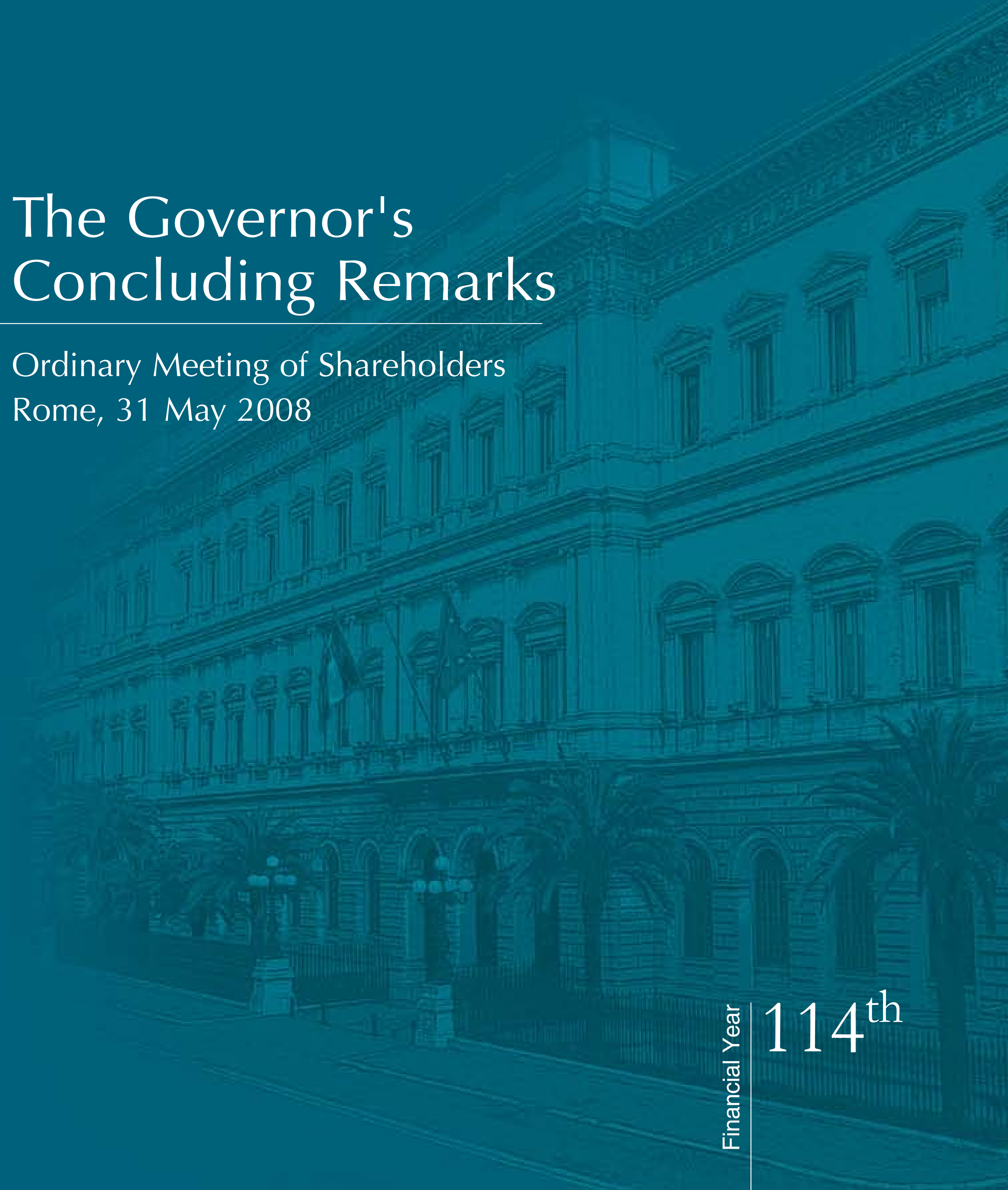
BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Ordinary Meeting of Shareholders
Rome, 31 May 2008



Financial Year 114th

114th FINANCIAL YEAR

2007

BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Ordinary Meeting of Shareholders

2007 - 114th Financial Year

Rome, 31 May 2008

Ladies and Gentlemen,

The new European gross interbank settlement system (TARGET2), in the development of which the Bank of Italy was a leading participant, is now operational. The Bank also collaborated in the establishment of the Single Euro Payments Area (SEPA). These initiatives will give further impetus to the integration of interbank services, bringing additional benefits to the citizens of Europe.

The Bank has completed the reorganization of its economic research and international relations function.

