BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

HELD IN ROME ON 31 MAY 2005

ABRIDGED REPORT FOR THE YEAR 2004

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Developments during the year

The expansion in world economic activity that began in the middle of 2003 gathered pace last year. It was sustained by still favourable financial conditions and by an improvement in the profitability and balance sheet situations of firms. Although the rise in oil prices was steeper and more protracted than first expected, its impact was limited, causing economic activity to slow only in the middle part of the year. In the industrial countries current and forecast core inflation rose slightly but remained low. The highly expansionary stimulus imparted by economic policies during the previous three years diminished. From June onwards the Federal Reserve began to make monetary conditions progressively less accommodating; official rates were also raised in the United Kingdom and in other countries. The expansion of budget deficits if the main industrialized areas came to a halt.

World economic activity continued to be driven by rapid growth in the United States and in the emerging Asian countries. The differentials in the pace of demand between the main regions of the world remained large, causing the US balance-of-payments deficit on current account to widen further. The dollar, which had been weakening against the other main currencies since the beginning of 2002, continued to lose ground in the last quarter of 2004. As in the previous year, its depreciation was contained by the strategies adopted in many emerging countries to counter their own currencies' appreciation by accumulating dollar reserves.

The rise in the price of oil that began in the spring of 2003 continued throughout 2004. Several demand and supply factors contributed to the surge. World demand for oil, estimates of which have repeatedly been revised upwards, expanded under the impetus of growing energy consumption in China and in the other emerging Asian economies, and, towards the end of the year, in the United States. Tensions in the Middle East and diminishing spare capacity in the OPEC countries led to greater rigidities on the supply side. Prices for the main grades averaged close to \$40 a barrel, an increase of 30 per cent with respect to 2003; in real terms (compared with the international prices of manufactures) this is close to the level seen in the mid-1980s, prior to the oil counter-shock. The prices of other basic materials, particularly metals, which had begun to increase in 2003, rose steeply, mainly in response to expanding demand in the emerging Asian economies; this benefited the exporting countries in Latin America and Africa.

The international financial markets were stable, favoured by abundant liquidity and the strengthening of economic activity. US bond yields rose rapidly in the early spring of 2004 in connection with emerging uncertainties about the stringency of the Federal Reserve's monetary restriction. They subsequently dropped back to the low levels recorded at the beginning of the year, where they remained, albeit with fluctuations, through the first few months of 2005. Share prices in the main industrial countries were virtually stationary at the high levels of end-2003. Risk premiums on corporate bonds, which had risen briefly at the beginning of 2004, fell back in response to the improvement in firms' profitability. Signs of an unexpected slowdown in the US economy in the early months of this year pushed them back up.

World output grew by an average of 5.1 per cent in 2004 (compared with 4 per cent in 2003), the fastest pace since 1976. World trade grew by 9.9 per cent, twice the increase in output and in line with the long-term trend. In Asia and in Central and Eastern Europe exports rose by more than 15 per cent. Euro-area exports, which had stagnated in 2003, expanded by 6.3 per cent.

In 2004 the GDP of the emerging and developing countries grew by 7 per cent, compared with 6 per cent in the previous year. China, Russia and India recorded above-average growth. In Latin America output growth accelerated to 5.7 per cent (from 2.2 per cent in 2003) owing to the strong recovery in Brazil and Mexico and to rapid growth in Argentina, which continued at a similar pace to the previous year. In Africa economic activity expanded by 5.1 per cent (4.6 per cent in 2003), boosting per capita income by 2.9 per cent, the largest gain since 1996; growth was equally strong in sub-Saharan Africa. In the ten countries of Central and Eastern Europe and the Mediterranean that joined the European Union on 1 May 2004 economic activity accelerated with respect to 2003; Poland and Hungary registered increases of 5.3 and 4 per cent respectively, thanks in part to the contribution of the foreign sector.

The United States

In 2004 GDP growth was 4.4 per cent, compared with 3 per cent in the previous year, reflecting a further increase in profits and in household wealth; the strongly expansionary stance of economic policy of recent years was attenuated. Substantial productivity gains helped to contain labour costs, limiting the impact of the rise in oil prices on core inflation, which stabilized at a moderate level after increasing in the early months of the year. Expectations regarding long-term price developments, gleaned from financial indicators and business surveys, were for inflation to remain low and stable.

Against this background, in June the Federal Reserve changed its monetary policy stance: the federal funds target rate, which had been lowered to 1 per cent in June 2003, was raised eight times, reaching 3 per cent in May this year. Real short-term interest rates calculated on the basis of core inflation, which were close to zero at the beginning of 2004, rose by more than 1 percentage point. The shift in the policy stance, which the Fed had taken care to signal to investors in the months running up to the change, had no repercussions on the financial markets. Unlike the reaction following the change in stance in February 1994, long-term yields declined.

US fiscal policy also became less expansionary, although the effects of measures introduced in previous years continued to weigh on the public finances. In fiscal 2004 the federal government budget deficit benefited from the strong growth in economic activity, remaining virtually unchanged with respect to 2003 at 3.6 per cent of GDP; general government net borrowing fell from 4.6 to 4.4 per cent of GDP. According to recent estimates by the Congressional Budget Office, in fiscal 2005 the federal deficit should narrow slightly, to 3.2 per cent of GDP.

In 2004 private consumption continued to be the main driver of demand, expanding by almost 4 per cent on an annual basis. As the pace of employment growth returned to a level in line with earlier periods of expansion, current and expected labour market conditions improved substantially, sustaining household expenditure. A considerable stimulus also came from the increase in net real and financial wealth. Households' saving rate fell to historically low levels at the end of the year.

The upturn in capital formation gained pace with respect to 2003. Thanks to higher profits, firms had no difficulty financing increased investment without jeopardizing efforts to strengthen their financial situation. The growth in profits since early 2002 has been exceptionally large compared with similar cyclical phases. This can be put down to moderate wage growth and, above all, to substantial gains in productivity generated by the increasingly pervasive availability and use of new information and communication technologies. Although slowing sharply in the second half of 2004, labour productivity in the private sector rose by 4.1 per cent for the year, compared with 4.4 per cent in the previous two years and 2.5 per cent in the second half of the 1990s. The slowdown was due to the resumption of employment growth in the service sector; in manufacturing, productivity continued to increase at a rate of over 5 per cent.

The persistent divergence between the growth in domestic demand in the United States and in the other main industrial countries caused a further deterioration in America's severe, structural imbalance in its external accounts: the current account deficit expanded from 4.8 per cent of GDP in 2003 to 5.7 per cent in 2004. The depreciation of the dollar was insufficient to reverse the widening of the trade deficit. Nevertheless, in conjunction with the recovery in share and bond prices in international markets it helped to limit the growth in the country's net external debt. Between 2002 and 2004 this effect is estimated to have been around half the cumulative current deficit for the period; thanks in part to the robust expansion in output, since 2002 net external debt has been virtually stable as a proportion of GDP, at about 25 per cent.

In 2004 the US continued to finance its external deficit against a background of a relatively stable dollar and low interest rates. Around a quarter of net inflows of funds went towards the purchase of dollar-denominated assets, for the most part government bonds, by foreign authorities, especially those of China and Japan.

The adoption of exchange rate strategies linked to the dollar has played a role in the US currency's 15 per cent depreciation in effective terms since February 2002. At the close of their recent meetings in Washington, the G7 finance ministers and central bank governors reaffirmed that fostering a gradual, comprehensive readjustment of world financial disequilibria through market mechanisms would require greater flexibility in the exchange rates of the more rigidly tied currencies.

Asia

In Japan GDP grew by 2.7 per cent in 2004, compared with 1.4 per cent in 2003. The expansion, which began in 2002 under the impulse of the upturn in exports to other Asian countries, came to a halt after the strong performance of the first quarter of 2004 owing to the fall in international demand for high-tech goods.

With economic activity slowing and consumer prices still falling slightly in 2004, the Bank of Japan continued its strategy of providing abundant liquidity and keeping nominal short-term interest rates close to zero. The quantitative target adopted in March 2001, based on the balance of financial institutions' current accounts with the central bank, was held steady after being raised again at the beginning of the year. Fiscal policy took on a moderately restrictive stance. According to recent OECD estimates, in 2004 the cyclically adjusted budget deficit decreased by 1 percentage point to 5.9 per cent of GDP.

In the emerging Asian countries (including the recently industrialized economies) growth continued apace in 2004, at close to 8 per cent. In China output grew by 9.5 per cent, the highest rate since 1996. The curb on credit growth that the Chinese authorities imposed in the early months of the year had a limited impact on investment, which continued to expand rapidly. By contrast, inflationary pressures eased towards the end of the year.

Between 1978 and 2004 the Chinese economy grew by an average of more than 7 per cent a year. In the same period GDP increased six-fold, reaching nearly 14 per cent of world output on a purchasing power parity basis (about 4 per cent at current exchange rates). Per capita output quintupled, while labour productivity also increased at an exceptionally fast pace, at about 7 per cent per year.

China's growth is an important opportunity for the entire world economy because it stimulates demand in other countries, particularly in Asia. Nevertheless, the expansion is also marked by imbalances and weaknesses. Although growth has been considerable, it has been less rapid than in other Asian countries, above all Japan, during similar stages of economic development. There are signs that resources are not being used efficiently in China, partly owing to the low level of interest rates. Income distribution is extremely unequal. The inadequate social security system encourages households to save as a precautionary measure. There is a danger that social conflict will increase under the pressure of widening income disparities. Weaknesses in laws and their enforcement means that the legal system is unable to safeguard rights as a market economy requires. Factors of geopolitical instability in the area appear to be increasing.

The outlook

IMF projections released in April indicate growth rates in 2005 of 4.3 per cent for GDP and 7.4 per cent for world trade. Divergences in growth rates between the main industrialized areas remain large: the United States and the emerging Asian economies are expected to continue to drive the global economy. In the United States growth is expected to slow to 3.6 per cent, moving into line with the potential growth rate as the stimulus of economic policies gradually weakens. In Japan output is projected to increase by just 0.8 per cent, mainly reflecting its poor performance in 2004; the domestic components of demand should gain strength in the course of the year. In the euro area economic activity is projected to grow by 1.6 per cent, although performance will differ among the various countries: Germany is expected to achieve growth of 0.8 per cent, France 2 per cent and Spain 2.8 per cent. Thanks to the good performance of the United Kingdom and the new member countries, output in the European Union is set to expand by 2.1 per cent. As a group the emerging economies are forecast to expand at a slightly slower pace than in 2004. Asia, which accounts for about a quarter of world output, is again expected to be the most dynamic area, with growth of about 7 per cent; China and India are forecast to grow by 8.5 and 6.7 per cent respectively. In Latin America output growth is expected to slow to 4.1 per cent owing to a deceleration in Brazil and Argentina. In Africa output is expected to expand rapidly again (5 per cent), as is per capita GDP (3 per cent).

This scenario faces a number of risks. The price of oil jumped sharply in the early months of 2005, to over $50 a barrel. In the United States and the euro area this presumably affected household disposable income and confidence in the first quarter. If the rise is perceived as enduring, as the futures curve now suggests, it could also impact on inflation expectations. The other source of concern is the US current account deficit. The capacity of international capital markets to finance large imbalances between saving and investment is much greater than in the 1990s. However, the current and expected size of the US deficit could trigger over-adjustments in the exchange rates of the main currencies and in US interest rates, with serious repercussions on countries' wealth and the performance of the world economy.

Performance in the first few months of this year generally bears out the IMF's forecasts. GDP growth in the United States slowed to an annualized 3.5 per cent in the first quarter, reflecting a sharper than expected downturn in investment. However, strong corporate profitability and the still relatively low ratio of productive investment to value added point to a revival in investment in the coming quarters. Employment, which increased significantly again in April, should continue to sustain consumption, offsetting the adverse impact of the rise in oil prices. Price strains remain moderate. In this context, the Federal Reserve is expected to continue progressively attenuating the monetary stimulus; after the last increase at the beginning of May, the markets expect the federal funds rate to reach 3.75 per cent by the end of the year.

Preliminary estimates for the euro area show annualized GDP growth of 2 per cent in the first quarter of 2005. However, signs of a slowdown have emerged in the second quarter. In Japan output growth has resumed; the annualized increase of 5.3 per cent in the first quarter was primarily due to the sharp upturn in consumption. In China, GDP grew by 9.5 per cent at an annual rate in the same period.

RECENT DEVELOPMENTS AND ECONOMIC POLICIES

Economic developments in the United States, Japan and the United Kingdom

The United States. – After surging in the spring of 2003, economic activity continued to gain strength during 2004, expanding by 4.4 per cent (Table 1). As the impetus provided by economic policies progressively waned, it was more than replaced by that from the recovery in employment and further improvement in corporate profitability; the latter in turn benefited from the strong gains in labour productivity. The rise in energy prices had little impact on core inflation, which increased moderately in the first half of the year, partly owing to the progressive reduction in idle capacity.

The growth in household consumption, which averaged 3.8 per cent compared with 3.3 per cent in 2003, was sustained by the rise in disposable income and a further increase in households' net wealth. Real disposable income increased by 3.7 per cent, as against 2.3 per cent in 2003, mainly owing to the trend in labour income; the contribution of tax cuts and government transfers, which had amounted to 30 per cent in 2003, became only marginal. The rise in energy prices reduced disposable income by about 0.8 percentage points. Households' net wealth increased from 546 to 562 per cent of disposable income during the year, mainly owing to the rise in the value of real estate. Renegotiations of mortgage loans diminished during 2004, but continued nonetheless to sustain consumption. Households' saving rate declined further, to an annual average of 1.3 per cent.

Capital formation by business, which had been recovering since the second quarter of 2003, continued to increase, contributing on average 1.1 percentage points to growth during the year. Non-residential investment expanded by 10.6 per cent, owing to increased spending on information and communication technology, the gradual upturn in that on industrial machinery and the slight recovery in investment in plant, after three years of marked contraction. Investment plans nonetheless remained cautious. Although investment has been gaining strength for the last three years, in relation to GDP it is still well below the level attained before the 2001 recession.

The profits of non-financial corporations as defined by the national accounts continued to grow very rapidly, rising by an average of 26.5 per cent in 2004. For the last three years internal funds have consistently exceeded capital expenditure, leading to a substantial strengthening of corporate balance sheets.

Table 1

GROSS DOMESTIC PRODUCT AND COMPONENTS OF DEMAND IN THE LEADING INDUSTRIAL COUNTRIES

(at constant prices; except as indicated, annualized percentage changes on previous period)

	2003	2004	2004				2005
			Q1	Q2	Q3	Q4	Q1
United States							
GDP	3.0	4.4	4.5	3.3	4.0	3.8	3.5
Household consumption (1)	3.3	3.8	4.1	1.6	5.1	4.2	3.6
General government expenditure (2)	2.8	1.9	2.5	2.2	0.7	0.9	-0.2
Gross fixed private investment	5.1	10.3	4.5	13.9	8.8	10.5	5.3
Change in stocks (3)	-0.1	0.4	1.2	0.8	-1.0	0.5	0.8
Net exports (3)	-0.4	-0.6	-0.8	-1.1	-0.1	-1.4	-0.7
Japan							
GDP	1.4	2.7	5.6	-0.8	-1.0	0.1	5.3
Household consumption (1)	0.2	1.5	2.7	0.2	-0.4	-1.4	4.7
General government expenditure	1.2	2.7	5.7	2.9	1.2	2.5	3.0
Gross fixed private investment	0.9	1.7	1.5	-5.8	-1.3	-0.5	3.1
Change in stocks (3)	0.2	0.2	1.7	-1.0	..	0.8	1.7
Net exports (3)	0.6	0.8	1.1	1.0	-0.6	-0.2	-0.3
Euro area							
GDP	0.5	2.1	2.9	1.8	1.0	0.6	2.0
Household consumption (1)	1.1	1.2	2.9	0.1	0.4	2.3	….
General government expenditure	1.6	1.6	0.8	1.3	2.4	1.0	….
Gross fixed private investment	-0.4	2.1	-0.6	2.0	1.9	2.3	….
Change in stocks (3) (4)	0.3	0.5	-0.4	0.4	2.2	-0.7	….
Net exports (3)	-0.6	0.1	1.7	0.7	-2.4	-0.6	….
United Kingdom							
GDP	2.2	3.1	2.7	3.9	2.2	2.8	2.0
Household consumption (1)	2.3	3.3	4.8	3.2	3.1	1.1	1.3
General government expenditure	3.2	4.7	3.6	2.8	4.7	3.4	2.8
Gross fixed private investment	2.3	5.6	1.0	10.7	4.3	2.3	-0.1
Change in stocks (3) (4)	..	-0.2	-2.7	-1.0	1.2	1.9	-0.8
Net exports (3)	-0.4	-0.8	0.7	0.4	-2.6	-1.0	1.4

Sources: Eurostat and national statistics.

(1) Comprises spending on consumption of resident households and that of non-profit institutions serving households. – (2) Includes public investment. – (3) Contribution to GDP growth in percentage points. – (4) Includes net acquisitions of valuables.

Again last year the rise in profitability was driven mainly by labour productivity, which rose by 4.1 per cent in the non-farm business sector, compared with 4.4 per cent in the previous two years. Labour costs in the sector increased by 4.5 per cent, compared with 4 per cent in 2003 and 3.2 per cent in 2002. Productivity gains slowed in the second half of 2004 suggesting that the scope for reorganizing production has been partly exhausted in some sectors. In the first few years of the present expansion the efficiency gains obtained by restructuring may have boosted productivity beyond its structural growth rate, generally estimated at between 2.5 and 3 per cent per year. However, the manufacturing sector was not affected by the slowdown in productivity, which continued to rise at a rate of over 5 per cent in the second half of the year as well.

Payroll employment in the non-farm sector rose overall by about 2.2 million in 2004 (equal to some 180,000 a month), recouping practically all the jobs lost between the recession of 2001 and the middle of 2003. A little under 85 per cent of the increase occurred in the service sector and over 10 per cent in construction; in manufacturing, where job losses have been heaviest, employment has not yet begun to pick up. The unemployment rate fell from 5.7 per cent at the beginning of the year to 5.4 per cent in December, partly because the participation rate remained below the levels recorded in earlier economic expansions.

The rate of consumer price inflation, excluding energy and food products, rose slowly but steadily in 2004, mainly reflecting the upturn in the prices of manufactures. The twelve-month rise in the consumer price index increased from 1.1 per cent in January 2004 to 2.3 per cent in March 2005. However, the deflator of personal consumption expenditure, excluding those same volatile items, rose only from 1.2 to 1.7 per cent during the period. This is what the Federal Reserve considers the most significant indicator of the risks of inflation in the US economy, since it more accurately reflects the range of goods and services effectively consumed.

The acceleration of prices in 2004 did not significantly affect inflation expectations. According to the latest surveys by Consensus Economics, consumer prices, including energy and food products, are expected to rise by 2.8 per cent this year, much the same as in 2004, and by somewhat less, 2.5 per cent, in 2006. One reassuring aspect of the situation regarding inflation is the moderate growth in labour costs, which in 2004 for the fourth year running increased in real terms less than productivity. Despite the recovery of employment, no wage tensions developed, indicating that there are still fairly wide margins of spare labour.

In the first quarter of 2005 output growth slowed to an annualized rate of 3.5 per cent, compared with 3.8 per cent in the fourth quarter of

2004. The decrease was largely unexpected and mainly caused by the sharp slowdown in investment, although this did not affect either residential building or information and communication technologies. Expenditure on capital goods was affected by the expiry in December of the tax incentives that had prompted firms to bring forward purchases in the second half of 2004. Consumption rose by 3.6 per cent, despite some deceleration. Net exports again made a negative contribution, however. Labour productivity in the non-farm business sector picked up from growth of 2.1 per cent in the last quarter of 2004 to 2.6 per cent. In the first four months of this year payroll employment continued to grow, gaining about 210,000 jobs a month, faster than the average for 2004.

Japan. – Economic activity, which had been expanding rapidly for several quarters, halted its progress in the second quarter of 2004. The standstill can be ascribed to the sharp slowdown in exports starting in the spring; later the contribution of the domestic components of demand also failed; in the second half of the year consumption declined.

Thanks to substantial gains in the fourth quarter of 2003 and first quarter of 2004, output for the year as a whole nevertheless increased by 2.7 per cent, compared with 1.4 per cent in 2003. The new method of calculating national accounts aggregates based on chained prices has entailed a reduction in growth estimates of about 1 percentage point compared with those based on the previous system.

The rate of growth in private fixed investment increased from 4.8 per cent in 2003 to 5.3 per cent in 2004, despite a sharp slowdown in the second half. After declining for three years, investment in residential building rose, while that in public infrastructure continued to fall as a result of the strategy of gradual adjustment of the public finances.

Capital formation was again driven by firms' return to profitability, assisted by the restructuring of production and finance under way since the mid-1990s. The profits of non-financial firms' increased by 23 per cent in 2004, after a 12 per cent gain in 2003; in manufacturing the improvement was again largely due to the 2.2 per cent reduction in staff costs, continuing the decline under way since 1999.

Firms' financial situation improved further. The ratio of debt to liabilities plus own equity and to GDP continued to diminish throughout 2004, to 52 and 70 per cent respectively by the end of the year.

Exports, which had expanded strongly in the first half of the year, were subsequently affected by the slackening of world demand for ICT products; the annualized rate of growth fell from 19.9 per cent in the first half of 2004 to 5.9 per cent in the second half.

After stagnating for two years, private consumption rose by 1.5 per cent despite a sharp downturn in the course of the year.

Household spending was again affected by the weak labour market. Although employment began to pick up slightly for the first time since 1997, firms persisted with the progressive replacement of full-time workers (down by 1 per cent) with part-time staff (up by 5.7 per cent). The rising proportion of part-timers, whose hourly pay is 60 per cent lower than that of their full-time colleagues, helped to contain wage growth. Real wages declined by 0.7 per cent in 2004, as against 0.4 per cent in 2003. The unemployment rate fell from 5.3 per cent on average in 2003 to 4.7 per cent in 2004, mainly as a result of the continuing contraction of the labour force.

The weak performance of wages again made it impossible to definitively overcome deflation. The consumer price index excluding the most volatile items declined by a further 0.1 per cent in 2004, after the 0.3 per cent drop in 2003. Producer prices, driven upwards by the rise in energy prices, rose by 1.3 per cent as against a decline of 0.8 per cent in 2003.

Output growth resumed in the first quarter of 2005; according to preliminary estimates the annualized rate of increase is 5.3 per cent, reflecting a strong recovery in private demand for consumer goods and investment, which rose by 4.7 and 5.7 per cent respectively. According to the Tankan survey conducted in March this year, firms intend to increase their investment moderately during the current fiscal year.

United Kingdom. – In 2004 output growth picked up from 2.2 to 3.1 per cent. Consumption expanded sharply in the first half before weakening considerably after mid-year, partly owing to the slowdown in real-estate prices and the tightening of monetary conditions. The recovery in corporate investment, which rose by 5.5 per cent during the year, was more moderate than in similar cyclical phases in the past; the negative contribution of the external sector was greater than in 2003.

Employment continued to expand, rising by about 200,000 in the course of 2004; despite signs that the labour market is approaching full employment, wage growth remained moderate. In the past decade the inequality of income distribution, which is large by international standards, has remained virtually unchanged (in 2002 the Gini index stood at 34 per cent).

The favourable trend in unit labour costs helped to contain price inflation. Measured by the harmonized consumer price index, which was adopted in December 2003 as the reference for monetary policy in place of the retail price index excluding mortgage interest payments, price inflation held steady below 1.5 per cent for most of 2004 before gradually rising to 1.9 per cent by April of this year.

