Italian Bankers’ Association
Annual Meeting

The banking industry and the prospects for the economy

Address by the Governor

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The European banking market

Over the past three years the European banking and financial system has managed to withstand, without repercussions for the cost of credit, the difficulties caused by the slowing of economic growth, fluctuations in share prices and the crises and collapse of major industrial groups.

Monetary policy in the three main areas of the world has been markedly expansionary, while prices have remained largely stable. There has been a substantial increase in the monetary base; interest rates on loans have fallen to historical low levels. In the case of real-estate investment the abundance of credit has fostered price rises in excess of the increase in prices of current output; in some countries, property values have been inflated by speculation.

The Federal Reserve’s recent increase in interest rates by 25 basis points marks the start of a move to bring the cost of money in the United States back to long-term equilibrium levels, against a background of robust economic growth. Even after the rate increase the yield curve has a sharp upward slope everywhere, in the United States, in Europe and in Japan, pointing to market expectations that interest rates will rise substantially in coming years.

The rise in interest rates will affect public finances, particularly in the most heavily indebted countries. It re-emphasizes the need for firms to ensure that costs and combinations of factors of production can guarantee the development of their activity and the growth of the economy, even with real and nominal interest rates closer to normal levels. The return on savings invested in financial assets will increase.

The resilience of the banking and financial systems in the face of destabilizing forces can partly be ascribed in Europe to the close collaboration between national supervisory authorities and the increasingly widespread adoption of harmonized rules.

Substantial progress has been made in the past ten years in improving the regulatory framework and strengthening the operational infrastructure and by integrating payment systems at national and international level.

The integration of the share and bond markets can benefit firms in terms of the range, quality and cost of the services provided to them, as well as households.

Wholesale financial activities, interbank transactions, syndicated loans and business services are concentrated and tend to develop on international markets. According to a survey conducted within the ambit of the European System of Central Banks, the 41 largest European banking groups, including three from Italy, have establishments in an average of five member states outside their own. Mergers and acquisitions have created banking groups whose home market encompasses the whole of Europe. In Italy as well, foreign intermediaries hold substantial market shares in such fields as securities trading on electronic markets and business services, including the placement of corporate bonds.

Success in the retail market, on the other hand, requires a knowledge of the social, economic and institutional characteristics of the place of business and experience in dealing with small firms and households. Collaboration arrangements with local banks and aggressive commercial policies can only substitute partially and temporarily for the informational advantages of local roots. In cross-border retail banking there have been few attempts to supply services without a permanent foothold in foreign markets; in practice the decision to do business in other countries has been accompanied by the acquisition of existing operators.

The Financial Services Action Plan launched at Community level in 1999 is due to be completed by the end of 2005; it covers legislative measures applying to both the wholesale and the retail segments.

Last April a directive on investment services was approved, abolishing the obligation to concentrate trades on regulated markets and providing for the protection of investors, and the directive on take-over bids, which lays the foundations for the development of a European market of corporate control. These directives supplement those, also recent, on the supervision of conglomerates operating in the banking, financial and insurance sectors and on the prevention of market abuse.

The supervision of banking systems is institutionally embodied in national legislation. In order for it to be efficient and, above all, effective, it must be performed close to the intermediaries concerned.

In January this year the London-based Committee of European Banking Supervisors began operation, alongside other similar committees set up for the markets in financial and insurance services. It is composed of representatives of the banking supervisory authorities and central banks of the European Union and its task is to provide technical advice to the Commission regarding legislative and regulatory proposals in the field of banking, as well as to promote the uniform application of Community directives and the convergence of supervisory practices in the member states.

The internationalization of the Italian banking system

Spurred by competition and privatizations, the Italian banking system has made significant advances in the last ten years with regard to the average size of intermediaries and the range of services offered. Efficiency has improved; efforts must continue, above all within recently formed groups, to increase the integration of operating structures and the effectiveness of risk-management systems.

In the Anglo-Saxon countries there is clear evidence of a structural shift in banks' business stemming from the greater development of these countries' financial markets; the relationships between banks and firms are changing. As international competition grows more intense, these trends will also affect the Italian financial system. The new aspects of credit business and the new operational instruments will need to be assimilated by Italian bankers and adapted to the specific features of the Italian economic and institutional context; the supervisory authority is following developments closely.

Mergers and acquisitions have narrowed the gap between Italian and foreign banks in terms of volumes of business. The gap reflects the less developed state of the Italian banking market. The ratio of credit to GDP is 85 per cent, a value comparable to that of France, less than those of Spain and Germany and the euro-area average, all well above 100 per cent.

Lending to households is less developed in Italy, among other things because of the higher propensity to save. Most of households’ borrowing consists of home mortgages; credit for the purchase of consumer durables is nonetheless expanding, thanks in part to a more diversified and efficient supply.

