 35.8 per cent of the Bank's employees were women.

The total number of staff increased by 51 compared with the end of 2013. In 2014 there were 240 new appointments, of which about 56 per cent held a university degree. Terminations, which decreased further owing to the introduction of new legislation on retirement, totalled 189 and were down 3 per cent compared with 2013 and 10 per cent compared with 2012.

Table 16.5

Composition of the Bank's staff

	At 31.12.2014					At 31.12.2013				
	Men	Women	**Total**	At branches	At Head Office (1)	Men	Women	**Total**	At branches	At Head Office (1)
Managers	460	153	**613**	139	474	460	146	**606**	137	469
Officers	944	535	**1,479**	393	1,086	933	537	**1,470**	394	1,076
Coadjutors	850	558	**1,408**	495	913	804	525	**1,329**	492	837
Other	2,288	1,290	**3,578**	1,541	2,037	2,324	1,298	**3,622**	1,573	2,049
Total	**4,542**	**2,536**	**7,078**	**2,568**	**4,510**	**4,521**	**2,506**	**7,027**	**2,596**	**4,431**

(1) Includes members of the staff assigned to the Financial Intelligence Unit and the representative offices abroad and those seconded to other organizations.

IT and logistics resources. – The Bank's expenditure commitments for IT amounted to €140.4 million in 2014. A total of €103.1 million was set aside for the current operation of ICT infrastructure and services, while projects were allocated €37.3 million. In its role as service provider the Bank made further progress in building the new platform for the settlement of securities transactions, TARGET2-Securities, and in improving the TARGET2 system. In accordance with Eurosystem guidelines on expanding the assets eligible for use by the banks in Eurosystem lending operations, the first steps were taken to adapt the collateral management procedures. Plans for a centralized European archive of bank credit (AnaCredit) were drawn up within the ESCB.

The objective of the Bank's property administration is to ensure the efficient functioning of its premises and security systems and to preserve the value of its real estate holdings, as well as to support plans for organizational reform. In 2014 efforts continued to ensure the business continuity of the Bank's 'critical' functions.

Management control system

The management control system ensures that considerations of cost and efficiency govern all the Bank's activities. A number of management tools are employed for this purpose, such as budgeting of expenditure commitments, cost accounting and performance indicators. Cost accounting is also a tool of external accountability, serving to illustrate how resources are distributed among the different institutional functions. It is also used to set the charges for the services offered to private users and other institutions, including Eurosystem national central banks.

The Bank continued to pursue its objective of cost containment in 2014, although one-off expenditures associated with the launch of the Single Supervisory Mechanism had a negative impact. Nonetheless, spending commitments for goods and services decreased by 0.2 per cent. Savings were made at the level of the Head Office and of the network of branches and foreign representative offices.

Internal audit and operational risk

The Bank of Italy's internal audit system uses a function-based approach in which each organizational unit is responsible for the management of its own risk exposure and controls and for its results in terms of effectiveness and efficiency. The units apply operational control procedures within their own spheres of responsibility. The Bank also has in place a system for the integrated management of operational risk, which includes an ad hoc committee to assist the Governing Board in drafting policy guidelines and monitoring their implementation.

An advisory committee on internal auditing has been set up with the aim of strengthening the system of controls and the independence and objectiveness of the internal audit function. The purpose of the committee is to provide advice and support to the Board of the Directors and the Governor on matters concerning the oversight of the internal audit function; the committee is also required to provide opinions on audit policy and the annual audit plan.

For legal questions the Bank of Italy has its own team of lawyers who are listed in a special annex to the professional register. The risk of non-compliance with tax law and expenditure rules is overseen by ad hoc units.

The Board of Auditors is responsible for monitoring the administration of the Bank as regards compliance with the law, the Statute and the General Regulations and for checking the accounts.

Environmental policy and workplace safety

The Bank has long been committed to reducing the environmental impact of its activities. To this end it has drafted, and put into effect in 2014 too, a series of measures that include (a) purchasing electricity for all of the Bank's institutional premises only from renewable sources; (b) installing a second photovoltaic system for domestic hot water production; (c) optimizing the two data processing centres with a view to reducing energy consumption; and (d) dematerializing internal and external documents and reducing paper consumption. In addition, environmental and social clauses have been incorporated into the main tenders for the supply of goods and services.

The Bank monitors its carbon footprint by means of specific quantitative indicators published in the annual Environment Report, available on the Bank's website.

Workplace health and safety risks are monitored by analysing the reports drafted by members of the Bank's workplace safety system and via annual on-the-spot inspections of the various sectors of the Bank, conducted by the prevention and protection service.

In 2014, the functions assigned by the Director General, in his capacity as employer, to the heads of the various organizational units were monitored more closely to ensure their correct performance, focusing on the most important aspects in terms of safety.

At the Bank's banknote printing facility, new technologies have been introduced to reduce the environmental impact of production and further improve the health safeguards for workers there.

ANNUAL ACCOUNTS

for the year ending 31 December 2014

BALANCE SHEET

ASSETS	NOTES	Amounts in euros 31.12.2014	Amounts in euros 31.12.2013
1 GOLD AND GOLD RECEIVABLES	[1]	**77,864,640,607**	**68,677,223,308**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	[1]	**39,268,754,714**	**36,833,904,316**
2.1 Claims on the IMF		11,830,627,785	11,888,283,997
2.2 Securities		25,130,606,429	23,108,784,786
2.3 Current accounts and deposits		1,370,619,023	1,378,219,855
2.4 Reverse operations		931,540,881	454,665,413
2.5 Other claims		5,360,596	3,950,265
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	[1]	**1,241,162,372**	**885,693,946**
3.1 Financial counterparties		1,241,162,372	885,693,946
3.1.1 Securities		*532,584,926*	*263,573,477*
3.1.2 Reverse operations		–	*72,511,058*
3.1.3 Other claims		*708,577,446*	*549,609,411*
3.2 General government		–	–
3.3 Other counterparties		–	–
4 CLAIMS ON NON-EURO-AREA RESIDENTS		**1,515,529,252**	**1,405,092,784**
4.1 Claims on EU central banks		–	–
4.2 Securities	[4]	1,515,443,919	1,405,057,331
4.3 Other claims		85,333	35,453
5 LENDING TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS	[2]	**194,521,780,000**	**235,869,200,000**
5.1 Main refinancing operations		25,743,200,000	22,160,000,000
5.2 Longer-term refinancing operations		168,778,580,000	213,709,200,000
5.3 Fine-tuning reverse operations		–	–
5.4 Structural reverse operations		–	–
5.5 Marginal lending facility		–	–
5.6 Credits related to margin calls		–	–
6 OTHER CLAIMS ON EURO-AREA CREDIT INSTITUTIONS	[3]	**4,958,737,740**	**9,030,360,601**
7 SECURITIES OF EURO-AREA RESIDENTS		**117,615,085,195**	**111,529,531,677**
7.1 Securities held for monetary policy purposes	[2]	35,486,124,342	37,571,581,510
7.2 Other securities	[4]	82,128,960,853	73,957,950,167
8 GENERAL GOVERNMENT DEBT	[4]	**14,349,351,206**	**14,484,463,862**
9 INTRA-EUROSYSTEM CLAIMS	[5]	**30,834,456,509**	**21,463,585,337**
9.1 Participating interest in the ECB		1,332,644,970	1,377,337,333
9.2 Claims arising from the transfer of foreign reserves to the ECB		7,134,236,999	7,218,961,424
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem		22,367,574,540	12,867,286,580
9.4 Other claims within the Eurosystem (net)		–	–
10 ITEMS IN COURSE OF SETTLEMENT		**3,994,693**	**12,714,869**
11 OTHER ASSETS	[6]	**48,449,634,525**	**54,215,726,293**
11.1 Euro-area coins		132,513,029	94,590,561
11.2 Securities related to the investment of reserves and provisions	[4]	37,426,146,165	40,033,818,971
11.3 Intangible fixed assets		92,317,311	65,423,437
11.4 Tangible fixed assets		2,394,974,673	2,962,900,887
11.5 Accruals and prepaid expenses		3,795,030,658	5,218,965,124
11.6 Deferred tax assets		3,184,080,544	3,695,755,498 (1)
11.7 Sundry		1,424,572,145	2,144,271,815
TOTAL		**530,623,126,813**	**554,407,496,993**

(1) Deferred corporate taxes reclassified in the provision for taxes.

THE ACCOUNTANT GENERAL: Paolo Marullo Reedtz **THE GOVERNOR:** Ignazio Visco

Audited and found correct - 30 March 2015
THE BOARD OF AUDITORS: Lorenzo De Angelis, Giovanni Fiori, Gian Domenico Mosco, Sandro Sandri, Dario Velo

BALANCE SHEET

LIABILITIES		NOTES	Amounts in euros 31.12.2014	31.12.2013
1	**BANKNOTES IN CIRCULATION**	[7]	**164,526,675,300**	**157,541,040,600**
2	**LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS**	[2]	**15,436,190,195**	**20,789,249,743**
	2.1 Current accounts (covering the minimum reserve system)		15,058,190,195	18,392,290,699
	2.2 Deposit facility		378,000,000	2,376,959,044
	2.3 Fixed-term deposits		–	20,000,000
	2.4 Fine-tuning reverse operations		–	–
	2.5 Deposits related to margin calls		–	–
3	**OTHER LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS**		**–**	**8,161,000**
4	**LIABILITIES TO OTHER EURO-AREA RESIDENTS**	[8]	**13,928,139,895**	**33,888,202,906**
	4.1 General government		7,858,663,892	27,116,969,782
	4.1.1 Treasury payments account		*7,740,798,545*	*7,973,293,376*
	4.1.2 Sinking fund for the redemption of government securities		*977,175*	*20,377,620*
	4.1.3 Other liabilities		*116,888,172*	*19,123,298,786*
	4.2 Other counterparties		6,069,476,003	6,771,233,124
5	**LIABILITIES TO NON-EURO-AREA RESIDENTS**	[9]	**23,659,295**	**555,342,893**
	5.1 To EU central banks		–	–
	5.2 Other liabilities		23,659,295	555,342,893
6	**LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY**	[1]	**386,910,118**	**401,829,300**
	6.1 Financial counterparties		–	–
	6.2 General government		386,910,118	401,829,300
	6.3 Other liabilities		–	–
7	**LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY**	[1]	**2,263,777**	**1,992,549**
	7.1 Current accounts and deposits		2,263,777	1,992,549
	7.2 Other liabilities		–	–
8	**COUNTERPART OF SDRs ALLOCATED BY THE IMF**	[1]	**7,841,355,007**	**7,354,065,166**
9	**INTRA-EUROSYSTEM LIABILITIES**	[5]	**208,576,061,446**	**228,381,753,593**
	9.1 Liabilities in respect of debt certificates issued by the ECB		–	–
	9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem		–	–
	9.3 Other liabilities within the Eurosystem (net)		208,576,061,446	228,381,753,593
10	**ITEMS IN COURSE OF SETTLEMENT**		**26,781,540**	**27,146,453**
11	**OTHER LIABILITIES**	[10]	**1,456,797,506**	**1,334,868,589**
	11.1 Bank of Italy drafts		117,846,369	104,547,106
	11.2 Accruals and income collected in advance		2,253,222	7,014,220
	11.3 Sundry		1,336,697,915	1,223,307,263
12	**PROVISIONS**	[11]	**7,749,125,060**	**7,985,672,394**
	12.1 Provisions for specific risks		970,097,098	1,372,117,869 (1)
	12.2 Staff-related provisions		6,779,027,962	6,613,554,525
13	**REVALUATION ACCOUNTS**	[12]	**66,200,567,755**	**54,191,327,073**
14	**PROVISION FOR GENERAL RISKS**	[11]	**17,173,675,075**	**15,373,675,075**
15	**CAPITAL AND RESERVES**	[13]	**24,296,682,724**	**23,537,853,745**
	15.1 Capital		7,500,000,000	7,500,000,000
	15.2 Statutory reserves		9,057,171,803	8,298,342,824
	15.3 Other reserves		7,739,510,921	7,739,510,921
16	**NET PROFIT FOR THE YEAR**		**2,998,242,120**	**3,035,315,914**
	TOTAL		**530,623,126,813**	**554,407,496,993**

(1) Deferred corporate taxes reclassified in the provision for taxes.