The Einaudi Institute for Economics and Finance was established in 2007, taking over the legacy of the former Ente Einaudi. It has already gained international recognition as an active promoter of theoretical and empirical research; it aims to provide a permanent base for highly qualified researchers.

Banking supervision must be adapted continuously to changes in the markets. The reform of this sector, which will come into effect on 1 August, will strengthen the safeguards of the Italian banking and financial system against the emergence of new risks, increase the protection of savings, and reduce the costs for intermediaries.

Today the General Council decided to merge the two functional areas of Central Banking and Markets and Payment System and Treasury Services. Financial management will be separated from institutional functions; risk monitoring will be independent of investment activity.

Like many other central banks, the Bank of Italy has an equities portfolio that it manages in compliance with strict rules of conduct: it does not invest in the shares of banks or other bodies it regulates; it adopts a long-term investment strategy; it exercises its shareholder rights according to principles based on international best practice and designed to reinforce the role of minority shareholders. As announced last year, we have intensified the restructuring of our portfolio, reducing the proportion of Italian shares and eliminating every discretionary element in new investments, which are now limited to benchmarked collective funds.

The reorganization of our branch network will begin in September.

It is no longer necessary for the Bank to have its own offices in the financial centres of the euro area; they will be closed by the end of this year. In agreement with the Ministry of Foreign Affairs, the Bank will second economic experts to Italian embassies in the main emerging countries of Asia and Latin America.

On 1 January 2008 the Bank of Italy acquired the powers, functions and personnel of the Italian Exchange Office, which has been closed. A Financial Intelligence Unit has been established, with broad powers to identify operations associated with money laundering and the financing of terrorism. The Unit is an independent body that performs its functions autonomously; the Bank regulates its organization and will increase its resources and capabilities, which are already stronger than in the past. Staff from the Unit act as advisors to the public prosecutors, in particular those most active in this area. Banking supervision plays an integral part in activities to combat money laundering.

The implementation of this broad programme of renewal and reorganization is confirmation that complex structures can be reformed without compromising the performance of delicate institutional functions.

The General Council and the Governing Board express their sincere gratitude to all the staff for their extraordinary commitment throughout this period of transition.

International finance

The turbulence that swept through the financial markets last summer came at the climax of an exceptional expansion in credit and finance, which for many years had contributed to the rapid growth of the world economy.

The long period of favourable macroeconomic conditions, the abundance of liquidity and low real interest rates had increased the amount of risk and the degree of debt that borrowers, investors and intermediaries were willing to take on. The rapidity of financial innovation heightened the system's potential to multiply credit in relation to invested capital. Operators did not keep pace in their ability to evaluate and manage the associated risks.

From 2003 onwards the narrowing of risk premiums and the reduction in expected volatility encouraged the rapid spread of loan securitization techniques using ever more complex and innovative securities that appeared to meet the requirements for the highest ratings. The rapid growth of the market in credit derivatives, which allowed investors to redistribute and hedge risks, helped to create an impression of virtually limitless opportunities for apparently safe investments. Credit instruments had never before appeared to be so liquid. As in a spiral, easy credit helped to reduce insolvency rates among borrowers, further reducing risk premiums and thus feeding new flows of lending.

Financial institutions, including some of the leading international banks, gave further impetus to this process, creating a sort of shadow banking system of vehicles specializing in investment and fund-raising on the credit derivatives market. Since these vehicles were not consolidated in the banks' balance sheets and were subject to much less stringent accounting and prudential requirements in the main financial centres, they operated with negligible capital, large liquidity imbalances, and an extreme maturity mismatch between assets and liabilities, due in part to gaps in the prudential rules prior to Basel II. Rating agencies, investors and banks underestimated the risk associated with structured products and, above all, the sudden concentration that would occur in the event of a generalized deterioration in the market. The banks, in particular, did not realize that if their vehicles' securities could not be refinanced in the market they would be forced to intervene to support them.

At the same time, redistributing the risk weakened the incentive for rigorous credit selection, above all in the United States; credit standards deteriorated and the foundations became fragile.

The trigger for the crisis came from the American real estate market. With interest rates rising, the fall in house prices led to an increase in defaults on subprime mortgages, revealing their high risk. Structured securities linked to this sector began to depreciate and their ratings were downgraded rapidly and drastically. Highly leveraged investors had to meet margin calls. The change in the perception of risk was sudden and swiftly spread to similar instruments in other market segments. Structured products offered by bank-related vehicles became impossible to refinance in the money market. To prevent their collapse, the sponsoring banks greatly increased their own liquidity requirements. The supply of funds on the interbank market dried up.