By contrast, lending to firms is comparable to the euro-area average in relation to GDP. Interest rates are in line with, and sometimes lower than, those in the other EU countries.

Another factor tending to reduce banking intermediation is the high level of public debt and the substantial investment of households’ savings in public-sector securities.

Although growing, the presence of Italian banks in foreign markets is still limited. According to the BIS, at the end of last year the Italian banking system’s assets abroad vis-à-vis non-bank counterparties equaled 13 per cent of GDP. The levels reached by the French, Spanish and German banking systems are much higher, respectively 49, 36 and 72 per cent.

The leading international banks are interested in the Italian market. German banks have $137 billion of claims on Italian residents, compared with Italian banks’ exposure of $33 billion to German residents; French banks have $114 billion of assets in respect of Italy, compared with Italian banks’ $28 billion in France.

These figures are mainly a reflection of the important production and above all marketing presence of German and French firms in Italy.

The expansion of credit must serve the needs and in fact follows that of production.

We have called on the banking system to increase the support it provides for the internationalization of the Italian economy.

The growth in Italian banks' operations in foreign markets will be assisted by greater industrial and marketing penetration of Italian firms in those markets.

In recent years the leading Italian banks have increased their presence appreciably in Central and Eastern Europe markets, among other things in order to grasp the opportunities for expansion in retail business in those countries and benefit from the prospects of economic growth following their entry into the European Union. They are countries where Italian firms are investing heavily, both to serve local demand and to take advantage of low production costs. In several of these economies Italian banks have acquired a significant market share, more than 20 per cent in some cases.

Foreign intermediaries hold a larger portion of the capital of major banks in Italy than is the case in the other main euro-area countries and the Anglo-Saxon countries; the shareholdings involved are minority interests. The shareholdings attributable to institutional investors, and to pension funds in particular, are negligible. The banking systems of France and Germany are characterized by the large share of bank capital held by the State, the US system by the presence of large institutional investors.

The capital and reserves of Italy's major banks surpass the standards agreed at international level; however, they are still less than those of the largest intermediaries operating in the European market.

Industrial companies are not substantial shareholders of the leading foreign intermediaries.

The holding of substantial or even controlling interests by industrial companies calls for careful evaluation in our system too, in the light of its possible consequences for the allocation of credit in the event of production problems or falling prices in some sectors. The strengthening of the banking system's capital base must come principally from self-financing, recourse to the financial market and, looking further ahead, greater participation by institutional investors.

The new Capital Accord

On 26 June the central banks and supervisory authorities of the Group of Ten countries approved the text of the new Accord on banks' capital, prepared by the Basel Committee.

The document represents the point of arrival of a complex process initiated in the second half of the 1990s in response to the recurrent financial crises in the global market, which hit Mexico, Thailand, Korea, Russia, Brazil and Argentina, and the parallel and partly related evolution of banking.

The Accord identifies more efficient methods for determining the amount of capital required to cover the different forms of risk.

Credit risk being equal, the amount of capital banks will be required to have should decrease by virtue of its more efficient allocation. However, the development of banks' activity and the complexity of their transactions have considerably increased their exposure to operational and legal risks.

The new Accord grants intermediaries complete freedom of initiative. The rules and risks have been defined, in analytical terms, borrowing from operational best practices.

The models and parameters for the measurement of capital requirements and their application are developed by each individual intermediary. The supervisory authorities assess them for approval and then oversee compliance.

In response to an initiative of the Bank of Italy, among others, the Accord provides for specific solutions designed to produce a better evaluation of credit risk for small loans. Intermediaries may use simplified methods for the calculation of requirements, similar to those now in force. Like the more complex methods, the simplified ones will on average involve a reduction in the amount of capital required, as a consequence of the more favourable treatment for small loans. It should also be recalled that the capital of many smaller Italian banks is above the required minimum today.

The new Accord will be incorporated in a Community directive; it will be phased in between the end of 2006 and the end of the following year.

Simulations performed on a large scale show that application of the Accord will not have restrictive effects on the supply of credit. Many large banks already set the terms and conditions of loans in line with those that will derive from the new Accord.

Under the new system it is essential that firms supply complete information on their assets and liabilities and profits and losses and on the structure and extent of their activities. This will result in firms themselves having an incentive to promote transparency and complete compliance with the rules.

The economic situation

Economic activity is expanding vigorously at global level. It is being driven by the cyclical upswing in the United States, the other major countries of the Americas, Japan and other Asian economies.

In the twelve countries of the euro area, GDP grew by 0.6 per cent in the first quarter of this year. Its growth over the whole year is likely to be 1.7 per cent. Industrial production is estimated to have increased by 2.5 per cent since the middle of 2003.

In Italy, GDP rose by 0.4 per cent in the first quarter. Consumption showed a recovery, as did business investment, which had the fallen in the two previous years. Exports declined in spite of an acceleration in world demand.