OFF-BALANCE-SHEET ACCOUNTS at 31 December 2014 amounted to**152,790,021,910** euros.

THE ACCOUNTANT GENERAL: Paolo Marullo Reedtz **THE GOVERNOR:** Ignazio Visco

Audited and found correct - 30 March 2015
THE BOARD OF AUDITORS: Lorenzo De Angelis, Giovanni Fiori, Gian Domenico Mosco, Sandro Sandri, Dario Velo

PROFIT AND LOSS ACCOUNT

	NOTES	Amounts in euros 2014	2013
1.1 Interest income		5,714,978,761	7,151,707,496
1.2 Interest expense		-419,039,705	-1,542,634,228
1 Net interest income	[14]	**5,295,939,056**	**5,609,073,268**
2.1 Realized gains/losses arising from financial operations		142,241,862	300,573,762
2.2 Write-downs on financial assets and positions		-5,637,011	-347,053,063
2.3 Transfers to/from the provisions for general risks for exchange rate, price and credit risks		-1,800,000,000	-2,183,000,000
2 Net result of financial operations, write-downs and transfers to/from risk provisions	[15]	**-1,663,395,149**	**-2,229,479,301**
3.1 Fee and commission income		26,509,583	29,506,266
3.2 Fee and commission expense		-12,183,150	-13,132,549
3 Net income from fees and commissions	[16]	**14,326,433**	**16,373,717**
4 Income from participating interests	[17]	**181,112,266**	**320,913,773**
5 Net result of the pooling of monetary income	[18]	**220,776,562**	**556,532,173**
6.1 Interest income		1,109,745,763	1,118,720,784
6.2 Dividends from equity shares and participating interests		187,615,211	197,916,661
6.3 Gains and losses on financial operations		649,945,030	794,532,333
6.4 Write-downs on financial operations		-90,565,524	-9,408,502
6.5 Other components		33,179,960	32,839,623
6 Net income from financial assets related to the investment of reserves and provisions	[19]	**1,889,920,440**	**2,134,600,899**
7 Other transfers from provisions		**723**	**831**
8 Other income	[20]	**93,448,047**	**77,376,636**
TOTAL NET INCOME		**6,032,128,378**	**6,485,391,996**
9.1 Staff wages and salaries		-609,777,400	-599,069,445
9.2 Social security and insurance		-157,454,320	-155,171,228
9.3 Other staff costs		-45,725,916	-47,146,455
9.4 Pensions and severance payments		-275,115,949	-293,348,495
9.5 Transfers to provisions for accrued expense and staff severance pay and pensions		-217,990,444	-63,496,495
9.6 Emoluments paid to head and branch office collegial bodies		-3,094,707	-3,009,269
9.7 Administrative expenses		-453,412,187	-441,264,460
9.8 Depreciation of tangible and intangible fixed assets		-150,422,994	-170,354,962
9.9 Banknote production services		–	–
9.10 Other expenses		-34,907,781	-42,222,442
9 Expenses and charges	[21]	**-1,947,901,698**	**-1,815,083,251**
10 Other transfers to provisions		**–**	**–**
11.1 Extraordinary income		105,867,349	20,854,405
11.2 Extraordinary expense		-33,122,203	-12,245,218
11 Extraordinary income and expense	[22]	**72,745,146**	**8,609,187**
PROFIT BEFORE TAX		**4,156,971,826**	**4,678,917,932**
12 Taxes on income for the year and on productive activities	[23]	**-1,158,729,706**	**-1,643,602,018**
NET PROFIT FOR THE YEAR		**2,998,242,120**	**3,035,315,914**

THE ACCOUNTANT GENERAL: Paolo Marullo Reedtz

THE GOVERNOR: Ignazio Visco

Audited and found correct - 30 March 2015

THE BOARD OF AUDITORS: Lorenzo De Angelis, Giovanni Fiori, Gian Domenico Mosco, Sandro Sandri, Dario Velo

NOTES TO THE ACCOUNTS

Legal basis, method of preparation and layout of the annual accounts

Legal basis of the annual accounts. – The annual accounts of the Bank of Italy are drawn up in compliance with special statutory provisions and, where these do not provide any guidance, the Bank applies the rules laid down in the Civil Code, referring to generally accepted accounting principles where necessary.

The main statutory provisions of reference are:

– Article 8.1 of Legislative Decree 43/1998 ('Adaptation of Italian law to the provisions of the treaty establishing the European Community for matters concerning monetary policy and the European System of Central Banks'). The Decree states that 'in drawing up its annual accounts, the Bank of Italy may adapt, inter alia by way of derogation from the provisions in force, the methods it uses in recognizing amounts and preparing its annual accounts to comply with the rules laid down by the ECB in accordance with Article 26.4 of the ESCB Statute and the recommendations issued by the ECB in this field. The annual accounts drawn up in accordance with this paragraph, with regard in particular to the methods used in their preparation, shall also be valid for tax purposes'. This validity is recognized by Article 114 of Presidential Decree 917/1986 (Consolidated Income Tax Law) as amended by Legislative Decree 247/2005.

  The special rules adopted by the ECB are contained in Guideline ECB/2010/20 (published in OJ L35 of 9 February 2011), as amended, which contains provisions referring mainly to items of the annual accounts concerning the institutional activities of the ESCB and non-binding recommendations for the other items of the annual accounts.

  On the basis of the authority granted by Article 8 of Legislative Decree 43/1998, the Bank of Italy has applied in full the accounting rules and recommendations issued by the ECB, including those on the layout of the profit and loss account in report form and that of the balance sheet. The latter is the same as that used for the monthly statement approved, pursuant to Article 8.2 of Legislative Decree 43/1998, by the Minister of Economy and Finance;

– the Bank's Statute (approved by a Presidential Decree of 27 December 2013), which lays down the principles and rules for the allocation of the net profit for the year and the creation of reserves and provisions.

For matters relating to the preparation of the accounts not covered by the foregoing rules, the following provisions apply:

– Legislative Decree 127/1991 ('Implementation of Directives 78/660/EEC on the annual accounts of certain types of companies and 83/349/EEC on consolidated accounts pursuant to Article 1.1 of Law 69/1990'), as amended;

– Legislative Decree 87/1992 ('Implementation of Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 89/117/EEC on the obligations of branches established in a member state of credit institutions and financial institutions having their head offices outside that member state regarding the publication of annual accounting documents'), as amended;

– Article 65 (transactions involving government bonds) of Law 289/2002, as amended by Decree Law 203/2005, ratified by Law 248/2005.

Principal changes in the annual accounts for 2014. – The Governing Council of the ECB has decided that the securities currently held for monetary policy purposes should be valued at amortized cost subject to impairment, regardless of whether they are held to maturity, which was the accounting policy adopted beforehand. No adjustment, for comparative purposes, of the previous year's figures has been necessary as the securities were already valued in that manner.

Accounting policies. – The accounting policies regarding the main balance sheet items and applied in preparing the annual accounts for 2014 are described below. Where provided for by law, they were agreed with the Board of Auditors.

Gold, foreign currency assets/liabilities, securities and participating interests

Gold and foreign currency assets/liabilities

– stocks, including those represented by foreign currency securities, are valued by applying, for each currency and for gold, the method of the 'average daily net cost', determined in the manner established by the ECB, which requires account also to be taken of net purchases of foreign currency with a trade date in the year and a settlement date in the next year;

– gold and foreign currency assets/liabilities are valued on the basis of the year-end gold price and exchange rates communicated by the ECB. Unrealized gains are included in the corresponding revaluation account, while unrealized losses are covered first by earlier unrealized gains recognized on the same foreign currencies, and any amount in excess thereof is included in the profit and loss account.

Securities and participating interests

– each type of security is valued by applying the method of the 'average daily cost', determined in the manner established by the ECB. In the case of bonds, account is taken of the amount of the amortization of the premium/discount, which is recorded daily for those denominated in foreign currency;

– the year-end valuation is effected:

  1. for securities held for monetary policy purposes, at amortized cost subject to impairment (verification of lasting reduction in value related to the position of the issuer);

  2. for other securities:
     a) held to maturity, at amortized cost subject to impairment;

b) not held to maturity:

   i) for shares, ETFs and marketable bonds, at the market price available at the end of the year; units of UCITS, at the year-end value published by the management company. Unrealized gains are included in the corresponding revaluation accounts; unrealized losses are covered first by earlier unrealized gains for the relevant security and any amount in excess thereof is included in the profit and loss account;

   ii) for non-marketable bonds, at amortized cost subject to impairment;

   iii) for non-marketable shares and equity interests not represented by shares, at cost subject to impairment;

3. participating interests in subsidiary and associated companies that constitute permanent investments are valued at cost subject to impairment. The participating interest in the capital of the ECB is valued at cost. The Bank's accounts are not consolidated with those of investee companies insofar as the Bank is not among the entities listed in Article 25 of Legislative Decree 127/1991.

Securities denominated in foreign currencies, including ETFs and units of UCITS, stated in the balance sheet item *Financial assets related to investments of reserves and provisions* are not included in the net foreign exchange position but shown as a separate item.

Dividends are recognized on a cash basis.

Tangible fixed assets

Buildings

– are stated at cost, including improvement expenditure, plus revaluations effected pursuant to specific laws. The depreciation of 'instrumental' buildings used in the Bank's institutional activities and of those that are 'objectively instrumental' in that they cannot be used for other purposes without radical restructuring – including investments of the provision for staff severance pay and pensions – is on a straight line basis using the annual rate of 4 per cent established by the ECB. Land is not depreciated.

