Italian Bankers’ Association

Annual Meeting

Public debt, saving and social security

Address by the Governor of the Bank of Italy
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Rome, 26 June 2002

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Total financial assets in Italy are equal to 7 times the gross domestic product. Despite the progress made in the last decade, the Italian financial system is less highly developed, quantitatively and qualitatively, than those of the other major industrial economies. In the United States the ratio of financial assets to GDP is 9 to 1, in the United Kingdom 14 to 1, in Germany 8 to 1 and in France 11 to 1.

Household and corporate liabilities are relatively smaller in Italy, whereas the public debt is about twice as large a portion of total financial assets as in the United States, France, the United Kingdom or Germany.

Social security and the public debt

The high level of Italy's public debt reflects the systematic excess of primary expenditure over revenue from the mid-1960s until 1990.

Starting in the mid-1980s and continuing through the 1990s, the average cost of the debt was higher than the growth rate of the economy, which helped to increase the debt ratio.

The public debt rose to 124 per cent of GDP in 1994. In the following years the ratio gradually came down as primary budget surpluses were achieved and thanks to privatization receipts. It now stands at 109 per cent.

Primary current expenditure, i.e. net of interest payments, rose from 27.5 per cent of GDP in 1965 to 39.5 per cent in 1992. About two thirds of the increase was due to increased pension spending.

In the 1970s budgetary policy and social spending were used in an effort to attenuate the repercussions on economic growth of the oil shocks and the enormous rise in labour costs. Pensions were made more generous and eligibility requirements less strict. Pension benefits actually became a partial substitute for more appropriate forms of social spending.

The devaluation of the lira fueled inflation. Economic activity was sustained at the cost of accelerating public debt. Monetary policy became more restrictive, especially in the early 1980s, in order to support the exchange rate and curb inflation. The rise in interest rates made it possible to place the growing issues of public debt. Savings were used to finance the deficit, diverting resources from productive investment.

Growth slowed down sharply from the previous decade.

In the 1990s budgetary adjustment relied on increases in revenue. The correction of the spending trend as a result of the beginning of reforms in the main areas of expenditure contributed to a moderate decrease in primary current expenditure in proportion to GDP; the ratio now stands at 37.5 per cent. The economy slowed down further.

More than 30 per cent of Italy's public debt today is accounted for by the excess of pension spending over contributions between 1970 and 2000, excluding strictly welfare benefits. Including early retirement benefits, it can be estimated that about 40 per cent of the present debt is due to the social security deficit.

There was a first, partial reform of the public pension system in 1992, under the pressure of the currency crisis. The retirement age was raised and pension benefits for given contributions and years of activity were revised downwards.

Substantial immediate expenditure savings stemmed from the indexation of pensions to prices only; above all, the long-term trend of spending was affected. The discounted value of the difference (charged to the public budget) between future pension benefits and the contributions of the work force as of 1992 was equal to four times GDP before the reform; after it, the value came down to three times.

Further adjustments were made in 1995, with significant effects in the short and medium term. The raising of the retirement age was accelerated and benefits were linked more closely to individual contributions.

The difference between the flows of benefits and contributions of the private sector employees' pension fund diminished in the subsequent years. Including early retirement benefits, the annual deficit was reduced from €12 billion in 1995 to €7 billion in 2000, *inter alia* owing to the assignment to the fund of part of the contributions formerly allocated to public housing programmes and family allowances.

Despite the reforms of the 1990s, pensions still account for about 40 per cent of general government primary current expenditure. The benefits paid by the main INPS schemes, which were 6.5 per cent of GDP in 1965, rose to 12 per cent in 1990 and 14 per cent in 2001. They will continue to rise in the coming years, even assuming that pensions remain indexed only to prices.

The present social security system was designed in the decades following the Second World War, when the economic growth rate was above 5 per cent a year and the number of active workers was about twice that of retirees. Currently, the number of persons employed is 1.2 times as great as the number of pensions being paid, and the prospects for economic growth, on which the number of persons employed and the volume of contributions depend, are more limited.

The trend in pension spending does not appear sustainable in the long term in the light of the aging of the population. In the absence of reforms, on the basis of official projections the ratio between the number of persons employed and the number of pensions will fall to 0.8 in 2030.

In all the economically developed countries pension expenditure trends are under examination. The outlook is for growing social security deficits.