Agriculture and services drove the expansion in GDP. In the second quarter industrial production continued to decline. According to preliminary estimates, it fell by 1.4 per cent between the end of 2003 and June of this year.

The trend of industrial output in Italy continues to diverge from that in the other European countries, particularly France and Germany. There has been a further loss of Italian manufacturing’s competitiveness both abroad and at home.

Between 2001 and 2003 unit labour costs in industry rose in Italy by a total of 9.9 per cent. In Germany the increase over the same three years was 2 per cent, in France 1.6 per cent. The gap mainly reflects the performance of productivity.

In contrast with the sharp drop in Italian exports, amounting to 3.4 per cent in 2002, 3.9 per cent in 2003 and 2.1 per cent in the first quarter of this year, the volume of French exports contracted slightly over the same period and German exports showed vigorous growth.

According to preliminary estimates, GDP growth was slower in the second quarter than in the first, both in Europe and in Italy.

In Italy, the behaviour of the main macroeconomic variables and business investment intentions point to an acceleration in activity in the second half of the year.

Credit continued to grow at a rapid pace in the first half of this year. The rate of increase in lending to the building industry remains high. Consumer credit is tending to expand for structural reasons.

Loans to firms are growing faster than GDP. The increase in lending in the twelve months ending in May was 3.7 per cent nationally and 6.5 per cent in the South.

The restoration of a climate of complete confidence among banks, firms and savers is necessary in order to ensure firms the support of credit in the face of important due dates and to finance the hoped-for expansion of activity in the second half of this year and in 2005.

Economic policy

Major problems and tasks lie ahead for economic policy and for the adjustment of the public finances in particular.

In the first half of this year the state sector borrowing requirement exceeded that of the first half of 2003 by more than €12 billion, or nearly one percentage point of GDP.

The progressive deterioration in the accounts in the first six months of this year suggests that in the absence of corrective action general government net borrowing for the year as a whole will be 3.5 per cent of GDP, as I indicated at the Bank of Italy's Annual General Meeting on 31 May.

The adjustment package the Government is about to adopt, amounting to some €7.5 billion or 0.6 per cent of GDP, is intended to ensure compliance with the 3 per cent limit.

In formulating the mid-year budget, the restrictive measures must not be allowed to have a negative impact on demand at a time when the economic recovery is still halting. It will be necessary to monitor the effectiveness of the measures, whose application is concentrated in the coming months.

The evolution of the public finances must be carefully verified, among other things owing to the uncertain outlook for some receipts that are an integral part of the budget for 2004 adopted at the end of last year.

The positive outcome of the Ecofin meeting prevented a worsening of expectations.

With a view to the publication of the Economic and Financial Planning Document, the size of Italy’s public debt requires the formulation, in accordance with the political calendar of a policy for the public finances that can reconcile their consolidation with faster growth in the medium term.

After the second half of the 1990s the public finances began to deteriorate again. In the last two years cyclical developments have also been a factor.

In the last three years the containment of the budget deficit has been entrusted mainly to one-off measures, which are useful in a period of transition and sluggish economic growth; it is now necessary to return to a lasting structural reduction of the gap between expenditure and revenue.

The primary surplus has progressively contracted; this year it is likely to be around 2 per cent of GDP, notably less than the value of 5.5 per cent set in order to participate in the Monetary Union and to ensure a significant rate of debt reduction in relation to GDP.

The outlook for the public finances needs to be verified both for this year and for 2005. The expected rise in interest rates worldwide will influence interest expenditure. The downgrading of Italy’s rating by an international rating agency is confirmation of the difficulties facing the country.

The structural curbing of current expenditure must reduce government borrowing and provide the resources for increased public investment. Reducing the burden of taxation must not lead to a rise in the deficit. The expansionary effect produced by the growth in disposable income would be outweighed by the negative effect deriving from the increase in the debt.

Conditions in the trade unions, firms and banks appear to be conducive to a return to growth-oriented cooperation.

To date the contribution from the implementation of public works has been limited; it must be boosted. The curb on public expenditure must not penalize firms in the weakest parts of the country. New prospects must be created for research, for the application of advanced technologies in production and for the development of alternative energy sources.

It is necessary to increase confidence. This can be done by drawing up a credible and broadly supported economic policy to reduce the absorption of savings by the State, lower (in part through faster growth) the ratio of public debt to GDP, and charts a course for progress in the years to come.

As I also noted on 31 May, the Italian economy's loss of competitiveness is the consequence of long-term trends; partly owing to an especially difficult international environment, the deterioration has not been halted in the last few years. It is necessary to act on several fronts and set in motion an improvement of the factors underlying growth.

It is necessary and possible to react, in Italy and at European level, so as to be able to participate in what promises to be a strong and prolonged recovery of the world economy.