Economic policies in the United States, Japan and the United Kingdom

Monetary policies. – In the United States, the Federal Reserve, which had announced in its press releases that it would take a less accommodating monetary policy stance, on 30 June 2004 increased its target for the federal funds rate by 0.25 percentage points, and at the seven successive meetings of the Federal Open Market Committee the rate was raised by the same amount, for a total of 1.75 percentage points, bringing it to 3 per cent. In the opinion of the US central bank monetary conditions are still accommodating and, together with the strong growth in productivity, will continue to sustain economic activity. Despite signs of an acceleration in prices in the early months of this year, inflation expectations remain moderate, particularly over the long term. This should allow the Federal Reserve to proceed with measured policy action.

The US monetary authorities have been increasingly careful in the wording of their public statements to render their assessments and decisions more transparent, thereby smoothing price volatility on the financial markets and keeping inflation expectations low.

The prices of futures contracts on federal funds indicate market expectations that there will be two further 0.25 percentage point increases in reference rates over the next three Open Market Committee meetings to be held before the end of September of this year.

Short-term interest rates, adjusted for the twelve-month change in the core personal consumption expenditure deflator, had been close to zero since the end of 2002; they began to edge up in the middle of 2004, reaching 1.3 per cent in March 2005.

In Japan, the persistence of deflationary tendencies, moderate though they were, prompted the Bank of Japan to continue its strategy of expanding liquidity. It accordingly maintained the target interval for financial institutions' current account balances with the central bank at ¥30-35 trillion from January 2004 (equal to 7-8 per cent of total bank lending) regardless of the market's occasional reluctance to absorb additional liquidity. The Bank reiterated that it would continue to pursue its current expansionary monetary policy until consumer price inflation once more turned steadily positive. Very short-term interest rates remained close to zero throughout the year.

The twelve-month rate of increase in the monetary base amounted to nearly 4 per cent in December 2004, compared with a much higher rate of 13 per cent in December 2003. The slowdown was probably due in part to the decision to suspend exchange market intervention by the Ministry of Finance, which had been made to counter the appreciation of the yen and had not been completely sterilized by the central bank. In 2004 and the early months of 2005 the pace of the contraction in lending to the private sector began to ease; in March this year the decrease was 0.8 per cent, 1.3 percentage points less than in December 2003.

The Bank of England continued until August to maintain the tight monetary policy stance adopted in November 2003, raising the official rate progressively from 3.75 to 4.75 per cent to counter the expansion in domestic demand and curb the rise in house prices. Since then, with house prices and consumption slowing, the Bank has kept monetary conditions unchanged.

Fiscal policies. – In the United States the particularly strong stimulus to demand provided by budgetary policy in the previous two years was attenuated. The federal deficit for fiscal 2004 showed virtually no change with respect to 2003 at $412 billion, equal to 3.6 per cent of GDP. Net borrowing by state and local governments declined from $114.1 billion to $79.8 billion; their net saving, which does not include capital expenditure and related amortization, remained close to zero, as in the previous years. Net general government borrowing amounted to $508.2 billion or 4.4 per cent of GDP, slightly less than in the previous year (4.6 per cent).

Federal revenues, which had fallen sharply for three years, increased by 5.5 per cent; the improvement was due largely to the revenue from taxes on corporate profits. Expenditure rose by 6.1 per cent, a slower pace than in 2003, reflecting the upturn in discretionary spending for defence. Against a background of strong economic growth, both revenues and expenditure remained virtually stable in relation to GDP at 16.3 and 19.8 per cent respectively. The progressive emergence of the large federal deficit raised the amount of federal debt held by the public from 33 per cent of GDP at the end of fiscal 2001 to 37.2 per cent in 2004; over the same period the gross federal debt rose from 57.4 to 63.7 per cent of GDP.

The budget proposal presented by the Administration in February of this year aims to reduce the federal deficit gradually to 1.3 per cent of GDP in 2010. The plan envisages a drastic reduction in discretionary spending; it is based on the assumption of an increasing tax burden stemming from good economic growth coupled with the progressive taxation of personal income, as well as fiscal drag.

In the longer term the public finances may be affected by a large increase in social security and healthcare expenditure. It is conservatively estimated that healthcare expenditure (Medicare and Medicaid) will rise from 4.1 per cent of GDP in 2004 to 12 per cent in 2050. Including costs borne by households and firms, spending on healthcare is high by international standards, amounting to 14 per cent of US GDP in 2001. The Administration has recently outlined the general guidelines for the reform of the social security system that is still under discussion.

In Japan budget policy also became less expansionary in 2004. The OECD estimates that the budget deficit, including the social security balance, diminished from 7.7 to 6.1 per cent of GDP; on a cyclically adjusted basis it improved by 1.1 percentage points. At the end of 2004 gross public debt rose to 157.6 per cent of GDP, compared with 154.6 per cent in 2003, twice the OECD average.

For the fiscal year starting in April 2005 the budget keeps overall expenditure virtually unchanged in nominal terms. The reduction, for the third consecutive year, in spending on education and public infrastructure will be offset by an increase in debt service and pension outlays. The rise in revenues, estimated at around 5 per cent in nominal terms, will stem from the partial abolition of tax cuts introduced in 1999 and the raising of pension contributions as part of the social security reform enacted last October.

In the United Kingdom, in the fiscal year ending in March 2005 overall public sector net borrowing decreased from 3.2 to 2.9 per cent of GDP, thanks partly to the favourable cyclical phase. The public debt, defined according to the criteria set out in the Treaty of Maastricht, amounted to 41 per cent of GDP at the end of March, 1.5 percentage points higher than a year earlier; net public debt rose from 32.8 to 34.5 per cent of GDP. The scenario outlined by the Government in the latest budget proposal presented in March of this year envisages a gradual reduction in the overall public sector borrowing requirement during the next five years. This will stem in part from an increase in revenues from 38.3 per cent of GDP in the fiscal year just ended to 40.6 per cent in 2009-2010, principally due to fiscal drag. The budget also provides for a further increase in capital expenditure, mainly for public infrastructural investment, which should increase by a total of around 0.7 percentage points of GDP in fiscal 2005 and 2006.

Developments and economic policies in the new EU member states

Economic growth strengthened considerably in the ten countries of Central and Eastern Europe and the Mediterranean that joined the European

Union in May 2004, accelerating from 4.1 per cent in 2003 to 4.8 per cent last year. The differential vis-à-vis the fifteen existing EU members was 2.5 percentage points. Thus the new member states further narrowed the per capita income gap vis-à-vis the old members; in 2003 the ratio between the two groups was 48.3 per cent.

Economic activity benefited from a better-than-expected performance of exports. With euro-area imports gradually picking up, the sharp expansion in the new members' exports partly reflected the integration of their productive systems with those of the rest of the area.

Domestic demand was sustained by the strengthening of the recovery in investment under way since 2003; private consumption contributed relatively less to GDP growth, after expanding rapidly in some countries in the previous two years, in connection with the rapid increase in lending to households.

The strengthening of economic activity in the ten new members did not lead to an upturn in employment, however. Employment once more contracted in the Czech Republic, but stabilized in Poland, after five years of decline, keeping the unemployment rate below 19 per cent, still the highest level in the area.

After three years of generalized abatement, inflationary pressures built up again in most of the new members between the end of 2003 and the first half of 2004. In addition to the cyclical upswing, transitory factors also contributed, associated with the rise in oil and food prices, the liberalization of regulated prices and indirect tax changes introduced with a view to joining the single market. After the middle of 2004 prices began to show signs of slowing, in some countries benefiting from their currency's appreciation against the euro.

After widening for three years, the public deficit of the ten countries as a group fell last year from 5.7 to 3.9 per cent of GDP. The improvement can be ascribed to the favourable economic situation rather than to structural measures to readjust the public finances. The situation remains problematic in several countries, particularly Hungary, and deteriorated further in Poland.

The deficit on the current account of the balance of payments of the ten countries as a group held stable in 2004 at 4.4 per cent of GDP, although individual performances diverged. In the three main countries the imbalance was contained in part by a reduction in the trade deficit as exports outpaced the rapid rise in imports. The large and persistent current account deficits of Hungary and the Czech Republic are increasingly due to the rise in net outflows of investment income.

Developments and economic policies in other emerging countries

In 2004 economic activity in the emerging Asian economies (including the newly industrialized countries) continued to expand at a rate of almost 8 per cent, driven by the acceleration in investment and exports. Some countries in the region specializing in high-tech goods were affected by a sharp slowdown in world demand for these products in the second half of the year.

In China the credit restriction introduced at the beginning of the year to curb the over-expansion of investment and counter rising inflation was only partly successful. From the autumn onwards inflation progressively diminished; investment expenditure, while slowing, nonetheless increased by 26 per cent in value terms in 2004 (28 per cent in 2003). In 2004 GDP grew by 9.5 per cent, the same as in 2003.

Household spending, although accelerating to 12.1 per cent in nominal terms, was still curbed by the strong propensity to save. Consumer price inflation, driven also by rising food prices in the first half of the year, averaged nearly 4 per cent, compared with 1.2 per cent in 2003; in September the rate of increase in prices began to ease, falling to 1.8 per cent in April 2005.

Against a background of booming growth and accelerating prices, monetary policy was directed at containing the expansion in domestic liquidity, which was fueled by large inflows of foreign capital, partly of a speculative nature.

In the first quarter of 2005 output continued to surge, with a year-on-year growth rate of 9.4 per cent. The large increase in exports produced a trade surplus of $17 billion, compared with a deficit of $8.6 billion in the same period of 2004.

In the newly industrialized economies (South Korea, Hong Kong, Singapore and Taiwan) growth ranged from 4.6 per cent in South Korea to 8.4 per cent in Singapore. In South Korea, domestic demand remained weak despite expansionary economic policies. Of the other emerging Asian countries, Thailand and Indonesia recorded growth of 6.1 and 5.1 per cent respectively.

In India, economic activity expanded by 7.1 per cent in 2004 (7.3 per cent in 2003), driven mainly by the growth in services, particularly in the information and communication technology sector, where India has a marked competitive advantage. Exports of services accounted for 34 per cent of total exports and 6.5 per cent of GDP. The manufacturing sector has also gained strength in recent years. Despite progress in economic and financial liberalization, inflows of foreign direct investment remained modest, partly owing to tight regulatory constraints and lack of infrastructure.

All the main Latin American countries recorded strong growth in 2004, for the first time in three years. The expansion of output accelerated from 2.2 to 5.7 per cent, benefiting from the strengthening of raw materials exports and the sharp upturn in domestic demand. Economic policies were directed at containing inflationary pressures and improving the public finances.

In Africa the pace of economic activity picked up in 2004 from growth of 4.6 to 5.1 per cent, the highest rate since 1996. In the sub-Saharan region the good performance of exports and the improvement in the terms of trade fostered an acceleration in output to 5.1 per cent, from 4.2 per cent in 2003. Substantial support also came from the improvement in domestic macroeconomic variables, especially the reduction in inflation. In South Africa, the largest and most advanced economy in the region, GDP grew by 3.7 per cent, up from 2.8 per cent in 2003, mainly thanks to a strong expansion in domestic demand; despite an improvement in labour market conditions, unemployment remained high, at around 27 per cent.

THE INTERNATIONAL FOREIGN EXCHANGE AND FINANCIAL MARKETS

Financial market conditions were generally favourable in 2004. Yields on US government securities remained moderate. Risk premiums were low for all categories of borrowers: spreads on corporate and emerging-country bonds fell to a minimum; share prices remained close to the high levels of end-2003, displaying considerably less volatility. In the industrial countries prices of real and financial assets benefited from the increase in corporate profitability. The strengthening of economic fundamentals sustained bond prices in many emerging countries, although some of them continue to have high levels of public and external debt. The abundance of liquidity prompted investors to seek higher yields and, in some cases, to take excessive risks. House prices in the industrial countries continued to rise, pushed up by the low interest rates on mortgage loans.

The dollar, which had been weakening since the beginning of 2002, continued to lose ground in 2004, albeit less rapidly. Its depreciation against the other main currencies appears to have been mitigated in the first half of the year by the acceleration of growth in the United States. In the fourth quarter increasing concern about the US external current account imbalance triggered renewed downward pressures. The emerging Asian economies accumulated dollar reserves more rapidly than in 2003 as part of their strategies to counter the appreciation of their own currencies. These policies not only make it more difficult to control internal monetary and credit conditions, heightening the risk of financial and macroeconomic instability; they also make no contribution towards a gradual and orderly reduction of international payments imbalances, as the finance ministers and central bank governors of the leading industrial countries reaffirmed at the end of their recent meetings in Washington.

The volatility of securities prices increased slightly in the early months of 2005. From the middle of February, growing inflationary pressures in the United States led to a rise in the yields on government securities. From the middle of March disappointing data for several macroeconomic variables generated uncertainty about the solidity of the US expansion: government securities yields fell and the risk premiums on shares, corporate bonds and bonds issued by the emerging countries were pushed upwards.

Financial markets in the industrial countries

In 2004 ten-year US Treasury bond yields fluctuated only slightly around the level of just over 4 per cent recorded at the end of 2003. From mid-February to mid-March of this year they rose by 0.7 percentage points, to 4.6 per cent, in response to the perception of an increase in inflationary pressure in the United States. In the weeks following they fell back close to the levels of end-2004.

Non-residents' net purchases of US government securities equaled the volume of net issues; at the end of 2004 the share of securities held by the market that were owned by non-residents exceeded 50 per cent (of which nearly two thirds held by foreign authorities), compared with 38 per cent at the beginning of 2002. Specific factors helped to contain long-term yields: growing demand from pension funds seeking to match the maturity of assets and liabilities and a reduction in the supply of long-term securities by the US Treasury, which caused the average residual life of the stock of public debt to decline.

The risk premium for US corporate bonds remained extremely low throughout 2004. This was partly due to a strengthening of firms' profitability and balance sheets, also evidenced by the decline in defaults and the improvement in the balance between rating agencies' upgrades and downgrades. The yield spread between bonds issued by firms with a high credit rating and ten-year Treasury bonds remained around 1 percentage point. For high-yield bonds the spread fell to 3 points at the end of the year; the decline was favoured by investors' search for higher yields and a greater propensity to take financial risks in a context in which liquidity was still abundant.

From mid-March of this year, with the publication of less favourable data than expected on the US economy and the worsening of problems in the automobile industry, risk premiums rose sharply, reaching 1.4 and 4.6 points respectively on 18 May.

The main international stock market indices recorded small gains in 2004, despite some fluctuations during the course of the year, notably in technology stocks. In Japan the Nikkei 225 index rose sharply in the first quarter in concomitance with the rapid expansion in economic activity. Subsequently it declined, although the increase for the year was still 8 per cent (Figure A9). The index of bank shares showed a larger gain (27 per cent), reflecting the improvement in banks' profitability and balance sheets. The interest rate on ten-year government bonds remains extremely low.

The balance sheets of Japanese banks continued to improve, benefiting from firms' good profitability performance and the strengthening of their financial situation. The unlimited public guarantee on time deposits was lifted on 1 April this year; originally, it was to have been listed in April 2003, but the action was postponed for fear it might jeopardize deposit-taking by the weakest banks.

International markets for derivatives continued to expand rapidly in 2004, although not at the exceptionally fast pace of the previous year. Demand for hedges with derivative instruments was strongest in the first half. Uncertainty about the decisions to be taken by the Federal Reserve and the Eurosystem – in March it seemed that monetary conditions might be relaxed in the euro area and in April and May that the rise in US interest rates would accelerate – boosted demand for futures and options on short-term interest rates. The brief increase in bond yields in the spring spurred demand for derivatives on long-term interest rates. The notional value of exchange-traded options increased by 20 per cent during the year (compared with 71 per cent in 2003) and that of futures by 38 per cent (33 per cent in 2003). The amount outstanding of these contracts, nearly all of them related to interest rates, reached $27,700 billion for options and $18,900 billion for futures, equal respectively to 107 and 93 per cent of the GDP of the major industrial economies.

In recent years investors have had significantly more recourse to instruments for transferring credit risk. Credit derivatives, consisting almost entirely of credit default swaps – in which the lender periodically pays a premium to hedge against the risk of default by the borrower – are the instruments that are spreading most rapidly in over-the-counter markets. They allow the credit risk attached to traditional lending to be transferred, thus profoundly altering the way markets and financial institutions operate. The authorities are consequently monitoring the phenomenon closely, including within the fora of international cooperation such as the Financial Stability Forum. According to estimates by the International Swaps and Derivatives Association, use of credit default swaps accelerated last year: the amount outstanding rose to over $8,400 billion, or by 123 per cent (compared with 72 per cent in 2003).

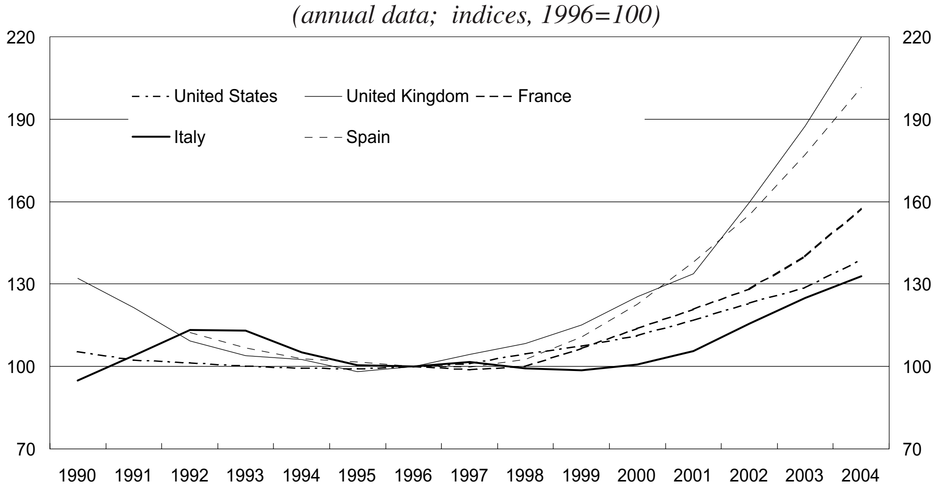
House prices in the industrial countries

House prices continued to rise in 2004 in the majority of the industrial countries. Adjusted for consumer price inflation, in France and the United States they rose at an average annual rate of 12 and 8 per cent respectively, compared with 9 and 5 per cent in 2003; in Spain and Italy they increased by 14 and 6 per cent respectively, similar to the previous year's figures (Figure 1). In the United Kingdom the restrictive stance of monetary policy caused house prices to slow sharply in the second half of the year; on average they rose by 17 per cent, the same as in 2003. In Australia the rate of increase fell to 5 per cent, well below the 15 per cent recorded in the previous year; the monetary tightening begun by the central bank in May 2002 contributed to the slowdown.

Figure 1

HOUSE PRICES IN REAL TERMS IN SELECTED INDUSTRIAL COUNTRIES (1)

(annual data; indices, 1996=100)



Sources: Based on national statistics. For house prices: OFHEO for the United States; Halifax for the United Kingdom; national statistics for France and Spain; Bank of Italy, using data from Istat and Il Consulente Immobiliare, for Italy.

(1) Indices of nominal prices deflated using consumer prices.

In Germany house prices in real terms fell by 3.7 per cent, again reflecting the large expansion in supply since unification. House prices in Japan, which had been falling since 1991, began to pick up in a few cities towards the end of 2004 and early months of this year.

In the United States the volume of mortgage refinancing fell markedly, to $1,180 billion, compared with an average of $1,860 billion in the three previous years. By contrast, there was a surge in new mortgages, which amounted to $1,470 billion in the year, compared with an annual average of $1,100 billion between 2001 and 2003. Despite expectations of a rise in short-term interest rates, about one third of the mortgages granted in 2004 carried variable interest rates; in 2002-03, when the US monetary policy stance was very expansionary, the share of such mortgages was 18 per cent. At present, variable rate mortgages account for an extremely small percentage of total mortgages and are generally preferred by households in lower income brackets, which are thus more vulnerable to increases in interest rates.

Foreign exchange markets

In the course of 2004 the dollar depreciated by 7.3 per cent against the euro, trading at a low of $1.36 at the end of December; its loss was smaller against the yen (4.1 per cent). In the early months of this year the dollar strengthened; the differentials in expected growth between the United States and the other main industrial areas widened. Since the dollar entered the prolonged period of weakness beginning in February 2002 it has fallen in nominal effective terms by 15 per cent; it has depreciated by 32 per cent against the euro and by 21 per cent against the yen.

As in the past, the dollar recorded only limited fluctuations against the currencies of the main emerging Asian economies. The central banks of Asia again countered the appreciation of their currencies by buying dollars. The US currency remained unchanged against those of China, Hong Kong and Malaysia, which continued to be pegged to it; it depreciated slightly against those of Singapore, Thailand and Taiwan and more markedly against the Korean won (14.8 per cent). By contrast the currencies of the Philippines and Indonesia weakened against the dollar. In the early months of 2005 the dollar remained broadly stable against all the currencies of the region.

Financial markets in the emerging countries

The low cost of borrowing encouraged many emerging countries to bring forward and increase their bond issuance, partly in order to restructure their debt and strengthen their financial positions. In 2004 the aggregate value of gross government and corporate bond issues for the emerging countries as a group was $131.5 billion, a third higher than in 2003 (about $100 billion). Gross bond issues increased significantly in the emerging countries of Asia and Central Europe, particularly in Indonesia, India, Thailand and Hungary; they remained virtually unchanged from the high levels of the previous year in Brazil, Mexico and Venezuela. By February of this year, bond issuance by the emerging countries as a group had already reached about half the programmed value for the year as a whole.

In Poland, Hungary and the Czech Republic financial conditions remained relaxed. The yield spreads between ten-year government bonds denominated in local currency and the corresponding German securities, which had widened slightly in the first nine months of 2004, subsequently narrowed. In April of this year the spread stood at 2 percentage points in Poland, 3.4 points in Hungary, and almost nil in the Czech Republic.

In Asia the yield spread between dollar-denominated government securities and the corresponding US securities, which had narrowed to a historically low level of around 2 percentage points at the beginning of 2004, widened by 1 point in the first half of the year. At mid-May 2005 it stood at 2.9 percentage points.

In Brazil, the continuing adoption of rigorous macroeconomic policies helped to maintain favourable financial conditions. In 2004 the risk premium fell by around 1 percentage point, to 3.7 points; in the early months of this year it rose back to 4.4 points.

On 14 January 2005 the Argentine authorities launched a tender offer to exchange $81.8 billion of defaulted debt. The offer closed at the end of February and was taken up by creditors holding 76.2 per cent of the debt.

In Turkey, thanks to the rapid growth of the economy and the dissipation of uncertainty about the start of negotiations to join the EU, the yield spread between dollar-denominated government securities and the corresponding US securities narrowed by 0.6 percentage points between the beginning of 2004 and mid-March of this year, to 2.4 points. The risk premium subsequently rose back to the levels recorded at the beginning of 2004.

In Russia financial market conditions also remained easy, despite the liquidity crisis affecting one of the country's leading banks and the difficulties of its second-largest oil company. During 2004 and early 2005 the risk premium fell by 0.7 percentage points to 1.8 points, a historically low level.

INTERNATIONAL TRADE AND THE BALANCE OF PAYMENTS

International trade

In 2004 the rapid expansion of world trade reflected the acceleration in economic activity and its spread to all the regions of the world. Trade in goods and services at constant prices increased by 9.9 per cent, compared with 4.9 per cent in 2003, rising at almost double the rate of world output (5.1 per cent). The elasticity of trade to economic activity, which had fallen sharply in the previous three years, returned to the levels of the previous two decades.

Trade in goods alone increased by 10.7 per cent, as against 5.3 per cent in 2003, driven by the strengthening of the world investment cycle and, in the first half of the year, by the upturn in industrial production in all the leading economies.

The growth in demand for energy sources and industrial raw materials, especially from the emerging countries of Asia, drove up the prices of raw materials and of oil products in particular.

