BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Ordinary Meeting of Shareholders
Rome, 31 May 2012

118th FINANCIAL YEAR

2011

Financial Year 118th

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Ladies and Gentlemen,

I take the floor at this meeting for the first time in trying days for our country and for Europe. Days in which we must all – government, institutions and individuals – perform our roles with care, to the best of our ability, because only if everyone does their duty can a solution be found to the crisis we are experiencing. This is the spirit in which the consequences of the grave and tragic earthquake that has hit the region of Emilia must be tackled. As on similar occasions in the past, the Bank will not fail to provide assistance.

The Concluding Remarks bring to a close the Bank of Italy's Report, which every year covers the international and Italian economy and our own activities; in it we have deployed our analytical skills. Referring to the Report, I shall give an account, in particular, of the activities specifically entrusted to us: to contribute to drafting and implementing the common monetary policy, financial regulation and supervision.

On 1 November last year Mario Draghi took up the post of President of the European Central Bank. He had been appointed Governor of the Bank of Italy by decree of the President of Italy Carlo Azeglio Ciampi at the end of 2005, at the culmination of a difficult period in the history of the Bank and of our financial system. During these years, his efforts, including in the demanding role of Chairman of the Financial Stability Board, brought prestige to our own institution and strengthened its reputation both in Italy and abroad. His direction was essential for the formulation of European monetary policy, for our supervisory action and for the modernization of the Bank's organization and method of operation. The Board of Directors has appointed him Honorary Governor. The Bank of Italy and the country owe much to him.

One of his first acts, in 2006, was to propose Fabrizio Saccomanni for the position of Director General. In that role Fabrizio supported him with his intelligence and his wide experience, participating in person in every major undertaking of the Bank, starting with the logistical and organizational reform of the head office and branch network. I wish to thank him for the invaluable contribution he has continued to make in recent months in running the Bank. The challenges we now face, and will continue to face together, are very demanding. We will devote all our abilities, our utmost efforts, to overcoming them in the interest of the Bank and of the country.

In January, Salvatore Rossi, formerly Secretary General and before that Managing Director for Economic Research and International Relations, was appointed Deputy Director General, joining Giovanni Carosio and Anna Maria Tarantola on the Bank's Governing Board. Our diverse experience, knowledge and aptitude contribute to the collegial nature of our activity.

The Bank's balance sheet shows total assets of €539 billion at the end of last year, 60 per cent more than the year before, partly as a consequence of the unconventional Eurosystem monetary policy operations we carried out. Thanks to the containment of operating costs, gross profit rose to €3.6 billion: €1.4 billion of this was transferred to the provision for general risks; €1.1 billion was paid in taxes; the Board of Directors allocated 40 per cent of the remaining €1.1 billion of net profit to the ordinary and extraordinary reserves and 60 per cent to the State.

For a long time we have been working to improve the Bank's organization, simplifying procedures, rules and work methods and making use of technological innovations.

In 2011, a new strategic planning system, with a three-year time horizon, was put into effect. Our priority objectives are more effective internal and external communication, closer integration between operations management and information technology, and social responsibility. Specific action plans establish the timing of programmed interventions.

The reorganization of the head office continued last year as well. A coordinating unit was set up to reinforce the Bank's action in the field of financial stability. A new unit was formed within the Supervision Area, devoted to promoting the financial education of the public. The areas dealing with currency circulation, accounting and expenditure control have been re-examined.

Together with the trade unions we have initiated a complex process of reform of staff positions, recruitment methods, personnel evaluation and career advancement, and compensation. Our aim is to move beyond a formal structure centred on roles and grades which, in a world of a radically new production and labour environment, no longer assigns proper value to human capital, specialist skills, tasks performed. I hope that discussions with staff representatives will be frank and constructive. The women and men who work in the Bank at every level and in every field are its lifeblood and its strength; it is to them that I express my deepest and most sincere appreciation and that of the Governing Board and the Board of Directors.

The economy and monetary policy

Since last summer Europe and Italy have been in the throes of an exceptionally serious crisis. After the worst effects of the financial crisis that had broken out in the United States four years before had been reined in with much effort, and financial assistance programmes had been drawn up for the euro-area countries in greatest difficulty with their public finances, banking systems and external accounts, for a year now new tensions have been present in the sovereign debt market. They were triggered not only by the deteriorating outlook for the global economy but also by the worsening of Greece's financial situation and the fears caused by the announcement of the involvement of the private sector in reducing the country's public debt. The tensions spread to the financial and banking markets of the euro area and had a direct impact on Italy and Spain.

