

Italian Bankers' Association

Annual Meeting

The banking industry and economic recovery

Address by the Governor of the Bank of Italy

Antonio Fazio

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In the United States GDP grew by 2.4 per cent in 2002, slowing sharply from the autumn onwards. Towards the end of the year, the heightened uncertainty that accompanied the aggravation of international political tensions led to a deterioration in the financial markets and large rises in oil prices. In the fourth quarter GDP growth declined to 1.4 per cent on an annual basis.

In the first quarter of 2003, US economic activity continued to expand at the same pace. The index of households' confidence fell sharply, private consumption remained weak and purchases of durable goods declined further. Investment in plant and equipment diminished, but purchases of ICT products rose by more than 10 per cent.

Investment in housing continued to benefit from strong demand, which was buoyed by low interest rates.

In April the end of the conflict in Iraq revived households' confidence and there have since been increasing signs of an upturn in economic activity. Payroll employment has stabilized, sustained by a modest recovery in the service sector. In May the decline in industrial production came to a halt. The growth of output in the second quarter was of the order of 2 per cent and economic activity expanded strongly.

The twelve-month rate of inflation, excluding the most erratic items, has settled at an extremely low level since February of this year.

At the end of June the Federal Reserve further reduced the federal funds rate to 1 per cent in order to dispel any threat of deflationary pressures.

In Japan, after the previous year's slow growth, economic activity remained at much the same level as in 2002; the upturn in foreign demand offset the slowdown on the domestic front. Between

the last quarter of 2002 and the first of 2003 GDP grew by 0.6 per cent on an annual basis; in the second quarter the growth in industrial production and employment with respect to the previous quarter was negative.

The real-estate market and financial institutions' balance sheets

In the United States house prices rose at an average annual rate of 4.1 per cent in real terms between the end of 1996 and the fourth quarter of 2002. In other industrial countries the rise was more pronounced, averaging between 8 and 10 per cent a year in the United Kingdom, Spain and the Netherlands. In Italy, house prices went up by 3.8 per cent a year between 1998 and 2002, after falling in the first half of the 1990s.

Structural, demographic and economic factors have helped to push up house prices in the United States. The past decade has seen a large rise in the number of people living alone, while between 1991 and 2000 total households increased by more than ten million, to 105 million. The public has shown a growing preference for home ownership.

The increase in prices also reflects home improvements; particularly in recent years, large amounts of funds previously invested in the stock markets have been redirected to the property market.

The nominal value of homes rose by 45 per cent between 1997 and 2002, enabling households to increase their mortgage debt significantly. Loan demand was boosted by the exceptionally large reduction in interest rates, with those on thirty-year mortgages declining between May 2000 and June 2003 from 8.5 to 5.2 per cent, the lowest level since 1971.

Episodes of falling nominal house prices have been extremely rare in the past; the index drawn up since 1975 by the Office of Federal Houses Enterprise Oversight has never recorded a

decline. Although in recent years prices in certain areas and in major cities have risen much faster than the national average, the most reputable research centres believe the danger of large and generalized decreases to be small.

At the end of 2002 outstanding mortgages amounted to \$7 trillion, or 67 per cent of GDP. The magnitude of the stock and the rise in property prices have drawn attention to the potential risks for the financial institutions providing credit.

Half of all mortgages are granted by specialized federal agencies and 29 per cent by commercial and savings banks. In recent years the two largest agencies, the Federal National Mortgage Association, *Fannie Mae*, and the Federal Home Loan Mortgage Corporation, *Freddie Mac*, have not sold all their mortgages on the secondary market, but instead retained large holdings themselves.

At the end of 2002 the on- and off-balance-sheet exposure of these agencies totaled \$3,150 billion and the own funds of the two agencies, which are not subject to capital adequacy requirements, amounted to 1.6 per cent of their total exposure. In addition, there is an interest rate risk due to the fact that the majority of securities issued have less than a one-year maturity, while assets consist of relatively long-term instruments and mortgages. To balance the duration of their assets and liabilities, the agencies make extensive use of derivatives.

Commercial banks, for their part, had about \$1.3 trillion of mortgage-secured loans in their balance sheets at the end of 2002, equal to 18 per cent of total assets. However, they also had a total indirect exposure of \$0.92 trillion, equal to 12.5 per cent of assets, consisting of securities issued by the specialized agencies. The US banking system is strongly placed in terms of profitability and capital base: in 2002 the return on equity was 14.5 per cent and the capital adequacy ratio was 12.8 per cent.

In Italy the property market still constitutes only a small risk for banks. In 2002 households were granted €37 billion worth of mortgages for home purchases, the stock of which increased by

19.5 per cent; three quarters of all the mortgages disbursed are indexed to market yields. The bank debt of Italian households totals 22.4 per cent of GDP, which is much less than in the other main euro-area countries.