A significant boost to world trade again came from the strong expansion in demand in the United States and in the emerging economies of Asia. US imports of goods and services at constant prices continued to increase at a faster pace than those of the advanced countries as a group (9.9 and 8.5 per cent respectively, compared with 4.4 and 3.6 per cent in 2003). Japanese imports rose by 8.9 per cent, mainly reflecting, as in 2003, the strong growth in demand for components of capital goods and electronic products. With the upturn in economic activity still weak, the rate of growth in euro-area imports rose to 6.5 per cent, from 2.2 per cent in 2003. In the newly industrialized economies of Asia imports were driven by the rapid growth in output in the sectors most exposed to foreign competition, rising by 15.8 per cent compared with 9.1 per cent in 2003.

In the developing countries and emerging economies as a group the growth in imports of goods accelerated to 16.9 per cent (10.3 per cent in 2003), an even higher rate than that recorded in 2000 (15.8 per cent). It is estimated that Chinese imports, which account for 5.4 per cent of world trade, contributed around 1.5 percentage points to its growth.

As in the previous two years, in 2004 exports of goods by the Asian countries outpaced those of the other main areas; the largest increases were recorded by China and the newly industrialized Asian economies, at 29.2 and 19.3 per cent respectively. Trade flows within the area expanded considerably. The strong competitiveness of the emerging Asian economies with respect to the rest of the world, which is partly due to the pegging of their currencies to the dollar, propelled exports outside the region. After rising sharply in the first half of 2004, Japanese exports of goods and services slowed to growth of 14.4 per cent in the year as a whole, compared with 9.1 per cent in 2003.

US exports of goods and services grew by 8.6 per cent, compared with 1.9 per cent in 2003, having become more competitive as a result of the dollar's depreciation in the last three years. Exports of goods by the Latin American countries grew even faster, by 10.5 per cent, up from 3.3 per cent in 2003; they were driven by the expansion in US and Asian demand in sectors linked to mining and raw materials processing.

The rate of growth in euro-area exports of goods and services (6.3 per cent) was again lower than that in world trade, reflecting the loss of competitiveness caused by weak productivity gains and the appreciation of the euro. The recovery with respect to 2003, when exports had been at a standstill, was driven by the expansion of demand in the rest of the world and closer integration with the Central and Eastern European countries. That region's exports of goods accelerated further, rising by 16.2 per cent, compared with 13.7 per cent in 2003.

In 2004 the rise in raw materials prices led to a marked improvement in the terms of trade of the developing countries that are exporters of such commodities, in particular energy sources. The terms of trade of the oil-exporting developing countries improved by 19 per cent, much more than in the previous two years; in the Latin American and African countries, which are large exporters of non-energy raw materials, the respective gains were 3.2 and 4.4 per cent. By contrast, there was a slight deterioration of 0.4 per cent in the terms of trade of both the advanced countries and the Asian developing countries, prevalently exporters of manufactures. The depreciation of the dollar caused a more substantial deterioration, of 2.1 per cent, in the terms of trade of the United States.

In early 2005 the multilateral rules governing world trade in textile products and clothing were amended. The abolition of the system of import quotas in force for more than three decades will greatly increase competition between exporting countries in the main markets of the West.

Raw materials prices

The upward pressure recorded by oil prices since May 2003 gained strength last year. Crude oil prices (as an average of the three main grades) jumped from \$25.5 a barrel in April 2003 to \$47 in October 2004 before dropping back to \$39 in December. The average price during the year was \$37.8, an increase of about 30 per cent from the previous year, compared with 16 per cent in 2003.

The higher-than-expected price rise was mainly due to the very strong growth in world demand, which also exceeded forecasts. Against a background of persistent geopolitical tensions in the Middle East and in other oil-producing countries, price volatility was accentuated by a further decline in spare capacity in the OPEC countries.

The price of oil recorded further increases in the early months of 2005. Having peaked at \$54.1 on 4 April of this year, it fell back to \$46.3 on 18 May. As a result of the very high level of prices, the OPEC countries decided on 16 March to raise their production target by 500,000 barrels a day, bringing it to 27.5 million. In the first quarter of 2005 the price of oil, adjusted for changes in world dollar prices of manufactures, moved close to the average for the three years 1983-85 before the counter-shock. Compared with the low recorded at the end of 1998, during a global cyclical downturn, the price of oil has more than tripled in real terms.

Futures contracts for WTI grade oil traded on NYMEX on 18 May of this year indicated that prices should rise to \$51.1 a barrel in December. Although they are expected to fall slightly during 2006, they are still likely to remain higher than the current spot prices of WTI (\$47).

The recovery in the prices of other raw materials that began in 2003 strengthened in 2004. The prices of metals, which react faster to the world economic cycle, increased by 36.4 per cent (11.9 per cent in 2003), while those of manufactures rose by 8.8 per cent. The increase in the prices of food and other agricultural products (14.5 and 5.5 per cent respectively) was curbed by price declines at the end of 2004 following good harvests.

Balance-of-payments developments

International disequilibria in external current accounts worsened in 2004 (Table 2). The deficit on the US current account increased from \$531 billion to \$666 billion, or from 4.8 to 5.7 per cent of GDP. The current account surplus of the Asian economies as a group rose from \$307 billion to \$365 billion, equal to 4 per cent of GDP, mainly reflecting the increase in that of

Japan (from $136 billion to $172 billion) and China (from $46 billion to $70 billion). The surpluses of the oil-exporting countries and Russia also expanded sharply, from $68 billion to $123 billion and from $35 billion to $60 billion respectively; so far only part of the further improvement in the terms of trade of these countries has been reflected in an increase in imports.

Latin America maintained the virtual balance in its current account achieved in 2003. By contrast, the countries of Central and Eastern Europe saw their deficit grow to $51 billion, or 5 per cent of GDP, partly owing to the progressive increase in net outflows of investment income.

A contributory factor in the widening of the current account surplus of the Asian economies, which is more than half the size of the US deficit,

Table 2

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS OF THE MAIN COUNTRIES AND AREAS

	Billions of dollars				As a percentage of GDP			
	2001	2002	2003	2000	2001	2002	2003	2004
Advanced countries								
United States	-385.7	-473.9	-530.7	-665.9	-3.8	-4.5	-4.8	-5.7
Japan	87.8	112.8	136.4	172.1	2.1	2.8	3.2	3.7
Euro area	-3.4	62.6	24.1	56.8	-0.1	0.9	0.3	0.6
Newly industrialized Asian economies (NIEs) (1)	50.6	59.3	84.5	89.6	5.0	5.5	7.4	7.1
of which: South Korea	*8.0*	*5.4*	*12.1*	*26.8*	*1.7*	*1.0*	*2.0*	*3.9*
Developing and emerging countries								
Latin America	-53.9	-16.4	6.6	15.9	-2.8	-1.0	0.4	0.8
of which: Argentina	*-3.9*	*8.6*	*7.4*	*3.1*	*-1.4*	*8.5*	*5.8*	*2.0*
Brazil	*-23.2*	*-7.6*	*4.2*	*11.7*	*-4.6*	*-1.7*	*0.8*	*1.9*
Mexico	*-18.2*	*-13.7*	*-8.6*	*-8.7*	*-2.9*	*-2.1*	*-1.3*	*-1.3*
Venezuela	*2.0*	*7.6*	*11.4*	*14.5*	*1.6*	*8.2*	*13.6*	*13.5*
Asia..	40.8	72.2	85.8	103.3	1.8	2.9	3.1	3.3
of which: ASEAN-4 (2)	*21.7*	*27.2*	*31.9*	*34.1*	*5.0*	*5.5*	*5.7*	*5.5*
China	*17.4*	*35.4*	*45.9*	*70.0*	*1.5*	*2.8*	*3.2*	*4.2*
India	*1.4*	*7.1*	*6.9*	*2.1*	*0.3*	*1.4*	*1.2*	*0.3*
Middle East	39.1	29.4	59.3	112.5	6.1	4.6	8.3	13.7
Central and Eastern Europe (3)	-16.6	-24.5	-37.0	-50.6	-2.7	-3.6	-4.4	-5.0
Russia	33.4	30.9	35.4	59.6	10.9	9.0	8.2	10.2
Memorandum items:								
Oil-exporting emerging and developing countries...	**45.0**	**33.4**	**67.6**	**122.5**	**6.4**	**4.9**	**8.8**	**13.2**
Japan, NIEs and Asian developing countries	**179.2**	**244.3**	**306.7**	**365.0**	**2.4**	**3.2**	**3.7**	**4.0**

Sources: Based on ECB and IMF data and national statistics.

(1) Hong Kong, Singapore, South Korea and Taiwan. – (2) Indonesia, Malaysia, the Philippines and Thailand. – (3) Including Malta and Turkey.

has been the improvement in their international competitiveness in the past three years thanks to the pegging of their currencies to the dollar. Major shifts in firms' and households' demand have helped to consolidate the region's structural surplus since the end of the 1990s.

The growth of the US current account deficit in 2004 continued to reflect that of the deficit on trade, which rose from $548 billion to $665 billion. About 40 per cent of the deterioration was due to energy imports, which increased from $133 billion to $180 billion. With imports exceeding exports in value terms by 70 per cent, the faster growth of domestic demand in the United States (4.8 per cent) with respect to the country's main destination markets (4.2 per cent) remained the principal cause of the deterioration in the current account deficit. While exports grew by 8.8 per cent at constant prices, imports increased by 10.8 per cent, partly because their elasticity to demand is greater than in the other leading countries.

The depreciation of the dollar affected US exports, which increased in value by 13.2 per cent, not only by sustaining volumes but also permitting increases in the dollar prices of exported goods. The rise in the dollar value of imports was contained by the modest extent of exchange rate pass-through.

The United States deficit was financed again in 2004 mainly by net inflows of private capital, which rose from $581 billion to $1,078 billion. Inflows originating from foreign authorities continued to increase, progressing from $28 billion in 2001 to $249 billion in 2003 and $355 billion in 2004 as a result of the build-up of dollar reserves, above all by the central banks of the main Asian countries. As in 2003, inflows of financial capital were mainly for investment in government bonds ($483 billion) and debt securities of private issuers ($254 billion).

The net foreign debtor position of the United States increased from 22.8 per cent of GDP at the end of 2001 to 24.1 per cent in 2003 and is expected to remain at much the same level in 2004. In the past three years the effect of the US current account deficit on its foreign debt has been largely offset by the change in the dollar value of international financial assets and liabilities.

Net capital flows to emerging countries

Net private capital inflows to emerging countries increased sharply, from $150 billion in 2003 to $197 billion last year, approaching the same levels as before the Asian crisis (Table 3). The greatest beneficiaries of the expansion were the Asian countries, whose net inflows rose from $56 billion to $130 billion, and the countries of Central and Eastern Europe, which recorded an increase from $52 billion to $61 billion.

Table 3

NET CAPITAL FLOWS TO EMERGING COUNTRIES (1)

(billions of dollars)

	1996	1997	1998	1999	2000	2001	2002	2003
	All emerging countries (2)							
Net private flows	198.4	84.8	89.1	60.8	60.9	75.8	149.5	196.6
Direct investment	*147.2*	*159.8*	*173.3*	*174.3*	*184.7*	*144.4*	*151.9*	*186.4*
Portfolio investment	*60.4*	*42.5*	*69.1*	*20.5*	*-86.9*	*-90.0*	*-9.9*	*28.8*
Other investment	*-9.2*	*-117.6*	*-153.3*	*-134.0*	*-36.9*	*21.4*	*7.5*	*-18.6*
Net official flows	27.7	53.5	18.2	-42.7	1.8	8.5	-58.1	-58.0
	Asia (2)							
Net private flows	36.5	-49.9	11.8	-2.0	10.7	23.9	56.1	130.1
Direct investment	*55.7*	*56.6*	*67.1*	*67.1*	*54.8*	*52.5*	*70.6*	*87.0*
Portfolio investment	*6.8*	*8.7*	*55.8*	*20.0*	*-57.6*	*-62.0*	*2.5*	*25.8*
Other investment	*-26.0*	*-115.2*	*-111.1*	*-89.2*	*13.5*	*33.3*	*-17.0*	*17.3*
Net official flows	22.7	15.4	-0.2	1.0	-6.6	-0.2	-14.4	7.0
	Latin America							
Net private flows	99.6	70.8	38.7	40.5	27.8	3.3	15.2	12.7
Direct investment	*57.7*	*62.0*	*65.9*	*69.3*	*71.3*	*43.8*	*34.7*	*45.4*
Portfolio investment	*29.9*	*25.5*	*1.0*	*1.3*	*-10.0*	*-15.5*	*-10.1*	*-14.2*
Other investment	*12.0*	*-16.7*	*-28.2*	*-30.1*	*-33.6*	*-25.0*	*-9.5*	*-18.5*
Net official flows	5.4	16.9	5.5	-7.4	26.4	19.8	8.7	-7.3
	Africa							
Net private flows	14.3	10.8	11.5	-1.7	7.6	6.9	12.3	11.4
Direct investment	*7.9*	*6.6*	*9.0*	*8.0*	*23.0*	*14.8*	*14.6*	*15.4*
Portfolio investment	*7.4*	*4.3*	*9.1*	*-1.8*	*-7.7*	*-0.9*	*0.4*	*3.9*
Other investment	*-1.1*	*-0.1*	*-6.6*	*-7.9*	*-7.7*	*-7.0*	*-2.8*	*-8.0*
Net official flows	-4.5	2.9	1.1	-0.2	-2.6	3.8	2.8	-0.5
	Middle East (3)							
Net private flows	7.9	19.1	-3.1	-2.2	4.5	-4.0	-2.4	-21.0
Direct investment	*8.3*	*10.1*	*4.5*	*3.5*	*6.8*	*4.2*	*11.6*	*8.8*
Portfolio investment	*-6.8*	*-2.3*	*0.7*	*3.9*	*-2.9*	*-4.9*	*-5.1*	*-10.5*
Other investment	*6.4*	*11.3*	*-8.3*	*-9.6*	*0.5*	*-3.3*	*-9.0*	*-19.3*
Net official flows	-1.1	7.9	14.3	-33.3	-16.4	-5.5	-44.6	-49.2
	Central and Eastern Europe (4)							
Net private flows	20.2	27.2	36.7	39.1	12.2	55.3	52.0	60.6
Direct investment	*11.6*	*19.2*	*22.6*	*23.9*	*24.2*	*25.1*	*15.1*	*22.1*
Portfolio investment	*5.4*	*-1.4*	*5.7*	*3.1*	*0.5*	*1.4*	*7.1*	*24.9*
Other investment	*3.2*	*9.4*	*8.4*	*12.2*	*-12.4*	*28.7*	*29.8*	*13.6*
Net official flows	-3.3	0.3	-2.6	1.5	5.5	-7.6	-5.5	-6.9
	Countries of the former Soviet Union (5)							
Net private flows	19.9	6.7	-6.4	-13.0	-1.8	-9.5	16.4	2.9
Direct investment	*5.9*	*5.3*	*4.2*	*2.4*	*4.6*	*3.9*	*5.3*	*7.7*
Portfolio investment	*17.6*	*7.7*	*-3.1*	*-6.1*	*-9.2*	*-8.2*	*-4.8*	*-1.1*
Other investment	*-3.7*	*-6.3*	*-7.5*	*-9.4*	*2.8*	*-5.3*	*15.9*	*-3.7*
Net official flows	8.6	10.0	0.1	-4.3	-4.5	-1.7	-5.2	-1.0
Memorandum item:								
Change in reserves (6)								
All emerging countries	-105.2	-37.4	-93.5	-121.9	-115.1	-194.4	-369.3	-518.9
of which: Asia	*-36.0*	*-52.9*	*-87.5*	*-61.2*	*-89.6*	*-158.4*	*-235.7*	*-344.3*

Source: IMF.

(1) Capital inflows less outflows. Other investment comprises bank loans and trade credit, foreign currency deposits and other assets and liabilities; it may also include some official flows. Rounding may cause discrepancies in totals. – (2) Including the newly industrialized economies (Hong Kong, Singapore, South Korea and Taiwan). – (3) Including Israel. – (4) Including Malta and Turkey. – (5) Including Mongolia. – (6) A minus sign indicates an increase in reserves.

As in 2003 net official financing was negative, by $58 billion, since several emerging countries decided to repay in advance their debts with the IMF and the World Bank. Given the widening current account surplus and the substantial inflows of capital, the monetary authorities of these countries accumulated further foreign exchange reserves, which rose from $369 billion to $519 billion. Two thirds of the increase was due to the Asian countries and the remaining third to the oil-exporting countries of the Middle East and Russia.

Net direct investment inflows increased from $152 billion to $186 billion, reflecting the strong growth of profits in the industrial countries and the improvement in economic fundamentals in the emerging countries.

Net portfolio investment, which had registered outflows since 2001, turned positive by $29 billion. The abundance of international liquidity and low interest rates in the advanced countries fostered inflows for investment in both shares and bonds.

Net private capital inflows to Latin America were modest at $13 billion, showing little change with respect to the previous year. While net direct investment inflows picked up from $35 billion to $45 billion, there was an increase in net outflows of portfolio investment and "other investment".

In the countries of Central and Eastern Europe the increase in private financing reflected above all the rise in net portfolio investment inflows from $7 billion to $25 billion, which thus overtook direct investment (up from $15 billion to $22 billion). The largest increase was in purchases of bonds issued by the ten new EU members, fueled not only by relatively high interest rates but also by the strengthening of their institutional and legal system and the liberalization of capital movements prior to joining the EU. Total inflows were almost nil in the former Soviet Union.

Emigrants' remittances to the emerging countries have become increasingly important in recent years and are now the second most important source of external finance after direct investment. Most remittances are made to Latin America and the developing countries of Asia. Between 1990 and 2003 India, Mexico and the Philippines recorded the largest inflows in absolute terms; in relation to GDP emigrants' remittances are particularly high in the smallest and poorest countries.

Emigrants' remittances characteristically have a low level of volatility, both on average and during balance-of-payments crises, and are basically acyclical, even compared with direct investment, the most stable component of capital flows. These features, along with the fact that remittances constitute inflows of international vehicle currency, endow them with a potentially stabilizing effect on the current account of the emerging economies.

INTERNATIONAL COOPERATION

International Monetary Fund financial assistance

In 2004 the International Monetary Fund approved twelve financial assistance programmes for a total of 1.3 billion SDRs, or $2.1 billion, just over a tenth of the previous year's amount. The main recipients were Peru and Romania, most of the remainder being allocated to low-income countries. A further four programmes, amounting to 0.5 billion SDRs, were approved in the first three months of 2005. On the whole, all finance remained within the normal limits of access to IMF resources, which are equal to 100 and 300 per cent respectively of a country's quota on an annual and cumulative basis.

The stock of IMF loans declined considerably as a result of large net repayments by Russia (2.6 billion SDRs), Brazil (1.9 billion SDRs), Turkey and Argentina (1.6 billion SDRs each). At the end of March 2005 the stock amounted to 50.3 billion SDRs ($78.2 billion), 14.7 billion SDRs less than at the end of 2003. Partly as a consequence of this, the Fund's forward commitment capacity for the next twelve months rose from 54.2 to 93.8 billion SDRs. The improvement was also due to the completion of the programme with Brazil and to the rouble's inclusion among the currencies eligible for use in financing operations, which was decided in March 2005 after Russia had repaid in advance its residual debt with the IMF.

The geographical concentration of IMF financing rose further, reaching the highest level of the past twenty-five years. At the end of March 2005 the five largest borrowers (in order, Brazil, Turkey, Argentina, Indonesia and Uruguay) accounted for 88.5 per cent of outstanding loans. This reflects prolonged recourse to IMF loans by some member countries, which is potentially the greatest factor of risk for the Fund's capital and revenue. The G10 finance ministers and central bank governors have called for a strengthening of the IMF's financial position, in particular through more rigorous compliance with the adjustment measures requested of borrowers and the introduction of new financial incentives to encourage prompt repayment and reduce the rate of programme renewals. Moreover, the Fund's own Independent Evaluation Office has suggested drawing up explicit "exit strategies" from the financial protection of the Fund to operate from the very start of the programme approval process.

In the last two years the IMF has used different methods, with varying results, to manage exit strategies from its financial protection for its three largest borrowers (Brazil, Turkey and Argentina). In their case the Fund sought to renew, albeit partially, loans already exceeding normal limits of access, and so remained heavily exposed for longer than originally envisaged. Given the absence of any real crisis affecting the capital account of these countries, approval of the programmes was justified by invoking the exceptional circumstances clause. The difference between the cases described lay in the way the IMF formulated adjustment measures and the extent to which these were implemented by the debtor countries.

Prevention and resolution of international financial crises

IMF surveillance. – At the end of the traditional two-yearly review of surveillance, the Fund's Executive Board confirmed that this activity was central to crisis prevention and to international monetary stability, and indicated key areas of reform in order to strengthen the Fund's role.

The priorities are the following: (a) greater selectivity in the case of countries deemed to be of systemic importance and regarding the most delicate aspects of their economic policies; (b) exchange rate regime; (c) regional economic and financial integration; (d) fine-tuning of debt sustainability analyses and deeper study of the financial sector; (e) closer dialogue with national authorities; (f) systematic assessment of the effectiveness of corrective action implemented in member countries.

The IMF member countries continued to prepare their Reports on the Observance of Standards and Codes (ROSCs) in the fields of statistics, finance and economic policy. At the end of March 2005 the IMF had completed 624 ROSCs for 110 countries. Participation in the Financial Sector Assessment Programme also increased. At the end of March 88 countries had completed the programme, 27 more than a year earlier; a further 14 FSAPs were in progress (including the programme for Italy) and another 16 countries had announced their intention to participate.

The Financial Stability Forum. – The IMF's surveillance of systemically relevant countries complements that of the Financial Stability Forum, which performs the important function of identifying the international financial system's main vulnerabilities.

At its meetings in Washington (September 2004) and Tokyo (March 2005) the Financial Stability Forum identified the main factors of macroeconomic risk as the persistence of global imbalances, the slowing of economic growth in China and high oil prices. Mention was also made of house prices, which are judged to be excessively high, and of the growing financial risk to which households in several industrial countries are exposed. At the structural level, emphasis was placed on the risks created by the rapid growth in hedge funds and their increasing systemic importance.

By the end of 2004 the IMF had completed 39 of the 42 off-shore centre assessment exercises according to the list published in 2000. The exercises showed that most of the centres had made appreciable efforts towards reform. Some, however, still have difficulty complying with international standards, especially regarding cross-border cooperation, information flows, and the adequacy of the resources available to supervisory authorities.

Sovereign debt restructuring principles. – Under the aegis of the G20 further progress was made in the task of preparing a voluntary "code of conduct" as a guideline for creditors and debtors in sovereign debt restructuring, which the Banque de France and the Institute of International Finance had initiated in 2000. A group formed by representatives of the private sector and of some of the main debtor countries (Brazil, Korea, Mexico and Turkey) agreed in November 2004 on a set of conditions based on four general criteria: transparency and timely exchange of information; close cooperation between the parties to prevent default, including through arrangements for creditors to renew short-term debt and the debtor to continue partial debt service; demonstration of good faith by the debtor during negotiations, to be verified by the IMF; fair treatment for all creditors. The agreement received a favourable evaluation from the G20, but has not yet been subscribed by some private sector associations and major debtor countries (such as Argentina). At the recent meetings in Washington in the spring, the International Monetary and Financial Committee called on the international community to make a last effort to finalize the agreement and broaden consensus.

Collective action clauses. – In recent months the dissemination of collective action clauses for securities issued by emerging countries has continued. These clauses allow a qualified majority of creditors to make amendments to loan conditions that are binding on all bond-holders and forestall legal action by individual creditors during the debt restructuring process.

The restructuring of Argentina's debt and the legal dispute between creditors and debtors. – On 14 January 2005 Argentina launched a tender offer to exchange sovereign debt securities in default since the end of 2001 amounting to $81.8 billion, of which $2.1 billion for interest arrears to 31 December of that year. While the offer was in progress the Argentine Parliament passed a new law preventing its reopening.

