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Speech by the Governor of the Bank of Italy
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The financial markets and the world economy

For a good many years low volatility and abundant liquidity were dominant on the financial markets, with interest rates and risk premiums at minimum levels. There was a wave of financial innovation, affecting mainly consumer credit, structured products and derivatives; in the United States in particular it saw banks transfer their loans to other investors (on the originate-to-distribute model); it also contributed to the exceptional growth of the non-bank financial sector and the integration of global capital markets.

The opening up of the world to trade and the credibility of monetary policies underpinned the economic growth of recent years. The abundant savings generated by the expansion of the Asian economies and by the surplus of the oil-exporting countries financed massive payment imbalances. The financial system took on far greater risks than ever before. Individuals and institutions that had once had difficulty obtaining credit could now borrow on a huge scale: financial techniques converted high-risk assets into investments with a good credit rating. The advent of insurance and swap mechanisms made it simple to hedge credit risk, which became easily transferable. There ensued an upsurge in borrowing that in turn aggravated systemic risk. The market became convinced that the distribution and diversification of risk would more than offset the increase in its level. At the same time, credit-rating standards declined in a number of countries, in some cases to the point of fraud.

This phase is now drawing to a close. The crisis of the US real estate sector has set off an abrupt and vast reaction, which the acutest observers had long been predicting. Operators, including the most sophisticated, suddenly realized how greatly risk transfer had been overvalued, how inadequate assessment and management methods would prove in times of crisis, and how vague and complaisant was their understanding of the products they traded. As a result many financial markets seized up, with immediate repercussions on the liquidity of banking institutions. Optimism about the financial industry's potential is turning into pessimism that is infecting the real economy. The nature and magnitude of the shock reflect the volume of assets liquidated, the variety of markets affected, the dramatic consequences for some of the world's leading financial institutions, and the difficulty of assessing the true exposure of the intermediaries implicated.

The system is responding by rapidly unwinding negative exposures, drastically reducing indebtedness, introducing massive recapitalization programmes, and tightening risk assessment and management practices; cases of insolvency among banks have been isolated, without systemic impact. The massive inflow of equity capital to the financial sector at a time of sharply falling share markets seems set to continue. The amount of resources invested in hedge funds has increased substantially since 2006. The crisis, which has severely affected the US banking industry, appears to have spread in much milder form to other parts of the world and other branches of the global financial industry.

There can be no doubt, however, that with a view to restoring confidence in the markets, which is essential to preserving the considerable benefits that financial innovation has brought for growth, the deficiencies that have emerged must be remedied. The main areas of attention for national and international regulators are the prompt implementation of Basel II with much greater recapitalization of the system, liquidity and risk management, the shortcomings of the credit transfer process, and transparency and honesty in loan contracts.

The central banks acted decisively. The ECB, together with the other major central banks, intervened repeatedly from the first half of August onwards to satisfy the demand for liquidity and to curb the divergence of very-short-term interest rates from the official rate. It made flexible and timely use of the different operating procedures available, resorting most frequently to fine-tuning and 3-month operations. Among other things, this resulted in a lengthening of the average duration of its lending. The ECB then extended the duration of the mid-December main refinancing operation, supplying an exceptionally large volume of liquidity. In agreement with the US Federal Reserve, it offered loans in dollars to euro-area counterparties.

The orderly working of the euro money market has been guaranteed at all times. Overnight rates, which went up sharply when the strains arose in August, have now fallen back into line with official rates, although they continue to display high volatility. Interbank rates on other than very-short-term maturities are still high, reflecting significant risk premiums.

The ECB's monetary policy action is distinct from its interventions on liquidity. At a time of pronounced uncertainty, the supply of abundant liquid instruments on the part of the ECB has helped to ensure the regular functioning of the markets. It has not altered the stance of monetary policy.

The turmoil on financial markets has coincided with and contributed to the slowdown of the world economy.

Since last autumn banks have come to adopt a more prudent stance in granting credit. Yesterday we announced the results of the Eurosystem survey on credit conditions conducted in January; they indicate that the standards adopted in lending have been tightened less in Italy than elsewhere.

Between September and November euro-area firms issued bonds amounting to €25 billion, as against €36 billion in the corresponding months in 2006. In the same period Italian firms made issues amounting to €1.6 billion, as against €13 billion in the whole of 2006. The increase in risk aversion has been reflected in a widening of spreads, although the effect has been partly offset by the fall in long-term yields; the cost of fund-raising for less creditworthy firms has risen.

