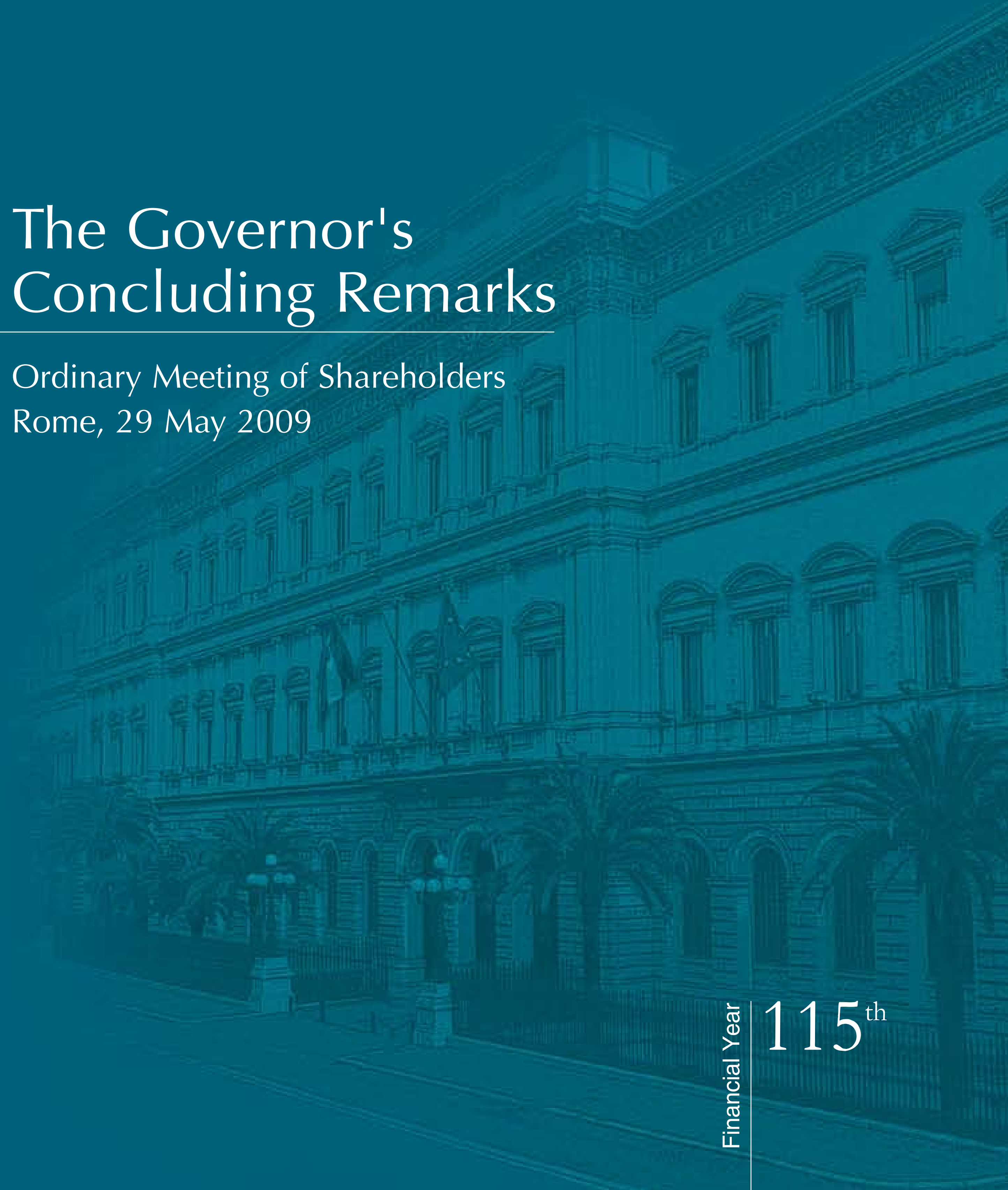
BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Ordinary Meeting of Shareholders
Rome, 29 May 2009



115th FINANCIAL YEAR

2008

Financial Year 115th

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Ladies and Gentlemen,

The reorganization of the Bank is going ahead as scheduled. Eighteen branches have already been closed and others will cease operations over the coming months. By the end of this year, 58 of the original 97 branches will still be operational, including 6 specializing in banking and financial supervision and 25 assigned, with a streamlined structure, to the State treasury service and to providing information services to the public. Banknote production will be reorganized, with the agreement of the trade unions, in order to expand output and increase efficiency.