The financial markets

Against a background of weak economic activity in the leading countries and delayed prospects of recovery, long-term yields in euros and dollars continued to decline in the early months of 2003.

After rising briefly in the second half of March in conjunction with the rapid progress of military operations in Iraq, interest rates began to ease again in May. They have become extremely low even by historical standards: in mid-June the interest rates on ten-year swaps in dollars and euros stood at 3.4 per cent and 3.6 per cent respectively. Real yields have fallen below 2 per cent in both the United States and the euro area.

Real short-term interest rates have also fallen very low. In the euro area they now stand at around 0.5 per cent, while in the United States they are negative at -0.9 per cent.

In the early weeks of 2003 the emergence of a risk premium associated with the imminent start of the conflict in Iraq forced share prices down by 9 per cent in the United States and by 19 per cent in Europe. Germany recorded a substantial reduction of 23 per cent, while in Italy it was 12 per cent.

Since the middle of March equities have picked up strongly.

In mid-April share prices in the United States returned to their level at the beginning of the year before climbing a further 10 per cent, partly owing to the reduction in dividend tax. In Europe the present levels are the same as at the end of 2002.

The largest gain has been in the shares of banks and high-tech companies, which were the worst affected by the earlier period of uncertainty.

In the United States and several European countries current share prices are consistent with a substantial increase in corporate profits. It is important to avoid another spate of over-optimism. Long-term profit growth depends on a strong and lasting recovery of the economies concerned.

In the main industrial countries the number of new listings on the stock market dropped from about 400 in the first half of 2002 to 150 in the first half of 2003; the value of the shares placed fell from €43.3 billion to €6.4 billion. There was a further diminution in mergers and acquisitions. With the outlook for economic activity still uncertain firms' efforts are directed at curbing indebtedness.

Gross international bond issues by euro-area companies decreased by 5 per cent in the first half of 2003 from the year-earlier period, falling to €69.7 billion. A larger decline was recorded in US companies' gross issues, which fell by half to €58.5 billion.

The yield differentials with respect to government bonds continued to narrow despite the persistent cyclical weakness. In the United States the premium on BBB-rated bonds, which stood at 3.9 percentage points in the middle of October 2002, fell to 2.6 points in December and then to 1.7 in June of this year. Yield differentials on the Euromarket decreased from 3 to 1.3 points. The derivatives market followed a similar pattern worldwide, with a substantial reduction in credit risk premiums.

On international markets the proportion of insolvencies among firms with a poor credit-rating grew to around 10 per cent in the early months of 2002, close to the value recorded during the recession of the early 1990s. In recent months the figure has fallen considerably.

With medium and long-term interest rates declining sharply, the narrowing of yield differentials between high-risk bonds and government securities can be attributed partly to investors' search for high returns.

The experience of the leading markets once again highlights the close link between the value of a bond and the issuer's financial conditions, profitability and balance sheet solidity.

It should not be forgotten that high yields naturally reflect higher risks.

Recent events involving the placement of bonds are being investigated. It will be possible to express judgements on individual cases when the actions of the parties concerned have been clarified.

Avoiding confusion, individuals' actions, companies' policies and the procedural and substantial aspects must be carefully examined.

Investors must be aware that high yields entail high risks. Intermediaries must impart accurate information through their employees and agents, in compliance with the relevant regulations. They must counsel wisely, guided by ethics and professionalism.

The protection of savings will not benefit from inopportune generalizations that might impede the proper operation of markets and nourish widespread expectations of intervention in the event of losses.

Developments in the banking system and risk management

The weakness of the real economy has generally had a limited impact on banks' balance sheets in the past two years. This has been due in part to the growth of the derivatives market.

The international financial system has managed to absorb the repercussions of events involving insolvencies of unprecedented proportion: the crisis of two of the world's largest corporations and of an important Latin American country. On the whole, banks have continued to be well capitalized.

In recent months firms' demand for loans has remained weak. In the international syndicated loans market, the volume of credit granted in the first quarter of 2003 declined with respect to the year-earlier period.

In the euro area the growth rate of bank lending held steady at just over 4 per cent in the early months of this year, although there were still considerable differences between the main countries. In France the rate was close to the average; in Germany it remained almost nil; in Spain it was of the order of 13 per cent.

In Italy, in the first five months of 2003 bank lending expanded at a rate of just under 7 per cent; the growth rate was highest for firms in the South and for those borrowing less than €5 million, a category that accounts for 45 per cent of all business loans. On the other hand, lending to larger firms continued to slacken as many of them implemented policies to reduce the debts contracted in 2000-2001 for major corporate actions. The expansion in bank lending in 2002 was concentrated in the medium and long-term end of the market.