The spiral that had driven the expansion of credit and finance went into reverse. A shortage of liquidity, the changed perception of risk and the reduction in leverage reinforced one another. The sharp depreciation of structured products was reflected in the valuation of bank assets themselves; uncertainty about the level of exposure, the extent of losses and the soundness of the banks' capital base increased the counterparty risk perceived in the interbank market, making the latter even less liquid. Forced to take back onto their balance sheets assets they had previously transferred and to record write-downs on them, the banks saw the size and rigidity of their balance sheets grow and their capital position weaken.

The central banks intervened when it appeared that the turmoil could have systemic implications. The scale, flexibility and promptness of their intervention and the degree of international cooperation were unprecedented. They averted a systemic crisis that could have had devastating effects on the real economy. They prevented it from also seriously harming those who bore no responsibility for it.

Although tensions in some markets are easing, normal conditions have not yet been restored. In some market segments, spreads and risk premiums, which had even been too low in previous years, are still close to the peaks reached at the height of the crisis. Other segments, such as securitization business, are finding it difficult to return to normal activity. The value of many financial and real assets has been written down sharply.

When, where and how the crisis would have broken was impossible to know; the event that triggered it occurred in a fairly marginal segment of financial activity. Despite this, some of us had been persuaded of the extreme fragility of the situation for some time. The build-up of tensions was apparent well before last summer. In my first public speech in my present capacity at the beginning of 2006, I drew attention to the imbalances that had developed and the new risks accompanying the undoubted benefits of financial innovation. In this forum a year ago, I pointed out that investors' perception of risk could suddenly change, with destabilizing effects, and that while growing market complexity and interdependence made the system stronger and more efficient in normal times, it could increase its vulnerability to extreme events.

Helping the market to recover does not mean taking over its role. Nor would undoing financial innovation help. That would make the system poorer, not more secure. The history of financial crises, even recent ones, reminds us that traditional instruments and intermediaries are not necessarily any more stable and reliable. At the end of the eighties, well before today's structured financial products became widespread, the crisis among American Savings and Loans Associations cost US taxpayers more than 2 per cent of the United States' annual GDP. The Japanese banking crisis, which followed only a few years later, entailed even greater cost.

A retrospective examination of the events of recent months is essential in order to design the measures to be taken for the future of the international financial system. In the leading international financial centres, incomplete regulation and perverse incentives led to excessive borrowing, especially since its true scale was not perceived, and to an undervaluation of risk.

The financial system that will emerge from the crisis must have different rules, less debt, and more capital. This is the unifying principle of the recommendations made by the Financial Stability Forum in its recent report, which considers the essential elements to be the rapid adoption of the new Basel II prudential criteria and an increase in capital requirements, particularly in respect of structured products. The report proposes instruments to improve liquidity and risk management, enhance the transparency of financial institutions' accounts, overhaul rating mechanisms and set guidelines for emergency measures.

The report was approved by the Group of Seven. Most of the proposals it contains do not require legislation, but can be adopted directly by the regulatory authorities that contributed to their design; they constitute a coordinated response to the crisis that does not disrupt the integration of the global financial market. They can and must be put into practice without delay. It is important that the shared determination to implement them should not falter at the first signs of an easing of tensions.

The repercussions that the financial turmoil is having on the real economy in the industrialized countries, and especially the United States, have become clear since the end of 2007. Its effects on emerging and developing economies have been less pronounced. These economies are now making a decisive contribution to supporting global production and trade.

The greatest threat to the world economy now comes from the build-up of inflationary pressures and the possible worsening of the American slowdown. The principal source of concern remains the continued rise in the prices of energy and other raw materials. While on the one hand this rise reflects in part the still robust growth prospects of the emerging economies, on the other it is having a further recessionary impact on the advanced economies and feeding inflation, thus constraining the monetary policy stance.

The single monetary policy and the Italian economy

Since last autumn consumer price inflation in the euro area, fuelled by increases in energy and raw materials prices, has accelerated by about 1.5 points, reaching an average of 3.3 per cent in the first quarter of this year. This is the highest level since the first half of the nineties. The latest figures point to a further acceleration.

Nevertheless, the rise in domestic costs has remained modest, and no wage-price spiral has developed to date. The firm anchoring of inflation expectations has allowed the European Central Bank to keep interest rates unchanged for quite some time, thus helping to support the economy. This is an important difference from previous oil crises, when in some European countries the instability of inflation expectations led to equally unstable monetary conditions, characterized by repeated cycles of expansion and forceful restriction, with dramatic repercussions on the economic cycle. Today the European Central Bank is keeping monetary policy firmly focused on the objective of price stability over the medium term while ensuring, in cooperation with the other major central banks, the necessary liquidity to maintain the orderly functioning of the global financial system at a time of severe strain.