The offer, which officially closed on 25 February of this year, was to exchange the old bonds for three categories of new securities (at par, discount and quasi-par) worth $35.2 billion, entailing an average loss for holders of 75 per cent of the old bonds' net value. The Argentine authorities reported an acceptance rate of 76.2 per cent in value terms, less than in previous restructurings (93-99 per cent). Argentine residents apparently took up over 95 per cent, non-residents much less (66-70 per cent, including Argentineans resident abroad). According to the authorities, upon completion of the offer the federal debt decreased from 124 to 72.4 per cent of GDP; the figure rises to 86.6 per cent if arrears due to private creditors who did not accept the offer and interest arrears to all bond-holders ($19.6 billion and $5 billion respectively) are taken into account.

The restructuring of Argentine's debt was accompanied by a wave of lawsuits without precedent in the history of sovereign debtor default, due to the large number of creditors and the authorities' refusal to enter into meaningful negotiations with them.

During the spring meetings in Washington the G7 countries and the International Monetary and Financial Committee advised Argentina to solve the problem of the arrears owed to bond-holders who did not accept the offer (the hold-outs), in compliance with IMF guidelines on lending into arrears.

Poverty reduction and development finance

Poverty reduction. – In the last five years the international community's commitment to combat poverty has found a more definite frame of reference in the Millennium Development Goals and the Monterrey strategy.

The main growth targets for 2015 approved by the United Nations General Assembly in 2000 (the Millennium Declaration) are to halve the number of people living in extreme poverty, ensure universal access to primary education, reduce infant mortality, safeguard environmental resources and combat the main infectious diseases (AIDS, malaria, tuberculosis).

The Monterrey strategy was agreed by heads of state and government at the United Nations international development finance conference held in that city in March 2002. Its aim is to mobilize the financial resources needed to achieve the Millennium Development Goals. The strategy commits the advanced countries and the international financial institutions (IMF, World Bank and multilateral development banks) on the donor side and calls on the developing countries to make better use of aid by implementing appropriate institutional reforms and pursuing macroeconomic policies geared to stability and better living standards for the poor.

The World Bank and the IMF make a yearly assessment of the state of progress of these initiatives. The report identifies deviations from the goals, assigns responsibility and recommends corrective action.

According to recent assessments the goals are unlikely to be fully achieved within the projected deadline, especially those not linked to income; the delay will vary considerably from one region to another.

The achievement of the Millennium Development Goals will depend on the ability of the institutions and countries involved to intensify their efforts. In particular, the developing countries must improve their macroeconomic policies and institutional systems. The developed countries, for their part, should open up their markets to poor countries' exports and increase official aid, ensuring it is more effective and better allocated.

In 2003 world flows of aid amounted to $69 billion at current prices, $10.7 billion more than the year before. At constant prices and exchange rates this represents an increase of barely $2.9 billion. Official aid amounted to 0.25 per cent of the donor countries' GNP, a figure well below the 0.7 per cent that World Bank experts judge necessary to achieve the Millennium Development Goals. Almost all of the increase in aid was for emergency measures connected with natural disasters, debt cancellation and technical assistance; a large proportion continues to be allocated according to the donor countries' geopolitical interests.

Innovative development finance mechanisms and the HIPC Initiative. – In view of the donor countries' budget constraints, the last two years have seen the proliferation of proposals for new development finance mechanisms designed to increase the volume of aid and reduce its variability.

One of the main proposals under discussion is the International Finance Facility (IFF) presented by the United Kingdom in 2003. The aim of the IFF is to speed up future disbursement of donors' aid commitments by issuing donor-guaranteed securities on the international capital markets. The proceeds of the issues, which should amount to around $50 billion a year until 2015, would be distributed according to criteria agreed beforehand among the beneficiary countries, using existing official bilateral and multilateral channels.

Another initiative, the International Finance Facility for Immunization (IFFIm), is in the launch phase. It is a pilot project developed by the United Kingdom and France in collaboration with the Global Alliance for Vaccines and Immunization on the model of the IFF; its aim is to raise $4 billion dollars between 2005 and 2015, doubling the resources available for a vaccination programme in the poorest countries.

Other proposals, such as the Landau Report commissioned by the French government, suggest financing aid by means of international taxation: taxes would be levied on international financial transactions, international arms trade, profits of multinational corporations, air travel, and gas emissions. However, such initiatives continue to arouse controversy, in part because of doubts about their economic efficiency and equity but above all because of the political difficulty of putting them into effect. One problem yet to be solved is that of the legal and institutional framework best suited to such a plan, not to mention that of the channels for distributing the revenue collected.

Considerable progress has been made with the HIPC Initiative to reduce the debt of the largest borrowers: 27 of the 38 potential beneficiaries have reached the so-called "decision point" and been officially recognized as eligible for debt forgiveness; 15 of these have also passed the "completion point", when creditors irrevocably cancel the whole debt calculated at the decision point. Among countries at decision point the ratio of debt service to government fiscal revenue in 2006 will be less than half the figure for 1999, when the initiative was launched; most of these countries have already increased direct public expenditure on the Millennium Development Goals.

The international community is currently examining further proposals to extend debt cancellation to more potential beneficiaries of the HIPC Initiative and other poor countries; this would be done by raising additional finance and by revising the requirements for eligibility. However, it is important that the resources be truly additional and not be obtained by diverting funds earmarked to increase official aid.

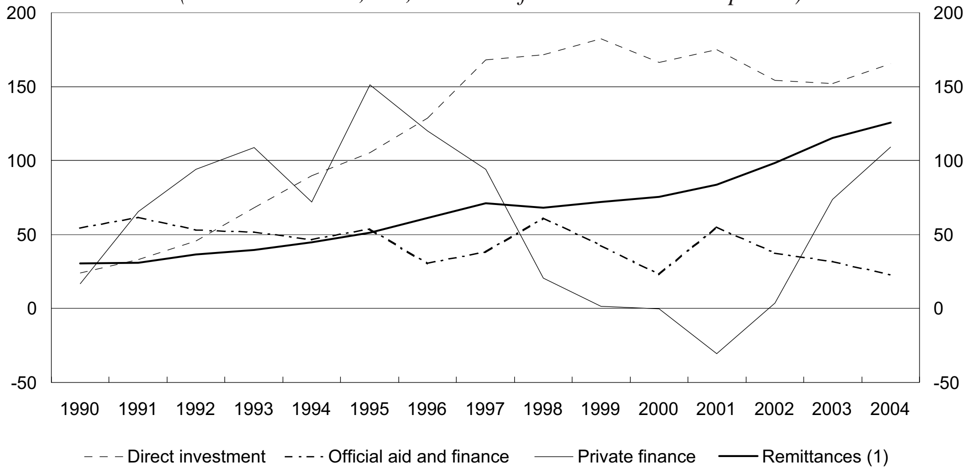
Migrants' remittances. – The World Bank estimates that in 2004 migrants' remittances to the developing countries amounted to $126 billion, over five times more than the financial resources made available by the official sector (international financial institutions and donor countries; Figure 2).

The large volume of migrants' remittances and their limited volatility could make them an important means of financing the development of the recipient countries. They represent additional funds available to increase consumption and investment. They also play a crucial role in reducing the external constraint of countries with persistent trade deficits and no access to international capital markets. Other benefits could derive from an improvement in human capital, if remittances are used to finance spending on health and education. The authorities of the countries of origin and destination should therefore pursue complementary objectives: facilitate international transfers of funds and encourage recipients to invest in productive activities.

Figure 2

FINANCIAL FLOWS AND REMITTANCES TO DEVELOPING COUNTRIES

(annual amounts, net; billions of dollars at current prices)



Source: World Bank, Global Development Finance 2005.

(1) Algebraic sum of the net balances of three balance-of-payments items associated with international labour mobility: “remittances”, “labour income” and “migrants’ transfers” (the last item is included under capital transfers).

In June 2004 the G8 countries launched a set of initiatives designed to facilitate the transfer of remittances. In particular, there are plans to facilitate migrants’ access to bank and financial services and to promote innovative instruments for the transfer of funds; by increasing competition in the market for remittance services, these instruments will help to bring about a significant reduction in costs, which are high at present. Furthermore, the World Bank and the Bank for International Settlements are coordinating work to draft a set of guidelines for remittance services. The recipient countries, for their part, can maximize the impact of remittances on economic growth by rapidly bringing in reforms, strengthening their banking and financial systems, and making their legal and institutional systems more receptive to private investment.

INCOME, PRICES AND THE BALANCE OF PAYMENTS

The euro area

Euro-area GDP grew by 2.1 per cent in 2004, the fastest rate in the last four years (Table 4), but still slower than the increase in Japan and, above all, the United States, which expanded twice as fast. The recovery in economic activity that began in the second half of 2003 strengthened in the first half of 2004, sustained by foreign trade. Growth gradually lost momentum in the second half of 2004 as the euro appreciated. The pattern of growth during the year, which was shaped by developments in exports, underscored the modest role of the domestic components of demand. The contribution of exports for the year as a whole was almost entirely offset by the negative contribution of imports.

The pace of the recovery differed in the main euro-area countries: although GDP grew by 2.3 per cent in France, it expanded by 1.6 per cent in Germany and no more than 1.2 per cent in Italy. Growth in the other countries was faster than the euro-area average.

In 2004 private consumption increased by just over 1 per cent, broadly in line with the previous year. After buoyant growth in the first quarter, household spending stagnated in the central part of the year. Spending picked up again in the last quarter, especially in France, which benefited from temporary measures introduced by the government.

After three years of contraction, gross fixed investment began to grow again (2.1 per cent), thanks above all to the components other than construction (3.2 per cent). The recovery in economic activity, notably in the first half of the year, and favourable financial conditions were contributory factors. Capital formation remained negative in Germany owing to a further reduction in activity in the building sector.

Employment expanded by about half a percentage point in 2004, sustained by the recovery in economic activity against a background of wage moderation. The large increase in employment in Spain contrasted with a slight decrease in France; in Germany employment started growing again, albeit very slowly. The euro-area unemployment rate was unchanged at 8.8 per cent.

Table 4

GDP, IMPORTS AND MAIN COMPONENTS OF DEMAND IN THE MAJOR EURO-AREA COUNTRIES

(at constant prices; seasonally adjusted data; percentage changes on the preceding period except as indicated)

	2002	2003	2004	2004			
	Year	Year	Year	Q1	Q2	Q3	Q4
				GDP			
Germany	0.2	..	1.6	0.4	0.2	..	-0.1
France	1.2	0.8	2.3	0.6	0.6	0.2	0.7
Italy	0.4	0.3	1.2	0.5	0.4	0.4	-0.4
Spain	2.7	2.9	3.1	0.8	0.5	0.6	0.8
Euro area	0.9	0.5	2.1	0.7	0.5	0.3	0.2
				Imports			
Germany	-1.0	4.2	6.7	0.8	2.3	2.7	0.2
France	1.7	0.7	6.9	0.5	3.0	2.2	1.0
Italy	-0.5	1.3	2.5	-1.2	2.6	1.1	0.1
Spain	3.8	6.2	8.0	1.2	2.5	5.1	1.0
Euro area	0.4	2.2	6.5	0.3	2.9	2.6	0.7
				Exports			
Germany	4.6	1.8	9.0	3.5	3.3	-1.0	1.1
France	1.5	-1.7	3.1	0.1	1.0	0.4	0.9
Italy	-3.2	-1.9	3.2	-1.8	3.7	4.8	-4.7
Spain	1.7	3.5	2.7	-0.9	3.2	3.6	-0.8
Euro area	1.9	0.4	6.3	1.4	3.1	1.0	0.3
				Household consumption (1)			
Germany	-0.4	0.3	-0.1	-0.2	-0.3	0.3	0.3
France	2.3	1.4	2.1	1.0	0.5	-0.1	1.1
Italy	0.4	1.4	1.0	1.1	-0.4	0.2	0.2
Spain	2.9	2.9	….	1.0	0.9	0.5	1.0
Euro area	0.6	1.1	1.2	0.7	..	0.1	0.6
				Gross fixed investment			
Germany	-6.1	-1.7	-0.5	-3.0	0.1	0.5	0.3
France	-1.7	2.7	2.5	-0.5	0.9	-0.3	1.3
Italy	1.2	-1.8	2.1	2.3	1.1	-1.2	-1.7
Spain	3.3	5.4	4.4	0.1	0.9	2.9	2.0
Euro area	-2.6	-0.4	2.1	-0.2	0.5	0.5	0.6
				National demand (2)			
Germany	-1.8	0.7	0.4	-0.7	-0.4	1.4	-0.6
France	1.3	1.5	3.4	0.7	1.2	0.7	0.7
Italy	1.2	1.2	1.0	0.6	0.1	-0.7	1.0
Spain	2.8	3.2	….	1.4	0.3	1.2	1.4
Euro area	0.3	1.2	2.0	0.3	0.3	0.9	0.3
				Net exports (3)			
Germany	1.9	-0.7	1.2	1.1	0.5	-1.3	0.4
France	-0.1	-0.7	-1.1	-0.1	-0.6	-0.5	-0.1
Italy	-0.8	-0.9	0.2	-0.2	0.3	1.1	-1.4
Spain	-0.6	-0.8	….	-0.7	0.1	-0.7	-0.6
Euro area	0.6	-0.6	0.1	0.4	0.2	-0.6	-0.1

Sources: Based on national statistics and Eurostat data. The figures for the euro area do not reflect the recent revisions of the national accounts of France, Germany and Spain.

(1) Expenditure of resident households and of non-profit institutions serving households. – (2) Includes changes in stocks and valuables. – (3) Contribution to the growth on the preceding period in percentage points.

Measured by the harmonized consumer price index, both general inflation and that excluding the most volatile components came to 2.1 per cent in 2004, as in the previous year. The appreciation of the euro against the dollar attenuated the impact of the rise in the prices of raw materials, especially oil. Inflation was also contained by the slowdown in unit labour costs. Developments in consumer price inflation differed in the main euro-area countries: it accelerated in Germany (from 1 to 1.8 per cent), remained stable in France (edging up from 2.2 to 2.3 per cent) and slowed in Italy (from 2.8 to 2.3 per cent).

Economic activity in Italy

In Italy GDP growth accelerated to 1.2 per cent in 2004 (Table 5). This was less than in the rest of the euro area owing to the weaker stimulus of domestic demand. After expanding moderately in the first half of the year, GDP growth slowed and turned negative in the last quarter, when the appreciation of the euro accentuated the difficulties faced by Italian firms in coping with competitive pressures; as a result, exports declined by 4.7 per cent with respect to the previous quarter. Gross fixed investment tracked developments in demand, rising sharply in the first half of the year and falling in the second. After expanding in the first half, consumption stagnated thereafter.

Growth in manufacturing was much weaker than that in GDP, confirming the major challenges facing this sector. After remaining basically flat in the first five months of 2004, in June the seasonally and calendar adjusted index of industrial production turned downwards, returning to its end-1995 level in the early months of this year (Figure 3). From its cyclical peak in December 2000, the index has fallen by about 8 percentage points with respect to the euro-area average, a gap similar to that recorded during the expansionary phase of the previous five-year period.

The growth in exports (3.2 per cent) was driven by the expansion in international trade (9.9 per cent). Italy's share of world trade at constant prices contracted further, falling below 3 per cent. Imports grew more slowly (2.5 per cent), owing to the weakness of demand; accordingly net exports made a positive contribution to GDP growth for the first time in two years (0.2 percentage points).

Despite the increase in exports, the merchandise trade surplus narrowed further in 2004 (from €9.9 billion to €8.8 billion) owing to higher spending on raw materials, especially oil. Thanks to the parallel improvement in the balance on services (which swung from a deficit of €2.4 billion to a surplus of €1.5 billion mainly as a result of the growth in the surplus on travel) and the reduction in the deficit on income (from €17.8 billion to €14.7 billion), the current account deficit contracted by nearly a third compared with 2003, falling to €12 billion or 0.9 per cent of GDP.

Table 5

ITALY: RESOURCES AND USES OF INCOME

	As a percentage of GDP in 2004	2003			2004		
		Percentage changes		Contribution to GDP growth at constant prices	Percentage changes		Contribution to GDP growth at constant prices
		Constant prices	Deflators		Constant prices	Deflators	
Resources							
GDP	–	0.3	2.9	–	1.2	2.6	–
Imports of goods *fob* and services (1)	28.3	1.3	-1.0	-0.4	2.5	3.7	-0.7
goods	*21.8*	*0.9*	*-0.4*	*-0.2*	*3.2*	*5.1*	*-0.7*
Uses							
National demand	99.6	1.2	2.5	1.2	1.0	2.6	1.0
Consumption of resident households	60.2	1.4	2.5	0.8	1.0	2.2	0.6
Consumption of general government and non-profit institutions serving households	18.3	2.3	3.5	0.4	0.7	2.1	0.1
Gross fixed capital formation	20.6	-1.8	1.9	-0.4	2.1	3.2	0.4
machinery, equipment and transport equipment	*10.7*	*-4.7*	*0.6*	*-0.5*	*1.4*	*2.2*	*0.2*
construction	*9.0*	*1.7*	*3.3*	*0.1*	*3.1*	*4.4*	*0.3*
intangible assets	*0.9*	*0.8*	*0.6*	*..*	*-0.8*	*1.8*	*..*
Change in stocks and valuables (2)	0.5	–	–	0.3	–	–	-0.1
Exports of goods *fob* and services (3)	28.7	-1.9	0.7	-0.5	3.2	3.8	0.9
goods	*22.9*	*-2.1*	*0.5*	*-0.5*	*3.3*	*4.1*	*0.7*
Net exports	0.4	–	–	-0.9	–	–	0.2

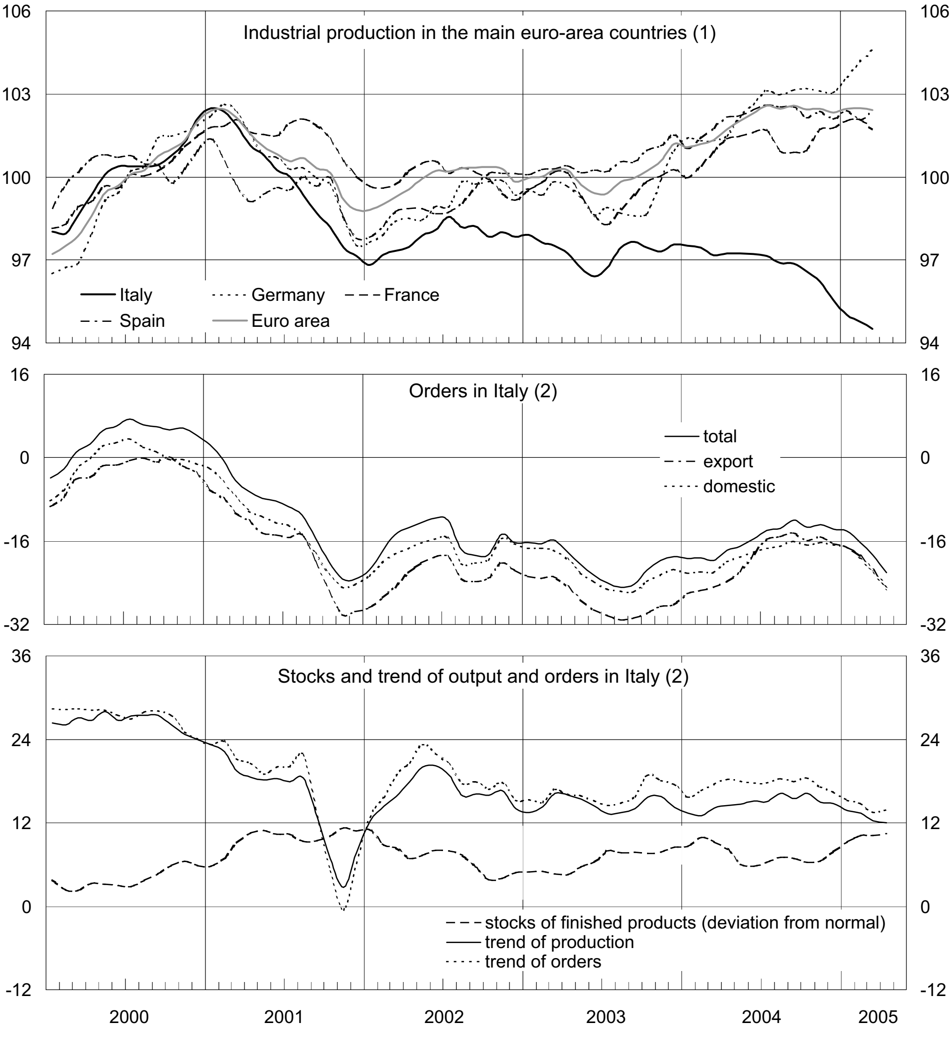
Source: Istat, national accounts.
(1) Includes residents' expenditure abroad. – (2) Includes statistical discrepancies. – (3) Includes non-residents' expenditure in Italy.

Gross fixed investment increased by 2.1 per cent in 2004, recouping the decline recorded the previous year (Table 5). The expansion, which benefited from favourable financial conditions and low interest rates, involved building and, to a lesser extent, the other sectors. Spare capacity in industry remained substantial, especially in the sectors with the largest proportion of turnover generated by exports. Against a background of weak domestic demand and an uncertain outlook, the pattern of spending on capital equipment over the year was closely correlated with developments in foreign demand: the substantial rise in the first half of the year (more than 6 per cent on an annual basis) was followed by a fall of similar proportions in the second. Investment in construction continued to grow for the sixth consecutive year, expanding by 3.1 per cent, compared with the average of 3.3 per cent in the five previous years. Factors contributing to the rise included the tax incentives for the renovation of residential property, first introduced in 1997, and the growth in the real estate market, sustained by abundant liquidity and the low cost of mortgages.

Figure 3

INDUSTRIAL PRODUCTION, DEMAND AND STOCKS

(moving averages for the three months ending in the reference month)



Sources: Based on Istat, Eurostat and ISAE data.

(1) Indices, 2000=100; seasonally adjusted data. – (2) Differences between the percentage of positive replies (“high”, “increasing”) and negative replies (“low”, “decreasing”) to ISAE business opinion surveys. Seasonally adjusted.

Household consumption increased by 1 per cent, which was less than in 2003 (Table 5). After a pronounced expansion in the first quarter of 2004, spending declined in the spring and was virtually stationary in the second half of the year. The growth in consumption was mainly fueled by spending on durable goods, which rose by nearly 8 per cent, with an especially large rise for high-tech products, most of which are imported.

In a context of widespread uncertainty about individual and general economic prospects, which has been reflected in the fluctuations of the household confidence index at a historically very low level, spending plans remained cautious, despite the increase of nearly 2 per cent in real disposable income net of the expected loss of purchasing power on financial assets due to inflation. As a result the average propensity to save increased further (from 10.6 to 11.4 per cent).

The continuous labour force survey Istat began last year showed that employment growth slowed from 1.5 per cent in 2003 to 0.7 per cent, with most of the increase coming in permanent jobs and self-employment. The rise in the number of persons in work was confined to the regions of the Centre and North, as employment decreased in the South. The reopening of the wage gap between the two macro-areas was accompanied by a resumption of migration from the South, mainly involving more highly qualified workers, who are more likely to find a job. Thanks to the acceleration in economic activity, labour productivity for the entire economy reversed the downward trend of the past two years and increased by half a percentage point; this was still less than in the other main euro-area countries.

Average consumer price inflation, measured with the harmonized index, declined from 2.8 to 2.3 per cent in 2004. Core inflation, which excludes the most volatile components, fell from 2.7 to 2.3 per cent. Italy's general inflation differential with the rest of the euro area virtually disappeared; that for core inflation remained slightly positive, at 0.3 points. The decline is attributable to steep falls in the prices of certain goods, such as telephone handsets, and the more gradual pass-through of higher prices for energy raw materials to electricity and gas charges than in the other main euro-area countries. The differential in the rate of increase of unit labour costs with respect to France and, above all, Germany remains large, mainly owing to the slow growth in productivity.