Sudden variations in private capital flows aggravated the payments imbalances of some European countries. The recovery in output was slowed down or reversed. Individual countries' weaknesses have been underscored: in Italy, slow growth and the high public debt. The incomplete construction of the Union's institutions weighs heavily on the market's judgement.

In Italy the yield on ten-year government securities jumped from 4.8 per cent in June to 7.3 per cent in November; the spread over German sovereign bonds reached 5.5 percentage points. The conditions for rolling over maturing debt in the winter months risked becoming prohibitive. Banks' wholesale funding channels dried up: towards the end of the year their bond issues on international markets almost came to a halt. The tensions were reflected in the cost of funds and in the availability of credit. The flow of loans to firms slowed and turned negative in December. There was a serious and real risk of a large, persistent contraction in bank lending.

The crisis was tackled on three fronts. The authorities of the most exposed countries made substantial corrections to their public finances and prepared structural reforms to foster growth, interacting with the European authorities; in Italy the actions initiated in the summer were completed and reinforced by the new Government. In the European Union the reform of governance was speeded up, the instruments for providing financial support to countries in difficulty were reinforced and banks were required to strengthen their capital bases. The Eurosystem intervened with very-large-scale extraordinary monetary measures.

Notwithstanding some hesitation in carrying out interventions and defects in the sequence and effectiveness of decisions at European level, the loss of confidence was halted. In Italy the measures adopted in the autumn made a decisive contribution; the yields on government securities came down, by 220 basis points between the end of December and the middle of March.

The tensions on the sovereign debt market have intensified again in the last few weeks, with the spread of new fears about the strength of the growth of the world economy and the possible emergence of a negative spiral between low growth, deteriorating public finances and problems with banking systems. The uncertainty about Greece after the general election has further strengthened the tensions. The spread between ten-year BTPs and Bunds is now back above 450 basis points. This has been due in part to the fall in German interest rates, which have been driven down by the search for safe haven assets. At the centre of the crisis there are now growing doubts among international investors about governments' cohesion in guiding the reform of European governance and even their ability to ensure the survival of the monetary union.

The economic situation has been deteriorating for a year. In Italy industrial production, which in the second quarter had with difficulty recovered less than half of the 25 percentage points lost in the recession of 2009, has fallen by 5 per cent since then. GDP has fallen for three consecutive quarters since last summer, contracting by a total of about 1.5 per cent. Unemployment has increased, rising from just over 8 per cent last July to nearly 10 per cent in March, and among young people under the age of 25 from 28 to 36 per cent.

According to consensus forecasts, over the next two years as a whole the GDP of the euro area will barely grow. For Italy 2012 will inevitably be a year of recession, owing to the financial uncertainty and the drastic, but indispensable, measures to adjust the public finances. In scenarios that are not excessively unfavourable, the fall in GDP can be kept to about 1.5 per cent; an upturn could begin towards the end of the year and its likelihood will increase the more effective are the structural interventions to improve the use of public and private resources and the clearer and more determined is the cohesion shown by the European Union.

Starting during the summer, the tensions in the sovereign debt market spread rapidly to banking systems. They were aggravated, with procyclical effects, by rating agencies' successive downgrades of the credit ratings of both sovereign borrowers and banks. The segmentation of the interbank market along national lines became more pronounced, with a sharp rise in the spreads between the overnight rates on the Italian and Spanish markets and the euro-area average.

Italian banks and those of other countries recorded a substantial reduction in their wholesale fundraising. In the last five months of 2011 the former's net fundraising from non-residents, on foreign interbank markets and by way of bond issues, shrank by more than €100 billion. Investors feared that a contraction in fundraising, together with a possible lack of eligible collateral for Eurosystem refinancing, could trigger a systemic crisis. The tensions were intensified by the large volume of bonds maturing on international markets in 2012, amounting to nearly €450 billion for the euro area and €75 billion for Italian banks. The single monetary policy was in danger of not being transmitted uniformly; financial stability was at risk.