In 2007 Italy's economy, along with the rest of the euro area, was affected by the global downturn and the acceleration in commodity prices; however, it slowed more markedly than those of the other euro-area countries. The phase of cyclical weakness will continue for at least the current year. Exports, which in the last two years grew at an annual rate of almost 6 per cent, have been the mainstay of GDP growth. The expansion in domestic demand was very modest, the capacity utilization rate declined, investment slowed sharply and business confidence indicators worsened.

Household expenditure is being curbed by the feeble growth in disposable income and by rising prices, which in recent months have hit the consumption of lower-income households hardest. Consumption continues to be affected by precarious employment relationships, which are especially prevalent among young people and in the weaker segments of the labour market. Uncertainty over current income and prospects for future increases are acting as a brake on spending decisions, not least owing to the shortcomings in the social safety net. Despite the improvements made in recent years, for example by increasing ordinary unemployment benefits, there has not yet been a comprehensive and rigorous overhaul of the protections offered, which is essential to combine flexibility and fairness in the labour market.

With international prices rising, the strong euro is protecting the purchasing power of citizens and their savings. But it calls for a disciplined approach by all those who contribute to the production of national income: devaluation of the currency, a short-lived boost for firms, is no longer an option. Competitiveness and the country's ability to grow depend on productivity: it is on this front that intelligence and action must be concentrated.

The productivity problem

The problem of productivity has remained unresolved for over ten years. Notwithstanding the interpretative difficulties caused by a changing statistical picture, the last two years have confirmed the existence of a productivity gap in relation to our main competitors.

Businesses exposed to international competition have not remained inactive. As I indicated on this occasion last year, parts of the economy have started to restructure; this development is not unrelated to the adoption of the euro and the disciplining effect it has had.

Our surveys indicate that this structural change is occurring in all branches of industry. In both the traditional and the more advanced sectors, for every business that has closed down or is experiencing serious difficulties, there is another that has made a qualitative leap in its competitive capacity. Corporate mortality levels have risen, but the profitability and internationalization of enterprises that survive are growing. The average size of businesses is increasing; ownership and control structures are being modernized, in part thanks to advances made in company law and the law on markets. These developments are encouraging; they reveal a more varied panorama than that painted by the aggregate statistics on productivity.

But in the economy as whole, most of which is sheltered from international competition, average productivity is still making no headway.

It is vital that Italian enterprises continue on the path of structural renewal. In the long term, wealth is not generated by defending monopolies or protection but by investing, innovating and taking risks.

Value added is barely keeping up with employment. In the last ten years the number of persons employed in industry and private services has risen by 17 per cent, or by 2.5 million, of whom two-fifths are immigrants. The unemployment rate has declined to just over 6 per cent, compared with over 7 per cent in Germany and France. In the North, unemployment has been at 4 per cent for seven years. These are the positive effects of new legislative and contractual measures introduced from the mid-nineties onwards, and of moderate wage growth. We cannot be satisfied with these results until the employment rate, especially for women, has caught up with European levels, until appropriate forms of flexibility have been introduced in the entire labour market rather than being concentrated in individual segments, and until there has been a generalized increase in productivity, which can be translated into higher earnings for payroll workers.

The public sector must help the economic restructuring process by acting in its own spheres of competence. The causes of the stagnation of productivity are well known. For some time, there have been calls from various quarters to increase productivity in public services by opening them to the market, to reduce rent-seeking by strengthening competition at national and local level, to ensure that schools and universities meet the standards of an advanced country, to bring infrastructure up to a satisfactory level, to ease the tax burden, to provide de facto legal certainty and effectiveness by simplifying legislation and making the justice system work, and to guarantee law enforcement and security everywhere.

A number of measures have been taken by successive governments in recent years. The gravity of the problems that have dogged the Italian economy for too long demands that the entire spectrum of public action – from the legal and regulatory framework to the size and quality of the budget – be directed towards achieving the priority objective of productivity and growth.

Economic efficiency and the budget

Budgetary policy must remain anchored to the macroeconomic necessity of reducing the ratio of debt to GDP. But if it is not oriented towards efficiency and growth at the microeconomic level, the economy will be held back and the restoration of sound public finances itself made more difficult.

Italy's public finances have improved in the last two years. In 2007 net borrowing fell to 1.9 per cent of GDP. The public debt declined to 104 per cent of GDP, the level at which it stood in 2004.

The outlook for the current year is less favourable. Based on the Combined Report on the Economy and Public Finances, net borrowing will rise to 2.4 per cent of GDP. The deficit adjusted for cyclical effects and temporary measures is set to worsen by 0.6 percentage points. The reduction of the debt ratio will be modest.