Key developments in the last four years

Following the cyclical peak reached between the end of 2000 and the first few months of 2001, in the last four years Italy's GDP has expanded at an average annual rate of 0.9 per cent, 0.4 points slower than in the other euro-area countries. In the five preceding years, the average GDP growth rate was close to 2 per cent, 0.8 points slower than the rest of the euro area. Per capita GDP increased by just over 1 per cent a year between 1995 and 2004, half a point less than in the other euro-area countries. As in the rest of the area, in Italy the slowdown between the two cycles mainly reflected the weakening of domestic demand, whose average annual contribution to growth halved, falling from 2.3 to 1.2 percentage points.

Despite an average annual increase in world demand of 4.5 per cent, exports have remained virtually unchanged over the last four years, after expanding by an annual average of 4 per cent between 1996 and 2000. Italy's share of world trade, which declined at constant prices from 4.6 per cent in 1995 to 3.5 per cent in 2000, slipped further last year, to 2.9 per cent. Measured in terms of current prices it has held steady since 2000, at around 4 per cent. In some cases this reflects a decision to trade market share for increased profit margins, in others it marks a shift towards segments where product quality and unit prices are higher.

The competitiveness of Italian industry continued to deteriorate. Measured on the basis of producer prices, the loss between 2000 and 2004 was 11 per cent, broadly in line with the average for France and Germany. Between 1996 and 2000, the competitiveness of Italian industry increased by 4 per cent, about 8 percentage points less than that of France and Germany. These developments were accompanied by a widening gap in the rise of unit labour costs, which was equal to 9 percentage points between 1996 and 2000 and 13 points in the four years to 2004, mainly as a consequence of the differential in productivity growth.

The stagnation of output per employee in Italy is part of a long-term trend reflecting a lack of material and "law and economics" infrastructure, the small size of firms, the persistence of old forms of product specialization, the modest level of competition and the direct and indirect effects of the imbalances in the public finances. These factors curb firms' propensity to invest in research and development and limit their ability to exploit innovative technologies and cope with increasing international competition.

After the cyclical expansion in the second half of the 1990s, the pace of capital formation slowed to 0.8 per cent between 2001 and 2004; its contribution to GDP growth declined to 0.2 percentage points. In a context of low real interest rates, the deceleration in gross fixed investment (which was common to the other euro-area economies) reflects the uncertain outlook for growth. The share of profits in value added for the entire economy remained at historically high levels, sustained in some service industries by weak competition. In manufacturing, which is more exposed to international competition, the share of profits decreased.

The slowdown in domestic demand is largely due to the deceleration in household consumption, whose annual rate of increase fell from 2.6 per cent between 1996 and 2000 to 0.9 per cent between 2001 and 2004. The decrease is not a consequence of slower growth in disposable income: net of expected losses of purchasing power on financial assets as a result of inflation, Italian households' disposable income rose at an average annual rate of 1.6 per cent in the last four years, compared with 1.3 per cent in the five preceding years.

The propensity to save has risen since 2000, when the downward trend under way since the mid-1980s reversed. The saving rate increased to 11.4 per cent in 2004, after falling from 14.5 to 8.8 per cent between 1995 and 2000. The rise is all the more remarkable in view of the fact that demographic changes, such as aging and the decline in household size, and the high level of accumulated wealth tend to push the saving rate down. The rise presumably reflects a deterioration in households' expectations for future income, which have been affected by slow GDP growth and developments in the labour market over the last decade.

Growth in labour costs moderated, also with respect to that in productivity (0.7 per cent annually between 1994 and 2004, compared with 1.7 per cent in the previous decade at constant prices, obtained by dividing by the deflator of value added at factor cost). This was a consequence not only of the incomes policy launched in the early 1990s but also of the large generational turnover in the labour force and increased use of fixed-term contracts. The introduction of more flexible mechanisms for adjusting payrolls, organizing production and managing working hours fostered more intensive use of labour. Thanks above all to the private sector, employment continued to increase from the mid-1990s onwards despite the slowdown in economic activity.

The transformation of the Italian labour market has been significant. The share of persons employed in government, which had risen constantly from the early 1960s onwards, reached 23.6 per cent in 1993-94 and subsequently declined to 20.8 per cent in 2003 (3.6 million standard labour units). According to labour force surveys, between 1994 and 2004 the employment rate for those aged between 15 and 64 rose by 5 percentage points to 57.5 per cent, although this is still low by international standards. The bulk of the increase came in part-time and fixed-term jobs. These changes mainly involved new workers, whose compensation has decreased with respect to the average. The expansion of employment in the private sector was less pronounced in the South, despite the slower growth in wages than in the Centre and North.

Recent developments

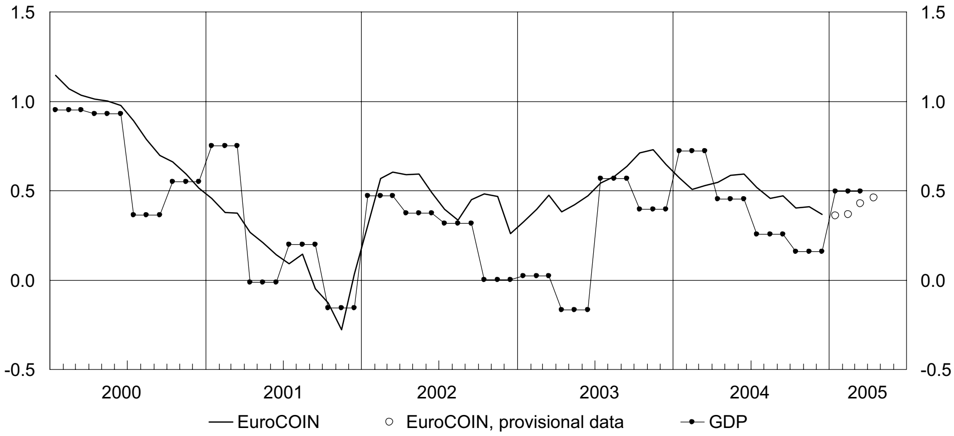
According to preliminary estimates by Eurostat, euro-area GDP grew by 0.5 per cent in the first quarter, accelerating with respect to the second half of 2004. The upturn has been surprisingly robust in Germany, where growth was 1 per cent, buoyed entirely by foreign demand. GDP growth slowed in France. In recent months the index of euro-area industrial production has settled at just above its end-2004 level (Figure 3).

The deterioration in euro-area indices of business and household confidence points to slower growth in the second quarter. The uncertainty that has characterized this business cycle has not yet been dispelled, as is confirmed by the weakness of the EuroCOIN coincident indicator (Figure 4).

Figure 4

EUROCOIN INDICATOR OF THE EURO-AREA BUSINESS CYCLE AND GDP

(three-month percentage changes)



Source: Center of Economic Policy Research.

In this context, euro-area inflation is generally expected to decline in 2005, with an annual average rate below 2 per cent; in 2006 it is forecast to edge down further. This inflation outlook is based on expectations of positive developments in domestic costs in the main euro-area countries and broadly stable oil prices.

The weakening of economic activity in Italy has grown more pronounced since the second half of 2003. The growth differential with respect to the euro area has widened since the end of last year. After contracting by 0.4 per cent in the fourth quarter compared with the previous period, GDP fell by a further 0.5 per cent in the first quarter this year; the comparable figures for the euro area show growth of 0.2 and 0.5 per cent. The indicators available do not signal a recovery in the second quarter: according to estimates based on electricity consumption, in April and May the index of industrial production hovered around the depressed level registered in the first quarter.

DEMAND

The euro area

Household consumption

In 2004 household spending in the euro area continued to grow at a rate of just over 1 per cent, in line with the modest average increase recorded since the start of the decade. Developments were especially unfavourable in Germany, where consumption began to contract again after the brief recovery in 2003.

After deteriorating in the first half of the year, household confidence resumed the moderately positive trend that had started in the spring of 2003. While pessimism continued to prevail in Italy and Germany, where households' views fluctuated sharply as uncertainty about the outlook for the labour market increased, in France confidence returned to the higher levels of the previous two years in the autumn. Since the start of 2005, it has diminished in all the main countries.

Investment

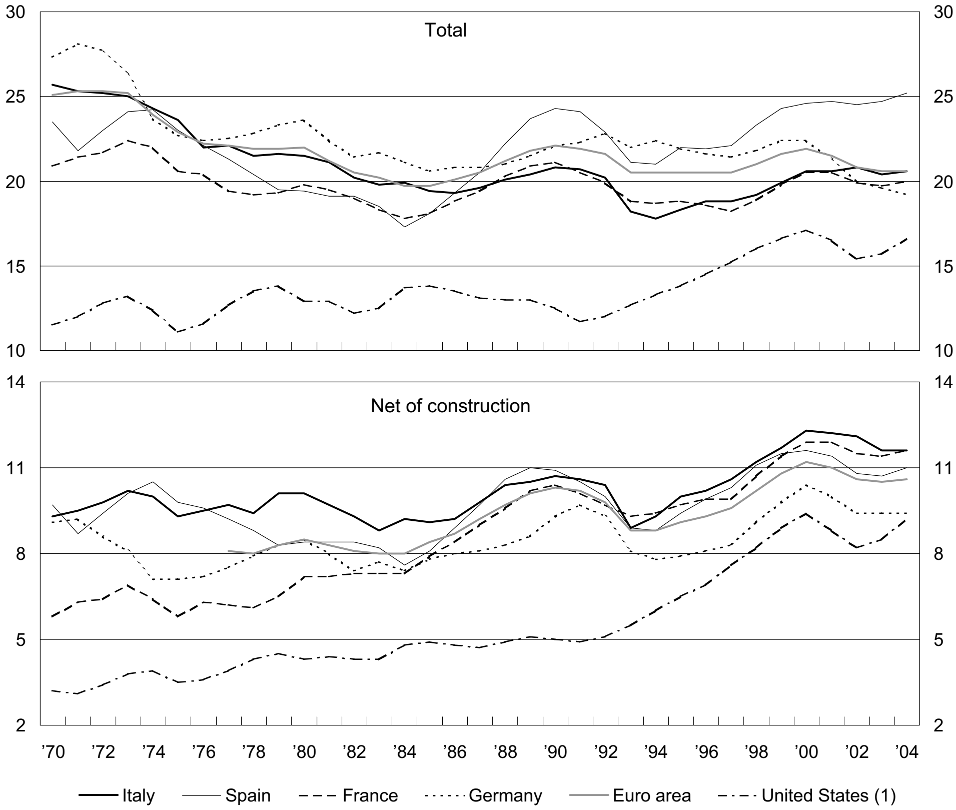
In 2004 gross fixed investment in the euro area turned upwards (2.1 per cent), recouping half of the decline registered over the previous three years. The rise was much smaller in construction, reflecting a further contraction in Germany. In addition to the continuation of favourable financing conditions, investment by euro-area firms was stimulated by a decrease in spare capacity, which fell to its lowest average level since 2001. The propensity to invest, as approximated by the ratio of capital formation to GDP, remained around the low for the last decade, at just over 20 per cent (Figure 5). Uncertainty about the strength of the recovery in demand was a contributory factor. The short-term expectations of industrial firms swung widely over the course of 2004 before turning sharply downwards in early 2005.

Investment in France was driven by domestic demand, which for the year as a whole expanded at a pace only slightly below the high recorded in 2000. By contrast, investment in Germany diminished for the fourth consecutive year despite the modest recovery in purchases of capital equipment.

Figure 5

RATIO OF GROSS FIXED INVESTMENT TO GDP IN THE MAJOR EURO-AREA COUNTRIES AND THE UNITED STATES

(constant prices; annual data; percentages)



Sources: Based on OECD and Eurostat data. The figures for the euro area do not reflect the recent revisions of the national accounts of France, Germany and Spain.
(1) Private sector.

Exports and imports

In 2004 exports of goods and services by the euro area as a whole – which include intra-area trade – increased by 6.3 per cent, led by the pronounced acceleration in Germany. The recovery also involved the other main area countries, although the pace of the growth was slower. According to foreign trade indices, exports of goods to countries outside the area rose by 8.4 per cent in volume terms, compared with 1 per cent in 2003. The adverse effects of the appreciation of the euro were partially attenuated by the sharp increase in demand in the main outlet markets, estimated at about 10 per cent. The euro area's share of the world market continued to contract.

Euro-area imports of goods and services – including intra-area imports – increased by 6.5 per cent at constant prices. Imports of goods from outside the euro area grew by 6 per cent, compared with 3.7 per cent in 2003.

In addition to the appreciation of the euro, the rise reflected the recovery in domestic demand and also the increase in exports, which contain a large proportion of imported products owing to the growing international integration of production processes. Imports expanded especially rapidly in France and Spain, where they more than offset the contribution of exports to GDP growth. In the rest of the euro area, net external demand ceased to subtract from growth, adding more than 1 percentage point in Germany but making only a negligible contribution in Italy.

The Italian economy

Household consumption

Household spending increased by 1 per cent at constant prices in 2004, compared with 1.4 per cent in 2003. Since the start of the decade, it has increased by an annual average of 0.9 per cent.

Table 6

ITALIAN HOUSEHOLD CONSUMPTION

(at 1995 prices; percentage changes)

	% share in 1995	% share in 2004	2001	2002	2003	2004
Non-durable goods	46.2	42.6	0.1	-0.1	0.8	-0.8
of which: food and beverages	*17.6*	*15.8*	*0.2*	*0.9*	*1.3*	*-0.4*
clothing and footwear	*9.6*	*8.9*	*-0.2*	*-1.3*	*-1.6*	*0.1*
Durable goods	9.9	12.6	-0.7	-1.7	1.3	8.0
of which: furniture and repairs	*4.0*	*3.6*	*-1.4*	*-4.7*	*1.5*	*-1.5*
electrical household appliances and repairs	*1.3*	*1.5*	*0.7*	*3.9*	*7.0*	*2.9*
television receiving sets,photographic, computer and hi-fi equipment	*0.9*	*1.4*	*6.4*	*2.6*	*4.2*	*3.4*
transport equipment	*3.1*	*3.9*	*-3.2*	*0.3*	*-3.2*	*6.2*
Services	43.9	44.8	1.6	0.6	1.3	1.3
of which: hotel and restaurant	*8.7*	*9.0*	*2.5*	*-0.8*	*-0.3*	*-0.8*
communication	*2.1*	*5.0*	*4.6*	*3.1*	*6.0*	*19.1*
recreational and cultural	*2.3*	*2.8*	*-0.7*	*0.5*	*-0.5*	*7.6*
healthcare	*3.1*	*3.0*	*-1.0*	*1.9*	*2.4*	*-0.2*
Total domestic consumption	**100.0**	**100.0**	**0.7**	**..**	**1.1**	**1.2**
Residents' consumption abroad	(1)	(1)	-5.6	7.1	5.1	-6.8
Non-residents' consumption in Italy	(1)	(1)	-5.5	-5.3	-4.6	1.0
Total national consumption	**–**	**–**	**0.8**	**0.4**	**1.4**	**1.0**
Memorandum item:						
Deflator of national consumption	–	–	2.8	3.1	2.5	2.2

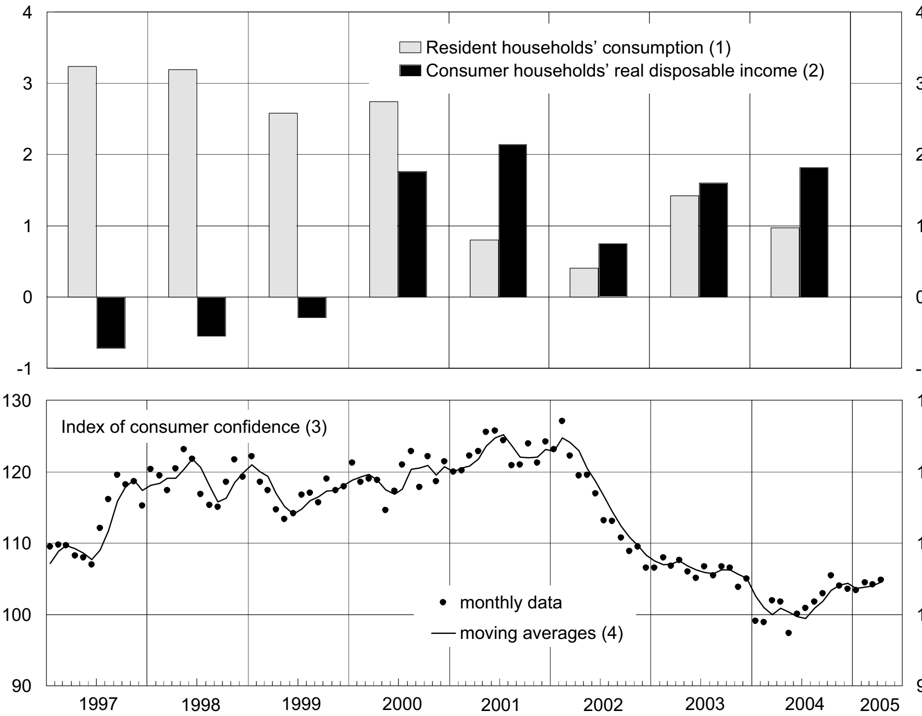
Source: Istat, national accounts.

(1) Residents' consumption abroad and non-residents' consumption in Italy amounted in 1995 to 2.3 and 4.4 per cent, respectively, of total domestic consumption; in 2004 the corresponding figures were 2.4 and 3.6 per cent.

Among the main components, purchases of durable goods made the largest contribution to consumption growth for the first time since 1997, when the first set of incentives for scrapping motor vehicles were in place. Demand for transport equipment increased sharply, returning to its level at the beginning of the decade. Another factor in the growth of consumption of durables was the protracted expansion in purchases of high-tech goods (such as computers, cell phones and photographic equipment), which have been rising at an average annual rate of 7.7 per cent since 1994 but are a segment in which domestic producers play a smaller role. Growth in spending on communication services picked up from 6 to 19 per cent (Table 6). This was offset by the fall of almost 1 per cent in purchases of non-durables, with food products accounting for nearly a quarter of the decrease.

Figure 6

CONSUMPTION, REAL INCOME AND CONSUMER CONFIDENCE IN ITALY



Sources: Based on Istat and ISAE data.

(1) At 1995 prices; percentage changes on previous year. – (2) Percentage changes on previous year in gross disposable income, divided by the resident households' consumption deflator. – (3) Indices, 1980=100; seasonally adjusted data. – (4) For the three months ending in the reference month.

Households' demand was dampened by uncertainty about the general economic prospects and their personal financial situation. The ISAE survey found that the decline in confidence that had begun two years earlier became steeper in the first half of 2004, leading to the lowest level recorded in the last ten years (Figure 6). The deterioration was especially pronounced for views of the labour market and the scope for saving. After a brief upturn in the summer, since October confidence has been stable, albeit with fluctuations, at the modest levels seen at the end of 2003.

In 2004 the gross disposable income of consumer households increased by 4.1 per cent at current prices, as in 2003; in real terms the growth accelerated from 1.6 to 1.8 per cent, thanks to the decline in inflation (Table 7). Adjusted to take account of the erosion of the purchasing power of net financial assets, the expansion in disposable income at constant prices slowed from 2.2 to 1.9 per cent.

Table 7

GROSS DISPOSABLE INCOME AND PROPENSITY TO SAVE IN ITALY

(at current prices, except as indicated)

	2001	2002	2003	2004
	Percentage changes			
Earnings net of social contributions charged to workers	5.7	4.3	4.0	3.6
Income from salaried employment per standard labour unit	*3.3*	*2.4*	*3.7*	*3.0*
Total social contributions (1)	*0.3*	*0.1*	*-0.2*	*0.1*
Standard employee labour units	*2.1*	*1.8*	*0.5*	*0.5*
Income from self-employment net of social contributions (2)	5.5	2.3	4.2	5.8
Income from self-employment per standard labour unit	*4.3*	*2.8*	*4.0*	*4.3*
Social contributions (1)	*0.6*	*-0.6*	..	..
Standard self-employed labour units	*0.5*	..	*0.2*	*1.5*
Net property income (3)	2.5	0.3	1.3	3.8
Social benefits and other net transfers	3.3	6.4	4.8	3.2
of which: net social benefits	*3.8*	*6.0*	*5.0*	*4.2*
Current taxes on income and wealth (–)	1.4	1.1	0.9	3.6
Households' gross disposable income (4)	**5.0**	**3.9**	**4.1**	**4.1**
at 1995 prices (5)	2.1	0.7	1.6	1.8
at 1995 prices, adjusted for expected inflation (6)	1.8	0.8	2.2	1.9
at 1995 prices, adjusted for past inflation (7)	2.3	..	2.4	2.5
Private sector gross disposable income	**4.3**	**3.4**	**4.0**	**3.7**
at 1995 prices (5)	1.5	0.3	1.5	1.5
at 1995 prices, adjusted for expected inflation (6)	1.3	0.2	1.9	1.3
at 1995 prices, adjusted for past inflation (7)	1.7	-0.4	2.1	1.9
	Percentages			
Households' average propensity to save (4) (8)	**12.4**	**12.7**	**12.8**	**13.6**
calculated on income adjusted for expected inflation	9.6	10.0	10.6	11.4
calculated on income adjusted for past inflation	9.7	9.3	10.2	11.5
Private sector average propensity to save (8)	**24.0**	**24.0**	**24.0**	**24.4**
calculated on income adjusted for expected inflation	24.6	24.6	24.5	24.9
calculated on income adjusted for past inflation	24.6	24.7	24.6	24.9

Source: Based on Istat data and estimates.

(1) Contribution of social contributions to the change in net income, in percentage points; negative values indicate an increase in social contributions relative to income. – (2) Includes mixed income and income withdrawn by members of quasi-corporations. – (3) Includes gross operating result (essentially actual and imputed rents), net rents of land and intangible goods, actual net interest, dividends and other profits distributed by corporations. – (4) Consumer households. – (5) Deflated using the resident households' consumption deflator. – (6) Gross disposable income net of expected losses on net financial assets due to inflation (estimated on the basis of the Consensus Forecasts survey), deflated using the resident households' consumption deflator. – (7) Gross disposable income net of actual losses on net financial assets due to inflation; deflated using the resident households' consumption deflator. – (8) Ratio of saving (gross of depreciation and amortization and net of the change in pension fund reserves) to the gross disposable income of the sector.

General government measures cut two-tenths of a point from the growth in disposable income: the 4.2 per cent increase in social benefits only partially offset the rise of 3.7 per cent in social security contributions and that of 3.6

per cent in current taxation of income and capital (compared with 0.9 per cent in 2003, when the first part of the reform of tax rates was introduced).

After falling between 1985 and 2000, in 2004 Italian households' propensity to save increased for the fourth year in a row, from 12.8 to 13.6 per cent (11.2 per cent in 2000). If income is adjusted for monetary erosion due to expected inflation, the saving rate rose from 10.6 to 11.4 per cent (8.8 per cent in 2000). The substantial increase in the stock of savings, equal to €126 billion at current prices and net of the change in pension fund reserves (€115 billion in 2003), sustained the accumulation of real estate and financial wealth.

Table 8

GROSS SAVING AND INVESTMENT IN ITALY

(as a percentage of gross national disposable income)

	Average 1981-1990	Average 1991-2000	Average 1994-2004	2001	2002	2003	2004
General government saving	-6.4	- 3.3	-0.3	1.0	0.7	-0.5	..
Private sector saving	28.8	24.1	21.1	19.2	19.2	19.4	19.6
of which: consumer households ...	*22.4*	*14.5*	*10.7*	*8.5*	*8.8*	*9.0*	*9.5*
Gross national saving	22.4	20.8	20.8	20.2	19.9	18.9	19.6
Gross investment	23.3	19.9	19.8	19.9	20.2	19.7	20.1
Memorandum item: Balance of current account transactions with the rest of the world	-1.0	0.8	1.0	0.3	-0.3	-0.9	-0.4

Sources: Based on Istat and Bank of Italy data.