Following the absorption of the Italian Foreign Exchange Office, for more than a year the Bank of Italy has had the function of combating money laundering through a Financial Intelligence Unit that operates within the Bank but with special autonomy. It has been endowed with substantial resources and expertise. In carrying out its tasks, the FIU has developed fruitful synergies with the banking and financial supervision area. This benefits the stability and the reputation of the banking system. The Unit cooperates closely with the judiciary and with the Finance Police, to which a constantly growing stream of complaints and reports are submitted.

This January Antonio Finocchiaro left the Governing Board to assume the office of chairman of the Pension Fund Supervisory Authority. In the course of a long career, Mr Finocchiaro served the Bank of Italy with rigour and dedication, making important contributions in a diversity of fields ranging from the original development of the Bank's IT system to the management of human resources and trade union relations, to operational organization and management. Let me offer him my most affectionate and grateful salutation. His place on the Governing Board has been filled by Anna Maria Tarantola, former Managing Director for Banking and Financial Supervision.

The Bank's staff last year faced an extraordinary commitment, commensurate with the difficulties of the economic and financial crisis we are experiencing and the exceptional response required at every level. The earthquake in Abruzzo has posed a painful additional challenge. All are responding with self-sacrifice, putting the great professional and human qualities that distinguish our team to the best possible use. I thank all of them on behalf of the General Council and the Governing Board.

The question of the Bank's ownership structure remains to be dealt with. For over seventy years now the present arrangements have ensured the independence and decision-making autonomy of the central bank. However, the evolution of the structure of the banking system has brought to light a formal anomaly that it is advisable to remove. We are prepared to design, together with our shareholders and with the Government, a solution that will work to the benefit of the entire system.

The global crisis

Since mid-March tensions in the financial markets have eased and share prices, despite fluctuations, have recovered, returning to the levels recorded at the beginning of the year; the qualitative indicators of the real economy point to a subsidence of recessionary pressures.

These are encouraging signs. The likelihood of deflation, in the sense of a protracted decline in the general price level, now appears slight, also because longer-term inflation expectations remain close to 2 per cent. However, in view of their seriousness, the persistent risks to the unfolding economic scenario require that the economy continue to be supported decisively using all available instruments. There is awareness of the need to prepare in advance strategies to reabsorb the large budget deficits and exceptional liquidity creation that characterize the current situation.

It is not yet possible to point with certainty to a definitive cyclical inversion: the forecast is for a return to growth in 2010. The general expectation is for falling levels of employment and revenue, accompanied by continuing volatility in the financial markets, with adverse effects on consumption and investment.

The task of economic policies is to attenuate the negative spiral of unemployment and consumption. The response has been prompt, vigorous and coordinated at the international level. Up to now there has been no sign of a significant resumption of protectionism.

Official interest rates have been cut drastically in all the main economies. Between October 2008 and the beginning of May, the Governing Council of the European Central Bank lowered the rate on main refinancing operations by 3.25 percentage points, to 1 per cent, the lowest level ever reached in the euro-area countries.

The reduction was reflected in market rates: the three-month Euribor rate is currently 1.3 per cent, over 4 percentage points lower than in the first ten days of October. Twelve-month interest rates in euro are aligned with those in dollars and slightly lower than the sterling rates.

The expansionary measures taken by all the central banks significantly enlarged their balance sheets in ways that reflect differing national financial structures. Bank credit in the euro area is relatively more important than in the United States (around 140 per cent of GDP compared with 60 per cent). Accordingly the Eurosystem has so far focused on banks.

The introduction in October last year of a system of bank funding at a fixed rate, limited only by the availability of collateral, was a highly important development; this, along with other measures, enabled banks to meet their liquidity requirements in a situation of money market paralysis. It also provided certainty regarding the rate they would have to pay for a much longer period than in the past: the maturities of longer-term refinancing operations were extended up to six months and, from next June, to twelve months. Against these loans banks can now post as collateral a much broader range of securities than were previously eligible.

A global systemic collapse was averted, but neither monetary expansion nor the effect of built-in stabilizers in government budgets could fully counter the fall in aggregate demand and the social costs of the recession.