Even in a difficult economic climate, the ratio of public debt to GDP must continue on a downward path. The Government's intention to move soon to define the measures to be adopted in the next three years could make budgetary action more systematic and facilitate the achievement of a balanced budget in 2011.

Deficit reduction in the last two years was due above all to the sharp increase in the ratio of tax and social security contributions to GDP by 2.8 percentage points between 2005 and 2007. The ratio of fiscal revenue to

GDP stands at 43.3 per cent, just below the peak recorded in 1997 at the height of the efforts to meet the Maastricht criteria; it is almost 3 percentage points above the average in the other European Union countries. The gap with respect to the United States and Japan is even wider.

The scale of irregular economic activity makes the burden on honest taxpayers heavier than in the rest of Europe. For every 100 euros of labour costs incurred by the employer, the taxes and social security contributions for a typical worker with no dependents amount to 46 euros in Italy. In the other euro-area countries the proportion averages 43 per cent of labour costs; in the United Kingdom it is 34 per cent and in the United States 30 per cent. The regional tax on productive activities further widens the gap between our country and the others. Despite the reduction that took effect in 2008, the overall rate of taxation on business profits is 8 percentage points above the average of the other EU countries.

High tax rates undercut firms' international competitiveness, reduce their propensity to invest and may cause distortions in their choice of size. They depress the earnings from regular work and discourage the regularization of unreported employment. As early as 1946, in the Constituent Assembly, Luigi Einaudi warned that "only by lowering current tax rates and reducing the incentive to engage in fraud will it be possible to obtain more revenue for the State".

Laying down a multi-year path for the reduction of some important tax rates would improve the expectations of both households and firms. Tax relief needs to be concentrated where it can give the most support to growth by reducing the distortions affecting economic activity. The effect on the economy will be all the greater if the formalities for taxpayers are simplified and legislation is made more stable.

Reducing the taxation of the components of earnings most closely related to productivity can have a positive effect on productivity itself, permit better plant utilization and encourage wage negotiations to reward increases in efficiency. Further ahead the tax burden will need to be alleviated for increasingly broad categories of workers, with preference given to measures that are simple and neutral.

Despite a slight slowdown recently, in the last ten years primary current expenditure has grown at an average annual rate of 2.1 per cent in real terms, which was much faster than GDP. This tendency will have to be corrected if the public debt is to be reduced and the tax burden eased. According to the macroeconomic scenario contained in the Combined Report on the Economy and Public Finances, achieving a balanced budget in 2011 and reducing the fiscal burden to 40 per cent of GDP over five years will require primary current expenditure to contract in real terms by about 1 per cent of GDP per year.

Every measure to curb public expenditure involves political and technical difficulties and runs up against deeply entrenched practices and special interests. The recent experience of other countries, such as Germany, nonetheless shows that substantial expenditure savings can be made without jeopardizing the fundamental goals of public action. The analyses conducted by the Technical Committee for the Public Finances indicate that there is scope for savings in many branches of expenditure. Contributions can come from measures to rationalize the presence of central government offices across the country, make managers accountable and introduce methods of assessment that reward the most deserving employees.

Some 30 per cent of the spending on old-age and seniority pensions currently goes to persons aged less than 65. In the medium and long term an increase in the average retirement age, accompanied by determined steps to boost supplementary pension provision, can make a major contribution to reducing public expenditure and help to contain the widening gap between the purchasing power of older pensioners and that of persons in employment.

Some features of the Italian pension system keep too large a proportion of the population from working. In Italy only 19 per cent of people aged between 60 and 64 are in work, as against 33 per cent in Spain and Germany, 45 per cent in the United Kingdom and 60 per cent in Sweden. It is time to remove the constraints and disincentives that stop people on the earnings-based pension system from continuing to work, widen the choice of retirement age for people on the contributions-based system, clear the remaining obstacles to combining earnings and pensions, and encourage flexible forms of employment, with hours that can be adapted to individual needs. This would allow people who have accumulated experience and expertise to continue, if they wish, to put them to use for their own benefit and for the benefit of their families and society.

The development of the Mezzogiorno and fiscal federalism

The quality of public expenditure and of the services it finances is fundamental for the development of the South of Italy, because the ratio of such expenditure to GDP is higher in the southern regions and because the inefficient use of public resources – all too often diverted towards special interests or plundered by organized crime – helps keep the South in its condition of backwardness and economic dependence.

The scope for growth is much greater in the South than in the North. Measures to exploit it can make a decisive contribution to the revival of the entire Italian economy.