Buildings for sale and those no longer used or usable for the Bank's activities are not amortized and are valued at whichever is lowest of net book value and realizable value based on market prices.

Plant and equipment

– are stated at cost, including improvement expenditure. They are depreciated on a straight line basis using the rates established by the ECB (plant, furniture and equipment, 10 per cent; computers and related hardware and basic software and motor vehicles, 25 per cent).

Depreciation begins in the quarter subsequent to that of acquisition both for buildings and for plant and equipment.

Intangible fixed assets

Procedures, studies and designs under way and related advances are valued at purchase or directly allocable production cost. Procedures, studies and designs completed are amortized on the basis of allowances deemed congruent with the assets' remaining useful lives.

Software licences are stated at cost and amortized on a straight line basis over the life of the contract or, where no time limit is established or it is exceptionally long, over the estimated useful life of the software.

Costs incurred in constructing and enlarging communication networks and one-off contributions provided for in multi-year contracts are amortized on a straight line basis over the foreseeable life of the network in the first two cases and over the life of the contract in the third case.

Costs incurred in improving buildings owned by third parties and rented to the Bank are amortized on a straight line basis over the remaining life of the rental contract.

Costs of less than €10,000 are not capitalized, except for those incurred for software licences.

Accruals and deferrals

Accrued income and expenses are recorded in the period in which they arise. Prepaid income and expenses must be recorded in the accounting period in which they are earned. Interest accrued on foreign exchange assets and liabilities is recorded on a daily basis and included in the net foreign exchange position.

Banknotes in circulation

The ECB and the euro-area NCBs, which together comprise the Eurosystem, issue the euro banknotes (ECB Decision No. 29 of 13 December 2010 on the issue of euro banknotes, in OJ L35 of 9 February 2011, as amended).

The total value of euro banknotes in circulation is allocated within the Eurosystem on the last working day of each month on the basis of the criteria described below.

The ECB is allocated 8 per cent of the total value of euro banknotes in circulation, while the remaining 92 per cent is allocated to the NCBs according to the weighting of each in the capital key of the ECB. The share of banknotes allocated to each NCB is disclosed under the balance sheet liability item *Banknotes in circulation*. On the basis of the banknote allocation key, the difference between the value of the banknotes allocated to each NCB and that of the banknotes it actually puts into circulation gives rise to remunerated intra-Eurosystem balances. From the year of the cash changeover of each member state that has adopted the euro and for the five subsequent years the intra-system balances arising from the allocation of euro banknotes will be adjusted in order to avoid significant changes in NCBs' relative income positions compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the reference period established by law and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments are reduced in annual steps for five years starting from the year of the cash changeover, after which income on banknotes is allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital (ECB Decision No. 23 of 25 November 2010 on the allocation of monetary income of the national central banks of member states whose currency is the euro, in OJ L35 of 9 February 2011, as amended). The adjustments recorded in 2014 arise from the entry into the Eurosystem of the central banks of Estonia in 2011 and Latvia in 2014; they will terminate at the end of 2016 and 2019 respectively. The adjustments arising from the entry of the central bank of Slovakia in 2009 terminated in 2014.

The interest income and expense on intra-Eurosystem balances are cleared through the accounts of the ECB and disclosed under *Net interest income*.

The Governing Council of the ECB has decided that the seigniorage income of the ECB arising from the 8 per cent share of banknotes allocated to the ECB and the income deriving from the securities held in connection with the SMP, the ABSPP and the CBPP3 will be recognized to the NCBs in full with reference to the financial year in which it accrued and will be distributed, as a rule, in January of the following year in the form of an interim distribution of profit (ECB Decision No. 57 of 15 December 2014, in OJ L53 of 25 February 2015). The interim distribution of ECB profit is recorded on an accrual basis in the year to which the income refers, by way of derogation from the cash basis applied in general to dividends. All of the seigniorage income and the income arising from the above securities purchase programmes is distributed, unless it exceeds the ECB's net profit for that year or the Council decides to transfer all or part of it to a provision for foreign exchange rate, interest rate, credit and gold price risks.

The Governing Council of the ECB may also decide to reduce seigniorage income to be distributed by the amount of expenses incurred in connection with the issue and handling of banknotes.

The amount distributed to the NCBs is entered in the profit and loss account under *Income from participating interests*.

Intra-Eurosystem assets and liabilities

Intra-Eurosystem balances arise mainly from cross-border payments in euros within the EU that are settled in central bank money. Most of these transactions are ordered by private individuals and settled in TARGET2 (Trans-European Automated Real-time Gross Settlement Express Transfer System), giving rise to bilateral balances in the TARGET2 accounts of the EU member states' central banks. These balances are netted out and then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position vis-à-vis the ECB. The intra-Eurosystem balance with the ECB arising from TARGET2 and the other intra-Eurosystem balances denominated in euros, including the provisional distribution of the ECB's profit to the NCBs and the result of the pooling of monetary income, are entered in the accounts as a single net position, appearing on the asset side under *Other claims within the Eurosystem (net)* or on the liability side under *Other liabilities within the Eurosystem (net)*.

The net intra-Eurosystem balance arising from the allocation of euro banknotes is included among the net claims or liabilities ensuing from the allocation of banknotes within the Eurosystem.

The intra-Eurosystem claims arising from the subscription of the ECB's capital and the transfer of official reserves to the ECB are included under *Participating interest in the ECB* and *Claims arising from the transfer of foreign reserves to the ECB*.

Provisions for risks

In determining the provisions for risks, the riskiness of each sector of the Bank's operations is taken into account in an overall evaluation of adequacy.

The provision for general risks (Article 41.2 of the Statute) is also for risks in connection with the Bank's overall activity that cannot be determined individually or allocated objectively.

The riskiness of the foreign exchange position and that of the securities portfolio are evaluated based on the methods in use within the Eurosystem, with consideration also given to the size of the revaluation accounts.

Tax provision

The provision for taxation is equal to the amount of taxes to be paid, determined on the basis of a realistic estimate of the foreseeable liability under the tax rules in force. It includes deferred tax liabilities for IRES and IRAP and amounts arising from possible fiscal checks and disputes with the tax authorities.

Staff-related provisions

– Transfers to the provision for severance pay and pensions of staff hired before 28 April 1993 are included in the annual accounts under Article 3 of the related rules for an amount that comprises the severance pay accrued at the end of the year, the mathematical reserves for the disbursements to pensioners and those corresponding to the situation of staff having entitlement;

– the provision for staff costs includes the estimated amount of costs that had accrued but not been paid at year-end;

– transfers to the provision for early retirement incentives connected with the reorganization of the Bank's branch network are entered for the amounts determined on the basis of the expected costs;

– transfers to the provision for grants to BI pensioners and their surviving dependents are made in accordance with Article 24 of the rules governing staff severance pay and pensions;

– transfers to the provision for severance pay of contract staff, who do not participate in pension funds or who pay only a part of the contributions for retirement benefits, are determined in accordance with Law 297/1982.

For staff hired from 28 April 1993 onwards a defined-contribution supplementary pension fund has been created (see below *Other assets and liabilities*).

Other assets and liabilities

Receivables are stated at their nominal value, except in the case of diminutions in value connected with particular situations concerning the counterparty.

Pursuant to Recommendation NP7/1999 of the Governing Council of the ECB, the costs incurred in the production of banknotes are not included in the valuation of stocks.

Deferred tax assets and liabilities are included in the financial statements on the basis of their presumable tax effect in future years. Deferred tax assets include those deriving from the application of Article 65.2 of Law 289/2002, as amended by Decree Law 203/2005, converted by Law 248/2005.

The items *Other assets* and *Other liabilities* include the investments and separate patrimony of the defined-contribution supplementary pension fund created for staff hired from 28 April 1993 onwards. The fund is invested in financial instruments, which are valued at year-end market prices. The resulting revaluation gains (losses) are treated as revenues (expenses) and, in the same way as for other operating revenues (expenses), added to (subtracted from) the fund's patrimony.

Securities lending transactions are entered in the balance sheet only if collateral is in the form of a cash deposit in an account of the central bank.

The other components are stated at nominal value or at cost depending on their nature.

Off-balance-sheet transactions and memorandum accounts

Forward foreign currency operations, which represent the forward component of foreign currency swaps and other financial instruments involving a swap of currencies at a future date, are included in the net outstanding foreign currency positions at the spot settlement date.

Forward purchases and sales of foreign currency

– forward purchases and sales are recorded in the memorandum accounts from the trade date to the settlement date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a pro rata temporis basis, under interest in the profit and loss account;

– forward sales of the currencies included in the SDR basket to cover the SDR position are valued in conjunction with the latter and therefore do not affect the net positions in the single currencies.

Foreign currency swaps

– forward and spot purchases and sales are recorded in the memorandum accounts from the trade date to the settlement date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a pro rata temporis basis, under interest in the profit and loss account.

At the time of the settlement of forward purchases and sales of foreign currency and foreign currency swaps, the entries in the memorandum accounts are transferred to the appropriate items of the balance sheet.

Futures contracts

– are recorded in the memorandum accounts at the trade date at their notional value and those denominated in foreign currency are translated at the end of the year at the exchange rate communicated by the ECB. Initial margins in cash are recorded in the balance sheet among claims, those in securities are recorded in the memorandum accounts. Positive and negative daily variation margins are communicated by the clearer and taken to the profit and loss account; those denominated in foreign currency are converted at the exchange rate of the day.

Other cases with the amount entered in the memorandum accounts

– securities of third parties denominated in euros held on deposit are stated at their nominal value; shares are stated on a quantity basis; other kinds, at face value or at conventional value;

– commitments in respect of foreign currency transactions are shown at the contractually agreed exchange rate. The entries are reversed at the time the commitments are settled;

– other foreign currency amounts are converted at the year-end exchange rates communicated by the ECB.

Notes on the items of the balance sheet

The items *Gold, assets and liabilities denominated in foreign currency, Monetary policy operations and Securities portfolio* are aggregated according to their purposes or type. The other items are commented on following the layout of the balance sheet.