The Governing Council of the European Central Bank reacted by extending its purchases under the Securities Markets Programme from the summer onwards, reducing the official interest rates in two steps and lowering the compulsory reserve ratio by half in December. It decided to carry out two refinancing operations, in December and at the end of February, with exceptionally long, three-year, maturities and full allotment. In addition, it extended the range of assets that could be used as collateral for loans.

In the euro area as a whole the liquidity injected by the two three-year operations amounted to over €1,000 billion, or €500 billion net of the amounts maturing. In Italy 112 banks participated in the operations, receiving a total of €255 billion, or €140 billion on a net basis. The shortfall in wholesale fundraising was thus made good by Eurosystem refinancing; part of the resources obtained in this way was invested in government securities.

In the aggregate, in view of developments in the economy, there was no increase in euro-area banks' overall requirement for liquid funds. The liquidity created through the two three-year refinancing operations could not fail to translate into an equal increase in the amount of funds held with the Eurosystem's deposit facility. But this does not mean that the liquidity remained idle: rather, it was re-deposited by different banks from those that had originally received it, after circulating among banks in different euro-area countries and taking the place of private capital flows where these had been interrupted. It preserved the orderly operation of the markets, kept yields down, and prevented the fall in fundraising from triggering a ruinous credit crunch for households and firms.

In the last twelve months Italian banks' loans to the private sector have increased by 1.3 per cent. Lending to businesses began to slow down in the spring of 2011 and contracted sharply in December, by more than €20 billion. It stagnated in the first quarter of this year and grew in April.

The actual dynamics of lending has not been due to supply factors alone but also to cyclically weak demand and falling credit quality. Nevertheless, there are signs that the improvement in banks' liquidity is helping to foster the supply of credit. In the first few months of this year, surveys of banks and firms reported some easing of lending terms with respect to the very critical conditions of the fourth quarter of 2011. On average, the interest rates on loans to firms turned downwards.

Italian banks' net purchases of Italian government securities, which had been modest or negative in the closing months of last year, amounted to €70 billion in the first quarter of 2012, about a third of it at maturities of less than a year. The liquidity of the market was partially restored. The banks' build-up of short-term assets will enable them to cope with the possible failure to roll over their maturing bonds and to serve a recovery in the demand for credit.

Re-establishing orderly credit market conditions is essential to the future growth of the economy. So far the rise in government security yields, banks' fundraising problems, and the higher cost and reduced availability of credit to the economy have had a depressive effect on economic activity in Italy that is estimated at about one percentage point for 2012 as a whole. Without the Eurosystem's interventions the effect would have been greater.

Italian banks' assets pledged as collateral for Eurosystem refinancing have increased by about €80 billion, thanks to the possibility, introduced at EU level in December, of obtaining government guarantees for bank bonds. The collateral pool deposited with the Bank of Italy, net of haircuts, reached €360 billion, €85 billion of which was unencumbered and promptly usable. Italian banks have an additional €100 billion worth of unencumbered eligible securities outside the pool.

Moreover, the availability of eligible collateral may increase significantly as a result of the Bank of Italy's measures making additional types of credit claims eligible, in implementation of the ECB Governing Council's December decision. The Bank of Italy's selection of the new collateral assets is subject to strict standards and controls, further refined of late. Hopefully, banks will adapt in order to take full advantage of this opportunity.

The Eurosystem's liquidity support measures were made possible by the credibility that its monetary policy had gained over the years and the stability of inflation expectations. The Governing Council's decisions responded fully to the mandate of the ECB. It was essential to keep monetary policy from losing effectiveness and being transmitted unevenly in different countries. The brusque cessation of the flow of credit to the economy and the interruption of the orderly working of markets would have entailed extremely serious threats to financial stability.

In Europe, the safeguarding of financial stability is entrusted to the regulatory authorities and the central banks. Macro-prudential oversight is the responsibility of the European Systemic Risk Board, within which the central banks play a leading role. The primary objective of the Eurosystem is to ensure price stability over the medium term; under the Treaty, it contributes to preserving the stability of the financial system. When financial stability is jeopardized, price stability itself is put at risk.

Monetary policy cannot redress all the imbalances within the euro area, but it can stop contagion, avert systemic crises and ease tensions. Its contribution in sustaining markets and supporting liquidity remains essential. Today, an exit from the present policy framework would be absolutely premature.