In 2007 the ratio of the per capita GDP of the South to that of the Centre and North was less than 60 per cent; it is still lower than thirty years ago. In Germany the per capita GDP of the eastern Länder grew much faster than that of the rest of the country in the last ten years. However, there are large differences within the Mezzogiorno: Abruzzo, Molise and Sardinia are no longer economically backward according to European Community standards.

Average labour productivity in the South is 18 per cent less than that in the Centre and North; the employment rate is 19 points lower. The proportion of irregular employment is still close to 20 per cent, twice the level in the central and northern regions. While necessary, the increased flexibility that has begun to be introduced in recent years in the use and remuneration of labour is not sufficient to overcome the persistent imbalances of the labour market in the South.

The backwardness of the South is influenced by the weakness of the public administration, insufficient trust and cooperation and a widespread habit of ignoring the rules. For southern society to advance, economic intervention must go hand in hand with the strengthening of social capital.

Over the last ten years regional policy in favour of the Mezzogiorno has been able to count on a volume of financial resources comparable to that available for the extraordinary intervention that was discontinued in 1992. The results have fallen short of expectations.

Public expenditure tends to be proportional to the population while revenue reflects per capita incomes and tax bases, which are much lower in the South. The net flow of resources to the South intermediated by the State, excluding interest payments on the public debt, is estimated to be of the order of 13 per cent of the GDP of the South and 3 per cent of that of Italy as a whole. This is a very large amount; for the Mezzogiorno it is also evidence of uninterrupted economic dependence. The ratio to regional GDP is not uniform throughout the South, ranging from 5 per cent in Abruzzo to 20 per cent in Calabria.

Despite this major financial effort, the disparity between the South and the Centre and North in the quality of the public services provided for given levels of expenditure is considerable. Differences are to be found in every sector: from health care to education, from the administration of justice to that of the territory, and from the protection of personal safety to social policies and the creation of infrastructure.

The focus must be shifted from the quantity of resources to the quality of the results. The design and operating procedures of national policies must take account of the disparities between the effectiveness of the same measures in different parts of the country. Whether it is decided to adopt, on a case-by-case basis, systems founded on centralized or decentralized decision-making and administration, if the quality of public action in the South is to be raised, one point holds constant: public action degenerates without a system of independent and transparent assessment providing citizens with clear and comparable information on the quality of services. The level of students' scholastic achievement, the migration of patients to public hospitals in other regions, the length of hospital stays and recovery rates, and the duration of civil cases are examples in fields in which there appears to be the greatest need for objective, systematic and frequent observations with which to measure the progress of individual entities, establish a proper system of incentives and guide the allocation of public resources.

Fiscal federalism will gain more general public acceptance the more it improves the effectiveness of public action. The local authorities, which the Constitution and the law entrust with a growing role, have a special responsibility. It is important that local taxation and expenditure arrangements reward efficiency and direct resources towards the most productive uses and the highest priorities. The extent of regional redistribution of income that is achieved through equalizing flows between central government and local authorities is a political choice; but it is necessary that the rules for determining these flows be simple and transparent and that those who receive funds give a full account of their use. The system of transfers to the local authorities must abandon the historical expenditure criterion, which rewards inefficiency. The key to a sound system of fiscal autonomy is a close relationship between outlays and taxation; ideally, every additional expenditure should be financed by the citizens to whom the authority is accountable. Conditions for this are the existence of broad and stable tax bases, severe restrictions on borrowing and predefined rules for transfers from the centre.

Italian banks

The turmoil in international financial markets has affected Italian banks much less than those of other countries. Write-downs have been limited and profitability has fallen no more than moderately.

The modest importance in their balance sheets of the financial assets hit hardest by the crisis, the limited exposure to financial instruments linked to

US subprime mortgages and more generally to American markets, and the dominant role of retail funding have spared Italian banks the problems of asset quality and liquidity management that have beset financial institutions in other countries. The creation of a more stable financial system has also benefited from a wise legislator and supervision in which support for innovation has been coupled with prudence.

Careful rules on prudential regulation of securitization operations, which have reached a significant volume in Italy as well, were adopted as early as 2000. Capital requirements may be reduced only where transactions actually transfer risk. Non-bank intermediaries, which can originate securitization operations, are subjected by the Bank of Italy to prudential rules and organizational requirements. Italian securitization vehicles are obliged to report the securitized claims to the Central Credit Register. Banks must comply with disclosure requirements in their financial statements.

Since the end of 2006 regulations have been in force under which only intermediaries that have an appropriate organization and effective control systems may engage in activity in structured financial products.