In the last few months the European economy has shown signs of slowing, in part due to the erosion of purchasing power caused by the rise in energy and foodstuff prices and to the greater prudence of households and firms in the face of a less certain economic outlook.

In the United States the effects of the financial turmoil are in addition to those of the sharp contraction in residential building, which is now being transmitted to household consumption and to other productive sectors. Nor can the recovery in exports, fostered by the depreciation of the dollar, provide much support to economic activity, given the smallness of external demand in relation to GDP. The unemployment rate rose from 4.7 to 5 per cent in December; expectations of a decline in profits are becoming more general; the fall in share prices has spread from the financial sector to the rest of firms. The official forecasts currently available indicate that the slowdown will be limited, thanks in part to possible fiscal stimulus measures. But there continues to be a real risk that the tighter financial conditions and more uncertain prospects will soon lead households and firms to revise their spending plans downwards.

In the emerging economies the financial turmoil has had a very limited impact so far. Unlike what happened in the past, the spreads on these countries' bonds have widened only a little; the increased volatility of share prices has not halted their rising trend nor has the inflow of foreign capital dried up. The emerging countries' much stronger financial positions make them less vulnerable to external shocks.

The cyclical situation in Italy

The cyclical indicators signal a slowdown of the Italian economy. Output growth is slackening considerably; this year and next it is expected to fall below its potential, which is itself low by international standards. The sharp rise in the prices of oil and some foodstuffs weigh on households' disposable income and depress their consumption. At a time of low productivity growth, the appreciation of the euro hurts the price competitiveness of Italian goods, is a brake on exports and encourages the purchase of imported products.

The growth gap vis-à-vis the other euro-area countries is widening again. Cyclical fluctuations aside, what is still lacking is a structural jump in productivity. This hurts not only competitiveness, but also the purchasing power of workers and households, hence consumption.

In the last ten years the growth in per capita disposable income, adjusted for inflation, has been modest, owing above all to the stagnation of productivity. Tax cuts have a positive impact on consumption and output, especially if targeted at the lowest-income households, whose propensity to consume is highest, although the expenditure of these households includes a high proportion of import-intensive goods. But it is only a rise in productivity and the supply of labour that can permanently sustain growth.

Tax reduction measures exert all their potential impact on the economy only if they do not lead to an increase in the public debt; in Italy's case, if they are offset by decreases in current expenditure, which is still very high.

The Istat data for the first nine months of 2007 show that the public accounts are better than in the past. The ratio of primary current expenditure to GDP declined; the tax burden relative to GDP rose further; public investment grew less than GDP, after contracting in the previous two years; interest payments rose substantially. The state sector borrowing requirement for the year as a whole fell to its lowest level since 2000; the public debt began to decline again in relation to GDP. It is important that the process of deficit reduction continue in 2008. A thorough evaluation of the state of the public finances will only be possible at mid-year, once the results of the first instalment of self-assessed taxes are in.

Inflation and monetary policy

Inflation causes insidious, serious and lasting damage. It hinders the proper functioning of the price system, the basis of the market economy; it redistributes revenue blindly and erodes the purchasing power of households on fixed incomes, especially the least affluent; it discourages investment and holds down growth. Once it has gained a foothold, it tends to be perpetuated through the vicious circle of expectations and the wage-price spiral. Italians know all too well how difficult it is to extirpate.

Towards the end of last year inflation in Europe showed a clear upward trend. Harmonized consumer price inflation rose to 3.1 per cent in the euro area in December and 2.8 per cent in Italy, among the highest twelve-month rates since the launch of Monetary Union. The average inflation rate for the euro area this year is expected to be 2.5 per cent, well above the value for price stability fixed by the Eurosystem; it is not expected to come back down to this value until 2009.

The origin of the rise in inflation is well known. In the last three years almost half the inflation recorded in Italy and the euro area was due to increases in energy and foodstuff prices. The weight of these two categories in the consumer price basket increased by more than 3 percentage points in 2007 and is now nearly 30 per cent.

Among the elements that have recently influenced the cost of food and energy products, structural factors have begun to emerge. The prices of primary inputs are being driven by the surge in the demand of households and firms in the emerging economies. Another factor is the growing use of some agricultural products in the bio-fuel industry.

The firm anchoring of inflation expectations has been the basis for the expansion of employment in the euro area. This must be maintained. Only in this way will such anchoring continue to be embodied in wage agreements and profit margins.

