ACI - The Financial Market Association

General Assembly

International Finance and Banking

Address by the Governor of the Bank of Italy

Antonio Fazio

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It is a great pleasure to welcome you to the city of Milan and to Italy. This is the first time your Association has chosen to hold its annual meeting in our country. The choice reflects the role that the Italian financial market has come to play on the global stage and is a cause of satisfaction for those who work in the banks and investment firms that do business here. It is also recognition of the virtuous path that Italy has followed and its consequent recovery of credibility in international markets.

The long march — which began with the increase in the discount rate in 1994 and continued with the tight monetary stance of 1995 and 1996 — led to a reduction first in inflation expectations, from the middle of 1995 onwards, and then in inflation itself. In November 1996 the lira rejoined the European Exchange Rate Mechanism. The large reduction in the budget deficit and the continuance of wage moderation completed the realignment of conditions in the Italian economy with those in the other major European countries.

Italy's external financial position, marked in 1992 by substantial indebtedness, has come back into balance. The expectations, assessments and day-by-day decisions of market participants determine the prices and trading volumes of the financial assets denominated in the various currencies, thus influencing the choices of all economic agents. Decision-making in the financial field has become extremely rapid; technological innovation has made the execution of transactions practically instantaneous. Every day the global financial market offers new instruments and opportunities, together with new factors of volatility and risk.

In this environment of rapid change your Association is an important reference point, a forum in which to exchange experiences and discuss topical and controversial issues concerning the financial industry.

International finance

Since the middle of the eighties the expansion in financial assets has outstripped that in economic activity. Between 1985 and 1997 the volume of bonds and shares in circulation in the G10 countries grew at roughly double the rate of their GDP at current prices. The growth was especially fast in the nineties.

The liberalization of capital movements and, more generally, the deregulation of the financial industry have fostered a more efficient allocation of resources and contributed to the growth in global investment and saving.

The expansion in the international foreign exchange market has been especially pronounced. According to the latest three-yearly survey carried out by the BIS in collaboration with the central banks and monetary authorities of forty-three countries, the total value of foreign exchange transactions has nearly tripled since 1989, with daily turnover rising to 1.5 trillion dollars in 1998.

Technological progress has led to increasing use of electronic trading systems, especially electronic brokerage. In the highly developed US financial market more than 30 per cent of foreign exchange transactions are carried out via such systems.

In the nineties the growth of the money supply in the G10 countries remained in line with that of GDP, owing to the rigorous monetary policies that were pursued. The restrictive policy stance, the rapid expansion in financial transactions and the rise in volatility fueled the development of derivative products.

The notional amount of foreign exchange and interest rate derivatives outstanding in the over-the-counter market was equal to 72 trillion dollars in June 1998, or nearly three times world GDP; daily turnover is estimated to have been around 1.3 trillion dollars.

Derivatives increase the volume of transactions that can be carried out with the same amount of cash balances; they permit financial risks to be managed more efficiently; and they increase the liquidity of the markets in the underlying instruments. Properly used, they improve the allocation of resources; at times of crisis, however, their huge volume can accentuate the instability of the markets.

In London and New York roughly half the foreign exchange trading is carried out by a relatively small group of intermediaries. They play a decisive role in the global transmission of monetary impulses and the development of financial trends. Brusque changes in the composition of their portfolios can have destabilizing effects.

The direction and size of international financial flows are above all the result of the operations of non-bank intermediaries that borrow on a very large scale in relation to their capital and make considerable use of derivatives to increase the leverage of their transactions.

Forestalling and managing the crises that have sprung up during the globalization of finance is a task that has involved the authorities of the leading countries and international institutions.

The action of the International Monetary Fund is aimed primarily at correcting balance-of-payments and budget disequilibria and fostering the efficient allocation of credit. Achieving this goal also depends on collecting and disseminating reliable data on countries' economic situations.

The Basle Committee on Banking Supervision has been working to strengthen banking and financial systems and has recently proposed a revision of the 1988 Accord on capital adequacy aimed at better defining the real riskiness of banks' assets. In particular, the proposal envisages the possibility of calculating capital requirements on the basis of rating agencies' assessments and banks' own methods of rating counterparties. Internal models for evaluating credit risk are deemed to need further testing.