Since last autumn international organizations have been emphasizing the need for decisive discretionary budgetary measures, coordinated internationally and involving all the main countries. The Council of the European Union called for stimulus interventions totalling 1.5 per cent of the euro-area GDP in 2009.

In all the industrial countries and in many emerging economies, first and foremost China, the fiscal policy response has been markedly expansive. The size, duration and makeup of the interventions have varied, reflecting in particular the uneven impact of the crisis, the initial state of the public finances and the scale of built-in stabilizers. The simultaneity of the stimulus measures adopted enhances their effectiveness.

According to recent estimates by the International Monetary Fund, in 2009 the fiscal deficits of advanced countries will reach almost 9 per cent of GDP, then fall by 1 percentage point in 2010. Between 2008 and 2010 government gross debt is forecast to increase by 27 percentage points of GDP in the United States, to almost 100 per cent, and by 16 percentage points in the euro area, to 85 per cent.

The need to place massive volumes of government securities on the market in the next two years puts upward pressure on interest rates; these will intensify with the easing of the recession and attendant rise in demand for private debt securities, checking the recovery of the economies. Once the crisis has passed, the public debt must be reduced sharply.

However, history teaches us that without the restoration of the banks to health and without the resumption of credit flows, the recession will be more drawn out and the recovery slower, despite the exceptional expansion of budget deficits.

After the failure of Lehman Brothers last September, government interventions to guarantee bank deposits and liabilities and to support recapitalization prevented additional collapses; they were insufficient to avert a contraction of credit. Financial markets are still struggling to become fully functional again. Risk aversion remains high.

Worldwide, in the past two years banks have recorded losses of over $1,000 billion in their balance sheets. Just under half of the funds used to rebuild their capital base came from government intervention.

Looking ahead, banks' capital requirements must be met by reactivating the market. This depends on the total transparency of banking assets. The cloud of uncertainty that continues to hang over banks' balance sheets limits the inflow of private capital, increases the level of capital ratios demanded by the market and makes the incentives to reduce assets more stringent.

Action must be taken to re-establish the certainty and credibility of the asset side of bank balance sheets. The measures announced by a number of countries to insure or transfer to separate entities part of their assets can prompt the emergence of the most problematic securities. But to restore confidence in the major international financial institutions, there remains the need for a full, internationally coordinated, consistent, rigorous and transparent stress testing of banks' balance sheets, which has already been launched in the United States and is being prepared in Europe.

Promoting financial stability

The crisis is rooted in distortions in the markets' functioning, regulatory and supervisory shortcomings and the conduct of intermediaries in the world's leading financial centres. The exceptional liquidity that flowed into those centres as a result of the prolonged disequilibria in savings rates and payments balances contributed to keeping interest rates, volatility and the cost of protection against insolvency at abnormally low levels. This led to a general underestimation of risk with a consequent overvaluation of financial assets and real estate. The defects in regulation and the management of risk by the world's largest banks were concealed. An accommodating monetary policy contributed to the artificial dilation of financial volumes and permitted the continuation of a situation rendered fundamentally unstable by the distortions and shortcomings mentioned above. The market rejected economic policy interventions despite their timidity; blinded, it lost its diagnostic capacity, its self-correction mechanisms were paralysed.

A financial system that combines innovation and solidity, profit and support for households and firms will have to have more rules, more capital and less debt. The global strategy that is emerging is based on three pillars: the international financial institutions, the regulatory authorities and the central banks.

The International Monetary Fund has taken on a crucial role; its resources have been more than doubled and its ability to intervene has been enhanced. Today the IMF can support countries in difficulty, especially the emerging economies that are suffering most from the adverse economic cycle; the Fund's assistance in managing imbalances is preventing the systemic propagation of the crisis. The IMF, together with the Financial Stability Board, has been entrusted with analysing and signalling threats to the stability of the global financial system. It is encouraging that the leading countries have at last accepted periodic IMF examination of the soundness of their financial systems.

More rigorous multilateral surveillance than in the past will contribute to the global consistency of national economic policies. But the orderly correction of current account imbalances will have to hinge on a world capital market that is fully functioning and free from defects in regulation and control.