The financial system and the Bank of Italy's supervision

Since the outbreak of the crisis, Italian banks have made considerable progress in strengthening their capital. They have turned to the market in difficult circumstances. Since 2007 the core tier 1 ratio of the five largest banking groups has been raised from under 6 per cent to 10 per cent. For the other banks it has remained stable at around 10 per cent. Based on risk analyses, the Bank of Italy has invited banks to take the necessary steps to maintain or achieve capital ratios well above the regulatory minimum. The advance towards Basel III is on schedule.

In these years the stability of Italian banks has been assured by a series of factors: low exposure to structured finance products; regulation and supervisory controls to prevent excessive risk-taking; low leverage by comparison with other banks in Europe; and a high proportion of capital instruments effectively capable of absorbing losses. Contributory factors were the absence of any real-estate bubble in Italy and the low level of household debt. However, the credit system is feeling the repercussions of two sharp recessions in three years and the sovereign debt strains.

Credit quality has deteriorated. The new bad debt ratio on Italian banks' loans to residents, which was less than 1 per cent in the years before the crisis, peaked at 2 per cent in 2009. The subsequent improvement came to an end in the second half of 2011 with the weakening of the economy, and the ratio went back up to nearly 2 per cent. There has also been an increase in substandard, restructured and overdue loans. For the most part the worsening of credit quality has involved loans to firms.

By means of inspections and analysis of the information gathered from banks, the Bank of Italy exercises stringent control on the appropriateness of write-downs with respect to the actual prospects of recovering impaired loans. "Thematic" inspections of five medium-sized and large banking groups in 2011 found that management of the loans at greatest risk of deterioration was generally correct. Not many instances of protracted support to firms with no hopes of survival were found.

Italian banks' reference market consists largely of the domestic market of households and firms. In March 2012 their loans to customers resident in Italy amounted to some €1,950 billion, or 125 per cent of GDP. Deposits and bonds held by households, the most stable forms of funding, finance 85 per cent of lending. In the first half of the last decade the figure exceeded 90 per cent. The funding problems and the increase in risk premiums on the wholesale markets – the European interbank and international financial markets – make it necessary for banks to rebalance, with the requisite gradualness, the relationship between loans and stable sources of funding.

Up to 2008 the expansion in loan volumes supported the growth in Italian banks' revenues and profits, even if these were not especially high by international standards. Since then the decline in economic activity has led to a slowdown in lending and an increase in credit risk and the associated losses. Even excluding the huge write-downs to goodwill by some banks, exceptional and non-recurring events, profits in the last financial year were particularly low.

In order to strengthen capital, self-financing must improve. But the current imbalance between lending and stable funding will make it difficult to return to a model of profitability growth based principally on expanding the volume of business.

Vigorous action is needed to tackle operating costs, which have been relatively inflexible in relation to the state of the banking industry. The present level of labour costs is unlikely to be compatible with the prospective growth of the Italian banking system. The compensation of directors and top managers too must reflect the objective of containing costs.

Ambitious strategies are needed to boost the efficiency of production and distribution significantly and capitalize on the contribution of new technologies. The widespread adoption of new modes of access to banking services calls for a rethinking of the economic viability of the entire distribution network. At the end of 2011 some 14.3 million bank accounts held by households and 1.7 million held by firms were enabled for on-line banking services, respectively five and three times more than a decade earlier. The number of bank branches grew by some 20 per cent between 2001 and 2008, and since then it has declined only modestly.

Bank mergers and acquisitions have not been followed up by sufficient streamlining of groups' organization or reduction in the number of board members. The ten largest banking groups have a total of 1,136 board positions, not counting foreign companies; bank subsidiaries alone have more than 700. The other intermediaries too often have overly large boards, which tends to make the individual members unaccountable and reduces board efficiency. Such arrangements are costly in themselves and are not justified by the professional expertise needed to effectively manage banks. The recent ban on interlocking board membership between firms in the financial sector is also an opportunity to modify the number of directors.

The banks' role in allocating resources has to be flanked by further development of the capital markets. For firms, a low proportion of equity capital and reliance on bank credit as the sole source of external finance constitute a factor of fragility in the short term and a drag on their growth potential. The difficulty that no few firms have encountered in accessing credit since the start of the crisis depends in part on their unbalanced financial structures, with excessive debt.