Strict rules do not work against the market but to its benefit, as is seen in times of difficulty. Nevertheless, no supervision, however robust, can eliminate every factor of vulnerability. Organization and capital call for constant attention on the part of banks.

The ability to make an integrated evaluation of all their credit, market and liquidity risks has been the decisive factor behind the success of the banks that in recent months have best weathered the difficulties due to the turmoil in the markets. For every bank it is essential to have an integrated system of management and control, and to identify in advance the interdependencies that suddenly appear in difficult times. The task is all the more urgent for banks that are large, complex and active in sophisticated markets and products. The consolidation of our banking system, which continued in 2007, must be accompanied by a significant acceleration in the integration of networks, organizational structures, IT systems and differing corporate cultures, not least to enable banks to manage the new and complex risks.

At the initiative of the Financial Stability Forum, international discussions are under way to strengthen capital requirements and at the same time mitigate their pro-cyclical effects. The Bank of Italy will ask the banks, in line with the Basel II standards, to increase their capital so as to make it sufficient to face all their risks, particularly those that are hard to quantify; it supports the introduction of instruments that encourage the banks to accumulate excess capital when market conditions are favourable so that they are not forced to shrink their assets in times of crisis.

Dividend policies and all expansion plans must be consistent with a strengthening of banks' capital base.

Supervision

Well before the turbulence hit the market, the Bank of Italy began a thorough review of its methods of intervention, the principles of regulation and its own organization for the performance of its supervisory function.

We have increased targeted inspections, especially for new types of risk. A programme of on-site controls on the leading banks' operations in derivatives was launched in 2006 and intensified last year. On several occasions I have drawn attention to the need for banks, when proposing innovative and complex products to customers, to guarantee the formal and substantial fairness of the transactions, the transparency of conditions and scrupulous compliance with the rules; they must ensure that such products fully correspond to the needs and risk profiles of the customer. Otherwise they expose themselves to legal and reputational risks, and, if market conditions turn sour, to serious counterparty risks as well. Inspections by the Bank of Italy have put an end to irregularities, and in one case we adopted particularly severe measures. We have asked the internal control bodies of all banks to conduct a careful evaluation of the banks' organizational arrangements, operating processes and control systems connected with activity in derivatives. We have devoted special attention to the use of derivative contracts with Italian banks by regional governments and local authorities: these instruments can be misused, with adverse effects on the transparency of balance sheets and often without the risks being properly understood. The Bank of Italy is working with the Ministry for the Economy to draft new rules on the transparency of derivatives contracts signed by local authorities.

The normal quarterly reports on banks' liquidity have become inadequate. Accordingly, we have asked the main banking groups to make a weekly report, which permits continuous monitoring; the liquidity positions of these intermediaries have improved substantially since the turn of the year.

Alongside adequate capital and organization, the third factor of the stability of the banking system is the quality of corporate governance. The new regulations require banks to establish a clear demarcation of tasks and responsibilities between their governing bodies, lay down rules for their composition, enhance the role of the control body, giving it more powers than those envisaged by the general legal framework, require the adoption of reporting flows that ensure that decision-makers are fully informed, and promote correct systems of incentives and remuneration. The regulations, which we issued after an extensive and fruitful consultation, establish general principles and essential implementing guidelines; they do not provide identical solutions for all banks, but demand that the solutions be calibrated to the individual banks' specific situations, in accordance with the principle of proportionality.

In the reorganization of supervisory activities, the decision to create a special unit to monitor relations between intermediaries and customers marks a significant refocusing of the Bank's attention. Even if recent events have reminded us again that savers' primary defence is the stability of the banking system, fairness and transparency in relations with customers constitute an additional, essential safeguard; they are the condition for the full working of competition.

The law entrusts a variety of bodies with tasks for protecting savers and users of financial services in general. The Bank of Italy is responsible for monitoring the transparency of the contractual conditions of deposits, loans and payment instruments. Within the scope of our powers under the law, we act on the basis of a clear principle: fairness towards customers is not only a legal obligation, but also protects stability. In these turbulent months the solid base of retail funding has been an extraordinary strength of the Italian banking system.

Banks themselves have become far more aware that it is necessary to be seen as a fair player, a loyal partner. Public opinion, customers and consumer associations expect ever higher standards of conduct. In recent years, legislatures, governments and regulatory authorities have intervened when the system has been unable to find adequate solutions on its own.

Many issues are still unresolved. The rules on the early repayment and transfer of mortgages have been slow to be put into practice, owing in part to difficulties of application. In April the Bank of Italy urged the banks to come into full compliance, by shortening the time and reducing the formalities required, and introduced specific requirements to inform customers of their rights; the Competition Authority began inquiries into possible commercial malpractice.