In the countries of continental Europe, retirement benefits are channeled essentially through the public budget and it is the central government that directly guarantees the payment of benefits. In other countries the state guarantees a basic pension to all citizens; the provision of additional benefits is entrusted to the private sector, the operation of the financial markets and economic growth.

In the United States public pension expenditure amounts to 4 per cent of GDP. Contribution rates are revised periodically on the basis of economic and demographic projections to ensure actuarial balance over the subsequent 75 years.

In the framework of a re-examination of the welfare state, there is growing awareness everywhere of the need to increase the average age at which people actually retire and to channel a growing share of retirement saving through the capital market, thus contributing to the growth of productive investment and to an increase in the resources available for pensions.

Employee severance pay provisions were instituted in Italy at a time when social security coverage for working people was limited. For firms, these funds represent an advantageous source of finance compared with other forms of borrowing.

The development of funded supplementary private schemes can produce greater retirement benefits for workers, owing essentially to the yield made possible in the long term by equity investment in a growing economy. In a sluggish economy, the public finances and hence the fulfilment of social security obligations are subject to strains. The transfer of a portion of resources from the public to the private system must necessarily be gradual.

The design of a pension system consisting of two components – a basic, public, pay-as-you-go pension scheme and supplementary, private, funded schemes – can enable workers to diversify risks to a greater extent and select income replacement ratios in line with their effective needs. This can benefit both present and future retirees, in view of the consequently increased security of public pension payments.

The social security system must operate with sustainable costs in the long term as well. The development of supplementary private retirement provisions can curb the downward trend in the household saving rate. The increased flow of savings to the capital market favours the expansion of firms.

A more modern financial system

The amount of resources available to finance investment is a decisive factor for economic growth. Empirical studies of all the most important countries indicate that well-developed and diversified capital markets make the selection of investment projects more efficient and foster the birth and growth of enterprises.

The sectors most open to external financing are those that expand fastest.

The protection of savings, creditors and minority shareholders and the transparency and correctness of accounting practices are significantly correlated with the size and efficiency of the capital markets.

In Italy the financial system has undergone rapid modernization in recent years. The 1993 Banking Law has given banks greater scope to hold equity interests in non-financial firms. The implementation of the 1998 Consolidated Law on Financial Intermediation has fostered the birth of venture capital companies and new types of investment fund, including private equity funds reserved to professional investors and hedge funds.

In the last few years pension funds have been set up under the new legislation on supplementary retirement provision. At the end of March, 33 occupational pension funds and 95 open funds had been authorized. At the end of last year the assets of such funds still amounted to only €3.6 billion, or just over one tenth of the total resources of supplementary pension plans. The occupational funds had more than 1 million members, while the open funds had 300,000.

At the end of 2001 pension fund assets were equal to 3 per cent of GDP in Italy, a figure broadly in line with that in Germany but far below the figures of 85 per cent in the United Kingdom and 70 per cent in the United States.

The technical reserves of life insurance companies have grown at a very fast pace since the mid-1990s, thanks in part to tax benefits, but at the end of 2001 they were still equal to only 16 per cent of GDP, a very low figure by international standards. Most of the new policies were basically financial rather than pension products.

Internally generated funds are the principal source of financing for productive investment, especially for smaller companies. The supply of external financing must be increased, so that firms can grasp opportunities for investment and growth and in order to make capital formation less sensitive to cyclical conditions.

Between 1900 and 2000 the return on shares was far higher than both the inflation rate and the yield on short-term government securities in each of the sixteen leading countries in the world. On average the annual differentials were 5.8 and 4.9 percentage points respectively.

In Italy the real return on shares in the last century was lower than the average for the 16 countries; however, the differential with the yield on short-term securities was wider.

The premium that savers demand as compensation for the greater risk of equities compared with bonds may have been reduced, albeit to a limited extent, by the refinement of financial techniques, the growth of institutional investors capable of spreading the risk, and the expansion of markets.

Large-scale professional investors help to promote financial market efficiency and liquidity, product innovation and competition between intermediaries. But above all they facilitate the flow of equity capital and long-term financing to firms with favourable prospects for profits and growth; they also carefully monitor these firms' operations.

Companies that produce high-tech goods, which are characterized by investment plans with a combination of high risks and returns and by their limited ability to provide collateral, have received fundamental support from venture capitalists. In 1999 and 2000 pension funds supplied more than 40 per cent of the resources raised by these intermediaries in the United States, compared with 23 per cent in Europe and 5 per cent in Italy.