Equity capital is the appropriate instrument for financing innovation. The incentives for increasing companies' capital that are part of the Government's pro-growth measures go in the right direction. Strengthening firms' financial structure also necessitates changes in their relations with banks.

In Italy 38 per cent of business loans are for maturities of less than twelve months, compared with 18 per cent in Germany and France and an average of 24 per cent in the euro area. Italian firms' greater dependence on short-term debts exposes them to higher refinancing risk and restricts the time horizon of investments. Over half the short-term loans in Italy are in the form of overdraft facilities. The variability in the drawings on these credit lines exposes banks to liquidity risk; it is one of the characteristics that prevent their use as collateral for Eurosystem refinancing.

The crisis has led to greater appreciation of the benefits of a more stringent regulatory regime, one able to avoid excessive recourse to leverage, volatile forms of funding and investment in assets far removed from banks' credit function. It has shown that a high return on equity achieved through leverage is unsustainable and a source of instability.

The new, more rigorous rules drawn up by the Financial Stability Board and the Basel Committee on Banking Supervision aim to reduce the risks of financial crises recurring. They may impose costs on economic agents and the economy as a whole, but they are aimed at preserving the basic functions of intermediation, which are essential to economic growth. Higher levels of capital reinforce banks' stability, their capacity to supply credit even in difficult conditions. Consistency between capital endowment and asset risk is confirmed as a linchpin of the regulatory framework.

Basel III comes into force next year. Two issues of fundamental importance in Europe are the definition of capital and the flexibility permitted to national authorities. The European Banking Authority must make sure that the capital instruments available to banks to protect against risks are defined in accordance with the reform. Allowing national authorities to impose conditions that are more stringent than the internationally harmonized requirements acknowledges the sometimes significant differences between banking systems. This needs to be accompanied by greater transparency and prior consultation at European level; the adoption of national measures must not jeopardize the smooth running of the single market.

But rules alone are not enough. The Bank of Italy is working for the adoption of intensive and rigorous oversight and control practices. One element that is essential for guaranteeing systemic stability is the choice of method to measure risk-weighted assets, the denominator of capital adequacy ratios. Within the European Union there is wide dispersion of ratios of risk-weighted to total assets. The differences depend on balance-sheet composition and risk profiles; divergent supervisory practices also play a part. After the latest validations of internal models of risk measurement, for the five largest Italian groups the ratio exceeds 50 per cent, well above the European average. The peer review of the methods of calculating risk-weighted assets now under way within the Basel Committee and at European level accordingly needs to be completed without delay.

The entrepreneurial nature of financial intermediaries must not be questioned. Government intervention limiting banks' freedom to do business and market competition have generally entailed, including in Italy's recent history, high intermediation costs and widespread distortions in the allocation of resources.

The recent institution of the Credit Observatory could provide additional information on the financing of the economy. In performing its role of monitoring credit, the Observatory must not open the door to outside interference in banks' assessments of customers' creditworthiness.

The Bank of Italy's customer protection rules are based above all on the promotion of informed financial decisions, transparency of contracts and greater efficiency. The inclusion of standard information in the most common contracts and the use of synthetic cost indicators aim to make it easier to compare the various offers available. The banks must take steps to ensure that their organizations are focused on customers' requirements. Special rules for payment services and consumer credit are designed to protect the weaker parties to contracts.

If the banks themselves fail to take an approach that pays greater attention to cost control, the management of risks, including fiscal risk, and the protection of their customers, if they regard high-quality customer relations as a cost rather than a competitive tool, in the long run the results cannot be other than disappointing.

The Bank of Italy is attentive to the need to ensure basic correctness in bank-customer relations. To this end, it has stepped up cooperation with the other authorities in the financial sector; it ensures the full functioning of the Banking and Financial Arbiter; and it has refined its oversight of intermediaries. The results of the checks and analyses performed, together with the continual flow of complaints from banking and financial customers, testify to the need for more vigorous efforts on the part of the banks.

Controls on non-bank financial intermediaries have been intensified in the light of the widespread deterioration in credit quality. In this area too we are paying close attention to the formal and substantive correctness of relations with customers.