Central banks are duty-bound to act promptly and resolutely. Price stability is entrusted to monetary policy by the treaty establishing the European Community; it has been maintained in recent years, it will be maintained in the future. The decisions of the ECB Governing Council, especially regarding interest rates, are and will remain focused on this objective.

Banking supervision in Europe

Today, in the wake of the recent wave of mergers and acquisitions, all the main European banking groups have systemically relevant units outside their home countries. Supervision of banking groups is the responsibility of the home-country authorities, while supervision over the single national entities is coordinated by a college of supervisors grouping representatives of all the countries involved.

This system has worked satisfactorily, though it cannot be said to have been tested by the recent financial turmoil. The most severely affected banks, which were not large, do business mainly on a national scale. International coordination nevertheless needs to be strengthened, especially for crisis situations. This would be made easier by the existence of uniform standards and procedures for emergency interventions.

A good deal of progress can be made simply with limited changes to the rules now in place, for which the necessary political consensus is a realistic prospect.

The Committee of European Banking Supervisors (CEBS) has worked successfully to date for the progressive harmonization of supervisory rules and practices. The process is not yet complete. Convergence needs to be accelerated. The Committee itself needs to be given greater powers of decision and greater resources, enabling it to play a more active role in information exchange and supervisory coordination.

The formation of colleges of supervisors needs to be made mandatory, and the essential features of their modus operandi must be regulated and harmonized. Today the home-country authority that coordinates the college can make binding group-wide decisions only about the approval of internal risk measurement models. This power should be extended to other aspects of capital adequacy assessment, which would reduce regulatory costs for intermediaries. At the same time, however, the main powers of intervention vis-à-vis subsidiaries, including emergency measures in cases of illiquidity or insolvency, must necessarily remain within the jurisdiction of the host country, both in order to take effective account of the national legal framework and because it is advisable to maintain the closest possible connection between those taking decisions and those incurring any costs.

Looking to the future, there is a need for greater uniformity in the procedures for the management and winding-up of distressed banks and in deposit insurance rules. The cross-country differences found today impede competition and complicate crisis management.

Supervision on the Italian banking system

The Bank of Italy is engaged in establishing a supervisory model in keeping with the principles of Basel II. Prudential regulations are being transformed, their obligations and constraints made less burdensome. Intermediaries have already been relieved of many authorization requirements, and further streamlining will follow. Much more than in the past, regulation now relies on banks' ability to determine their own risk profile and devise defences, in compliance with general standards. The Bank of Italy intervenes, for the most part at consolidated level, to check the solutions that the banks have adopted. Where necessary it requires corrective action.

This way of operating is designed to keep red tape to a minimum, but it presupposes constant interaction between banks and supervisors, which is essential to assessment of the systems of governance, management and control that the banks have chosen and approval of the internal risk measurement models used in determining capital requirements. Supervisory action is now more flexible and better targeted. There is more frequent recourse to partial inspections covering selected business activities, areas of risk or operational matters, or verifying that certain corrective measures have actually been implemented. On-site inspection has become quite an ordinary supervisory tool.

Without prejudice to safeguards against the traditional risks, which are better known and more easily measured, the Bank of Italy is especially attentive to the risks deriving from financial innovation, from the increased size of banks and from their presence and business abroad. It is important that the intermediaries themselves signal problem areas requiring action.

The organization of the banking supervisory function will change. The supervision of the leading intermediaries will be carried out entirely at the Bank's head office; its branch offices will supervise the local banks. This will eliminate overlapping and duplication in supervisory activity, increase its efficiency and timeliness, and reduce its cost for intermediaries.

As markets evolve, risks change. Recent experience has shown that the liquidity of markets and of intermediaries can contract suddenly, with cumulative and sometimes devastating impact, transforming a problem of liquidity into one of solvency. The management of liquidity risk has become crucial. Safeguarding stability demands that banks not only have capital well in excess of the Basel II minimum requirement but also maintain a good safety margin on their liquidity position.

The Bank of Italy has greatly intensified its supervision of liquidity. Newly-issued guidelines require banks to reinforce their impact assessment instruments for adverse contingencies, including worst-case scenarios, and to update the stress-testing of their liquidity management plans. Since September we have been regularly and systematically monitoring banks' liquidity. This programme not only covers the main banking groups and those whose situation requires special attention but will soon be extended to small and medium-sized banks as well, above all those specializing in medium- and long-term lending.

The repercussions of the international financial market turmoil on bank liquidity have been less severe in Italy than in other countries, thanks to the system's smaller direct and indirect exposure to the US subprime mortgage market, to the large share of funding that consists of customer deposits, to a solid capital base, and to satisfactory operating profitability.