The flow of new bad debts amounted to 1 per cent of outstanding loans in 2002, having averaged close to 3 per cent in the mid-1990s; the situation may deteriorate slightly this year. A fundamental stimulus towards the development of more advanced risk-measurement techniques stems from the constant dialogue with the supervisory authorities.

The main banking groups continue to work on perfecting their internal rating systems. Similar initiatives are also being undertaken by smaller banks, mainly in the mutual credit sector.

Statistical analyses by the Bank of Italy of the conditions applied to over 100,000 firms of all sizes, although mostly small ones, show that there is already a close correlation between the interest rates on individual transactions and the riskiness of the borrowers.

The new methods of risk assessment must be designed to channel more savings towards financing the firms that make the most efficient use of productive factors and have the ability to promote product and process innovation. Customers' creditworthiness should be assessed not only on their current standing but also on the project skills of entrepreneurs and the prospects of medium-term returns; account should also be taken of macroeconomic and sectoral factors that might affect the borrower's financial situation.

Risk-analysis methods rely on the know-how and professional expertise of the banking system and on the information of intermediaries established in local credit markets. One of their purposes is to reduce the instances of credit-rationing that may occur in adverse cyclical phases.

The natural environment in which to use such methodologies is that of small and medium-sized enterprises, for which no market-based assessments are available. The essential requirements remain complete and transparent financial reports and exhaustive figures on firms' profitability and financial situations.

Banks can strengthen the bond of trust with their customers by regularly providing information, advice in the search for more sophisticated forms of funding, and support during the most delicate phases of corporate development and expansion.

With their knowledge of businesses and markets throughout the country, banks can foster contacts between even geographically distant firms, with a view to realizing merger projects and highly innovative investments.

In order to guarantee the stability of the system and of individual intermediaries, effective control must be maintained over the quality of borrowers and an independent assessment made of the

riskiness of operations involving syndicated loans, securitizations and derivatives. The Bank of Italy and ISVAP cooperate in systematically monitoring transfers of credit risk between the banking and insurance sectors.

In 2002 the volume of risk-weighted exposures exceeding 10 per cent of the lending bank's own funds dropped by 6 per cent; in December the stock of large exposures, calculated on a consolidated basis, represented 6.5 per cent of the banking system's assets.

The banking system's total assets vis-à-vis non-financial companies include an equity component. At the end of last year, such holdings amounted to some €7 billion, 5 per cent of banks' own funds; two thirds of their value was accounted for by the six largest banking groups, which made moderate use of the margins contemplated by prudential regulations.

In the South of Italy GDP growth was 0.7 per cent in 2002, 0.5 percentage points higher than in the Centre and North.

The banking system, with its stronger capital base and enhanced operating capacity, must help the South realize its potential for development, among other things as a means of reducing the disparities in economic and social conditions in the different parts of the country.

Substantial improvements in the supply of credit followed from the action that had to be taken to cope with the serious crisis affecting the majority of southern banks after the 1993 recession. The extraordinary measures adopted and the intervention of banks from the Centre and North guaranteed continuity to the intermediation of households' saving and the flow of financing to firms. Between 1995 and 2001 lending to residents in the South grew at an average annual rate of 4.1 per cent. Including bad loans, bank lending in the South increased at much the same rate as in the Centre and North.

In 2002 loan disbursements in the South rose by 7 per cent; the upturn in lending to firms was accompanied by an increase in undrawn margins on current account overdraft facilities.

Interest rates on short-term bank loans to non-financial companies and sole proprietorships fell in 2002 by 0.3 percentage points in the South and by 0.4 points in the Centre and North, to 7.9 and 6.3 per cent respectively; in the case of manufacturing companies the reduction was more pronounced in the southern regions. The differential between interest rates on short-term loans to firms in the South and those in the Centre and North was 2.3 percentage points in 1996. The flow of new bad debts in the South continues to be above the national average.

Lending must go hand in hand with a comprehensive range of services to foster market access, corporate expansion and the achievement of a more balanced financial structure. Relations between banks and firms should be based increasingly on mutual trust and must become more stable.

The banking system's profitability increased considerably in the second half of the last decade; on a consolidated basis the return on equity reached 12.9 per cent in 2000.

In 2002 the ratio dropped to 6.4 per cent, with the sharpest decline, from 17.1 to 6 per cent, occurring among the largest groups. The figures for the first quarter of 2003 indicate a recovery at the main banking groups with respect to the second half of 2002.

As in other banking systems, the fall in profits in 2002 was also partly due to the performance of income from services and securities trading, severely hit by the deterioration in conditions in the financial markets. From €17.1 billion in 2000 income from asset management declined to €7.7 billion last year.

The financial difficulties of several countries and large foreign corporations had severe repercussions on the banking system's profitability; there was an increase in the proportion of operating profits eroded by loan losses and value adjustments to shareholdings.