[1] Gold and assets and liabilities denominated in foreign currency

Table 16.6

Gold and assets and liabilities denominated in foreign currency
(thousands of euros)

	31.12.2014	31.12.2013	Changes
Gold (Item 1)	**77,864,641**	**68,677,223**	**9,187,418**
Net assets denominated in foreign currency	**32,279,388**	**29,961,710**	**2,317,678**
Assets denominated in foreign currency	**40,509,917**	**37,719,597**	**2,790,320**
Claims on the IMF (Sub-item 2.1)	11,830,628	11,888,284	-57,656
Securities (Sub-items 2.2 and 3.1.1)	25,663,191	23,372,358	2,290,833
Current accounts and deposits (Sub-items 2.3 and 3.1.3)	2,079,196	1,927,829	151,367
Reverse operations (Sub-items 2.4 and 3.1.2)	931,541	527,176	404,365
Other assets (Sub-item 2.5)	5,361	3,950	1,411
Liabilities denominated in foreign currency	**8,230,529**	**7,757,887**	**472,642**
Counterpart of SDRs allocated by the IMF (Item 8)	7,841,355	7,354,065	487,290
Advances of general government departments (Sub-item 6.2)	386,910	401,829	-14,919
Current accounts and deposits (Sub-item 7.1)	2,264	1,993	271

At the end of 2014, the value of gold amounted to €77,865 million, up by €9,187 million on the previous year. The increase was entirely due to the rise in the metal's price. The volume remained unchanged at 79 million ounces or 2,452 tons.[1] Owing to the appreciation of the main foreign currencies, especially the dollar, against the euro, the value of net foreign assets rose from €29,962 million to €32,279 million.[2]

Compared with the end of 2013 there were unrealized gains at the end of the year that were imputed to the revaluation accounts for gold (€9,187 million), dollars (€2,246 million), pounds sterling (€216 million), SDRs (€139 million),

[1] Gold reserves are valued at the year-end market price in euros per fine ounce. This price was obtained by converting the dollar price of gold at the London fixing on 31 December 2014 using that day's exchange rate of the euro against the dollar. Compared with end-2013, gold appreciated by 13.38 per cent (from 871.22 to 987.77 euros per ounce).

[2] The US dollar rose from 1.3791 to 1.2141 dollars per euro, the pound sterling from 0.8337 to 0.7789, the Australian dollar from 1.5423 to 1.4829 and the special drawing right from 1.1183 to 1.1924 euros per SDR. The yen depreciated slightly from 144.72 to 145.23.

Australian dollars (€50 million) and renminbi (€10 million).[3] There were unrealized losses that were entirely covered by the corresponding revaluation account for yen (€14 million). After the above write-downs, at the end of 2014 the exchange rate revaluation accounts amounted to €62,453 million, of which €58,444 million was in respect of gold, €2,779 million the dollar, €567 million the pound sterling, €402 million the yen, €201 million the SDR including the valuation of the relative hedging operations, €50 million the Australian dollar and €10 million the renminbi (see *Revaluation accounts*).

Table 16.7

Accounts with the International Monetary Fund
(thousands of euros)

	31.12.2014	31.12.2013	Changes
Assets			
Claims on the IMF (Sub-item 2.1)	**11,830,628**	**11,888,284**	**-57,656**
a) Reserve Tranche Position in the IMF	1,724,664	2,252,202	-527,538
Quota in the IMF	*9,398,833*	*8,814,756*	*584,077*
IMF holdings	*-7,674,169*	*-6,562,554*	*-1,111,615*
b) Participation in the PRGF	860,007	807,677	52,330
c) Participation in the NAB	1,935,712	1,977,853	-42,141
d) Special Drawing Rights	7,310,245	6,850,552	459,693
Liabilities			
Counterpart of SDRs allocated by the IMF (Item 8)	**7,841,355**	**7,354,065**	**487,290**

Claims on the IMF decreased by €58 million even taking into account the positive effect of the appreciation of the SDR against the euro. The change was the result of the increase in the IMF's holdings following repayments by debtor countries.

The portfolio of securities denominated in foreign currency classified as not held to maturity was made up almost entirely of bonds, issued primarily by foreign government bodies and international organizations. Of the total portfolio 70 per cent was denominated in US dollars, 14 per cent in yen, 11 per cent in pounds sterling and 5 per cent in Australian dollars.

The other foreign currency assets (Sub-items 2.3, 2.4, 2.5, 3.1.2 and 3.1.3), denominated primarily in US dollars, consisted mainly of fixed term deposits (€1,278 million), current accounts (€803 million), reverse operations (€931 million) and foreign banknotes (€4 million).

Among the liabilities denominated in foreign currency, primarily in dollars, the most important are the liabilities to general government (€387 million, Sub-item 6.2) in respect of advances received for the management of foreign currency cross-border payments and collections.

[3] Purchases of renminbi began in 2014.

[2] Monetary policy operations

The operations outstanding at 31 December 2014 carried out by the Bank of Italy within the framework of the single monetary policy of the Eurosystem are shown in Table 16.8.

The total value of main refinancing operations decreased owing to early repayments by credit institutions of the amounts allocated at the two three-year auctions at the end of 2011 and the beginning of 2012. As regards composition, longer-term refinancing operations continued to predominate not only as a result of the two auctions (at year-end €87 billion was still outstanding) but also the new TLTROs conducted in September and December 2014 for €57 billion.

The year-end value of the stock of *Main refinancing operations* increased, as did the average value (€5,250 million to €11,253 million). There was a decrease in both the year-end value of *longer-term refinancing operations* and the average value (€247,078 million to €178,707 million) owing to the early repayment of amounts assigned at the two three-year auctions mentioned above, which were only partly offset by the new TLTROs. The *Marginal lending facility*, for which the value was zero at the end of the two years considered, also recorded a decrease in the annual average figures, from €27 million to €2 million. No recourse was made in 2014 to either *Fine-tuning reverse operations* or *Structural reverse operations*.

Table 16.8

Monetary policy operations
(thousands of euros)

	31.12.2014	31.12.2013	Changes
Lending to euro-area credit institutions (Item 5) (1)			
5.1 Main refinancing operations	25,743,200	22,160,000	3,583,200
5.2 Longer-term refinancing operations	168,778,580	213,709,200	-44,930,620
5.3 Fine-tuning operations	–	–	–
5.4 Structural reverse operations	–	–	–
5.5 Marginal lending facility	–	–	–
5.6 Credits related to margin calls	–	–	–
Total	**194,521,780**	**235,869,200**	**-41,347,420**
Securities held for monetary policy purposes (Sub-item 7.1)	**35,486,124**	**37,571,582**	**-2,085,458**
Liabilities to euro-area credit institutions (Item 2)			
2.1 Current accounts (covering the minimum reserve system)	15,058,190	18,392,291	-3,334,101
2.2 Deposit facility	378,000	2,376,959	-1,998,959
2.3 Fixed-term deposits	–	20,000	-20,000
2.4 Fine-tuning reverse operations	–	–	–
2.5 Deposits related to margin calls	–	–	–
Total	**15,436,190**	**20,789,250**	**-5,353,060**

(1) At 31 December 2014 the collateral for lending to euro-area credit institutions amounted to €343.8 billion.

On the liability side the deposits held by credit institutions, including their minimum reserve requirements, decreased in value at year-end and in terms of average stock (€25,804 million to €17,590 million). Credit institutions' holdings in the *deposit facility* decreased sharply at year-end and in terms of average stock (€1,280 million to €147 million). This was partly due to the application of negative interest rates from June 2014. Similarly, the year-end value of *fixed-term deposits* was nil, while the average stock decreased from €2,271 million to €1,620 million. No recourse was made to *Fine-tuning reverse operations*.

Table 16.9

Movements in securities held for monetary policy purposes (Sub-item 7.1)
(thousands of euros)

	Total bonds (1)				Total
	Covered bond (1st programme)	Covered bond (2nd programme)	Covered bond (3rd programme)	Government securities (SMP)	
Opening balance	**6,693,189**	**2,257,440**	**–**	**28,620,953**	**37,571,582**
Increases	**–**	**873**	**4,662,809**	**271,341**	**4,935,023**
Purchases	–	–	4,662,809	–	4,662,809
Net premiums and discounts	–	873	–	271,341	272,214
Decreases	**-1,297,605**	**-223,500**	**-10,376**	**-5,489,000**	**-7,020,481**
Sales and redemptions	-1,283,700	-223,500	–	-5,489,000	-6,996,200
Net premiums and discounts	-13,905	–	-10,376	–	-24,281
Closing balance	**5,395,584**	**2,034,813**	**4,652,433**	**23,403,294**	**35,486,124**

(1) The first two covered bond purchase programmes were approved in 2009 and 2011 and concluded in 2010 and 2012. The third programme was approved in September 2014 and will continue for at least two years. The SMP was launched in 2010 and concluded in 2012.

Table 16.10

Comparison with market price of securities held for monetary policy purposes – (Sub-item 7.1)
(thousands of euros)

	31.12.2014		31.12.2013		Changes	
	Amortized cost	Market price	Amortized cost	Market price	Amortized value	Market price
Covered bond (1st programme)	5,395,584	5,762,922	6,693,189	6,986,396	-1,297,605	-1,223,474
Covered bond (2nd programme)	2,034,813	2,211,015	2,257,440	2,380,708	-222,627	-169,693
Covered bond (3rd programme)	4,652,433	4,656,574	–	–	4,652,433	4,656,574
Government securities (SMP)	23,403,294	26,491,635	28,620,953	30,662,876	-5,217,659	-4,171,241
Total	**35,486,124**	**39,122,146**	**37,571,582**	**40,029,980**	**-2,085,458**	**-907,834**

Securities held for monetary policy operations consisted of covered bonds acquired under the three programmes approved by the Governing Council of the ECB, the last of which was launched in October 2014, as well as of government securities issued by some euro-area countries and purchased under the Securities Markets Programme. In

2014 covered bonds under the first two programmes, amounting to €1,507 million, and government securities amounting to €5,489 million reached maturity.

Securities held for monetary policy purposes are valued at amortized cost subject to impairment. The impairment tests conducted at year-end by the Eurosystem did not indicate any long-lasting decrease in value. If the securities were valued at end-year market prices the value of the portfolio at that date would be €39 billion.

Regarding the riskiness of monetary policy operations, under Article 32.4 of the ESCB Statute losses associated with refinancing operations, should they materialize, may be shared, on the basis of a decision adopted by the Governing Council of the ECB, among the Eurosystem NCBs in proportion to their shares of the ECB's capital. However, the Governing Council has decided to waive the principle of risk sharing where certain types of collateral are accepted by NCBs at their own discretion. As regards securities purchased under the SMP and the CBPP3, the Governing Council has decided that any losses will be shared among the Eurosystem NCBs. At the end of 2014, the Eurosystem's total refinancing operations amounted to €630,341 million (€752,288 million in 2013). The securities purchased by the NCBs under the SMP and the CBPP3 amounted to €161,496 million, against €165,845 million in 2013 for the SMP alone.

[3] Other claims on euro-area credit institutions

These claims amounted to €4,959 million at the end of 2014 (€9,030 million in 2013) and consisted in large part of reverse repos on securities denominated in euros amounting to €4,805 million, mainly associated with the provision of Eurosystem Reserve Management Services (ERMS).[4] The item also includes claims in connection with the management of cross-border euro payments and collections for general government (€129 million) and other claims denominated in euros (€25 million). The decrease in the item was due in part to the full repayment of liquidity-providing operations with national counterparties outside Eurosystem operations for monetary policy purposes, which amounted to €3,470 million at the end of 2013.

[4] Securities portfolio

Securities denominated in euros (Total A) consist exclusively of bonds and are detailed in:

– Sub-item 4.2 (*Claims on non-euro-area residents – securities*). This item consists mostly of bonds issued by international organizations;

– Sub-item 7.2 (*Securities of euro-area residents – other securities*). This item consists mainly of bonds issued by the Italian government and by other euro-area governments;

[4] The Eurosystem NCBs can offer management services for euro-denominated reserves (ERMS) to central banks and government bodies of non-euro countries and to international organizations, according to a set of harmonized rules and economic conditions.