This belief underlies the establishment by the G20 Heads of State and Government of the Financial Stability Board. The new body has a broadened membership and mandate by comparison with the Financial Stability Forum; in April 2008 the latter had produced the first report on the steps to be taken to overcome the shortcomings of regulation. The Board is now responsible for monitoring national authorities in the application of those recommendations, coordinating the many committees of regulators and accountants that determine the standards for banks, and proceeding with the establishment of international colleges of supervisors for the largest financial institutions. More rigorous capital and liquidity requirements, the extension of the scope of regulation to non-bank institutions, the completion of Basel II and amendment of the accounting rules in order to reduce their procyclicality, and more demanding supervision and regulation for institutions whose size makes them a systemic risk; these are the measures describing the path of the Financial Stability Board's work in the coming months.

The Italian presidency of the G8 is conducting the work to set global standards for the transparency, propriety and integrity of international economic and financial activity.

The crisis has considerably broadened the consensus on the need for central banks to expressly include financial stability among their objectives; restricting their task to taking corrective action after a crisis is no longer deemed sufficient. The idea is gaining ground that the functions of monetary policy and supervision reinforce each other. The debate on these issues is complex and far from over.

In Europe the revision of large parts of the system of banking and financial supervision is already under way. The fundamental aspects of this process appear correct; in some points it needs to be strengthened.

The assignment of supervisory tasks aimed at systemic stability to a European council is a good idea if it has real powers of intervention and operates in close coordination with the national supervisory authorities.

In at least some areas the common supervisory standards should be binding and directly applicable at national level. It is necessary to harmonize deposit guarantee systems and the mechanisms for crisis management.

The repercussions of the crisis in Italy

According to the latest forecasts, the world crisis will cause GDP to fall in Italy by about 5 per cent this year, after decreasing by one per cent in 2008.

The collapse of foreign demand has triggered a sharp contraction in industrial production and investment. The reaction of firms, especially those most exposed to the international cycle, was immediate: the temporary closure of entire factories and production lines; temporary and permanent reductions in the workforce; postponement of purchases of intermediate and capital goods; and unusually long delays in paying suppliers. In the six months from October 2008 to March 2009 GDP fell by more than 7 per cent on an annual basis compared with the previous six months.

The recent signs of an easing of the most acute phase of the recession come from the financial markets and opinion surveys, more than from the statistics available to date on the real economy. For a return to sustained growth there must be a stable recovery of the world economy, the weakness of the labour market must not have an even more severe impact on domestic consumption, and the structure of our productive system must be strengthened.

Employment and consumption

Among the prudential measures that firms have taken to cope with the recession, those involving labour have been of three types: a reorganization of shifts and working hours and a freeze on hiring; recourse to the Wage Supplementation Fund; and non-renewal of fixed-term contracts and layoffs of permanent employees. Nearly all firms have used measures of the first type. Ordinary wage supplementation was also used extensively, quickly reaching the peak levels recorded in the 1992-93 recession; the cover it potentially provides is nonetheless limited – one third of payroll workers in the private sector – and it provides workers with a maximum monthly benefit that is less than half the average gross earnings in industry. It is estimated that two fifths of the industrial and service firms with 20 or more workers will reduce their staff this year; the reduction will probably be most pronounced among the smallest firms. More than 2 million fixed-term workers will see their contracts expire this year; more than 40 per cent work in private services, nearly 20 per cent in the public sector; 38 per cent work in the South.

Workers on wage supplementation and job seekers already amount to about 8.5 per cent of the labour force, a share that could rise above 10 per cent. Households' disposable income and consumption are expected to go on falling, despite the substantial decrease in inflation. The governmental measures in favour of less well-off households and the incentives for the purchase of durable goods are providing temporary support.

A first risk of the current cyclical phase is a sharp reduction in domestic consumption, to which firms could react by further restricting their purchases of capital goods and inputs.

Firms and the crisis

Thanks to the commitment of our regional branches, we have conducted a particularly thorough survey of the state of the Italian economy, the difficulties that firms are encountering and how they are reacting to the crisis.

Expectations of a sharp fall in turnover (of more than 20 per cent according to many firms) and great uncertainty as to the duration of the crisis have caused investment plans for this year to be reduced by 12 per cent in industry and services overall and by more than 20 per cent in the manufacturing sector – exceptionally high figures by historical standards.

Restructuring in large parts of the economy began in the first half of this decade. Prior to the crisis, some positive results were already visible in terms of productivity and competitive strength on foreign markets, but these difficult times jeopardize the process.