The Bank of Italy is also entrusted with the task of preventing and combating the financial system's involvement in money laundering. Provisions governing the organizational and internal control structures of intermediaries were recently adopted for this purpose. The banks have been called on to step up their efforts to block the infiltration of organized crime into the legitimate economy, which tends to intensify in times of crisis.

The effectiveness of on- and off-site inspections has increased, and cooperation with the judicial authorities and Finance Police has been strengthened. The Financial Intelligence Unit, established at the Bank, has enhanced the effectiveness of its role as a junction between reports by intermediaries and investigations, to which it makes an active contribution.

Europe and Italy

If the euro area were viewed as a single entity, having, for instance, the form of a federal state, there would be no alarms regarding the resilience of its monetary and financial structure, notwithstanding the worries about the repercussions of the financial crisis on the economic cycle, banks and markets. But there is no political union in Europe. In the long term this makes monetary union more difficult to sustain; tangible progress must be made in the European construction; a path must be charted with political union as its ultimate goal, and each step marked along the way. As Tommaso Padoa-Schioppa observed on the eve of the changeover from the lira to the euro, "The danger lies in thinking that the euro is the final step, that united Europe is now fully forged. Those who wanted the single currency most, wanted it because it would facilitate further steps ahead, not because it would be the last one.” It is necessary to recall the original reasons underlying the European project, including in spheres that transcend economic activity.

The economy of the euro area has now been integrated for some time; it counts over 300 million people and almost 20 million firms. Considered as a whole, it has external accounts in balance; an estimated public sector deficit and debt for the current year of just over 3 and 90 per cent of GDP, respectively; households with gross financial wealth three times their annual disposable income and debt equal to that income; and aggregate corporate financial debt equal to one year’s output. The numbers depict a solid and balanced economy, in many respects more so than other advanced areas of the world.

European monetary union has confirmed economic integration in these years, giving it new impetus. The traditionally most virtuous countries have made a special contribution to the rest of the area: the example of sound policies, prudent on public expenditure, attentive to the needs of a structurally competitive productive system; and a basic national consensus on the objectives of price stability and social cohesion. They have benefited from a strong but not overvalued currency, from the absence of competitive devaluations, from a market larger than the national one and easily accessible. Countries such as ours that came from repeated bouts of inflation and currency crises have obtained stable prices and low interest rates, two basic prerequisites of economic development. We have taken little advantage of it.

Political inertia, disregard of the rules and mistaken economic decisions have favoured the emergence of internal imbalances, long obscured by the euro and unheeded by the markets, which today put the entire European edifice at risk. We feel the absence of some of the fundamental characteristics of a federation of states: decision-making processes that favour the adoption of far-sighted policies in the general interest; shared public resources for financial stability and growth; rules that are truly accepted; and commonly agreed and timely measures for the financial system and banks. These are tasks and conditions that lie outside the sphere of the European System of Central Banks: they imply political responsibilities, both at national and European level. The Eurosystem and the European Central Bank cannot be called on to shoulder them; what they can do is fill temporary vacuums, contribute to policy analysis and design.

In the last three years, driven by the tensions in the markets, significant progress has been made in reinforcing euro-area governance. But the decision-making processes, conditioned by the intergovernmental method and the principle of unanimity, remain slow and tortuous. A change of pace is required.

In the immediate future, above all the need is for convergent manifestations of the unshakable will to preserve the single currency. If governments, the EU authorities, the European Central Bank itself, judge the progress of the troubled countries in financial restructuring and structural reform positively, this must be followed by a practical commitment on their part to orient the markets' assessments in the same direction. The current yield spreads of government securities do not seem to take account of what has been accomplished: they fuel further imbalances, leading to a redistribution of resources from countries in difficulty to those perceived as sounder; they impede the correct operation of the single monetary policy; they are a source of risk to financial stability, an obstacle to growth.

The instruments of financial assistance to states in difficulty must be made more effective in operational terms. There must be the possibility of intervening promptly in the securities markets and directly in favour of banks, with procedures that are more flexible and less penalizing for the beneficiary countries that respect the rules of the Union. It must be possible to make effective use of the significant resources already allocated by the member states. This is in the interest of all.

Europe is also struggling with economic growth. The levers for reviving it are mainly in the hands of the national authorities, but the immediate launch of common co-financed investment projects, with particular attention to the weaker countries, could be an important signal to citizens and investors, who are currently concerned by the poor growth prospects of individual countries or regions.