Highly-leveraged international investors ensure an efficient allocation of financial resources. In order to prevent waves of instability, they must provide exhaustive information on the risks they assume. It is necessary to define appropriate degrees of regulation and supervision.

The Financial Stability Forum at the Bank for International Settlements — which brings together representatives of G7 finance ministries, central banks and market supervisory authorities and international institutions — has begun to analyze the highly-leveraged institutions' behaviour, off-shore centres and short-term capital flows.

The prevention of international financial crises necessarily requires the contribution of market intermediaries, their ability to analyze, assess and manage risks. Excessively variable evaluations and expectations, coupled with herd behaviour, have sometimes led to tensions and crises in international markets.

The question of the ability, theoretically unlimited, of financial markets to multiply credit and money remains open.

The Italian banking and financial system

The Italian banking and financial system is increasingly integrated into the global economy; Italy's participation in the euro area will accelerate the process. By comparison with other industrial countries, a size gap remains to be closed.

The capitalization of the Italian stock market, equal to 45 per cent of GDP, is lower than that of leading markets abroad. The development of the Italian market is hampered by the prevalence of businesses that are too small to turn to the stock market and the limited propensity of medium and large-sized firms to seek a listing. Bank shares are of much greater importance in Italy than in the stock markets of other leading European countries.

Important legal and regulatory reforms have been enacted in recent years to promote the development of the stock exchange. Major progress has been made in improving its organization. Liquidity and transparency have increased. The number of transactions carried out on the exchange has risen considerably. The development of the derivatives market has stimulated the growth of the cash market.

Spurred on by the supervisory authority, the Italian banking system has been engaged in a far-reaching transformation for some years now.

Banks have been forced to build up productive structures able to withstand the increase in international competition; this has meant a very large number of banking mergers and acquisitions. The proportion of Italian bank capital that has changed hands in the nineties is one of the highest anywhere. At the same time the privatization of banks’ ownership has proceeded apace.

The presence of foreign intermediaries has stimulated competition and innovation. The market shares of these banks are especially large in the supply of financial services to households and firms and in securities trading. The participation of foreign groups in the capital of major banks is larger today in Italy than in Germany or France.

In 1998 the Italian banking system achieved important results in restoring profitability thanks to the action taken to curb costs and increase income from services and securities trading; more progress will have to be made in this direction in order to consolidate and enhance the improvement.

Further efficiency gains and increases in the size of major banks are needed.

The Italian economy

Especially in the last few years the Italian economy has been held back by the consequences of the exceptional efforts called for in order to reduce the budget deficit. Between 1996 and 1998 GDP growth averaged 1.2 per cent in Italy, compared with 2.6 per cent in the other euro area countries. In 1998 economic activity was also affected — to a greater extent than in other countries — by the weakness of export demand and the increased competitiveness of the South-East Asian countries.

Following the introduction of forms of flexibility, the number of persons in employment rose in the second half of last year. Some 110,000 jobs were created on average in 1998, an increase of 0.5 per cent on 1997 that reflected the spread of fixed-term and part-time contracts. The proportion of jobs accounted for by such contracts is nonetheless still below the European average. The rise in employment was spread across the whole country and has continued in 1999.

In 1998 the average inflation rate, measured on the basis of the harmonized index of consumer prices, was 2 per cent in Italy; in the euro area as a whole it was 1.1 per cent. The convergence of Italian inflation towards the average level in the area resumed in the second half of the year. The core rate, excluding food and energy products, also converged; on a twelve-month basis it slowed from 2.5 per cent in June 1998 to 1.8 per cent in May of this year. In the same month the twelve-month rise in the general index was equal to 1.5 per cent. Forecasting centres expect the inflation gap with Germany to close next year and that with France to narrow to 0.4 percentage points.

In the early months of this year the continued weakness of export demand was the principal cause of the decline in industrial production compared with the last part of 1998. Economic activity nonetheless expanded slightly in the first quarter of 1999 after the contraction in the fourth quarter of 1998. There are signs pointing to a possible upturn in the second half of the year.

The surplus on the current account of the balance of payments remains substantial, indicating the existence of resources for increased investment. In order to conserve and strengthen the renewed confidence of international markets and create the conditions for a high level of capital spending, it is necessary to tackle the structural problems and persevere in the efforts aimed at restoring the economy to a sound footing. Progress must be perceived by financial firms and enterprises as lasting. This will allow Italy to join profitably in the recovery in the international economy.