According to our survey, about half of the 65,000 industrial and service firms with 20 or more employees are engaged in restructuring. They expect a much smaller than average drop in turnover in 2009. At one extreme, the more financially solid among them are now buffering the impact of the recession by consolidating their technological edge and diversifying their outlet markets. There are a fair number of such firms, we estimate more than five thousand, employing nearly a million people. Some appear ready to take advantage of the crisis by repositioning themselves in the market. At the other extreme lie the firms that, having decided to grow in size and technological intensity, and to open up internationally, had taken on debt. Now, with the crisis, they are faced with the drying up of cash flows, more rigid bank credit, and considerable problems in accessing capital markets. At least six thousand companies, once again with almost a million workers, are affected in this way.

The effects of the crisis are being felt above all by firms with fewer than 20 workers. In manufacturing alone there are nearly 500,000 such firms, employing just under two million workers. The very survival of those subcontracting for larger firms that are cutting orders and deferring payments is sometimes at stake.

The coming months will be decisive; excessive mortality due to financial strangulation of too many companies that have the potential to prosper after the crisis has passed is a second, serious, risk for the Italian economy.

Financing the economy

The deterioration of the economy tends to curb bank lending. In April the quarterly rate of growth of credit to non-financial firms was nil; it had been 12 per cent a year earlier. Lending to households has also continued to slow.

A part of the deceleration can be explained by a decline in manufacturing and real estate investment and in the consumption of durable goods. But the supply of bank lending has also been curtailed, mainly owing to difficulties in raising medium and long-term funds and to the increase in credit risk.

Our survey found that the loan applications of 8 per cent of firms were rejected – the highest figure since the mid-1990s; it was less than 3 per cent a year ago. Over 10 per cent of firms state that since last October they have been asked for early repayment. This happens more frequently in the South of Italy but affects the whole country and even some larger companies.

Banks cannot be asked to be less prudent in granting credit; a banking system that risked the integrity of its balance sheets and the confidence of those who entrust their savings to it would not serve the interests of the economy. What can, and must, be asked of our banks is to improve their ability to recognize creditworthiness in the present, exceptional circumstances. Special attention must be paid to the longer-term prospects of the firms that apply for financial assistance. When evaluating and making decisions, banks must take account of technology, organization and the dynamics of firms' main markets.

The Government's recent initiatives to increase the Guarantee Fund for small and medium-sized firms can strengthen banks' support to smaller companies.

Consideration should also be given to the possibility of making a public loan guarantee scheme available to a broader range of firms, as in other countries, for a limited period of time and with safeguards to reduce distortions in resource allocation.

However, it is also important to reactivate the Italian securitization market; if properly structured these instruments will remain a key channel for financing. The less risky *tranches* backed by portfolios of mainly newly-granted loans could be covered by government guarantee. The State would not be required to make an immediate outlay of funds and its guarantee would be adequately remunerated.

Anti-crisis measures

Economic policy currently presents more difficulties in Italy than in other countries. Action to bolster demand is restricted by government debt from the past. Measures taken to date to mitigate the social costs of the recession have relied mainly on funds allocated to other purposes.

But firm and credible action to set the public finances right within an agreed time frame can provide scope for a more incisive economic policy.

The first concern is the danger of a further deterioration of labour market conditions. The crisis has highlighted long-standing deficiencies in our system of social protection, which continues to be fragmented. Otherwise identical workers are treated differently only because they are employed in a craft firm rather than in a larger company. It is estimated that 1.6 million employees and quasi-employees have no right to any assistance if they are dismissed. More than 800,000 full-time workers in the private sector, that is 8 per cent of potential beneficiaries, are entitled to an allowance of less than €500 a month.

A good system of social buffers for the unemployed that balances out financially over the economic cycle lifts some anxiety from workers, supports consumption, improves mobility between firms and sectors, and helps re-direct individual skills into more productive employment. Well-defined, non-discretionary assistance, conditional upon engaging actively in a job search – stronger controls being essential here – increases people's sense of security, gives their life-plans substance, and makes it less necessary to save for a rainy day; it narrows the disparities between workers with and without safeguards.

In a welcome move, the Government has already included temporary income support among its anti-crisis measures, including in the case of shut-downs in companies not covered by the Wage Supplementation Fund. It has also made provision for experimental measures in favour of some quasi-employees.