The availability of more common resources and also the constitution – proposed in several quarters – of a fund to which to transfer sovereign debt in excess of a uniform threshold, to be redeemed gradually according to a clearly defined calendar and procedures, are the substance of a form of fiscal union that cannot be uncoupled from cogent rules nor from powers of control and intervention.

The moral hazard of counting on help from others so as to persevere in the bad policies of the past needs to be prevented by strong political and regulatory pressure, requiring the fulfilment of the commitments undertaken, on the basis of programmes that are ambitious but at the same time realistic. It is up to the countries in trouble to implement the reforms that will allow them to recoup competitiveness and reduce accumulated imbalances, within an appropriate timeframe and gradually but without the bar being lowered. It is up to the stronger countries to foster this process by not hindering rebalancing and by achieving structural progress that favours an expansion of demand.

It is necessary to counter the dangerous tendency towards the renationalization of financial systems. In the first place, it is essential to avoid measures that, taken in good faith but from a purely national standpoint, effectively impede the workings of the single market and the single monetary policy. The transition to a uniform system of rules and oversight of the financial sector must be hastened, especially in the euro area. At the same time, consideration should be given to establishing common guarantee and insurance mechanisms, able to reassure savers and investors and to prevent panic and destabilizing flights of capital. Rapid progress in setting up a European fund to resolve banking crises would help to allay uncertainty in the markets.

Italy has important tasks to perform. It has already begun to work on three different but interconnected fronts: a public sector that keeps its accounts in order, is not wasteful, and facilitates the economy; a sound and efficient banking system; and a productive system that is capable of innovating, competing and growing.

The criticism that banks have failed to heed the needs of the economy is wrong: they are significantly exposed to households and firms that are creditworthy, albeit in difficulty: they can continue to sustain them. Beyond the short term, however, inconsistency between the level of lending and the stability of funding will inevitably have repercussions on credit activity. The supply capability of the banking system needs rethinking. At the same time, revised capital regulations, oversight and market practices are pushing the banks towards more careful risk control; they necessitate lower but steadier profits than in the pre-crisis decade. Bank shareholders need to realize this.

It had been clear for some time in Italy that there was an urgent need for two necessary and inter-related economic policy actions: setting the budget on a sustainable and credible course and carrying out incisive structural reforms to revive the capacity for economic growth. The government has undertaken both.

The first action, on the budget, has been rapid and decisive: according to current forecasts, this year the deficit will be well below the 3 per cent limit; next year it will be near structural balance and the public debt will begin to fall in relation to GDP thanks, in part, to the completion of the pension reform. There is a large and growing primary surplus; non-interest current expenditure has been falling in real terms for two years now.

We have nonetheless paid the price of raising the tax burden to a level incompatible with rapid growth. This increase can only be temporary. The challenge now lies elsewhere: it is necessary not only to reduce tax evasion further but also to find spending cuts to counterbalance the reduction that must be made in the tax burden. If the cuts are identified with precision and based on equity, they will not prejudice growth; rather, if they eliminate inefficiencies in the public sector, simplify decision-making processes and curb administrative costs, they can stimulate it. The scope for reducing the public debt by selling assets in the public domain must be exploited to the full.

The second action, for structural reform, has met with greater and more widespread resistance, but it has nevertheless achieved some important results. Work has begun on a vast scale and must be continued with increased energy and taking the broad view in fields ranging from education to justice and health. The task is to rationalize and prune the regulations and prevent total public expenditure from increasing. Yet spending priorities can be revised, the budget balance remaining constant, for instance in favour of education and research. The country can ask its entrepreneurs to make an extra financial effort to strengthen their firms' capital when they benefit from a thorough streamlining of the regulatory and administrative environment. Investment will benefit, the real economy will be more robust, firms' relations with banks will improve.

Economic policy action can be undertaken serially, one matter at a time, but the overall design and the stakes must be clearly communicated and reasserted. Getting out of this tight spot will impose costs on all of us. They are bearable costs if they are properly shared and seen to have a clear purpose. The journey will not be short.

Italian society cannot avoid confronting a changed world in which no position rents are allowed. At the same time, politics must ensure the prospect of a profound renewal that nourishes hope and responds to the aspirations of the younger generations.

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