In the period from 1980 to 1995 pension funds achieved an average real rate of return of 9.8 per cent per year in the United Kingdom and 8.4 per cent in the United States.

Italian legislation on supplementary retirement provision establishes a framework ensuring high professional standards for the management of private pension funds. The cost of investing the reserves must be low and commensurate with the type and quality of services offered. The interests of workers who rely on these intermediaries for an important part of their future income must be fully protected.

The ratio of gross national saving to gross national income in Italy averaged 20.7 per cent between 1991 and 2001, 1.6 percentage points less than in the previous ten years.

The improvement in the general government current account corresponded to a decline in households' propensity to save. Although still high by international standards, the ratio of households’ saving to income is much lower today than ten years ago, having fallen from just over 24 per cent in 1991 to 12.4 per cent in 2001.

Savings are an essential resource for our economy. In recent years they have increasingly been invested abroad, often through investment funds. These invest 57 per cent of the resources they manage in securities of non-resident issuers. Last year 17.5 per cent of households’ financial assets were invested abroad directly or indirectly.

The conditions must be created so that a higher proportion of Italians’ savings is invested in Italian companies.

The number of listed companies is very low both by international standards and compared with the number of medium-sized and large companies operating in Italy. Only 4 per cent of the firms with at least 200 employees surveyed by the Company Accounts Data Service are listed; the proportion falls to 0.4 per cent among those with fewer than 200 employees.

Greater recourse by firms to the equity market will be facilitated by the removal of the constraints on their growth, which derive above all from the heavy tax burden and the still limited flexibility they have in the utilization of productive factors.

Firms will have to grasp the opportunities they are offered, organize their production more efficiently and increase their capacity to invest.

The banking system

The consolidation and reorganization of the banking sector has raised its efficiency in allocating credit and providing services to households and firms.

The mergers and acquisitions carried out since 1990 have involved banks accounting for 47 per cent of the sector’s total assets.

The percentage of loans classified as bad debts each year has declined, owing in part to the strengthening of companies' financial structures and the increase in the share of loans to more creditworthy firms. In 2001 loans to companies that became insolvent fell to 1.2 per cent of total lending, compared with 3.6 per cent in the mid-1990s.

In the South of Italy lending grew at an annual average rate of 7 per cent in 1999-2001, twice as fast as in the previous three years. The improvement in credit quality was particularly pronounced in these regions, where consolidation involved intermediaries with 70 per cent of the total assets of the banks based in the area. Loans to companies that became insolvent during the year fell to 2.5 per cent of total lending in 2001, compared with 6.7 per cent in the mid-1990s.

The expanded presence in the South of banking groups from the Centre and North has contributed not only to the rescuing of troubled banks but also to the reorganization of banking structures; it makes it possible to deliver more reliable financial support to the economy. By maintaining the old names and a sufficient degree of decision-making autonomy, local roots can be preserved and strengthened. The interest rate differential with respect to the Centre and North narrowed between 1998 and 2001 from 2.2 to 1.8 percentage points for short-term financing and from 1.1 to 0.6 points for medium and long-term loans. The difference reflects the smaller size of firms, their greater financial fragility, and the slowness and inefficiency of credit recovery procedures.

The improved quality of credit has helped to increase the profitability of the Italian banking system.

The industry's return on equity in 2001 remained above the average of the last five years despite the fall in income from services and the provisions made for losses on investments in Latin American countries and loans to some large foreign companies.

Substantial productivity gains have been made since the mid-1990s. Between 1995 and 2001 total assets and revenues per employee rose at constant prices at average annual rates of 4.5 and 3 per cent respectively.

The banking system has deployed information and communication technology rapidly. Between 1995 and 2001 staff costs fell from 64 to 55 per cent of total costs, while ICT costs rose from 7 to 13 per cent.

The productivity gains made possible by technological innovation must be realized in full. Operating systems must be constantly upgraded, organizational rigidities eliminated and the best possible use made of the means of achieving flexibility introduced by the national labour contract for the banking industry.

The range of services provided to firms has been broadened, thanks in part to changes in the law governing financial institutions' operations. There nonetheless remains considerable scope for further progress in this direction. The supply of corporate finance must be improved to match firms' plans for strengthening their capital structures.