A thorough examination, including indirect exposure through structured securities, confirms that Italian banking groups' risk exposure in this regard is currently low by international standards. The gross exposure comes to less than 3 per cent of regulatory capital and 20 per cent of the gross profits of the banking system, so that even further asset write-downs in this segment would not threaten overall capital solidity.

The balance sheet valuation of structured securities, the decision on consolidating off-balance-sheet entities — conduits and SIVs — that today benefit from credit lines and liquidity on the part of banks, must be informed by criteria of the utmost rigour and transparency.

The consolidation of the Italian banking system has made further progress in the past year. The process has not been completed: it will be extended, possibly in different forms, to the smaller banks. Capturing the efficiency gains deriving from new mergers and acquisitions and the completion of those in course is even more important at a time when banks' profitability is unlikely to maintain the levels of the recent past.

Banks' governance

In the past months a consultation was held on the Bank of Italy's draft regulation concerning banks' corporate governance arrangements, with extensive participation of the banking system and the academic world.

This phase, now over, revealed a broad consensus on the innovative and systematic nature of the proposed measure.

The consultation text contains general principles, consistent with domestic regulations and international guidelines, and, for the aspects of particular importance for supervision, rules that are more specific than the general provisions of the Civil Code.

Some of the rules for applying the two-tier system introduced by the reform of company law have revealed the difficulty of reconciling the complexity of the new corporate governance structures with the purposes of supervision.

In the new model of banking supervision, governance, organization, capital requirements, and risk management and control systems form an integrated whole in the pursuit of the objective of sound and prudent management of banks.

The new system is neutral with respect to the specific articulation of the governing bodies. It refers to the functions of strategic supervision, management and control, which are important from the standpoint of supervision and typical of every corporate entity, regardless of the board model adopted.

These functions must be assigned to the governing bodies (sometimes within them) and it is necessary to guarantee a clear division of responsibilities, checks and balances, and a proper hierarchy of control. The supervisory rules provide, again with the aim of ensuring sound and prudent management, specific safeguards for cases in which, as practical experience has shown, civil law does not totally exclude the possibility of an overlapping or commingling of functions.

The supervisory board can combine and in fact usually does combine guidance functions, typical of the shareholders' meeting, strategic supervision functions, vested in the board of directors, and control functions, proper to the board of auditors. The supervisory rules will ensure a clear distinction between strategic supervision reserved to the supervisory board and management reserved to the management board and will erect defences to protect the impartiality and efficiency of the controls performed by the supervisory board. This is the rationale of the provisions that call for the detailed identification of the powers of the supervisory board and the management board, which are also reflected in the latter's composition.

The comments and suggestions deriving from the consultation, which have confirmed the correctness of this approach, will permit the fine-tuning of the application of the general principles, which will nonetheless remain unchanged.

Autonomy in drawing up bylaws is desirable; prudential regulation must ensure that its exercise in the banking sector is compatible with sound and prudent management.

Once the rules have been issued, banks will be expected to make, in accordance with the principle of proportionality, a detailed self-assessment to verify the compliance of their corporate governance systems with the new rules. A suitable transition period will allow intermediaries to make any adjustments that may prove necessary.

Mortgages

For most people the purchase of a house to live in is the most important investment of their life. The possibility of obtaining a loan is often a necessary condition.

The strains in the money market have also affected lending to households. Between July and December the interest rates on mortgage loans indexed to interbank deposit rates rose by about 30 basis points. The burden of repayment instalments increased for the many households that had taken out loans of this kind. These rates may now be trimmed, following recent money market developments. Our estimates show that the overall incidence of bad debts on the stock of mortgages remains moderate, albeit with a slight deterioration, which is confirmed by the latest data on the flow of new bad debts.

The structural conditions of the mortgage market in Italy have made significant progress in recent years. The range of contracts available has widened, loans have become more flexible and lenders' spreads have narrowed. However, borrowers shoulder other costs besides interest — taxes, insurance premiums, commissions, notary fees and expenses, appraisers' fees — that are particularly burdensome for small mortgages. Here, as elsewhere, more exposure to competition is essential to reduce the costs for households, but it is not a sufficient condition. Banks must carry on their effort to increase the transparency of contracts and improve the information given to customers. Choosing the mortgage best suited to the household’s economic situation is complex. Providing high-quality service benefits the customer and the reputation of the bank.