Gross disposable income of the private sector as a whole – households and enterprises – slowed from 4 to 3.7 per cent at current prices, reflecting the drop in the retained earnings of firms; at constant prices the increase was similar to that registered in 2003 (1.5 per cent). The private-sector saving rate rose to 24.4 per cent after having stabilized at 24 per cent over the three previous years. The overall national saving rate increased more sharply, to 19.6 per cent (Table 8).

Investment

Gross fixed investment increased by 2.1 per cent in 2004, reversing the decline of the previous year (Table 9). The upturn in investment in construction (3.1 per cent) was offset by continuing weakness in the other segments. After a steep fall in 2003, purchases of machinery, equipment and transport equipment increased at a modest pace (1.3 per cent).

Net of depreciation, fixed investment rose slightly for the first time in four years (0.7 per cent; Table 9), but was still more than 10 per cent below its level at the start of the decade.

Table 9

FIXED INVESTMENT IN ITALY

(at 1995 prices; percentage changes and percentages)

	% composition in 2004	Percentage change			As a percentage of GDP (1)		
		2002	2003	2004	2002	2003	2004
Construction	43.7	3.2	1.7	3.1	8.7	8.8	9.0
residential	*24.1*	*4.4*	2.8	3.0	4.8	4.9	5.0
other	*19.6*	*1.9*	0.3	3.2	3.9	3.9	4.0
Machinery and equipment	40.6	-0.2	- 4.2	2.7	8.6	8.2	8.3
Transport equipment	11.3	-0.4	- 6.1	- 2.9	2.6	2.4	2.3
Intangible assets	4.4	0.3	0.8	- 0.8	0.9	0.9	0.9
Total gross fixed investment	**100**	**1.2**	**- 1.8**	**2.1**	**20.8**	**20.4**	**20.6**
Total excluding residential buildings	–	0.3	- 3.1	1.8	16.0	15.5	15.6
Total excluding construction	–	-0.2	- 4.2	1.3	12.1	11.6	11.6
Total net fixed investment (2)	**–**	**-2.3**	**- 11.1**	**0.7**	**6.7**	**5.9**	**5.9**

Source: Istat, national accounts.
(1) Rounding may cause discrepancies in totals. – (2) Net of depreciation.

During the course of the year investment was affected by the deterioration in industrial firms' opinions on demand conditions. According to ISAE, assessments of the outlook for orders, which had been increasingly optimistic until the summer, turned markedly more cautious in subsequent months, above all owing to the rapid deterioration in expected foreign demand. At the same time, stocks of finished goods increased.

Figure 7

INVESTMENT, CAPACITY UTILIZATION AND TREND OF THE ECONOMY IN ITALY

Sources: Based on Istat and ISAE data.
(1) At constant prices. Indices, 2000=100. – (2) Average of seasonally adjusted differences between the percentage of positive replies ("increasing") and negative replies ("decreasing") to ISAE business opinion survey regarding the 3-4 month trend of output; indices, 2000=100. – (3) Average of Bank of Italy's indicators (Wharton) and ISAE indicators for industrial sectors; indices, 2000=100. Right-hand scale.

After a small increase in the first half of the year, the capacity utilization rate returned to the low levels reached at the end of 2002 (Figure 7). The situation became especially difficult for sectors that earn a significant proportion of their revenues from exports, which had already experienced an abrupt drop in capacity use in 2003.

In 2004 the expansion of investment in construction gathered pace, spreading to non-residential building (Table 9). Civil engineering projects made a large contribution, mainly reflecting the resumption of activity in public works.

According to the semi-annual survey of 485 construction firms conducted by Bank of Italy branches in March and February this year, in 2004 output in the public works sector slowed sharply from more than 5 per cent to about 1.5 per cent at constant prices, with virtually no growth in the second half of the year.

Table 10

REAL HOUSE PRICES IN THE MAIN ITALIAN CITIES (1)

(percentage changes, except as indicated)

	% of total (2)	2001	2002	2003	2004	Relative to 2004 prices (3)
Rome	4.22	4.1	12.8	18.2	13.1	1.66
Milan	2.32	14.8	9.2	16.2	9.0	1.76
Turin	1.56	-0.3	7.6	9.1	-4.2	0.79
Naples	1.33	-0.3	11.6	18.8	-2.9	1.16
Genoa	1.12	7.5	18.5	7.8	2.2	0.97
Palermo	0.99	0.1	9.1	-8.0	8.6	0.64
Bologna	0.71	11.0	12.5	12.9	5.6	1.19
Florence	0.63	23.3	23.4	25.0	6.5	1.35
Venice	0.47	4.4	10.5	8.4	29.5	1.55
Bari	0.48	3.6	2.5	12.4	1.5	0.78
Trieste	0.41	-2.6	9.7	6.8	5.7	0.72
Cagliari	0.26	2.8	-0.9	11.7	2.5	0.67
Perugia	0.24	1.6	6.0	1.7	14.5	0.72
Ancona	0.17	-2.3	18.2	2.7	5.0	0.80
Trento	0.18	-0.3	9.4	2.9	8.3	0.80
Catanzaro	0.14	8.0	11.3	-2.8	8.5	0.51
L'Aquila	0.12	-4.2	4.2	9.5	8.7	0.59
Potenza	0.10	-5.0	5.2	3.6	9.3	0.56
Campobasso	0.08	1.0	7.7	-2.3	4.7	0.53
Aosta	0.06	0.6	8.1	-6.2	4.9	0.76
Italy	**100**	**4.5**	**9.6**	**8.2**	**6.3**	**1.0**

Sources: Based on data from *Il Consulente Immobiliare*, Istat and Bank of Italy, *Indagine sui bilanci delle famiglie italiane.*

(1) Prices per square metre in euros obtained by deflating current prices with consumer prices in each city. – (2) Share of total housing units in Italy in 2004. – (3) Average nominal prices in each of the cities as a ratio to the national average in 2004, which was €3,072 per square metre.

Investment in residential construction continued to expand rapidly (3 per cent), bringing the total increase over the last six years to 20 per cent. The growth reflected the construction of new homes as well as renovation and extraordinary maintenance, which benefited from a further extension of the tax incentives introduced in 1997. Although buoyed by favourable mortgage lending conditions, demand in the real estate market shows signs of easing. After peaking in 2002 at the culmination of the rapid expansion that began in 1996, growth in the number of sales has averaged about 2.5 per cent in the last two years. In 2004 property prices slowed by two percentage points to 6.3 per cent in real terms (Table 10).

Exports and imports

Exports. – After contracting by 5.1 per cent over the previous two years, in 2004 exports of goods and services recovered partially in volume terms, expanding by 3.2 per cent compared with 6.8 per cent in the rest of the euro area (Table 11). Performance fluctuated considerably over the course of the year, as a strong recovery in the second and third quarters was followed by another sharp contraction in the fourth.

Table 11

ITALY'S EXPORTS AND IMPORTS OF GOODS AND SERVICES

(percentage changes on previous year, except as indicated)

	2002			2003			2004		
	Goods	Services	TOTAL	Goods	Services	TOTAL	Goods	Services	TOTAL
Exports (1)									
At current prices	-1.6	-1.9	-1.6	-1.6	0.1	-1.2	7.5	5.6	7.1
At 1995 prices	-2.9	-4.6	-3.2	-2.1	-1.3	-1.9	3.3	2.8	3.2
Deflators	1.4	2.9	1.7	0.5	1.4	0.7	4.1	2.7	3.8
Imports (2)									
At current prices	-1.2	2.7	-0.3	0.5	-0.3	0.3	8.5	-0.8	6.3
At 1995 prices	-1.0	1.5	-0.5	0.9	2.6	1.3	3.2	0.2	2.5
Deflators	-0.2	1.3	0.2	-0.4	-2.8	-1.0	5.1	-1.0	3.7
Exports/Imports									
At current prices, % ratio	108.2	90.3	103.9	106.0	90.6	102.3	105.1	96.3	103.1
At 1995 prices, % ratio	108.1	90.6	104.1	105.0	87.1	100.8	105.0	89.4	101.4
Terms of trade (indices, 1995=100)	100.1	99.7	99.9	101.0	104.0	101.5	100.1	107.8	101.7
Contribution of net exports to real GDP growth (3)	*-0.5*	*-0.4*	*-0.8*	*-0.7*	*-0.2*	*-0.9*	..	*0.1*	*0.2*

Source: Istat, national accounts

(1) Includes non-residents' consumption in Italy. – (2) Includes residents' consumption abroad. – (3) Percentage points.

In the last three years, against the background of an acceleration in international trade, Italy's export growth gap with respect to the rest of the euro area has come to a total of about 12 percentage points. Although outlet markets have expanded rapidly (Table 12), Italian merchandise exports have been held back by the progressive erosion of price competitiveness in a context of growing penetration of the world market by the emerging economies, whose product specialization partially overlaps with that of Italian exporters.

Table 12

EXPORTS AND IMPORTS OF GOODS AND SERVICES OF THE MAJOR EURO-AREA COUNTRIES AND INDICATORS OF DEMAND AND COMPETITIVENESS

(at constant prices; percentage changes)

	2000	2001	2002	2003	2004
Germany					
Imports of goods and services (1)	10.2	1.2	-1.0	4.2	6.7
Exports of goods and services (1)	13.5	6.3	4.6	1.8	9.0
Outlet markets (2)	10.3	1.1	1.3	3.1	6.7
Indicators of competitiveness (3)					
overall	-7.0	3.3	1.8	6.4	0.5
export	-7.8	3.4	2.3	7.4	0.9
import	-5.8	3.0	1.1	5.1	..
France					
Imports of goods and services (1)	14.9	2.2	1.7	0.7	6.9
Exports of goods and services (1)	12.4	2.5	1.5	-1.7	3.1
Outlet markets (2)	11.2	1.0	1.9	2.4	6.9
Indicators of competitiveness (3)					
overall	-4.9	0.7	1.7	4.4	0.6
export	-5.9	1.1	2.4	5.5	1.1
import	-3.9	0.3	1.1	3.1	0.2
Italy					
Imports of goods and services	7.1	0.5	-0.5	1.3	2.5
Exports of goods and services	9.7	1.6	-3.2	-1.9	3.2
Outlet markets (2)	11.4	1.0	1.7	2.9	7.6
Indicators of competitiveness (3)					
overall	-3.1	1.6	2.3	5.2	1.5
export	-4.4	1.9	3.0	6.5	2.0
import	-1.4	1.2	1.3	3.4	0.9
Spain					
Imports of goods and services (1)	....	4.2	3.8	6.2	8.0
Exports of goods and services (1)	....	4.0	1.7	3.5	2.7
Outlet markets (2)	10.9	1.0	1.4	2.2	6.8
Indicators of competitiveness (3)					
overall	-3.0	1.1	2.2	3.9	1.8
export	-4.2	1.3	2.8	5.0	2.2
import	-2.1	1.0	1.7	2.9	1.5

Sources: Based on national statistics.

(1) National accounts revised by sectoral allocation of financial intermedition services indirectly measured. – (2) Average of the changes in imports of goods and services of the principal importing countries, weighted using their respective weights in the indicator of competitiveness. – (3) Based on the producer prices of manufactures. A positive value indicates a loss of competitiveness.

The deterioration in the competitiveness of Italian firms reflects a decline in efficiency in industry: after stagnating in the second half of the 1990s, total factor productivity has decreased at an estimated annual rate of 0.7 per cent since the start of the decade. Measured on the basis of producer prices, in 2004 the competitiveness of manufactures, which had decreased by 9.5 per cent in the previous three years, dropped by a further 1.4 per cent. Over the entire period, the loss of competitiveness of German producers was slightly less, while that of French producers was 3 points greater (Figure 8). Developments in unit labour costs have been even less favourable: in 2004 they rose by a further 2.5 per cent, after increasing by 9.5 per cent in the previous three years. Over the entire four-year period, unit labour costs declined in Germany and rose by 2.4 per cent in France. The international pricing policies of exporters in these two countries were more aggressive than those of Italian firms.

Figure 8

INDICATORS OF COMPETITIVENESS OF THE MAJOR EURO-AREA COUNTRIES COMPARED WITH ALL COMPETITOR COUNTRIES (1)

(monthly data; indices, 1993=100)

Sources: Based on national statistics and IMF.
(1) Real effective exchange rates; an increase indicates a loss of competitiveness.

In 2004 the largest contribution to the growth in Italy's export volumes came from sales of metals and metal products, thanks to strong world demand for steel, and of mechanical machinery and equipment and transport equipment, especially "motor vehicle parts and accessories and motor vehicle engines" and "ships and boats". By contrast, there was a decline in exports of textiles and clothing, leather and leather goods, including footwear, and "other manufactures", which include furniture.

For the fourth year running Italian exports to the other EU countries, which represent 60 per cent of the total, grew less rapidly than those to the rest of the world. The largest increase among European countries came in exports to France and Spain, which rose by 2.4 and 3.9 per cent respectively. By contrast, exports to the ten new EU members decreased by 5.9 per cent as a result of the steep fall in sales of mechanical machinery and equipment and textiles. Italy's exports to the United Kingdom and Germany, the country's largest outlet market, stagnated.

Among non-EU countries, the volume of Italy's exports to Russia jumped by 25 per cent and those to China by 13 per cent, boosted by the demand for capital equipment. China's share of Italian exports was 1.2 per cent at current prices and exchange rates.

Table 13

ITALIAN EXPORTS AND IMPORTS *CIF-FOB* BY MAIN COUNTRIES AND AREAS: VALUES AND INDICES OF AVERAGE UNIT VALUES (AUV) AND VOLUMES (1)

(percentage composition and percentage changes on previous year; indices, 2000=100)

	Exports						Imports					
	2003			2004			2003			2004		
	% composition of values in 2003	% change in AUV	% change in volumes	% composition of values in 2003	% change in AUV	% change in volumes (2)	% composition of values in 2003	% change in AUV	% change in volumes	% composition of values in 2003	% change in AUV	% change in volumes (2)
EU countries	**60.6**	**1.2**	**-1.1**	**59.8**	**4.7**	**1.4**	**61.4**	**0.7**	**0.1**	**60.4**	**4.0**	**2.4**
EU-15 countries ..	54.7	1.1	-1.7	54.3	4.5	2.3	57.9	0.8	-0.2	56.6	4.1	1.7
of which:												
France	*12.5*	*2.0*	*-2.6*	*12.5*	*4.9*	*2.4*	*11.4*	*1.7*	*-2.2*	*11.0*	*4.7*	*..*
Germany	*14.1*	*2.0*	*-2.4*	*13.7*	*3.8*	*0.9*	*18.1*	*-0.6*	*1.5*	*18.1*	*3.9*	*4.5*
UK	*7.1*	*-3.4*	*2.5*	*7.0*	*5.5*	*0.6*	*4.9*	*-0.7*	*-5.7*	*4.3*	*1.9*	*-5.4*
Spain	*7.1*	*1.4*	*7.1*	*7.3*	*5.9*	*3.9*	*4.8*	*4.1*	*0.4*	*4.7*	*4.2*	*0.4*
New EU countries	5.9	2.7	4.7	5.5	6.0	-5.9	3.5	-1.3	5.0	3.8	2.6	13.3
Non-EU countries	**39.4**	**0.2**	**-4.9**	**40.2**	**3.9**	**5.5**	**38.6**	**-2.0**	**1.6**	**39.6**	**6.0**	**5.2**
of which:												
China	*1.5*	*2.8*	*-7.8*	*1.6*	*2.4*	*12.5*	*3.6*	*-10.9*	*28.8*	*4.1*	*1.3*	*22.0*
Japan	*1.6*	*-0.3*	*-4.1*	*1.5*	*6.2*	*-5.7*	*2.0*	*-0.4*	*-0.6*	*1.9*	*0.5*	*4.2*
DAE (3)	*3.2*	*-2.2*	*-6.0*	*3.2*	*1.8*	*2.2*	*2.4*	*-2.3*	*8.2*	*2.6*	*4.4*	*11.2*
Russia	*1.5*	*3.2*	*-1.7*	*1.7*	*3.1*	*24.8*	*3.1*	*1.2*	*2.6*	*3.4*	*6.7*	*11.0*
US	*8.3*	*-4.8*	*-10.3*	*7.9*	*-0.7*	*2.9*	*3.9*	*-4.1*	*-14.8*	*3.5*	*2.5*	*-4.9*
Total ...	**100.0**	**0.8**	**-2.7**	**100.0**	**4.3**	**3.1**	**100.0**	**-0.3**	**0.7**	**100.0**	**4.8**	**3.5**

Source: Based on Istat data.

(1) The change in values for EU countries and the total is calculated on the basis of data corrected for the estimated of transactions measured annually and taking account, in view of past experience, of delays in submitting customs declarations value.. – (2) For EU countries, changes in volumes for 2004 are calculated on the basis of deflated AUV data. – (3) Dynamic Asian economies: Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand.

Imports. – In 2004 imports of goods and services increased by 2.5 per cent at constant prices, compared with 1.3 per cent in 2003. Given the slightly larger rise in exports, the contribution of net foreign demand to GDP growth turned positive again, albeit by a slim 0.2 percentage points. In the previous two years the external sector had subtracted a total of 1.7 points.

The growth of imports in Italy is primarily attributable to purchases of electrical machinery and equipment (up 8 per cent), metals and metal products (4.7 per cent) and transport equipment (2.4 per cent). Imports from non-EU countries expanded much more rapidly than those from the member states, reflecting the rapid growth in imports from China (22 per cent) and, to a lesser extent, from the "dynamic Asian economies" and Russia.

China's share of total Italian imports continued to expand, from 3.6 per cent in 2003 to 4.1 per cent last year. The country has become Italy's chief non-EU supplier of manufactures. Chinese exports to Italy of mid-tech products, especially electrical machinery, accounted for 22.3 per cent of the total, while its share of advanced goods, such as machinery and chemical products, was 19.4 per cent, virtually the same as that for textiles and clothing.

DOMESTIC SUPPLY

Economic sectors and company demographics

In Italy value added at factor cost grew by 1.3 per cent in real terms in 2004 (Table 14); services accounted for 0.8 percentage points of the increase and agriculture for 0.3 points, while the contribution of industry was barely positive.

After falling in 2003, value added at constant prices in industry excluding construction rose by 0.3 per cent in 2004 on the strength of the increase of 4.1 per cent in the energy sector, which was more than double that of the previous year. In the manufacturing sector, value added remained virtually unchanged last year after declining by 1.4 per cent in 2003; the textile industry recorded a large contraction of 5 per cent.

In construction value added grew by 2.7 per cent, compared with 2.3 per cent in 2003. In services it increased by 1.2 per cent (0.9 per cent in 2003), thanks mainly to the contribution of public social services and health care; in private business and household services the growth in value added slowed abruptly, from 1.7 to 0.3 per cent. The increase of 10.8 per cent in agriculture last year marked a sharp turnaround from the decline of 5.2 per cent recorded in 2003.

The balance between new entries and deletions in the Chamber of Commerce register of companies was positive by about 90,000. The positive net flow thus returned to the level of 2001, after easing to about 70,000 in 2002 and 2003. At the end of 2004 the number of registered businesses was 1.6 per cent higher than a year earlier, compared with an increase of 1.3 per cent in 2003.

There was net business creation in all the geographical areas; the birth rate in the South was again higher than the national average (1.8 and 1.5 per cent respectively last year, 1.4 and 1.2 per cent in 2003).

In manufacturing industry there was a further net decrease of 1.5 per cent in the number of firms following that of 1 per cent in 2003; the principal factor was the sharp contraction of 3.2 per cent in the textiles and clothing sector.

Table 14

VALUE ADDED AT FACTOR COST IN ITALY

	2003		2004		Percentage changes			
	Current prices (millions of euros)	Share of value added (%)	Current prices (millions of euros)	Share of value added (%)	Volumes		Deflators	
					2003	2004	2003	2004
Industry	**311,984**	**26.4**	**324,388**	**26.4**	**-0.4**	**0.8**	**2.1**	**3.2**
Industry excluding construction	**252,898**	**21.4**	**260,987**	**21.3**	**-1.0**	**0.3**	**2.2**	**2.9**
Mining and quarrying	4,937	0.4	4,781	0.4	0.3	-3.7	-1.0	0.5
Manufacturing	221,139	18.7	228,827	18.7	-1.4	-0.1	1.6	3.5
Production and distribution of electricity, gas, steam and water	26,822	2.3	27,379	2.2	1.9	4.1	7.4	-2.0
Construction	**59,086**	**5.0**	**63,401**	**5.1**	**2.3**	**2.7**	**1.7**	**4.5**
Services	**836,964**	**70.9**	**868,793**	**70.9**	**0.9**	**1.2**	**3.5**	**2.6**
Wholesale and retail trade, repairs	149,847	12.7	153,158	12.5	0.3	2.1	1.9	0.1
Hotels and restaurants	43,287	3.7	43,724	3.6	-0.4	-1.3	4.9	2.4
Transport, storage and communication services	87,179	7.4	90,913	7.4	0.3	1.7	2.1	2.5
Financial intermediation services (1)	67,841	5.7	67,988	5.5	1.0	-2.1	3.2	2.4
Services to businesses and households (2)	252,967	21.4	269,247	22.0	1.7	0.3	3.4	6.1
Public administration (3)	67,147	5.7	69,631	5.7	1.2	1.0	7.0	2.6
Education	60,343	5.1	59,756	4.9	0.8	1.0	5.8	-2.0
Health and other social services	55,432	4.7	59,868	4.9	1.4	4.0	0.8	3.9
Other community, social and personal services	43,203	3.7	44,600	3.6	-0.2	5.7	5.4	-2.4
Private households with employed persons	9,718	0.8	9,908	0.8	2.2	0.6	4.3	1.4
Agriculture (4)	**32,024**	**2.7**	**32,757**	**2.7**	**-5.2**	**10.8**	**6.7**	**-7.7**
Value added at factor cost (5)	**1,180,972**	**100.0**	**1,225,938**	**100.0**	**0.3**	**1.3**	**3.2**	**2.5**

Source: Istat.

(1) Includes insurance and pension funds. – (2) Includes real estate, renting, computers, research and other professional and business services. – (3) Includes defence and compulsory social security services. – (4) Includes forestry and fishing. – (5) Gross of indirectly measured financial intermediation services.

Manufacturing industry's competitiveness problems

Reflecting the weakness of economic activity in the euro area, value added at factor cost in Italian manufacturing contracted by 0.8 per cent per year between 2000 and 2004, compared with average annual growth of 1.1 per cent in the 1990s and 1.7 per cent in the 1980s. The average annual growth rate of labour productivity fell progressively from 3.1 per cent in the 1980s to 2 per cent in the 1990s; it turned negative by 0.7 per cent in the last four years.

In the traditional sectors of manufacturing, the index of industrial production has been falling since 2002, pulled down by average annual reductions of 4.6 per cent in textiles and clothing and 8.2 per cent in leather and footwear. These industries are suffering from the growing competition of countries with low labour costs; the standardized nature of most of their products offers limited scope for non-price competition and even less for differentiation, two key factors for facing the test of competition on international markets.

The difficulties in the traditional sectors have not been offset by increased competitiveness in technology-intensive sectors or those distinguished by substantial economies of scale. Between 2001 and 2004 production fell at an average annual rate of 7.2 per cent in the electrical and electronic equipment sector and 3.9 per cent in transport equipment.

The composition of employment confirms Italy's specialization in traditional products compared with the structure of production in France and German. Between 1991 and 2001 labour productivity growth in the manufacturing sector as a whole averaged 2.2 per cent per year in Italy, substantially lower than in France and, to a lesser extent, Germany (3.7 and 2.4 per cent respectively; Table 15). The increase in Italy did not differ appreciably from that in the other two countries in the traditional sectors, but the differences were significant in higher-tech industries, particularly chemicals, mechanical engineering, electrical equipment and, vis-à-vis France, transport equipment.