The Government has recently adopted a measure, to be finalized in agreement with the banking system, to facilitate the renegotiation of variablerate mortgages in order to stabilize the size of repayment instalments. Debt restructuring could provide relief to households and possibly benefit the banks as well, by reducing the number of defaults. The effects of the measure on the market in existing securitizations will need to be carefully scrutinized. In any event, the broadest possible scope must be left for competition to offer customers the best possible terms.

In the past we have already called attention to the commission on the maximum current account overdraft, which is hardly defensible in terms of transparency. Where the nature of the credit relation requires, this charge should be replaced by a commitment fee commensurate with the amount of credit granted, as in other countries. This innovation will require a complex adaptation of banking practices, but it should be undertaken with resolution, proposing the modification to new clients, not least to avert the risk of a mandatory solution imposed by law.

Developing a good system for the out-of-court settlement of disputes could help significantly to improve relations between intermediaries and customers. The consultation with the relevant stakeholders has now been concluded, and the Bank of Italy will submit a proposal to the Interministerial Committee for Credit and Savings to regulate a new ombudsman system in implementation of legislation.

Our survey of the costs of current accounts shows that banks offer especially competitive terms mainly to new customers; vis-à-vis existing customers, inertia reigns. The banks need to simplify the structure and terms of contracts. Any moves that the banking system makes in this direction are to be encouraged. The survey will be repeated in 2008.

Asset management

The decline of Italian investment funds has not halted. Open-end funds recorded net redemptions of 52 billion euros in 2007 and over 30 billion euros in the first quarter of 2008 alone. It is evident that the system for marketing financial products is inadequate to customers' requirements. The prime need is for advice, for help with making the choices that have to be made by those savers who, more than in the past, are now asked to provide for their future by means of financial investment, steering a path among a multitude of products that are often difficult to evaluate. The cost of better services to customers could be covered out of the ample earnings of the distribution networks.

There is a widespread perception among intermediaries themselves that the present structure of the industry needs to be changed. Some banking groups have decided to relinquish control of their investment fund management companies. Having a multiplicity of placement channels will yield benefits. However, it is also necessary to revise the rules of conduct of distributors in order to ensure that customers' rights are observed and to weaken the incentive to maintain closed distribution structures, thereby reducing position rents.

The working group organized by the Bank of Italy and involving the participation of authorities and firms active in the industry has found broad consensus on the main problems: drawing a clear line between product placement and advice, ensuring the independence of boards of directors from the parent company, adopting uniform standards of information transparency for all types of financial product, and eliminating the tax disadvantage of Italian investment funds. The group will set out proposals for urgent measures, some of which are within the competence of the technical authorities themselves, while others will need to be submitted to the Government and Parliament.

* * *

The financial turmoil that swept over the major advanced economies brought to an end a long period of growth, low inflation and plentiful credit. It is too early to say that it has passed: the write-down in asset values by the major banks involved has been much more rapid than in previous banking crises, but these past episodes teach us that initial estimates of their cost may be far exceeded by reality. And it is too early to assess fully the impact on the real economy: much will depend on the scale and speed of the recapitalization that is under way at the leading international financial institutions.

One thing is certain, however: the European monetary union, whose central bank celebrates its tenth anniversary tomorrow, has shielded its members from the worldwide turmoil. We still have vivid memories of the periodic currency crises that afflicted the lira whenever the markets sneezed.

Our banks have withstood well the onslaught of the crisis in recent months: the effect on their assets has been only marginal, their balance sheets are soundly based on fund-raising from customers. The banks bear a special responsibility. With a single monetary policy, it is predominantly the terms, quality and volume of credit, and hence the banks, that determine the specific financial conditions for the majority of enterprises in the various member countries. Since the introduction of the euro, they have become even more important than in the past as a determinant of the competitiveness of the country. A careful assessment of creditworthiness, transparency in customer relations and a dynamic approach towards customer assistance must be the main elements in their strategy.

Italy has the will, the ambition and the resources to return to the path of growth; it knows that, over the long term, growth is an essential precondition for financial stability. Its history demonstrates that there is nothing inevitable in the crisis of growth that has paralyzed it for years. The actors in the recovery must be those who hold the future in their hands: the young, who today are let down by the inadequacy of the education system, by a labour market that discriminates in favour of older people, and by an economic system that too often does not reward merit or value ability. There is broad agreement on the action to be taken, but it clashes with the vested interests that have written the script of our impoverishment in recent years. Political stability and strong institutions are the foundation on which to build the corrective measures. Their implementation will require the commitment of all the energies the country possesses. The reward is the resumption of lasting growth.