– Item 8 (*General government debt*). This item contains the Italian government securities assigned to the Bank following the bond conversion under Law 289/2002 and the termination of the management of mandatory stockpiling.

Table 16.11

Securities portfolio
(thousands of euros)

	31.12.2014	31.12.2013	Changes
A. SECURITIES DENOMINATED IN EUROS (Sub-items 4.2 and 7.2 and Item 8)			
1. Securities held to maturity	**87,628,845**	**81,260,623**	**6,368,222**
a) Government securities (Sub-item 7.2)	*71,516,784*	*65,111,088*	*6,405,696*
b) Other bonds (Sub-items 4.2 and 7.2)	*1,762,710*	*1,665,071*	*97,639*
c) Government securities assigned to Bank of Italy (Item 8)	*14,349,351*	*14,484,464*	*-135,113*
2. Securities other than those held to maturity	**10,364,911**	**8,586,848**	**1,778,063**
a) Government securities (Sub-item 7.2)	*9,490,622*	*7,856,620*	*1,634,002*
b) Other bonds (Sub-items 4.2 and 7.2)	*874,289*	*730,228*	*144,061*
Total A	**97,993,756**	**89,847,471**	**8,146,285**
B. SECURITIES RELATED TO THE INVESTMENT OF RESERVES AND PROVISIONS (Sub-item 11.2)			
1. Securities held to maturity and other permanent investments	**28,298,788**	**30,632,207**	**-2,333,419**
a) Government securities	27,169,921	29,911,468	-2,741,547
b) Other bonds	545,086	558,181	-13,095
c) Shares and other equity	583,781	162,558	421,223
of subsidiary companies and entities	*526,823*	*105,600*	*421,223*
of other companies and entities	*2,410*	*2,410*	*–*
of other companies and entities denominated in foreign currency	*54,548*	*54,548*	*–*
2. Securities other than those held to maturity and other permanent investments	**9,127,358**	**9,401,612**	**-274,254**
a) Government securities	*16,817*	*16,230*	*587*
b) Shares and other equity	*6,123,620*	*6,083,472*	*40,148*
of subsidiary companies and entities	*–*	*122,343*	*-122,343*
of other companies and entities	*6,123,620*	*5,961,129*	*162,491*
c) ETFs and shares/units of UCITS	*2,986,921*	*3,301,910*	*-314,989*
- of which: denominated in foreign currency	*997,124*	*962,560*	*34,564*
Total B	**37,426,146**	**40,033,819**	**-2,607,673**
Total (A+B)	**135,419,902**	**129,881,290**	**5,538,612**

Securities related to investments of reserves and provisions (Total B) are denominated in euros and to a very small extent in foreign currency. At year-end, 74 per cent of the portfolio consisted of bonds and 26 per cent of shares, participating interests, ETFs and shares/units of UCITS. Almost all of the investments in shares consisted of listed securities. As regards the issuers of these securities, the majority were Italian and the bulk of the remainder from other euro-area countries.

Most of the purchases made during 2014 consisted of shares. The increase of €421 million in permanent investments was due entirely to the transfer to the wholly-owned company SIDIEF SpA of the Bank's portfolio of rental properties, mainly consisting of residential buildings. The transfer, at book values, took effect on 1 January 2014, giving rise to a correspondent increase in the value of the shareholding.

The portfolio does not include securities held to maturity whose book value is significantly higher than their valuation at market prices.

The Bank of Italy has a controlling interest in SIDIEF SpA. During the year it sold its controlling interest in the listed company Bonifiche Ferraresi SpA, retaining a stake of less than 2 per cent; 60.37 per cent of the company's capital was sold to a group of entrepreneurs and institutional investors for around €104 million.

The Bank also holds 20 per cent of the capital of Fondo Strategico Italiano (FSI), with a book value of €951 million, consisting of one third of ordinary shares and two thirds of preference shares. The shareholding was acquired in 2013 following the transfer of the Bank's interest in Assicurazioni Generali SpA (Generali). Under the agreement, which was signed with FSI and its parent company Cassa depositi e prestiti in 2012, FSI undertook to sell its entire interest in Generali at market prices by 31 December 2015 and to then redeem the Bank's preference shares. In 2014, FSI began putting its shares in Generali on the market.

The other interests held as permanent investments include shares of the Bank for International Settlements, which are denominated in SDRs, valued at cost and translated at historic exchange rates. The Bank's stake is equal to 9.4 per cent of the BIS's capital.

[5] Intra-Eurosystem claims and liabilities

Table 16.12

Positions with the ECB and the other euro-area NCBs
(thousands of euros)

	31.12.2014	31.12.2013	Changes
Assets			
9.1 Participating interest in the ECB	1,332,645	1,377,337	-44,692
9.2 Claims arising from the transfer of foreign reserves to the ECB	7,134,237	7,218,961	-84,724
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem	22,367,575	12,867,287	9,500,288
9.4 Other (net) claims within the Eurosystem	–	–	–
Total	**30,834,457**	**21,463,585**	**9,370,872**
Liabilities			
9.3 Other (net) liabilities within the Eurosystem	208,576,061	228,381,754	-19,805,693
Total	**208,576,061**	**228,381,754**	**-19,805,693**

On the asset side:

– the *Participating interest in the ECB*[5] decreased by €45 million as a result of the five-year adjustment of the Bank's share. Accordingly, *Claims deriving from transfers of reserves to the ECB*,[6] which are computed according to the Bank's subscription, also decreased;

– *Net claims related to the allocation of euro banknotes within the Eurosystem* amounted to €22,368 million (see *Banknotes in circulation*).

On the liability side:

– *Other (net) liabilities within the Eurosystem* amounted to €208,576 million (compared with €228,382 million in 2013) and represent the Bank's net position vis-à-vis the Eurosystem, mainly deriving from the operation of the TARGET2 system. The latter gave rise to an overall debtor position of €208,945 million at end-2014 (compared with €229,128 million in 2013). At the end of the year the overall position was reduced by a) a claim of €148 million (€245 million in 2013) for the ECB interim profit distribution pertaining to 2014 and b) a claim of €221 million (€501 million in 2013) deriving from the net result of the pooling of monetary income in 2014 (€100 million) and the recalculation (€121 million) of monetary income pertaining to previous years.

[6] Other assets

This item consists mainly of investments in securities of reserves and provisions and funds (see *Securities portfolio*).

The decrease in the value of buildings related to the Bank's investment of the severance pay and pension provision was due to the transfer of that property at book value to the company SIDIEF SpA.

The year-end market value of the buildings owned by the Bank was estimated to be €3,939 million.

Deferred tax assets (Sub-item 11.6) decreased by €512 million, almost entirely as a consequence of the offsetting of €507 million, on the taxable income for 2014, of the remaining tax loss for 2002.

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5 Pursuant to Article 28 of the Statute of the ESCB, the NCBs are the sole subscribers and holders of the capital of the ECB. Subscriptions depend on the shares, which are determined on the basis of the key for the subscription of the ECB's capital established in Article 29 of the Statute and adjusted every five years or when a new country joins the EU. The last periodic five-year adjustment was made on 1 January 2014; at the end of 2014 the Bank of Italy's share of the ECB's subscribed capital was 12.3108 per cent. Considering only the NCBs belonging to the Eurosystem, it was equal to 17.5923 per cent; this amount was reduced to 17.4890 on 1 January 2015 following the accession of Lithuania.

6 *Claims deriving from transfers of reserves to the ECB* represent the interest-earning claim denominated in euros recorded at the start of the third stage of EMU following the transfer of gold, foreign securities and foreign currencies to the ECB in proportion to the Bank's share of the ECB's capital, as in the case of the other Eurosystem NCBs.

The amount of deferred taxes is calculated using the tax rates that are expected to be in force at the time the temporary differences that have generated them are reversed. The bulk of the deferred tax assets included in the balance sheet derive from the carry-forward of the residual tax losses from the bond conversion under Law 289/2002. The rules governing the carry-forward of these losses are laid down in Article 65 of Law 289/2002 as amended by Law 248/2005. They state that the losses may be utilized, with no time restriction, to offset up to 50 per cent of the corporate taxable income each year. The inclusion of deferred tax assets in the balance sheet is based on the reasonable expectation – considering the outlook for the Bank's income and the applicable tax law – of offsetting the full amount of the above tax losses.

Sundry (Sub-item 11.7 on the asset side) includes the balance sheet total of €353 million of the defined-contribution supplementary pension fund for staff hired since 28 April 1993, which is matched on the liability side by an equal amount entered in Sub-item 11.3 of *Other liabilities*. The other components of the sub-item are mainly payments on account of corporate income tax and IRAP made in 2014.

[7] Banknotes in circulation

The total value of banknotes in circulation issued by the Eurosystem is distributed among the NCBs according to their respective shares (see 'Legal basis, method of preparation and layout of the annual accounts'). The item, which represents the Bank of Italy's share (16.2 per cent), increased by €6,986 million (from €157,541 million to €164,527 million). Instead, the value of banknotes effectively put into circulation by the Bank decreased by €2,515 million (from €144,674 million to €142,159 million). Because this amount was lower than the notional amount assigned to the Bank, the difference of €22,368 million gave rise to a claim on the Eurosystem entered in Item 9.3 on the asset side, *Net claims related to the allocation of euro banknotes within the Eurosystem*. The average stock of banknotes effectively put in circulation fell from €139,621 million to €137,323 million, a decrease of 2 per cent compared with a 6 per cent increase for the euro area.

[8] Liabilities to general government and other counterparties

The item, which amounted to €13,928 million at the end of 2014, against €33,888 million in 2013, refers mainly to the deposits held by the Treasury with the Bank of Italy (€7,741 million) and those of customers that used the Eurosystem Reserve Management Services (€4,805 million), which are included under the sub-item *Other liabilities* (see *Other claims on euro-area credit institutions*).

The year-end balance on the Treasury deposits with the Bank of Italy diminished slightly with respect to 2013, but the annual average balance rose significantly from €845 million to €15,033 million. The year-end value for the Treasury's fixed-term deposits was nil and the average value fell from €24,934 million to €18,886 million.

The year-end balance of the sinking fund for the redemption of government securities decreased, as did its average value, from €2,868 million to €155 million.

The Sub-item *Other liabilities* also includes debtor positions with general government in respect of advances received for the management of cross-border euro payments and collections amounting to €110 million (compared with €116 million in 2013) and deposits amounting to €7 million.

Liabilities to other counterparties, amounting to €6,069 million (€6,771 million in 2013), included, in addition to the deposits of customers that used the Eurosystem Reserve Management Services, other deposits totalling €1,264 million.