Nonetheless the banking system's capital adequacy ratio rose from 10.4 to 11.2 per cent. In 2001 the Bank of Italy had asked the 14 largest banking groups to set their capital adequacy objectives above the minimum requirement and by the end of last year half of them had achieved the new targets.

On a consolidated basis, the supervisory capital of Italian banks amounts to €135 billion.

The outlook

The satisfactory performance of the US economy in the spring, the continuous and rapid growth in productivity, the moderate rate of inflation indicate that American GDP will accelerate in the third and fourth quarters of 2003. On an annual basis the increase will be over 3 per cent in each period.

Household demand will receive a boost from tax reliefs to the tune of \$20 billion concentrated in the next two months. Although part of the gain will be saved, it will nevertheless have a positive effect on future spending by reducing consumers' debt.

Information technology products apart, investment has not yet begun to pick up, although interest rates, long-term included, continue to be extremely attractive.

Economic activity is recovering in Latin America after last year's crisis and it remains strong in Asia. In Japan the economic situation is still uncertain.

Growth in the euro area remains unsatisfactory; GDP is projected to expand by 0.7 per cent in 2003, following last year's 0.8 per cent. Only in 2004 is growth expected to reach 1.6 per cent.

Investment still shows a tendency to decline and the growth in consumer demand is weak. The rate of inflation is expected to fall permanently below the 2 per cent threshold. Italy continues to lag behind the other euro-area countries in terms of both falling inflation and productivity growth.

This has a damaging effect on our competitiveness and on the expansion of our economy. According to the Bank of Italy's preliminary estimates, industrial production, which had increased in April, declined in May before rising again in June; after falling for two consecutive quarters, it appears to have increased slightly on average in the second quarter.

To date, approximately €8 billion of liquidity, equal to 0.6 per cent of GDP, has been mopped up through the acquisition of one-off receipts, which was necessary to prevent the budget imbalance moving too close to the 3 per cent threshold.

Postponing and failing to decide on structural measures to rectify the budget do nothing to make the outlook more certain.

In a renewed climate of shared responsibility and collaboration, lines of action must be established that can be quantified in the Economic and Financial Planning Document; this covers a sufficiently long period of time and should re-propose a gradual reduction in the tax burden, accompanied by a decrease in the ratio of current public spending to GDP with a view to canceling the deficit and curbing the growth of the debt.

The labour market reforms introduced towards the end of the last decade are producing good results in terms of the number people in work and the number of jobless.

The employment rate is nonetheless still very low in Italy by international standards: 55 per cent, compared with 64 per cent in Europe and 71 per cent in the United States.

The employment rate in the South, including irregular workers, is exceptionally low at 45 per cent. The unemployment rate is 18.3 per cent and especially high among young people. When enlarged to include people discouraged from joining the labour market by the near impossibility of finding work, the rate becomes even higher.

The additional reforms already incorporated in agreements between management and labour and in new legislation will provide renewed stimulus to employment.

However, to avoid a decline in the productivity of newly employed workers and, above all, to prevent flexibility mutating into precariousness, there must be an acceleration of growth.

The plan for major public works throughout Europe can contribute to that growth in the years to come if, without too much delay and after detailed specification of the projects, it leads to actual expenditure.

In the present context of weak economic activity and low inflation, public works are a means of reviving domestic demand.

In Italy such works have long been hampered more by planning, organizational and administrative difficulties and conflicts of assignment than by a lack of funds. They have resumed since the middle of last year. Efforts must continue to open new construction sites, do the building, see it through to completion and make the works available for use.

Private investment is tending to decrease.

As part of more decisive action in favour of growth based on the necessary policies and reforms, firms must start to expand their productive capacity again, incorporating a greater innovative content than in the past.

Italy's expenditure on research, both private and public, is among the lowest of the developed economies. In other countries the public sector plays a greater role in fostering research and innovation, in the private sector as well.

Productivity and innovation are essential in order to restore less negative rates of growth in industrial production; they will also halt the loss of competitiveness that leads to production growing completely out of line with the other euro-area countries.

By counting on the large availability of young manpower, enhancing certain centres of excellence and avant-garde initiatives, relying on flexibility in the use of the factors of production, the relative backwardness of the South's economy can become a starting point for raising the growth rate of the Italian economy over the medium term. We must continue to make good the shortcomings in infrastructure, transport, energy and water supply.

The six-month Presidency of the European Union is an opportunity for Italy to mobilize all the public, institutional, economic and social forces to achieve an acceleration in our rate of growth.

The actions of the Presidency, of Parliament, of management and labour can eliminate uncertainty and restore confidence, reviving prospects of progress in our economy and society, in a European context.

There is an urgent need to proceed with clear objectives and tools, with determination and confidence.