Assisting firms in obtaining finance in forms other than bank credit — from corporate bond issues to venture capital and merchant banking initiatives, from the provision of finance for mergers and acquisitions to the floating of companies on the stock exchange — is an important source of income that can offset the decline in revenues from banks' traditional intermediation business. Providing services whose purpose is to increase the funds raised by firms directly in the market is entirely compatible with maintaining stable and lasting business relationships, of which lending will continue to be an important part.

Some large banks are working, *inter alia* through the development of staff skills, to enhance their ability to supply such services to firms. It is necessary to take further steps in this direction; the benefits for firms, banks and the structure of Italy's real economy are likely to be substantial.

By making good use of their trust-based relationship with customers and their extensive distribution network, in the 1990s banks successfully guided households away from the direct investment of their savings in government securities to forms of asset management typical of the more advanced financial systems.

The proportion of Italian households' financial assets managed by institutional investors rose from 15 to 35 per cent between 1995 and 2001. Banks are currently responsible, either directly or via specialized subsidiaries, for more than 80 per cent of the assets under management.

The integration of international financial markets has called for closer coordination between supervisory authorities, which have seen an increase in both the range and the complexity of their duties.

In the European Union a harmonized regulatory regime allows intermediaries to provide services in the different member states. Market stability is pursued through bilateral and multilateral cooperation among the supervisory authorities.

There is broad agreement that prudential supervision is performed most effectively by the authorities that are closest to the institutions to be supervised. This solution makes it possible to benefit fully from the advantages inherent in direct knowledge, acquired in part through a nationwide presence, of the relevant markets and of the modus operandi of the intermediaries concerned.

Supervision is rooted in national legal systems; it is consistent with the need for links with other government bodies; the cost of insolvencies is borne by the taxpayers of the individual member states.

The activity of the European committees that have been set up contributes to the drafting of Community law and makes it possible to assess the national transposition of harmonized rules, share experiences with the use of supervisory methods and practices, and carry out macroprudential analyses aimed at ensuring systemic stability.

The Bank of Italy makes public the principles and methods that govern its supervisory activity; periodically it reports on this, *inter alia* in its annual report.

Conclusions

Credit, money and securities markets able to supply a broad range of services and finance are indispensable for firms' growth; they allow households to diversify their financial portfolios and to improve the allocation of consumption, saving and investment over their life cycles.

In the long run the financial variables, the prices of securities move, must move, in line with output, with corporate profitability, with the real economy.

In the United States and the other industrial economies the conditions exist for a cyclical recovery, which should become stronger from the second half of this year.

There should be an upturn in investment and profits. The situation is weighed down by international political tensions and the uncertainty deriving from the instability of some Latin American economies and their financial difficulties. On the stock markets of the United States and some leading industrial countries the exuberant valuations of the last few years are being corrected. All in all, Italian stock market prices do not appear to be out of line.

In the short term prices may be more volatile. Investments in stocks require careful analysis of the fundamentals of economies, sectors and individual firms.

In periods of market turbulence, transparent and correct conduct on the part of market participants is all the more necessary to strengthen the relationship of trust between intermediaries and investors, which is essential for the stability of banks and the financial system.

"Workers have the right to the provision and guarantee of adequate means for their needs when they are … old …".

"The Republic shall encourage and protect savings in every form; it shall regulate, coordinate and control the granting of credit".

That is what the Italian Constitution lays down in Title III of the first part.

Public and private provision for retirement and the protection of savings in every form are components of a single harmonious design. Historical circumstances have led to saving for retirement being entrusted almost entirely to the public sector.

Demographic developments on the one hand and the outlook for economic growth on the other call for a better balance, in order to overcome the difficulties facing the public finances and direct a growing share of retirement savings to productive uses in the economy.

An economic policy aimed at improving the composition of public expenditure, modernizing the endowment of infrastructure and fostering the growth of firms will create the conditions ensuring an adequate return on saving, give certainty to public and private retirement benefits, and accelerate the growth of the economy.

A diversified and efficient financial market and a stable and competitive banking system are essential to growth. They will make it possible to attract and protect domestic saving, guarantee its efficient use in projects in the real economy, and contribute to the growth in firms’ size, to technological innovation and to increased employment.

The role of the banking system and the capital market in allocating resources, the contribution they can make to the financing of a new investment cycle, the need to meet the expectations of workers who entrust them with their retirement savings increase the tasks and heighten the responsibilities of the Bank of Italy, of the supervisory authorities.