[9] Liabilities to non-euro-area residents denominated in euros

Sub-item 5.2 *Other liabilities* amounted to €24 million (€555 million in 2013) and referred mainly to accounts held by customers that used the Eurosystem Reserve Management Services.

[10] Other liabilities

As detailed below:

Table 16.13

Other liabilities (Item 11)
(thousands of euros)

	31.12.2014	31.12.2013	Changes
11.1 Cashier's cheques	117,846	104,547	13,299
11.2 Accruals and deferrals	2,253	7,014	-4,761
11.3 Sundry	1,336,698	1,223,308	113,390
of which: Supplementary Pension Fund	*353,258*	*299,302*	*53,956*
Total	**1,456,797**	**1,334,869**	**121,928**

[11] Provisions and provision for general risks

The balances and movements in Provisions are shown in Tables 16.14 and 16.15.

Table 16.14

Movements in provisions for specific risks (Sub-item 12.1)
(thousands of euros)

	Insurance provision	Tax provision (1)	Provision for charges	Total
Opening balance	**309,874**	**1,049,273** (2)	**12,971**	**1,372,118**
Increases	**–**	**650,550**	**–**	**650,550**
Allocations	–	649,500	–	649,500
Other increases	–	1,050	–	1,050
Decreases	**–**	**-1,039,600**	**-12,971**	**-1,052,571**
Withdrawals	–	- 980,127	–	-980,127
Other decreases	–	- 59,473 (3)	-12,971	-72,444
Closing balance	**309,874**	**660,223**	**–**	**970,097**

(1) *Other increases* and *Other decreases* include the change in deferred tax liabilities.– (2) The opening balance is reclassified to include deferred corporate tax liabilities previously entered as a decrease in prepaid taxes.– (3) The excess of the tax provision is entered in the profit and loss account.

The decrease in *Provisions for specific risks* (Sub-item 12.1) was due to the net change in the *Tax provision*. The provision for charges, which was set up in previous years to cover costs incurred for the restructuring of the Bank's buildings in L'Aquila damaged by the earthquake of 6 April 2009, was transferred to SIDIEF SpA with the Bank's buildings.

Table 16.15

Movements in staff-related provisions (Sub-item 12.2)
(thousands of euros)

	For staff severance pay and pensions	For staff costs	For severance pay (1)	For grants to BI pensioners and their survivors	Total
Opening balance	**6,446,100**	**161,690**	**3,182**	**2,583**	**6,613,555**
Increases	**166,369**	**91,131**	**589**	**103**	**258,192**
Allocations	166,369	91,131	88	103	257,691
Other increases	–	–	501	–	501
Decreases	**-559**	**-90,719**	**-1,441**	**–**	**-92,719**
Withdrawals	-559 (2)	-90,719	–	–	-91,278
Other decreases	–	–	-1,441 (3)	–	-1,441
Closing balance	**6,611,910**	**162,102**	**2,330**	**2,686**	**6,779,028**

(1) Includes severance pay accrued by contract staff and ordinary staff prior to joining the supplementary pension fund. – (2) Includes the transfer of severance pay of staff participating in the supplementary pension fund.– (3) Transfer to SIDIEF SpA of the severance pay provision of concierges employed on contract.

Staff-related provisions (Sub-item 12.2) amounted to €6,779 million. In 2014:

- the severance pay provision was increased by €166 million to €6,612 million. The allocation for the year reflected above all the new economic and financial parameters used to calculate actuarial reserves;
- the provision for staff costs was basically unchanged at €162 million. Of this figure €40 million was in respect of early retirement measures in connection with the reorganization of the Bank's branch network.

Table 16.16

Movements in the provision for general risks (Item 14)
(thousands of euros)

	Provision for general risks
Opening balance	**15,373,675**
Increases	**1,800,000**
Allocations	1,800,000
Decreases	**–**
Withdrawals	–
Closing balance	**17,173,675**

It was necessary to adjust the financial buffers to reflect the prospective growth in the size of the Bank's balance sheet and its progressively greater risk exposure as a result of the private and public securities purchases programmes launched by the Eurosystem in October 2014. In order to gradually augment the provisions to cope with the most adverse scenarios the *Provision for general risks* (Item 14) was increased by €1,800 million (€2,183 million in 2013).

[12] Revaluation accounts

These include the valuation at market prices of gold, foreign currency, securities and forward operations (see *Gold, assets and liabilities denominated in foreign currency* and *Securities portfolio*).

Table 16.17

Revaluation accounts (Item 13)
(thousands of euros)

	Opening balance	Withdrawals	Net revaluations	Closing balance
Exchange rate revaluations	**50,624,582**		**11,828,084**	**62,452,666**
of which: gold	*49,256,331*		*9,187,417*	*58,443,748*
net foreign currency assets (1)	*1,361,582*		*2,646,771*	*4,008,353*
financial assets related to the investment of reserves and provisions (1)	*6,669*		*-6,104*	*565*
Price revaluations	**3,566,744**		**181,157**	**3,747,901**
of which: foreign currency securities	*126,462*		*94,945*	*221,407*
securities denominated in euros	*469,749*		*288,157*	*757,906*
financial assets related to the investment of reserves and provisions	*2,970,533*		*-201,946*	*2,768,587*
Revaluations at 1 January 1999	**1**	**–**		**1**
Total	**54,191,327**	**–**	**12,009,241**	**66,200,568**

(1) Includes net revaluations relating to operations to hedge exchange rate risks on the Bank's SDR position and foreign currency investments related to reserves and provisions.

[13] Capital and reserves

As detailed below

Table 16.18

Capital and reserves (Item 15)
(thousands of euros)

	31.12.2014	31.12.2013	Changes
15.1 Capital	**7,500,000**	**7,500,000**	**–**
15.2 Statutory reserves	**9,057,172**	**8,298,343**	**758,829**
Ordinary	4,596,283	3,989,220	607,063
Extraordinary	4,460,889	4,309,123	151,766
15.3 Other reserves	**7,739,511**	**7,739,511**	**–**
Revaluation reserve under Law 72/1983	694,502	694,502	–
Revaluation reserve under Law 408/1990	683,274	683,274	–
Revaluation reserve under Law 413/1991	16,943	16,943	–
Revaluation reserve under Law 342/2000	896,577	896,577	–
Revaluation reserve under Law 266/2005	1,521,240	1,521,240	–
Fund for the renewal of tangible fixed assets	1,805,044	1,805,044	–
Surplus from the merger of UIC (Law 231/2007)	2,121,931	2,121,931	–
Total	**24,296,683**	**23,537,854**	**758,829**

The movements in the ordinary and extraordinary reserves are detailed below:

Table 16.19

Movements in ordinary and extraordinary reserves (Sub-item 15.2) *(thousands of euros)*			
	Balance at 31.12.2013	Allocation of 2013 profit (1)	Balance at 31.12.2014
Ordinary	3,989,220	607,063	4,596,283
Extraordinary	4,309,123	151,766	4,460,889
Total	**8,298,343**	**758,829**	**9,057,172**

(1) Under Article 40 of the Statute.

The distribution of the shareholdings in the Bank of Italy's capital at 31 December 2014 is detailed in Table 16.20.

Table 16.20

Shareholders in the Bank of Italy				
	At end-2014		At end-2013	
	Number	Shares	Number	Shares
SpAs engaged in banking, including companies referred to in Article 1, Legislative Decree 356/1990	52	253,500	53	253,500
Social security institutions	2	17,000	1	15,000
Insurance companies	4	29,500	6	31,500
Total	**58**	**300,000**	**60**	**300,000**

Off-balance-sheet accounts

At the end of 2014 the off-balance-sheet accounts totalled €152,790 million as detailed in Table 16.21.

Table 16.21

Off-balance-sheet accounts *(thousands of euros)*			
	31.12.2014	31.12.2013 (1)	Changes
Orders in progress	**146,834**	**256,877**	**-110,043**
Purchases	126,464	145,034	-18,570
Sales	20,370	111,843	-91,473
Forward operations	**2,365,586**	**2,892,047**	**-526,461**
Forward sales of foreign currencies	1,273,634	1,805,642	-532,008
Forward purchases of foreign currencies	–	483,390	-483,390
Futures contracts purchased	1,006,129	551,157	454,972
Futures contracts sold	85,823	51,858	33,965
Commitments	**38,342,695**	**38,249,729**	**92,966**
To the IMF for loans granted	38,342,648	38,249,729	92,919
Other	47	–	47
Collateral granted	**12,045**	**11,060**	**985**
Third-party securities and valuables on deposit with the Bank	**111,424,295**	**138,326,257**	**-26,901,962**
Memorandum accounts of the supplementary pension fund	**498,567**	**259,824**	**238,743**
Total	**152,790,022**	**179,995,794**	**-27,205,772**

(1) For the sake of comparison, the amounts for the previous year do not include collateral granted, which appears in other sections of the notes to the accounts.

Forward sales of foreign currency include the commitment arising from operations to hedge the exchange rate risk on the Bank's SDR position and foreign currency investments related to reserves and provisions (*see Securities portfolio*).

Commitments to the IMF for loans granted relate to existing IMF initiatives with Italy for financing to be disbursed.

The Bank participates in the automatic securities lending programmes managed by specialized intermediaries both for securities included among its foreign currency assets and for covered bonds purchased as part of monetary policy operations. At the end of 2014, the Bank's lending under these programmes amounted to €224 million for foreign currency securities and €5,726 million for covered bonds.

Notes on the items of the profit and loss account

[14] Net interest income

Net interest income (Item 1) decreased by €313 million, from €5,609 million to €5,296 million, due entirely to the reduction in interest on securities denominated in euros. Almost the whole of the large decline in interest income from lending operations was offset by the reduction in interest payments on intra-ESCB balances connected with TARGET2.

Total interest income amounted to €5,715 million, down €1,437 million on the previous year (Table 16.22).

Table 16.22

Interest income (Sub-item 1.1) (1)
(thousands of euros)

	2014	2013	Changes
On assets denominated in euros	5,472,906	6,930,503	-1,457,597
Securities	*5,051,503*	*5,357,283*	*-305,780*
Lending operations	*340,632*	*1,446,114*	*-1,105,482*
Intra-ESCB balances	*37,139*	*86,073*	*-48,934*
Other	*43,632*	*41,033*	*2,599*
On assets denominated in foreign currency	242,073	221,204	20,869
Receivables from the IMF	*10,387*	*10,341*	*46*
Securities	*223,763*	*201,374*	*22,389*
Other assets	*7,923*	*9,489*	*-1,566*
Total	**5,714,979**	**7,151,707**	**-1,436,728**

(1) Interest earned on *financial assets related to the investment of reserves and provisions* is shown as a separate income item (see *Net income from financial assets related to the investment of reserves and provisions*).

Interest expense totalled €419 million (Table 16.23). This represented a decrease of €1,124 million overall with respect to 2013.