The time is ripe for a rigorous, comprehensive reform that will rationalize the current system of social buffers and provide more universal benefits. There is no need to overturn the existing system. It can be re-designed around the two traditional instruments of the ordinary Wage Supplementation Fund and unemployment benefits, suitably adjusted and graduated. These should be accompanied by income support for the cases they do not cover, as happens almost everywhere else in Europe and as proposed in the Government White Paper. A form of tax credit could be considered for those on low wages: this system has been successfully adopted in many countries and could help to regularize informal employment.

Among the anti-crisis measures for the productive system, priority must go to action to ease firms' financial problems, such as the plan of intervention being drawn up with the assistance of Cassa Depositi e Prestiti and SACE, the export credit insurance agency. Additional and more direct support could be provided by cutting payment times for general government trade payables, which amount to about 2.5 per cent of GDP. A further move would be made in this direction by temporarily suspending the requirement to pay into the National Social Security Institute, INPS, the part of contributions to severance pay not allocated to a pension fund, amounting annually to 0.3 percentage points of GDP. While both actions would entail greater recourse to the financial markets, neither would worsen the central government's net financial position.

Measures to stimulate private investment in residential property, which it is hoped will be introduced in suitable form very shortly, will assist the recovery of capital accumulation. Existing building work should be completed at the earliest opportunity and encouragement should be given to local projects, many of which are fairly small and could be launched without delay.

The adjustment of the public finances and structural policies

The recession is slowly producing an effect on the tax yield: having decelerated for most of 2008, it fell during the last two months. VAT receipts decreased by 1.5 per cent in the year as a whole, compared with an increase of 2.3 per cent in consumption, partly due to the shift towards essential goods carrying a lower rate. In the first four months of this year, VAT receipts were down 10 per cent on the same period of 2008. Revenue from corporate income tax, which dropped by more than 9 per cent in 2008, could fall by a still larger amount this year. Only the revenue from personal income tax is holding up.

The action of built-in stabilizers is likely to raise the public deficit by around 2 percentage points this year, to more than 4.5 per cent of GDP. In 2010 the deficit could exceed 5 per cent.

Even without additional measures to support the economy, by the end of the crisis the public debt will have increased considerably in terms of GDP, back to the levels of the early 1990s. The ratio of primary current expenditure to GDP, which in 2008 reached the highest value recorded since the Second World War, will rise by 3 percentage points in 2009. Total public expenditure will be well over 50 per cent of GDP, and unless steps are taken it will tend to stay at that level in the years to come. There is a danger that the economy will have to bear the burden of extremely heavy taxation for many years.

After the crisis has been overcome, Italy will find itself not only with more public debt but also with an endowment of private capital – physical and human – impoverished by the sharp drop in investment and the rise in unemployment. If we were to do no more than return to a low growth path like that of the past 15 years – starting, moreover, from decidedly worsened conditions – it would be difficult to pay down the debt, while the necessity for restrictive policies to ensure its sustainability would become more stringent.

We must aim, immediately, at achieving faster growth in the medium term. It is necessary to act on two fronts: to ensure the consolidation of the public finances and to implement the long-awaited reforms that will enable our economy to be an active partner in the world economic recovery.

The measures reducing current expenditure must be introduced into legislation immediately, even if the effects are deferred, not put off to further legislative acts or administrative decisions. In many cases this simply means proceeding more resolutely on the courses already embarked upon.

The gradual raising of the average age at retirement will guarantee adequate pensions. A higher employment rate among those between the ages of 55 and 65 will increase both households' disposable income and the economy's potential output.

In 2008 occupational pension funds recorded negative yields of 6 per cent and open funds lost 14 per cent. These results must not induce us to modify the process launched in the early 1990s to foster the development of a second, funded retirement pillar. In the long run a mixed system is preferable to a straight pay-as-you-go system. Nevertheless, some adjustments and additions may be advisable. It is necessary to encourage the introduction of products that automatically diminish the riskiness of portfolios as retirement nears and to offer securities allowing for better management of risks over the long term.

The implementation of fiscal federalism must make a contribution to curbing government expenditure. By strictly linking spending and taxation decisions, without forgoing the principle of solidarity, it can lead to more efficient use of public resources. A crucial feature of the reform enacted by Parliament is the replacement of historical expenditure by standard costs as the criterion for the assignment of resources to local authorities. Until now the reference to historical expenditure has made public budgets more rigid, institutionalizing inertial mechanisms in expenditure trends.