Table 15

SHARES OF EMPLOYMENT AND GROWTH OF LABOUR PRODUCTIVITY IN THE MANUFACTURING SECTOR

(percentages)

Branch	Share of employment in 2001			Growth of productivity 1991-2001 (annual average)		
	Italy	France	Germany	Italy	France	Germany
Food products, beverages and tobacco	9.1	16.6	12.4	1.8	-1.0	0.8
Textile products, clothing, leather and footwear ...	18.6	6.5	3.1	2.8	3.5	3.6
Wood and wood products	3.8	2.4	2.2	3.3	2.8	3.3
Paper, printing and publishing	5.9	8.5	7.0	2.4	1.7	2.0
Chemical, rubber and plastic products	9.2	12.2	12.0	0.7	5.0	4.2
Non-metallic mineral products	6.6	4.4	3.6	1.1	2.3	3.0
Basic metals and metal products	15.0	14.7	14.3	2.1	1.7	2.5
Mechanical engineering, electrical equipment	20.4	19.5	28.6	2.3	7.3	2.6
Motor vehicles and other transport equipment	5.5	10.1	13.2	1.9	5.8	0.7
Other branches of manufacturing	5.9	5.2	3.7	3.6	1.8	-0.8
Total ...	**100.0**	**100.0**	**100.0**	**2.2**	**3.7**	**2.4**

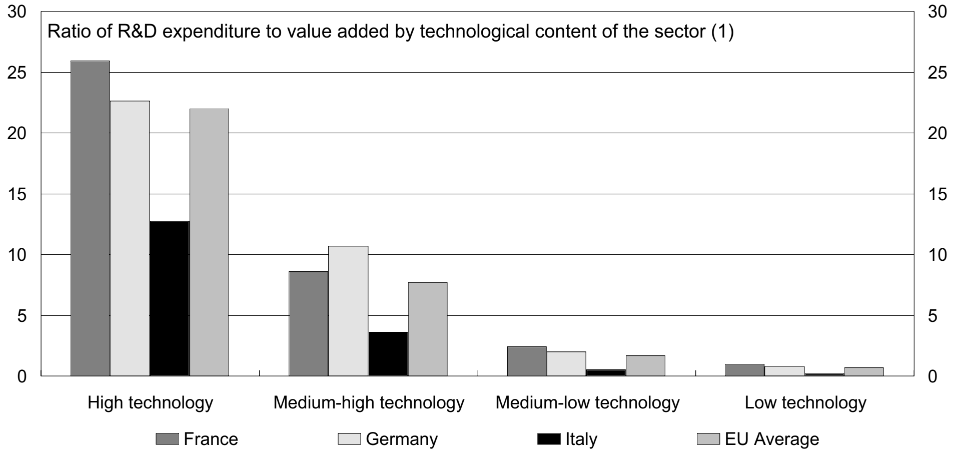
Source: Based on OECD data.

Italian manufacturing's productivity growth differential is not due to product specialization alone. Had the sectoral composition of manufacturing employment in Italy been that of Germany or France, productivity growth in Italy would have remained broadly unchanged. By contrast, for a given sectoral composition of employment, if the productivity growth rates actually recorded in France and Germany are applied to the sectors in Italy, the increase in productivity in Italy is comparable to that in the other two countries. The weak performance of Italian manufacturing, therefore, is not entirely attributable to the preponderance of traditional sectors: not only do the advanced sectors account for smaller shares of employment than in the other countries, but they also display a significant negative productivity growth differential. Progressing beyond a model of product specialization biased towards traditional sectors depends crucially on improving efficiency in higher-technology sectors, where the negative consequences of the Italian economy's lag in innovation are greatest.

R&D activity, an international comparison. – According to OECD data, Italy's relatively low total expenditure on research and development is mainly due to the small contribution of the private sector. In 2001 Italian firms invested 0.55 per cent of GDP in R&D, against an EU average of 1.25 per cent; the level of public-sector investment in Italy was comparable to the EU average (0.56 and 0.68 per cent respectively). The gap is not solely the consequence of the preponderance of low-tech products in the Italian industrial structure. An analysis of the ratio of R&D expenditure to sectoral value added for the four technology categories defined by the OECD shows that Italy's ratio is significantly lower in every category (Figure 9).

Figure 9

R&D ACTIVITY OF FIRMS IN SELECTED EUROPEAN COUNTRIES
(percentages)



Sources: OECD, *Main Science and Technology Indicators*, 2004.
(1) Refers to 2001 or a later date for which data are availlable.

Other indicators of innovation also signal that the Italian economy is lagging behind. The number of patent applications filed with the European Patent Office in 2000 was equal to 5.6 per 100,000 inhabitants in Italy, compared with a European average of 12.1. Only Greece, Portugal and Spain had lower figures. In this case, again, the lower propensity to innovate is not attributable solely to product specialization: patenting intensity by sector, defined as the number of patent applications in relation to the number of workers in the sector, is lower in Italy than the EU average for all the sectors considered (Table 16). The gap is greatest in such high-tech sectors as pharmaceuticals and electronics, where the productivity growth differential is also largest (Table 15).

Table 16

NUMBER OF PATENTS FILED PER 1,000 WORKERS IN THE MANUFACTURING SECTOR IN 2000

Branch (1)	France	Germany	Italy	EU average
Food products, beverages and tobacco	0.14	0.19	0.12	0.17
Textile products, clothing, leather and footwear	0.27	0.72	0.14	0.20
Wood products and furniture	0.34	0.72	0.25	0.35
Paper, printing and publishing	0.36	0.51	0.28	0.35
Chemical, rubber and plastic products (excluding pharmaceuticals)	1.20	2.16	0.64	1.36
Pharmaceuticals	6.56	12.26	2.51	7.50
Non-metallic mineral products	1.02	1.16	0.47	0.73
Basic metals	0.60	1.19	0.28	0.66
Metal products (excluding electronics)	1.31	2.53	0.83	1.43
Machinery	2.62	3.30	1.21	2.33
Computers and office equipment	8.29	13.91	7.39	9.57
Electrical machinery (excluding electronics)	3.64	3.16	1.51	2.56
Electronics	6.71	11.50	1.73	7.21
Precision, medical and optical instruments	1.37	2.49	0.94	1.59
Motor vehicles	1.24	1.83	1.02	1.26
Other transport equipment	6.74	18.90	3.91	8.72
Total	**1.74**	**2.66**	**0.79**	**1.67**

Source: Eurostat, *European Business Facts and Figures*, 2004; calculations based on European Patent Office data.
(1) The patents are reclassified from the International Classification of Patents, provided by the European Patent Office, to the International Standard Industrial Classification (ISIC), version 2.

Public intervention to support innovation by firms. – All the industrial countries use public incentives for business investment in R&D, considering the activity to be partially of the nature of a public good. According to the OECD, the scale of governmental support for business innovation in Italy does not differ significantly from that in the other developed countries. In 2003 central government contributions to firms' investment in R&D were equal to 0.08 per cent of GDP, compared with 0.10 per cent in the EU, 0.12 per cent in France and 0.11 per cent in Germany. Larger differences are found with regard to the criteria of resource allocation: France and Germany adopt more selective policies targeted to the development of high-tech sectors, while Italy tends to prefer horizontal measures aimed at assisting the diffusion of existing technologies.

Horizontal policies for innovation appear less suited to strengthening the high-tech component of the productive system. Innovation in these sectors would benefit more from measures focused on firms with a higher growth potential and designed to provide effective incentives for the creation of consortiums and cooperative arrangements, especially between small and medium-sized enterprises and public research institutes. In addition, existing instruments such as the National Research Plan could also be used to make incentives longer-lasting, with a careful definition of the priorities and allocation of funds, thereby enabling firms to plan their own R&D activity over a longer time horizon.

Privatizations and market regulation

Privatizations. – The privatization of companies controlled by the public sector regained momentum in 2004, thanks in part to the positive performance of the stock market. Including transactions carried out by local authorities and firms held indirectly by the Ministry for the Economy and Finance, in 2004 the value of disposals amounted to about €13 billion, more than twice as much as in 2003.

In October the third public offering was made of a tranche of Enel's capital, equal to 19.6 per cent of the total. The transaction's gross proceeds of €7.6 billion were the largest of any privatization in Europe in 2004. Other transactions concerned firms only indirectly controlled by the State (Table 17).

In April 2004 ENI made a public offering of 9.5 per cent of Snam rete gas, the company that owns the natural gas transport network; the proceeds amounted to €651 million. The transaction falls within the scope of the policies for the liberalization of the energy sector (electricity and gas) promoted by the European Commission and implemented by a decree issued by the Prime Minister on 11 May 2004. With a view to ensuring equal conditions of access to network services, gas and electricity producers are required to reduce their equity interest in network companies to below 20 per cent by 1 July 2007. In line with these provisions, in 2004 Enel sold 50 per cent of Terna, the company that owns the national electricity grid, in a public offering that brought proceeds of €1.7 billion. Enel also sold New Real, a company to which it had transferred most of its property portfolio, for around €1.4 billion. Finmeccanica sold 10 per cent of the capital of STMicroelectronics to Cassa Depositi e Prestiti for €1.4 billion.

Table 17

MAIN PRIVATIZATIONS IN ITALY IN 2004

Company	Sector	Number of employees in 2003	Seller	Method of sale	% of share capital sold	Date of completion	Gross proceeds (millions of euros)
Snam rete gas	Energy	2,484	ENI	Public offering	9.5	April 2004	651
Terna	Energy	2,821	Enel	Public offering	50.0	June 2004	1,699
New Real	Property	1,429	Enel	Direct sale to institutional investors	100.0	July 2004	1,396
Enel	Energy	64,770	Ministry of the Economy and Finance	Public offering	19.6	October 2004	7,621
STMicroelectronics	Manufacturing	10,081	Finmeccanica	Direct sale to institutional investors	10.3	November 2004	1,442

Sources: Mediobanca, *R&S*; Fondazione ENI Enrico Mattei and Fondazione IRI, *Privatization Barometer*; company financial reports; financial press.

Currently the Ministry for the Economy and Finance holds equity interests of 20.3 per cent in ENI, 31.5 per cent in Enel and 62.3 per cent in Alitalia (Table 18).

Table 18

MAIN PUBLIC SHAREHOLDINGS AT 31 DECEMBER 2004

Company	Sector	Turnover in 2003 (millions of euros)	Number of employees in 2003	Residual % interest held by the Ministry for the Economy and Finance
ENI	Energy	51,487	76,521	20.3
Enel	Energy	30,022	64,770	31.5
Finmeccanica	Defence and aerospace	8,233	46,861	32.3
Poste italiane	Postal services	8,058	156,146	65.0
Ferrovie dello Stato	Transport	5,156	101,947	100.0
Alitalia	Transport	4,306	22,200	62.3
RAI	Television and multimedia	2,785	11,447	99.6

Sources: Mediobanca, *R&S*; company financial reports; Ministry for the Economy and Finance.

Market regulation. – OECD indicators show that market regulation is more favourable to competition today than in the past ten years. However, there are still considerable differences from market to market.

In line with Community legislation, since 1 July 2004 all end-users who buy electricity for non-domestic uses may choose their supplier in the so-called "free market"; previously this right was only granted to those who consumed at least 100,000 kWh per year. According to data released by GRTN, the national transmission network operator, with the removal of this restriction the free market's share of total electricity consumption rose from 37.7 per cent in 2003 to 42.8 per cent last year.

In April 2004 the electricity exchange established by Legislative Decree 79/1999 started operating. The exchange offers customers of the free market an alternative means of supply with respect to direct bilateral contracts with producers. From April through December 2004 the volume traded on the exchange was equal to about 30 per cent of total electricity demand.

According to Eurostat data, in 2004 the prices of electricity for industrial use in Italy remained appreciably above the European average. Supply conditions would benefit from an increase in generating capacity. Between 2002 and 2004 the Ministry for Productive Activities issued 40 approvals for the construction or modification of thermoelectric power plants with a capacity of more than 300 thermal MWh. According to GRTN, 9 are expected to come on stream in 2005 and another 9 by 2007; most of them are located in the North-West and the South.

In the distributive sector, the regional governments have exclusive power to regulate the opening of mass retailing outlets. Most of the regions have set quantitative limits and other restrictions on the growth of large-scale distribution, whose costs and unit prices are generally lower than those of traditional retailers. The distributive system remains highly fragmented: according to the Ministry for Productive Activities, in 2004 there were more than 750,000 retail outlets or 130 for every 10,000 inhabitants, roughly double the EU average. The further growth of large-scale distribution can have beneficial effects on employment levels in the sector.

A recent study by the Bank's Economic Research Department compares the evolution of employment between 1998 and 2002 in Abruzzo and Marche. These two regions have similar economic and social-demographic structures but their legislation differs in that Abruzzo has introduced stringent limits on the opening of large-scale retail outlets. It is estimated that in the two years following the introduction of the respective regional laws, other conditions being equal, the ratio of employment in the distributive sector to the total working-age population increased by about one percentage point more in Marche than Abruzzo. The growth of employment in mass retailing was accompanied by stable employment levels in smaller units, a fall in the number of owners but an increase in that of employees. The latter finding supports the hypothesis that intensified competition has moved smaller retailers to restructure and reorganize in networks or franchising arrangements.

Law and competitiveness

The reform of company law introduced by Legislative Decree 6/2003, which came into force in January 2004, aims at streamlining the regulation of business activity. The new provisions allow private limited companies broad leeway as regards their bylaws and establish more flexible rules for public limited companies; corporate governance systems have been overhauled. In general, the new legislative framework expands the range of options available, trusting in firms ability to establish rules, procedures and instruments better tailored to their needs.

International comparisons show that Italy ranks very low among the advanced countries in terms of the duration of civil trials. This has negative effects on the performance of the whole economy. The slowness of proceedings is only partially compensated for by the fact that the costs of access to justice in Italy are lower than the European average. Of course, these evaluations do not consider the quality of decisions, which is the primary objective of a judicial system but nevertheless hard to measure.

Analysis suggests that supply-side factors, particularly those connected with the organization of justice, are among the main determinants of the length of trials. The allocation of human resources to the administration of justice in Italy is broadly in line with that in the other European countries: the number of judges per inhabitant is a little higher than in France and the Netherlands and lower only with respect to Germany; each judge is served by almost five administrative officers, one of the highest figures in Europe. However, inefficiencies emerge in the way these resources are utilized. The division of Italy into jurisdictions is highly fragmented. Each court serves an average of 55,000 inhabitants, compared with 842,000 in the Netherlands, 90,0000 in France and nearly 100,000 in Germany; it is staffed by six judges, comparable to the number in France but far fewer than in the Netherlands (64) and Germany (19). A reorganization of the courts to increase their size could permit a greater specialization of judges and more flexible use of resources. Major benefits would derive from the diffusion of information and communication technology; though it is still at an experimental stage, the project for the computerization of procedures confirms that there is scope for improving efficiency. The length of trials appears to be adversely affected by factors connected with the current regulation of the legal profession and by certain procedural rules. As regards the latter, changes intended to condense and simplify trials could be effective.

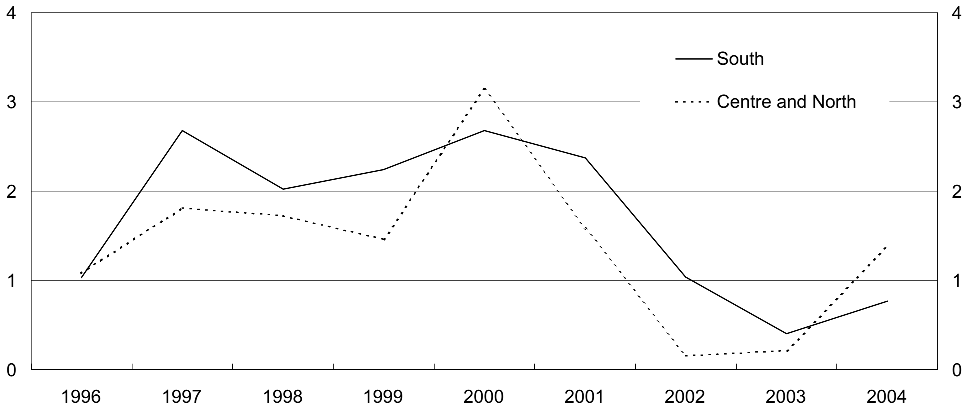
Regional economic developments and regional policy

Svimez (the Association for Industrial Development in Southern Italy) estimates that output in the South grew by 0.8 per cent last year, compared with 0.4 per cent in 2003; in the Centre and North GDP increased by 1.4 per cent, after two years of stagnation. The increase in final consumption was slightly higher in the Centre and North than in the South (1.1 against 0.9 per cent); the South's result was affected by sharply lower growth in general government expenditure (0.8 per cent, compared with 3 per cent in 2003). Recovering from its decline in 2003, gross fixed investment grew at about the same rate in the South (2.1 per cent) as in the rest of the country (2 per cent).

In the period 1996-2004 the average annual growth in GDP at constant prices was slightly higher in the South than in the rest of Italy (1.7 against 1.4 per cent; Figure 10).

Figure 10

RATE OF GDP GROWTH IN THE SOUTH AND THE REST OF ITALY
(at constant 1995 prices)



Source: Istat, *Conti economici territoriali*, for 1996-2003 and Svimez estimates for 2004.

In 2004 the value of merchandise exports grew in all the geographical areas (Table 19). The increase was largest in the South and the North-East (8.9 and 7.8 per cent respectively), smallest in the North-West. In all the geographical areas export growth was greatest towards countries outside the European Union, especially towards Russia, Turkey and the EFTA countries; in the case of the regions of central Italy, the growth in exports to non-EU countries accounted for all of the change.

Table 19

EXPORTS BY GEOGRAPHICAL AREA

(at current prices)

	Percentage share in 2004 (1)	Percentage change on previous year			
		2001	2002	2003	2004
North-West	40.4	5.7	-3.5	0.5	4.4
North-East	31.5	5.5	0.8	-2.6	7.8
Centre	15.7	2.3	0.6	-4.7	5.7
South	10.7	3.6	-3.0	-2.6	8.9
Italy	**100.0**	**4.9**	**-1.4**	**-1.6**	**6.1**

Source: Istat, *Le esportazioni delle regioni italiane.*
(1) The total for Italy includes the share of exports (1.7 per cent) not attributed to any region.

Regional policy. – The principal instrument of regional policy is the Fund for Underutilized Areas established by Law 289/2002 (the Finance Law for 2003), which unifies all of the resources to be spent on incentives for firms or on public investment in the South and the least-developed parts of the Centre and North.

A recent revision of the system of incentives for firms affected both the amount of allocations and their disbursement. The Finance Law for 2003 made access to the tax credit for investments and employment, which had been automatic, dependent on the tax authorities accepting an application; in the case of investments, the application must specify a three-year implementation plan that is subject to auditing by the Revenue Agency.

The instruments provided by Law 488/1992 (investment incentives and negotiated planning) are also to be revised. In particular, investment incentives, now disbursed in the form of a grant, will be progressively flanked by supported credit and ordinary bank credit granted by the credit institution entrusted with evaluating the investment project. Pending the reform, last year the Interministerial Committee for Economic Planning did not decide the appropriation of resources to finance new invitations to tender. According to the Ministry for the Economy and Finance, investment grants amounting to about €655 million were disbursed in 2004, compared with €764 million in 2003.

Net of private contributions, the resources provided by the Community Support Framework 2000-06 for expenditure in connection with

Structural Fund programmes amount to just over €58 billion, consisting in equal measure of the Community contribution and national cofinancing. According to the Ministry for the Economy and Finance, as of September 2004 payments had been made amounting to less than €20 billion, or 34 per cent of the total, a lower percentage than initially set in the expenditure plan for the period 2000-08 (47 per cent). During 2004 the planning cycle was revised to take account of the slower pace of implementation; the new version envisages a large concentration of expenditure (about 35 per cent) in the two years 2007-08, the last period in which payments are admissible.

THE LABOUR MARKET

The euro area

The moderate recovery in economic activity in the euro area was accompanied by a slight pick-up in employment growth. Partly estimated data based on national accounts indicate that the number of residents in work rose by an average of 0.5 per cent in 2004, compared with 0.2 per cent in 2003 (Figure 11). However, the expansion was less than could have been expected given the elasticity of employment to value added in recent years. This may have been due to some extent to an increase in per capita working hours. OECD figures indicate that the number of hours worked per employee for the entire economy returned to growth in France and Germany; they continued to decline in Italy and Spain, but less than in previous years.

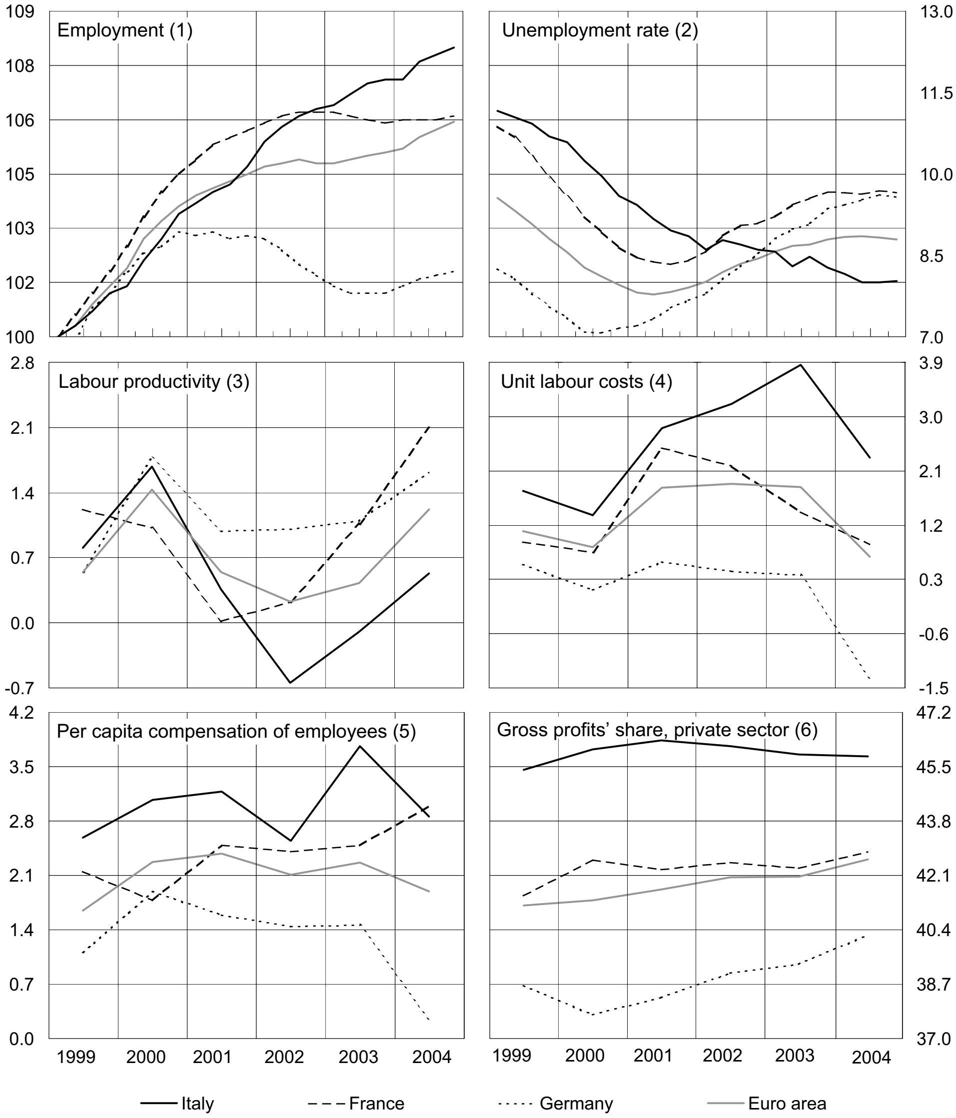
The increase in jobs was concentrated in the construction industry and the financial and business services sector (1.1 and 2.8 per cent respectively). In industry excluding construction and in agriculture employment contracted further (by 1.6 and 0.7 per cent respectively), but less sharply than in 2003.