Table 16.23

Interest expense (Sub-item 1.2) *(thousands of euros)*	2014	2013	Changes
On liabilities denominated in euros	411,791	1,533,009	-1,121,218
Treasury payments account	*46,942*	*76,089*	*-29,147*
Treasury fixed term deposits	*32,982*	*9,350*	*23,632*
Current accounts (covering the minimum reserve system)	*18,922*	*71,595*	*-52,673*
Intra-ESCB balances	*303,152*	*1,355,386*	*-1,052,234*
Other	*9,793*	*20,589*	*-10,796*
On liabilities denominated in foreign currency	7,249	9,625	-2,376
Counterpart of SDRs allocated by the IMF	*6,342*	*6,017*	*325*
Other	*907*	*3,608*	*-2,701*
Total	**419,040**	**1,542,634**	**-1,123,594**

[15] Net result of financial operations, write-downs and transfers to/from risk provisions

Table 16.24

Net result of financial operations, write-downs and transfers to/from risk provisions (Item 2) *(thousands of euros)*	2014	2013	Changes
Profits (+) and losses (-) on financial operations	142,242	300,574	-158,332
Foreign exchange trading	*107,339*	*90,879*	*16,460*
Trading in securities denominated in euros	*6,264*	*168,183*	*-161,919*
Trading in securities denominated in foreign currency	*43,529*	*41,779*	*1,750*
Derivative contracts denominated in foreign currency	*-15,620*	*-1,096*	*-14,524*
Other transactions	*730*	*829*	*-99*
Write-downs (-) of financial assets and positions	-5,637	-347,053	341,416
Due to exchange rate changes	*- 59*	*-266,558*	*266,499*
Due to price changes			
– securities denominated in euros	*-3*	*-8,472*	*8,469*
– securities denominated in foreign currency	*-5,575*	*-72,023*	*66,448*
Transfers to (-) the provision for general risks for exchange rate, price and credit risks	-1,800,000	-2,183,000	383,000
Total	**-1,663,395**	**-2,229,479**	**566,084**

[16] Net income from fees and commissions

The net result for the year (Item 3) amounted to €14 million, down €2 million on the previous year. *Fee and commission income* (Sub-item 3.1) included the charges payable by the participants in TARGET2 (€6 million), the charge payable for the management of securities used as collateral for monetary policy operations (€4 million), fees for financial services on behalf of general government (€5 million), substitute protest declarations (€2 million), fees for Correspondent Central Banking Model services (€2 million), those for the retail clearing system (€3 million) and those for the use of Central Credit Register information (€2 million). *Fee and commission expense* (Sub-item 3.2) referred primarily to the centralized securities management service (€9 million).

[17] Income from participating interests

The Item *Income from participating interests* (Item 4) decreased by €140 million to €181 million and comprised:

- €11 million, the Bank of Italy's share of the ECB profits earned in 2013 and distributed in 2014 (€76 million in the previous year);
- €22 million, the adjustment of the share in the ECB's net equity among the Eurosystem NCBs;
- €148 million, the ECB interim profit distribution for 2014 (€245 million in 2013).[7]

[18] Net result of the pooling of monetary income

The result for 2014 was €221 million (Item 5), consisting of:

- the receipt of the Bank of Italy's share of the pooling of monetary income (€100 million, compared with €498 million in 2013). This represents the difference between the monetary income pooled by the Bank (€1,650 million) and that redistributed (€1,750 million);
- the effect, positive for €121 million, of the redetermination of the pooling of monetary income for prior years (the effect was positive for €3 million in 2013).

MONETARY INCOME

The monetary income (to be pooled) of each NCB is determined by measuring the actual annual income that derives from the earmarkable assets held against its liability base. The liability base of each NCB consists mainly of (a) banknotes in circulation; (b) liabilities to euro-area credit institutions related to monetary policy operations denominated in euros; (c) net intra-Eurosystem liabilities resulting from TARGET2 transactions; and (d) net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is deducted from the monetary income to be pooled. The earmarkable assets of each NCB consist mainly of (a) lending to euro-area credit institutions related to monetary policy operations; (b) securities held for monetary policy purposes; (c) intra-Eurosystem claims equivalent to the

[7] In February 2015, the Bank of Italy received a further dividend of €26 million, supplementing that already paid in advance.

transfer of reserve assets to the ECB; (d) net intra-Eurosystem claims resulting from TARGET2 transactions; (e) net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; and (f) a limited amount of each NCB's gold holdings and gold receivables in proportion to their subscribed capital key. Gold is considered to generate no income. The securities held for monetary policy purposes under the first two Covered Bond Purchase Programmes (Decision No. 16 of 2 July 2009 and Decision No. 17 of 3 November 2011 of the Governing Council of the ECB) are considered to bear interest at the last marginal rate applied to Eurosystem main refinancing operations. Where the value of an NCB's earmarkable assets exceeds or falls short of the value of its liability base, the difference is offset by applying the last marginal rate on Eurosystem main refinancing operations.

The monetary income pooled by the Eurosystem is redistributed to each NCB according to its capital key. The difference between the amount pooled by each NCB and the amount, which may be larger or smaller, redistributed to it depends on two factors. The first relates to the possible differences between NCBs in the interest income from specific earmarkable assets and the interest expense for some components of the liability base. The second relates to the fact that the amounts of the above assets and liabilities in the NCBs' balance sheets do not generally coincide with their share in the ECB's capital.

[19] Net income from financial assets related to the investment of reserves and provisions

Item 6 of the profit and loss account amounted to €1,890 million, down €245 million on the previous year (Table 16.25). The decrease was due to the lower net profit from trading and the larger write-downs relating to investments in shares and in EFTs and shares/units of UCITS. The net profits from trading included €101 million from the sale of the Bank's controlling interest in Bonifiche Ferraresi SpA. There was a small reduction in income from interest as a result of the lower average yields, which was only partly offset by an increase in the average stock of bond holdings.

Table 16.25

Net income from financial assets related to the investment of reserves and provisions (Item 6)
(thousands of euros)

	2014	2013	Changes
Interest	1,109,746	1,118,721	-8,975
Dividends on shares and participating interests	187,615	197,917	-10,302
Profits/losses from trading and disposals	649,945	794,532	-144,587
Write-downs	-90,566	-9,409	-81,157
Other components	33,180	32,840	340
Total	**1,889,920**	**2,134,601**	**-244,681**

[20] Other income

The item *Other income* (Item 8) amounted to €93 million, up €16 million with respect to the previous year.

Table 16.26

Other income (Item 8) (thousands of euros)			
	2014	2013	Changes
Rental income	5,745	29,947	-24,202
Procedures, studies and designs completed	10,145	10,752	-607
Other	77,558	36,678	40,880
Total	**93,448**	**77,377**	**16,071**

The item includes reimbursements by the Eurosystem NCBs in connection with the development of platforms, applications and IT infrastructures by the Bank of Italy in cooperation with the other central bank providers. The increase was for the most part due to reimbursements for the TARGET2 and TARGET2-Securities platforms amounting to €64 million in 2014, against €22 million in 2013. Rental income instead showed a large decrease in connection with the transfer of the Bank's residential properties to SIDIEF SpA (see 'Notes on the items of the balance sheet' – *Securities portfolio*).

[21] Expenses and charges

Expenses and charges (Item 9) amounted to €1,948 million, against €1,815 million in 2013.

Table 16.27

Sundry expenses and charges (Item 9) (thousands of euros)			
	2014	2013	Changes
Staff wages and salaries	609,777	599,069	10,708
Social security and insurance	157,454	155,171	2,283
Other staff costs	45,726	47,146	-1,420
Pensions and severance payments	275,116	293,349	-18,233
Transfers from/ to provisions for accrued expenses and staff severance pay and pensions	217,991	63,497	154,494
Emoluments paid to head office and branch collegial bodies	3,095	3,009	86
Administrative expenses	453,412	441,265	12,147
Depreciation of tangible and intangible fixed assets	150,423	170,355	-19,932
Banknote production services (1)	–	–	–
Other expenses	34,908	42,222	-7,314
Total	**1,947,902**	**1,815,083**	**132,819**

(1) Costs for external banknote production services and purchases of banknotes.

The increase was due to transfers to the staff severance pay provision reflecting the new economic and financial parameters used to compute actuarial reserves (see 'Notes on the items of the balance sheet' – *Provisions and provision for general risks*).

Gross employee compensation (including that of contract workers), comprising wages and salaries, overtime and accrued expenses not yet paid, amounted to €610 million, up from €599 million in 2013. The average number of full-time equivalent employees (taking into account overtime, part-time and unpaid absences) was 7,486. The average gross per capita wage was virtually unchanged at €81,456, against €80,083 in 2013.

Total staff costs, i.e. gross wages and salaries plus related costs (pensions and social security contributions) and other staff costs (including per diem expenses for missions and transfers), amounted to €813 million, against €801 million in 2013.

Table 16.28

The Bank's staff

	Average number of persons in service		Percentage composition	
	2014	2013	2014	2013
Managerial	2,078	2,060	29.5	29.5
Non-executive	4,167	4,111	59.1	58.8
General services and security	340	353	4.8	5.0
Blue-collar	461	471	6.5	6.7
Total	**7,046**	**6,995**	**100.0**	**100.0**
Contract workers	31	32		

The *Emoluments paid to head and branch office collegial bodies* comprised the emoluments paid to all the members of the Board of Directors (€412,230), the Board of Auditors (€137,430) and the Governing Board. By resolution of 30 October 2014, the Board of Directors fixed the emoluments to be paid to future members of the Governing Board at €450,000 to the Governor, €400,000 to the Director General and €315,000 to each Deputy Director General. The Governor, the Director General and the three Deputy Directors General in office announced that, for the duration of their term, they would receive the same emolument as that established for future members of the Governing Board.

Administrative expenses amounted to €453 million (€441 million in 2013). The increase was due to the expenses incurred in connection with the launch of the Single Supervisory Mechanism, in particular the cost of the asset quality review required by the ECB. Excluding the above one-off outlays, administrative expenses decreased overall. In detail, the cost of raw materials and subsidiary materials for banknote production increased by €10 million (from €36 million to €46 million) and that of external software leasing and maintenance by €4 million (from €37 million to €41 million). Spending on security services and banknote escort decreased by €9 million (from €74 million to €65 million), building maintenance by €8 million (from €58 million to €50 million), systems assistance by €2 million (from €36 million to €34 million) and utilities by the same amount (from €29 million to €27 million). The costs of electronic transmission (€16 million), equipment rental (€14 million) and participation in TARGET2 (€7 million) were basically unchanged.

The decrease of €20 million in *Depreciation of tangible and intangible fixed assets* was the result of the transfer to SIDIEF SpA of the Bank's residential property and of suspending depreciation of some buildings up for sale and no longer used by the Bank.

Other expenses, amounting to €35 million, comprised €30 million for taxes, of which €26 million for IMU and TASI property taxes.