Much is expected from the planned reform of the public administration. The breadth of the plan, the emphasis it places on transparency and on the measurement of government performance and the recognition of merit are all important elements of change. The efficacy of the reform will depend on the design of evaluation systems and on the organizational rules adopted.

Progress has been made in simplifying and reordering regulations and in reducing red tape, in particular for business start-ups. Yet new regulatory provisions continue to be both complex and opaque. The bureaucratic costs for business activity remain high, with substantial differences from region to region.

Regulatory simplification and effective public action are necessary conditions for reducing the incidence of the underground economy, which is estimated to account for more than 15 per cent of overall economic activity in Italy. The concealment of a considerable proportion of the tax base increases the burden on law-abiding taxpayers. It undermines the competitiveness of the majority of firms, creates inequities and disrupts the social fabric. Progress in fighting underground economic activity would make it possible to lower official tax rates, attenuating distortions and unfairness.

It is necessary to improve the quality and increase the quantity of human capital and physical infrastructure. Last year on this occasion I dwelt on the urgent need to elevate educational attainment in our schools and universities. The drive for reform in this area must proceed and intensify. Physical infrastructure is a crucial factor in competitiveness. In the last twenty years the gap between Italy's infrastructural endowment and that of the other leading EU countries has more than tripled. As regards major public works, the failure to set long-term priorities has resulted in discontinuity and the dissipation of funds on a multitude of projects. The list of high-priority strategic infrastructures, originally 21, has now swollen to over 200. The time and the costs for high-speed rail lines and motorway network extensions, and even for short road links and bypasses, are far greater than in other European countries. A kilometre of motorway can cost over twice as much as in France or Spain. The causes are the uncertain attribution of powers and jurisdiction between national and regional government, poor initial cost estimation and shortcomings in reporting and continual project alterations. Regulatory defects limit recourse to project financing.

The process of liberalization undertaken in years past must not halt or retreat. In the countries where services are less liberalized, the growth problems of technologically advanced industries are more severe. Local public services are an example of the way in which the absence of regulation entrusted to bodies that are competent and independent of the service providers can engender inefficiency and higher costs for consumers.

The crisis and the banks

In the recent past the Italian banking system underwent a major transformation, spurred by heightened competition. A large number of mergers and acquisitions, by increasing the average size and efficiency of Italian banks, helped to improve their resilience in the face of the crisis.

The crisis caught the Italian banking system at a time when reorganizations were being completed, new forms of governance were being tested and the presence in foreign markets was being expanded. The system remains characterized by the clear prevalence of credit intermediation activity in favour of households and firms, strong local roots and a generally balanced structure of assets and liabilities.

The impact of the crisis on the banks has been less traumatic in Italy than in other countries, thanks above all to a limited exposure to structured finance products and lesser reliance on wholesale funding. At the end of 2008 structured credit instruments represented just under 2 per cent of the assets of the main banking groups. Wholesale funding made up 29 per cent of total funding for our system, against an average of 41 per cent in the euro area.

A fundamentally sound model of intermediation, together with a particularly prudent regulatory framework and supervisory approach, has shielded Italian banks from the most devastating effects of the market turbulence. Taxpayers have not been saddled with the costs of losses and bankruptcies seen in other countries.

The banking system is not immune to the consequences of the crisis, however. Italian banks' profits contracted sharply in 2008. The return on equity of the largest groups fell by 5 percentage points.

Lending rates have come down rapidly since October. The average initial rate on new variable-rate mortgage loans to households declined from 5.6 per cent to stand at 3.7 per cent in March. Interest rates for fixed-rate mortgages have also fallen swiftly; the differential that still existed at the beginning of last year between Italy and the euro-area average has narrowed considerably. For short-term loans to firms, the reduction in rates between October and March averaged about 2 percentage points. But it is also true that the risk and rate differentials between borrowers have widened: the difference between the cost of new loans of limited amount and that of high-value transactions has grown; the disparity in borrowing costs between small and large firms has increased. Those now in greatest need of credit suffer from this.

Bad debts and loans classified as "substandard", that is to say in temporary repayment difficulty, are growing rapidly. The lesson of experience is that the recession will continue to affect loan quality even two or three years after the cyclical upturn.