Some of the households that took out adjustable-rate mortgages when money-market yields were particularly low may now deem it advantageous to renegotiate some terms and conditions. The measures introduced by the Government and Parliament regarding early repayment and the portability of mortgages have prepared the ground for the more effective working of competition by increasing the options available to borrowers. The banks are responding. According to the Italian Banking Association, in the first nine months of 2007 as many as 42,000 customers renegotiated interest rates, spreads and duration of mortgages taken out in previous years, far more than had done so in the corresponding period of 2006. The number of early repayments also increased.

The launch of the Single Euro Payments Area

The integration of the European financial industry is about to reach a milestone with the inception on 28 January of the Single Euro Payments Area (SEPA). Operating conditions and service levels for payments in euros will be uniform throughout Europe for certain instruments. It will be possible to compare the offers of different intermediaries and the conditions will be created for an improvement in the quality of the services provided to final users: individuals, firms, the public administration.

The internationalization of Italian firms has not been accompanied so far by an increase in the flow of cross-border payments handled by Italian banks. SEPA is an opportunity for them to recoup ground, provided they rise to the challenge of change. SEPA will facilitate the supply of new services to corporate customers, the expansion of the European market, and investment in products that satisfy the needs of Italian firms.

Credit transfers and payment cards, which involve over 31 billion transactions a year, will be the first to be standardized. A European Commission study estimates that the benefits to the Union’s economy can exceed €120 billion over the next six years.

The crisis of Italian investment funds

The outflow of savings from Italian investment funds intensified in 2007, with net disinvestment of nearly €53 billion. By the end of the year assets under management had shrunk to about €350 billion, a contraction of one quarter since the start of the decade. The disappointing performance of fund-raising has been protracted; the crisis is structural.

The contraction of the industry is unique among the main European countries. The European market share of harmonized Italian funds, which ranked third at 12 per cent in 2000, has come down to just 5 per cent today and is still falling. Even when the funds operated in foreign financial centres by subsidiaries of Italian groups are counted, the decline is only slightly less severe. The portion of Italian households’ portfolios consisting of investment funds has fallen by more than half since 2000 to about 8.5 per cent. For Italian funds the decrease has been even more pronounced; their share of households’ financial assets is now just 5.8 per cent, scarcely a third as high as in 2000. Above all the portfolio reallocation has favoured life insurance products, whose share has risen by 5 percentage points to about 11 per cent. Bank instruments, by contrast, have scored very limited gains of about 1 percentage point both for deposits and for securities.

Tax treatment no doubt severely handicaps Italian funds with respect to their foreign competitors. Competition needs to be brought back exclusively to the sphere of management quality. The reform of the taxation of financial assets represents an opportunity for action. Asymmetries in regulations on transparency and fee structures, both of which are less favourable for managed assets than for insurance and structured products, are one factor in the crisis of investment funds. But they are not the entire explanation. The competitive scene has changed; the asset management industry has been radically transformed, internationalized. The current crisis points up the inadequacy of models that were viable in the past. Asset managers and their groups have to rethink their strategic positioning, realizing economies of scale, accentuating specialization, and aligning their fees with product features and market conditions.

The Bank of Italy has repeatedly warned the asset management industry of the need to deal with these structural problems, specifically by opening up the distribution networks and by instituting adequate guarantees of the independence of asset management companies from banking groups, including by separation of ownership where appropriate. To date the response has been disappointing.

There is not just one possible model. Some groups may concentrate on marketing the products of others and on consulting, capitalizing on customer relations, a course that has been elected not only by small credit institutions but also by several leading international banks. Others may count on developing their asset management capabilities. As a result of banking consolidation, Italy now has institutions potentially capable of occupying an important position within the European asset management industry. Such a choice requires large asset management companies that can plan their growth independently of the banks themselves, even outside the perimeter of the group and the national territory, and that have the financial resources to attain – whether through internal growth or acquisitions – the size, innovative capacity and efficiency required to compete in world markets. The opening up of distribution networks could foster the consolidation of the industry.

The Bank of Italy, consistently with its institutional duties and the independence of individual intermediaries, will promote the creation of a working group, with the participation of the operators concerned, to study the legislative and regulatory changes that have now become necessary to relaunch the asset management industry.

The prospect in view as the year opens is one of financial turmoil coupled with cyclical weakness.

Our financial system is solid, thanks to its customer base, its capital and the strides it has made in the last few years.

In Italy the recent slowdown in activity demands attention not only for its intrinsic importance, but above all because it comes against a background of underlying economic weakness. This is what we must tackle; we must identify the structural problems clearly and work to solve them.