[22] Extraordinary income and expenses

Extraordinary income and expenses (Item 11) showed a positive balance of €73 million. *Income* (Sub-item 11.1) amounted to €106 million and consisted, among other things, of a surplus of €59 million in the provision for taxes, tax credits for €34 million (€11 million of which relating to tax refunds under Article 38 of Presidential Decree 602/1973), and €6 million of profits on the sale of buildings no longer used by the Bank. *Expenses* (Sub-item 11.2) amounted to €33 million and included write-downs on fixed assets for sale (€17 million), tax costs (€11 million) and costs related to previous years (€5 million).

[23] Taxes on income for the year and on productive activities

Taxes for the year (Item 12) amounted to €1,159 million and comprised both the current taxes due and the change in deferred tax assets and liabilities.

PROPOSALS FOR THE BOARD OF DIRECTORS

Pursuant to Article 40 of the Statute, the Board of Directors, acting on a proposal from the Governing Board and after hearing the opinion of the Board of Auditors, proposes the following allocation of the net profit for approval by the Meeting of Shareholders:

	€
– 20 per cent to the ordinary reserve	599,648,424
– to the shareholders, a dividend equal to	340,000,000
– 5 per cent to the extraordinary reserve	149,912,106
– the remaining amount to the State	1,908,681,590
Total	2,998,242,120

THE GOVERNOR
Ignazio Visco

DOCUMENTATION ATTACHED TO THE ANNUAL ACCOUNTS

REPORT OF THE BOARD OF AUDITORS

ON THE 121st FINANCIAL YEAR OF THE BANK OF ITALY
AND THE ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2014

To the shareholders,

We have examined the annual accounts of the Bank of Italy for the year ended 31 December 2014, drawn up in accordance with the accounting standards and valuation methods decided by the Board of Directors and agreed by us, which are described in detail in the notes to the accounts.

We conducted our examination of the annual accounts in accordance with the rules and principles of conduct for the board of auditors issued by the Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili. We also took the same principles into account in performing the checks required by Article 20 of the Bank of Italy's Statute.

In our opinion the annual accounts of the Bank of Italy for the year ended 31 December 2014 have been prepared in accordance with the accounting standards and valuation methods indicated in the notes to the accounts. They comply with the law in force and with the harmonized accounting rules laid down by the Governing Council of the ECB and made applicable for the purposes of the annual accounts by Article 8 of Legislative Decree 43/1998.

We call particular attention to the following matters, which are treated at length in the notes to the accounts and the management report.

a) The inclusion in the balance sheet of deferred tax assets, deriving chiefly from the carry-forward of the residual tax loss from the bond conversion under Law 289/2002, is based on the reasonable expectation, considering the outlook for the Bank's income, of offsetting the full amount. In relation to the result for the year, deferred tax assets diminish by €512 million (from €3,696 million to €3,184 million).

b) The Board of Directors approved the transfer of €1,800 million to the provision for general risks, which is now expressly provided for in Article 41 of the new Statute.

c) Transfers to the *Provision for staff severance pay and pensions* amount to €166 million; this sum reflects the revision of the economic and financial parameters used for calculating the mathematical reserves.

We attest that in our opinion the total amount of the Bank's general and specific risk provisions is prudent.

We have examined the management report, required under Article 39 of the Statute, that accompanies the annual accounts and consider it to be consistent therewith.

During the financial year ended 31 December 2014 we verified compliance with the law, with the Bank's Statute and General Regulations, and with the principles of correct management.

We attended all the meetings of the Board of Directors and made the tests and controls within the scope of our authority, including checks on the quantities of cash and valuables belonging to the Bank and third parties. We monitored the activity of the Bank's peripheral units, in accordance with Articles 20 and 21 of the Statute, with the assistance of the examiners at the main and local branches, whom we thank warmly.

We examined the adequacy of the administrative and accounting aspects of the organizational arrangements, checking their operation and verifying that a system was in place to ensure a full and accurate accounting record of events. The accounts were kept in conformity with the standards and rules laid down by the law in force. The individual items of the annual accounts, which were also audited by external auditors, were compared by us with the accounting records and found to conform with them.

No significant facts warranting mention in this report emerged in the course of our auditing activity, as described above, or from our discussions with the external auditors and the heads of the corporate functions.

The accounts submitted for your approval show the following results:

Assets	€	530,623,126,813
Liabilities	€	503,328,201,969
Capital and reserves	€	24,296,682,724
Net profit for the year	€	2,998,242,120

The off-balance-sheet accounts, equal to €152,790,021,910, refer to commitments, forward transactions, guarantees granted and received, and third parties' deposits of securities and sundry valuables.

Pursuant to Article 40 of the Statute, the Board of Directors proposes the following allocation of the net profit:

– 20 per cent to the ordinary reserve	€	599,648,424
– a dividend to the shareholders	€	340,000,000
– 5 per cent to the extraordinary reserve	€	149,912,106
– the remaining amount to the State	€	1,908,681,590
Total	€	2,998,242,120

To the shareholders,

Bearing in mind Article 39.2 of the Statute, we recommend that you approve the annual accounts for 2014 that have been submitted to you (the balance sheet, the profit and loss account and the notes to the accounts) and the proposed allocation of the net profit for the year pursuant to Article 40 of the Statute.

Rome, 30 April 2015

THE BOARD OF AUDITORS

Dario Velo (Chairman)

Lorenzo De Angelis

Giovanni Fiori

Gian Domenico Mosco

Sandro Sandri

ADMINISTRATION OF THE BANK OF ITALY

AT 31 DECEMBER 2014 [1]

GOVERNING BOARD - DIRECTORATE

Ignazio VISCO	Governor
Salvatore ROSSI	Senior Deputy Governor
Fabio PANETTA	Deputy Governor
Luigi Federico SIGNORINI	Deputy Governor
Valeria SANNUCCI	Deputy Governor

BOARD OF DIRECTORS

Franca Maria ALACEVICH
Francesco ARGIOLAS
Nicola CACUCCI
Carlo CASTELLANO
Paolo DE FEO
Giovanni FINAZZO
Andrea ILLY
Cesare MIRABELLI
Giovanni MONTANARI
Ignazio MUSU
Lodovico PASSERIN D'ENTREVES
Stefano POSSATI
Donatella SCIUTO

BOARD OF AUDITORS

Dario VELO - Chairman
Lorenzo DE ANGELIS
Giovanni FIORI
Gian Domenico MOSCO
Sandro SANDRI

ALTERNATE AUDITORS

Anna Lucia MUSERRA
Angelo RICCABONI

HEAD OFFICE

MANAGING DIRECTORS

Paolo MARULLO REEDTZ	- accountant general
Ebe BULTRINI	- director general for it resources and statistics
Umberto PROIA	- director general for human resources and organization
Eugenio GAIOTTI	- director general for economics, statistics and research
Marino Ottavio PERASSI	- general counsel
Nunzio MINICHIELLO	- director general for property and tenders
Emerico Antonio ZAUTZIK	- director general for markets and payment systems
Carmelo BARBAGALLO	- director general for financial supervision and regulation
Letizia RADONI	- director general for currency circulation
Daniele FRANCO	- state accountant general
Vieri CERIANI	- adviser on budget policy to the ministry for the economy and finance
Giuseppe SOPRANZETTI	- managing director with special duties and manager of the milan branch

* * *

Claudio CLEMENTE	- director of the financial intelligence unit

[1] *For changes made up to 26.5.2015 see the following page.*

ADMINISTRATION OF THE BANK OF ITALY
AT 26 MAY 2015

GOVERNING BOARD - DIRECTORATE

Ignazio VISCO	Governor
Salvatore ROSSI	Senior Deputy Governor
Fabio PANETTA	Deputy Governor
Luigi Federico SIGNORINI	Deputy Governor
Valeria SANNUCCI	Deputy Governor

BOARD OF DIRECTORS

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Eugenio GAIOTTI	- director general for economics, statistics and research
Marino Ottavio PERASSI	- general counsel
Nunzio MINICHIELLO	- director general for property and tenders
Emerico Antonio ZAUTZIK	- director general for markets and payment systems
Carmelo BARBAGALLO	- director general for financial supervision and regulation
Letizia RADONI	- director general for currency circulation
Daniele FRANCO	- state accountant general
Giuseppe SOPRANZETTI	- managing director with special duties and manager of the milan branch

* * *

Claudio CLEMENTE - director of the financial intelligence unit

LIST OF ABBREVIATIONS

ABI – *Associazione bancaria italiana*
Italian Banking Association

BI–COMP – *Banca d'Italia Compensazione*
Bank of Italy Clearing System

BI–REL – *Banca d'Italia Regolamento Lordo*
Bank of Italy real-time gross settlement system

BOTs – *Buoni ordinari del Tesoro*
Treasury bills

BTPs – *Buoni del Tesoro poliennali*
Treasury bonds

CC&G – *Cassa di Compensazione e Garanzia SpA*

CCTs – *Certificati di credito del Tesoro*
Treasury credit certificates

CIPA – *Convenzione interbancaria per i problemi dell'automazione*
Interbank Convention on Automation

Confindustria – *Confederazione generale dell'industria italiana*
Confederation of Italian Industry

Consob – *Commissione nazionale per le società e la borsa*
Companies and Stock Exchange Commission

Covip – *Commissione di vigilanza sui fondi pensione*
Pension fund supervisory authority

CTOs – *Certificati del Tesoro con opzione*
Treasury option certificates

CTZs – *Certificati del Tesoro zero-coupon*
Zero-coupon Treasury certificates

EFD – *Documento di economia e finanza (DEF)*
Economic and Financial Document

EFSF – European Financial Stability Facility

ESM – European Stability Mechanism

Euribor – Euro interbank offered rate

FIU – Financial Intelligence Unit

HICP – Harmonised index of consumer prices

ICI – *Imposta comunale sugli immobili*
Municipal property tax (until 2011)

IMU – *Imposta municipale unica*
Municipal property tax

INAIL	–	*Istituto nazionale per l'assicurazione contro gli infortuni sul lavoro* National Industrial Accidents Insurance Institute
INPS	–	*Istituto nazionale per la previdenza sociale* National Social Security Institute
IRAP	–	*Imposta regionale sulle attività produttive* Regional tax on productive activities
IRES	–	*Imposta sul reddito delle società* Corporate income tax
IRPEF	–	*Imposta sul reddito delle persone fisiche* Personal income tax
IRS	–	*Interest Rate Swap*
Istat	–	*Istituto nazionale di statistica* Italian National Institute of Statistics
Ivass	–	*Istituto per la vigilanza sulle assicurazioni* Insurance Supervisory Authority
MAC	–	*Mercato Alternativo del Capitale* Alternative Capital Market
MTS	–	*Mercato telematico dei titoli di Stato* Screen-based secondary market in government securities
RGS	–	*Ragioneria Generale dello Stato* State Accounting Office
SACE	–	*Istituto per i servizi assicurativi per il commercio estero* Foreign Trade Insurance Services Agency
SIM	–	*Società di intermediazione mobiliare* Italian investment firm
TARGET	–	Trans-European Automated Real-Time Gross Settlement Express Transfer System
TASI	–	*Tassa sui servizi indivisibili* Municipal Services Tax