In Italy, unlike other large countries, writedowns to loans are immediately tax deductible only up to 0.3 per cent of the amount of total lending; the portion exceeding that amount is deductible over 18 years. The rule becomes especially stringent in this recessionary phase, in which the pressure to curtail lending in order to satisfy capital requirements is mounting.

Banks' capital

Despite the decline in profitability, banks have maintained capital above the minimum standards. The average ratio of capital to risk-weighted assets was 10.4 per cent for the largest groups at the end of last year. The higher ratios found abroad often reflect massive injections of public capital. By international standards, leverage, measured by the ratio of total assets to core capital, is lower in Italy.

The Bank of Italy assesses capital adequacy with stringent criteria. Instruments of lesser quality make up 13 per cent of the core capital of the five largest Italian banking groups, compared with 22 per cent for the 15 largest euro-area banking groups.

Stress tests, which evaluate resilience in the face of markedly unfavourable economic developments, have become a practice in supervisory action since 2005, when the International Monetary Fund conducted its Financial System Stability Assessment for Italy.

We have just completed an aggregated exercise to estimate the impact on banks' balance sheets of a deterioration in the quality of credit exposures to Italian households and firms in the two years 2009-10 under assumptions of more adverse macroeconomic conditions than those foreseen for Italy by the main international organizations.

The results of the exercise indicate our banking system's ability to hold up, even under more adverse scenarios.

But I have already let it be known on several occasions that capital strengthening is a priority for the banking system. It is not only a question of increasing the buffers safeguarding stability. Capital strengthening is essential in order to compete with the leading intermediaries; it is also a necessary although not sufficient condition to maintain the flows of credit to the economy.

This is why in the present phase it is also necessary to limit the distribution of profits. Many banks have done so. The sacrifice shareholders are being asked to make today is compensated for by the greater solidity of their investment.

The markets have reacted positively. Compared with mid-March, the premiums on the credit default swaps of the largest Italian banks have fallen by more than half, a significantly greater decline than the average reduction recorded in Europe.

The effort must continue. The public instruments for capital strengthening envisaged by law are now available. The intervention of the state is temporary; the private shareholders will have to replace the public funds as soon as market conditions permit.

* * *

These concluding remarks were written in the throes of a general crisis that has catapulted the world into perhaps its gravest difficulties since the middle of the last century. The wound that has been inflicted upon the public confidence – confidence in the markets and their protagonists, in the future of millions of people, in the social compact that binds us together – has to be healed.

Overcoming the crisis means rebuilding that confidence. Not by means of artifices but with the patient, laborious effort to understand what has happened and what future scenarios are possible; and with the consequent action. Much has been done. It is not the work of a day. Much remains to be done: to create jobs again, to restore vitality to firms, to repair the financial markets, to earn the citizens' trust.

The Bank of Italy, both at home and in international fora, is engaged in improving the regulatory framework and detecting the vulnerabilities and risks of banking and financial business. We shall continue to improve supervision. We must progress in our action to safeguard a system that so far – thanks in part to that action – has withstood the crisis better than others.

Every country faces the crisis with its own special strengths and its weaknesses, its own history. There is a national aspect to the response: for Italians, the repercussions will be more or less severe depending on our own choices. In the last twenty years our story has been one of stagnant productivity, low investment, low wages, low consumption and high taxes. We must lift our gaze from the present woes to take the longer view. An effective response to today's emergency is possible only if it is accompanied by the sort of conduct and reforms that can raise our growth above the low path of recent decades.

Italian banks' balance sheets are not weighed down by a legacy of impaired assets. Let them exploit this advantage over their competitors to face a present and a future that will not be easy; show foresight in assessing their customers' creditworthiness; follow the example of the bankers who financed the reconstruction and the economic boom of the 1950s and 1960s. Let firms strive to continue the rationalization they began just a few years ago;

safeguard the accumulated skills of their workers, which will be invaluable again in what we hope is a not too distant future. The completion of the country's social buffers, the resumption of public investment and the actions to sustain demand and credit that have been outlined today will have the desired effects if they are coupled with structural reforms – not just in order to be able to tell the markets that the deficit is under control, but because these reforms are the foundation for future growth.

Confidence cannot be rebuilt with false hopes. But neither can it be restored without hope. Surely we can emerge from this crisis stronger than before.