Employment expanded in all euro-area countries except the Netherlands and France, where it fell by 1.6 and 0.1 per cent respectively. Germany returned to employment growth with the number of jobs rising by 140,000 or 0.4 per cent, after a loss of 570,000 (1.5 per cent) in 2002-03. It thus accounted for more than two thirds of the expansion in the euro area.

On average for the year there were 12.7 million persons unemployed, or 8.8 per cent of the euro-area labour force, compared with 8.7 per cent in 2003. The unemployment rate for persons under 25 rose to 17.9 per cent, but in absolute terms the rise was most substantial among those aged 25 and older and among men. The results varied from country to country. Unemployment diminished by nearly half a percentage point in Italy and Spain to 8 and 10.8 per cent respectively. There were also small decreases in Belgium, Finland and Ireland. The rate rose by nearly one percentage point in the Netherlands, where it nevertheless remains at frictional levels, and by half a point in Portugal. In Germany the unemployment rate rose by 0.4 points to 9.5 per cent, a level fractionally lower than in France, where it rose by 0.2 points.

Figure 11

THE LABOUR MARKET IN THE EURO AREA
(seasonally adjusted data)



Sources: Based on Istat and Eurostat, national accounts and continuous labour force survey.
(1) Index, 1st quarter 1999=100. Partly estimated. – (2) Percentages. – (3) Percentage change in value added at 1995 base prices per worker; for Italy and France, based on standard labour units.– (4) Percentage change in the ratio of per capita compensation of employees to value added per worker at 1995 base prices. – (5) Percentage changes. – (6) Value added at base prices less total compensation of labour (including labour income imputed to self-employed workers based on the average compensation of employees) as a percentage of total value added.

Between 2000 and 2004 the German unemployment rate rose steadily by a cumulative 2.3 percentage points and 800,000 persons. In part this was a statistical effect of the labour market reform under which, since 1 July 2003, workers losing their jobs must register immediately with employment centres or lose their benefits.

The expansion of economic activity in the area was accompanied by a recovery in labour productivity, which gained 1.3 per cent; this is more than the cumulative gain in the three years from 2001 to 2003 and about the same as the annual increases of the late 1990s (Figure 11). The upturn in productivity may be the result not only of cyclical factors but also of the waning impact effect of the transition towards more labour-intensive factor combinations triggered by the labour market reforms and wage moderation experienced in many countries since the mid-1990s.

The area-wide improvement reflected sharp gains in output per worker in France and Germany (2.1 and 1.6 per cent), due in part to the increase in hours worked. More modest gains were posted in Italy (0.5 per cent) and Spain (0.3 per cent).

The rate of increase in unit labour costs in the euro area diminished from 2 per cent to 0.6 per cent, thanks to the satisfactory performance of productivity and the simultaneous slowdown in per capita earnings (from growth of 2.3 per cent to 1.9 per cent). In Germany unit labour costs fell by 1.3 per cent, as per employee costs remained stable.

The value added deflator for the private sector rose more than unit labour costs in 2004, increasing the share of value added going to profits in all the main area countries except Italy, where it remained broadly unchanged.

Employment, unemployment and the labour supply in Italy

Istat's new continuous labour force survey, which replaced the old quarterly survey in January 2004, found that the number of persons employed in Italy averaged 22.4 million last year, 164,000 more than in 2003, for a gain of 0.7 per cent (Table 20). The employment rate for the working age population held steady at 57.5 per cent.

In the past decade employment has increased mainly in the Centre and North of Italy. Between the beginning of the expansion in 1995 and 2004 the number of persons employed nationwide rose by 2,164,000 or 10.7 per cent: 1,754,000 (12.3 per cent) in the Centre and North and 410,000 (6.8 per cent) in the South. As the working-age population (15 and older) grew at approximately the same pace in the two parts of the country, the geographical disparity in employment rates worsened, from 9.8 percentage points in 1995 to 12.4 in 2004 (Figure 12). The differential in labour costs in the private sector widened, unit labour costs in the Centre and North rising from 105 per cent of those in the South in 1998 to 114 per cent in 2003, essentially because the increase in earnings was more gradual in the South.

Table 20

STRUCTURE OF EMPLOYMENT IN ITALY

(thousands of persons and percentages)

	2004		Change 2004-2003	
	Thousands of persons	Percentage share (1)	Thousands of persons	Percentage share (2)
Employess	16,117	66.1	78	0.5
Permanent	14,209	58.3	139	1.0
full-time	*12,618*	*51.8*	*103*	*0.8*
part-time	*1,590*	*6.5*	*36*	*2.3*
Fixed-term and temporary	1,909	7.8	-61	-3.1
full-time	*1,491*	*6.1*	*-52*	*-3.4*
part-time	*418*	*1.7*	*-9*	*-2.2*
Self employed	6,288	25.8	86	1.4
full-time	5,454	22.4	138	2.6
part-time	834	3.4	-52	-5.8
Total employment	22,405	92.0	164	0.7
women	8,783	36.0	86	1.0
men	13,622	55.9	78	0.6
Unemployed	1,961	8.0	-88	-4.3
women	1,036	4.2	-76	-6.9
men	925	3.8	-12	-1.2
Labour force	24,366	100.0	76	0.3
women	9,818	40.3	9	0.1
men	14,546	59.7	66	0.5
Participation rate (ages 15-64)		62.5		-0.4
women		50.6		-0.3
men		74.5		-0.4
Employment rate (ages 15-64)		57.5		-0.1
women		45.2		0.1
men		69.7		-0.3
Youth unemployment rate (ages 15-24)		23.5		-0.2
women		27.2		-0.4
men		20.6		0.1

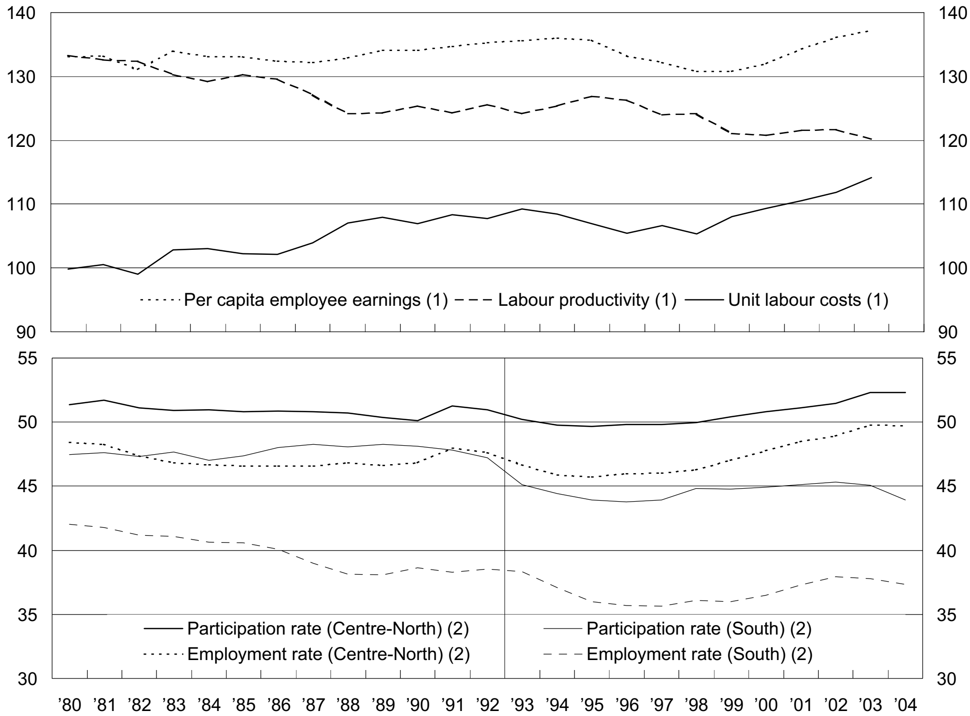
Source: Based on Istat, continuous labour force survey.

(1) For employment of employees and self-employment and for unemployed, the shares are in proportion to the labour force. Participation and employment rates are for the population aged 15-64. The youth unemployment rate is for the labour force in the 15-24 age-group. – (2) For participation, employment and unemployment rates, change in percentage points.

The slower rise in employment rates in the South was accompanied by a resumption of gross and net emigration. The flow of southerners taking up residence in the Centre and North increased from about 100,000 in 1995 to 150,000 in 2000, subsiding to 130,000 a year in 2001 and 2002. These outflows are comparable in size to those of the early 1970s and nearly half as large as those of the 1960s. Insofar as emigrants have a better chance of finding work, the increase in emigration may have contributed to the divergence in employment rates. According to the survey of households' income and wealth, persons of working age who emigrated from the South to the Centre and North between 1997 and 2002 were younger and better educated than those who stayed. In fact about a quarter were university graduates, compared with 7 per cent of the total southern population; and on average they were two years younger.

Figure 12

GEOGRAPHICAL DISPARITIES BETWEEN CENTRE-NORTH AND SOUTH



Source: Istat, regional accounts, continuous labour force survey and quarterly labour force survey.

(1) Private sector; value in Centre and North as percentage of value in South. – (2) Based on population aged 15 and older. There is a break in the series in 1992.

In 2004, as in the previous years, most of the increase in employment was accounted for by employees on open-ended contracts (139,000 jobs) and self-employed workers (86,000). By contrast the number of fixed-term employees declined by 61,000.

Temporary employment, defined as the sum of fixed-term contracts, continuous, coordinated collaboration contracts and occasional employment contracts, involved 9.6 per cent of Italian households in 2004. For 3.6 per cent, it was the sole form of employment (Table 21). Having exclusively temporary employment is more common among households with just one person employed (9.3 per cent) and especially among larger families. In the South, fixed-term employment is found in 10.5 per cent of households and is the sole form of employment in 11.5 per cent of households with just one person in work.

The national unemployment rate averaged 8 per cent in 2004, 0.4 points lower than the previous year (Table 20). Most of the reduction concerned the long-term unemployed (those jobless for more than 12 months), whose share of the total labour force thus fell from 4 to 3.7 per cent, and women, especially in the South. The decline in male unemployment was confined to the South and was almost completely offset by a rise in the rest of the country.

Table 21

FIXED-TERM EMPLOYMENT AND NON-EMPLOYMENT IN ITALIAN HOUSEHOLDS

(percentage of all households in each area)

	1 person employed	2 persons employed	3 persons employed	4 + persons employed	Total
Households with at least 1 fixed-term employee (1)					
Centre-North	2.5	4.7	1.6	0.4	9.2
South	4.3	4.6	1.3	0.3	10.5
Italy	3.1	4.7	1.5	0.4	9.6
Households with only fixed-term employees (1)					
Centre-North	2.5	0.3	0.0	0.0	2.9
South	4.3	0.6	0.1	0.0	5.0
Italy	3.1	0.4	0.0	0.0	3.6
Total households with cmployed persons (2)					
Centre-North	31.7	27.5	4.4	0.9	64.6
South	37.3	19.4	3.0	0.5	60.2
Italy	33.5	24.9	3.9	0.8	63.2
	1 member	2 members	3 members	4 + members	Total
Households with no persons employed or pensioners					
Centre-North	3.3	2.5	0.6	0.1	6.5
South	3.8	4.1	1.9	1.2	11.0
Italy	3.5	3.0	1.0	0.5	8.0
Households with no persons employed and at least one pensioner					
Centre-North	15.5	12.3	1.1	0.1	28.9
South	14.2	11.9	2.1	0.5	28.8
Italy	15.1	12.2	1.4	0.3	28.9
Total households					
Centre-North	29.1	44.5	17.1	9.3	100.0
South	23.4	41.9	17.5	17.1	100.0
Italy	27.3	43.6	17.3	11.8	100.0

Source: Based on Istat, continuous labour force survey.

(1) Includes fixed-term contracts, coordinated and continuous collaboration and occasional work. – (2) Includes permanent positions, fixed-term contracts, coordinated and continuous collaboration, occasional work and other self-employed persons.

In the years before 2004 the reduction in unemployment had been accompanied by an increase in the labour supply both in absolute terms and in proportion to population. The labour force participation rate for the population aged 15-64 rose from 58.4 per cent in 1995 to 62.9 per cent in 2003, sustained more by a rise in women’s participation (from 44.3 to

51 per cent) than in that of men (from 72.5 to 74.9 per cent). In 2004 the labour force again expanded, by 76,000 or 0.3 per cent. In proportion to the population of working age, however, it declined for the first time in a decade, by 0.4 points to 62.5 per cent; both women and men were affected, mainly in the South, where two consecutive years of declining employment may have led some people to abandon their job search and discouraged others from entering the labour force.

Nearly 8 million households, 36.9 per cent of the total (Table 21), had no member employed in 2004. It is estimated that in three quarters of them at least one member was drawing an old age or seniority pension. The others were households in which all members were either unemployed or economically inactive; 12.8 per cent of households with only one potential earner (a member aged 15 or older) and 6.6 per cent of those with two or three had neither a job nor a pension. For other classes of household the incidence was lower.

In the South 39.8 per cent of households had no employed member, and 11 per cent had neither job-holders nor pensioners. Among households with just one potential earner, 76.9 per cent had no employment and 16.3 per cent had no pension either. For households with two or three potential earners these proportions fell to 33.7 and 10.1 per cent.

The share of the labour force aged 15-25 has diminished rapidly over the past decade, as these age cohorts themselves have become smaller while increasing their propensity for education. As a result the youth unemployment rate has declined.

The school attendance rate for the high-school age-group (14-18) rose from 80 per cent in the 1995-96 school year to 89.8 per cent in 2001-02, while the proportion of 19-year-olds with an upper-secondary diploma rose from 63.1 to 72.8 per cent. The increase in university attendance has been comparably marked. The number of registered university students was equal to 39 per cent of the 20-24 age-group in 1995 and 51 per cent in 2003. The rise was especially rapid starting with the 2000-01 academic year when three-year degree courses were instituted.

The supply of labour continues to draw on a growing population. In October 2004 the number of residents in Italy was 58.3 million, up 1.35 million (2.4 per cent) since the census of 21 October 2001. The increase was due entirely to immigration. The natural balance has been negative since 1993. On 1 January 2004 foreign citizens on Italian civic registers numbered nearly 2 million (441,000 more than a year earlier and 655,000 more than on the census date). Based on residence permits issued for ordinary immigration and for regularizations under Law 189 of 30 July

2002, the foreign population legally present in Italy can be estimated at 2.5 million. This is almost half a million more than the resident foreign population, owing to the time lapse between permit issue and entry on the civic register. Resident foreigners accounted for 3.4 per cent of the total population at the start of 2004, up from 2.7 per cent at the start of 2003 and 2.3 per cent at the 2001 census.

Labour input and sectoral developments in Italy

In 2004 labour input, measured in standard labour units for the national accounts, increased by 0.8 per cent or 191,000 units (Table 22). This was more in line with the increase in the number of persons employed (212,000 or 0.9 per cent) than had been the case in 2003.

Table 22

SECTORAL DISTRIBUTION OF LABOUR INPUT IN ITALY
(standard labour units; percentage shares of total and percentage changes)

	Total employment				Payroll employment			
	Share		Change		Share		Change	
	1994	2004	2004/1994	2004/2003	1994	2004	2004/1994	2004/2003
Agriculture, forestry and fishing	**7.8**	**5.2**	**-28.1**	**-3.7**	**4.2**	**3.0**	**-22.9**	**-6.1**
Industry excluding construction	**22.8**	**21.6**	**0.8**	**-0.3**	**26.8**	**25.3**	**2.4**	**-0.4**
of which: manufacturing	*21.8*	*20.9*	*1.9*	*-0.2*	*25.4*	*24.3*	*3.8*	*-0.2*
Construction	**7.0**	**7.2**	**9.0**	**2.9**	**6.2**	**6.0**	**6.1**	**4.0**
Services	**62.4**	**66.0**	**12.7**	**0.8**	**62.9**	**65.8**	**13.4**	**0.9**
Wholesale and retail trade, repair of personal and household goods	15.6	15.3	4.5	1.3	10.2	11.6	23.3	2.4
Hotels and restaurants	4.8	5.4	21.4	0.9	3.8	4.2	19.1	-0.6
Transport, storage and communications	6.1	6.2	7.5	0.9	6.7	6.6	7.4	1.1
Monetary and financial intermediation	2.8	2.7	2.3	2.1	3.5	3.3	2.3	1.6
Services to businesses and households (1)	7.6	11.1	54.5	2.4	6.2	8.7	50.4	3.6
Public administration (2)	6.5	5.5	-9.1	-3.1	9.3	7.8	-9.1	-3.1
Education	7.0	6.7	1.4	..	9.4	8.6	-0.5	0.1
Health	5.4	5.5	8.0	-0.9	6.2	6.2	7.7	-0.3
Other community, social and personal services	3.7	4.4	26.5	1.3	3.3	4.1	35.8	1.7
Private households with employed persons	2.9	3.3	19.8	2.1	4.2	4.7	19.8	2.1
Total ...	**100.0**	**100.0**	**6.5**	**0.4**	**100.0**	**100.0**	**8.5**	**0.5**

Source: Based on Istat, national accounts.
(1) Real-estate, renting, computer and research services and other professional and business services. – (2) Includes defence services and compulsory social security services.

In April Istat released its estimates of total hours worked from 1993 to 2003; they are based on all existing jobs, regardless of type of employment contract and of regular or irregular status. The number of hours actually worked, i.e. the sum of those worked for each employment position, is a more precise measure of labour input than standard labour units, because it also takes account of overtime and absences. By this measure, labour input increased by 4.3 per cent between 1993 and 2003, or two points less than standard labour units (6.5 per cent). Actual annual working time per job diminished by 7 hours (0.5 per cent); it had risen by 23 hours (1.7 per cent) between 1993 and 1999 and declined by 31.1 hours (2.1 per cent) over the next four years, reflecting the cyclical downturn.

For the economy as a whole, between 1993 and 2003 labour productivity rose by 14.1 per cent, or at an average annual rate of 1.3 per cent if labour input is measured by hours worked and by 11.7 per cent or 1.1 per cent per year if measured in standard labour units (Table 23). The discrepancy is widest in agriculture, totaling about 10 percentage points. Positive though variable differentials are registered in all manufacturing segments. Between the peak of the last expansionary phase in 2000 and 2003 hourly labour productivity for the entire economy rose by 0.2 per cent per year, but when gauged by standard labour units it fell by 0.1 per cent per year.

Table 23

LABOUR PRODUCTIVITY IN ITALY

(average annual percentage changes)

	1993-2003		2000-2003	
	Productivity per standard labour unit	Hourly productivity	Productivity per standard labour unit	Hourly productivity
Agriculture	**3.3**	**4.0**	**-1.3**	**-0.9**
Industry excluding construction .	**1.4**	**1.6**	**-0.4**	**-0.2**
of which: manufacturing	*1.1*	*1.4*	*-1.0*	*-0.8*
Construction	**0.2**	**0.2**	**-0.7**	**-0.2**
Services	**0.8**	**0.8**	**0.0**	**0.3**
Wholesale and retail trade, repair of personal and household goods	1.4	1.6	-0.1	0.0
Financial intermediation	1.5	1.6	-1.2	-0.7
Services to business and households	-1.7	-1.8	-1.4	-0.3
Public administration	1.2	1.7	1.5	2.7
Education	-0.5	-1.2	-0.2	0.4
Health	1.6	1.8	3.5	4.5
Total ...	**1.1**	**1.3**	**-0.1**	**0.2**

Source: Istat, national accounts.

Between 1993 and 2003 unit labour costs increased by 17.6 per cent based on hours worked and 21.2 per cent based on standard units. The discrepancy between the two measures was relatively marginal only in industry excluding construction (15.6 as against 16.3 per cent).

In agriculture labour input increased for the first time since 1983, by 0.4 per cent or 5,000 standard labour units, in response to the sharp expansion in output (growth of 10.8 per cent in value added at 1995 base prices). In industry it contracted again by 0.4 per cent (0.3 per cent in 2003) or by 21,000 standard units. In manufacturing alone the decline came to 15,000 units or 0.3 per cent, compared with 0.2 per cent in 2003. Once again the largest falls were in textiles and tanning (20,000 units). Employment also diminished significantly (14,000 units) in basic metals and metal products and non-metallic minerals.

The Bank of Italy's survey of industrial firms with at least 20 workers found that last year's decline in the number of employees involved all parts of the country and all sizes of firms. It was accompanied by a decrease in the share of fixed-term employment and an upturn in hours worked per capita. Labour turnover was further reduced as both hirings and separations diminished (Table 24).

Table 24

EMPLOYMENT AND WORKING HOURS IN ITALIAN INDUSTRY EXCLUDING CONSTRUCTION: FIRMS WITH AT LEAST 20 WORKERS
(percentages)

	2003	2004								
		Total	Size class (number of workers)				Geographical area (1)			
			20-49	50-199	200-499	500+	North-West	North-East	Centre	South and Islands
	Payroll employment									
Average employment (2)	-1.4	-1.6	-1.3	-1.1	-0.5	-2.9	-2.2	-1.1	-0.9	-1.3
Employment at end of year (2)	-1.8	-1.4	-1.3	-1.6	-1.0	-1.3	-1.7	-1.3	-0.5	-1.4
Proportion of fixed-term workers at end of year	5.9	5.5	5.7	6.1	5.3	4.7	4.7	5.7	6.2	6.5
Percentage of immigrants	2.9	3.1	4.1	3.1	3.0	1.8	….	….	….	….
	Turnover (3)									
Turnover (4)	29.1	26.6	26.2	29.6	25.4	24.8	21.2	29.0	27.2	38.1
Hirings	13.7	12.6	12.4	14.0	12.2	11.8	9.7	13.8	13.4	18.4
permanent	5.7	5.2	6.5	5.2	4.6	4.4	4.4	6.0	5.2	6.1
at fixed term	8.0	7.4	6.0	8.8	7.6	7.3	5.4	7.8	8.2	12.2
Separations	15.4	14.0	13.7	15.6	13.2	13.1	11.5	15.1	13.9	19.7
for expiry of fixed-term contract	8.0	7.6	6.2	8.1	7.6	8.3	5.3	8.2	8.2	12.7
for other reasons	7.3	6.4	7.5	7.5	5.6	4.7	6.1	6.9	5.6	7.0
	Actual working hours									
Hours worked per employee (2)	-0.7	0.8	0.8	1.0	0.7	0.7	0.8	0.6	1.3	0.8
Overtime (5)	4.1	4.1	3.8	4.1	4.0	4.5	4.3	4.0	3.8	3.9
Temporary employment (5) (6)	2.0	2.1	….	1.7	2.6	2.5	2.3	2.2	1.7	1.9
Wage Supplementation (5) (6)	1.5	1.6	….	1.6	1.2	1.9	1.9	1.0	1.5	2.5

Source: Banca d'Italia, *Indagine sulle imprese dei servizi.*

(1) Actual location of employees. – (2) Percentage changes on previous year. – (3) Ratio of hirings and separations in the year to the average of employment at the beginning and at the end of the year. – (4) Sum of hirings and separations. – (5) As a percentage of total hours actually worked by firms' employees. – (6) Total refers only to firms with at least 50 workers.

In construction, where the work force had been expanding rapidly since the end of the 1990s, employment grew by 3.4 per cent or 60,000 standard labour units, bringing the overall increase between 1998 and 2004 to 20.1 per cent or 300,000 units. More than two thirds of this came after 2000, the peak of the last economic expansion, owing to the substantial growth in value added (11.1 per cent between 2000 and 2004), which was boosted by tax incentives for housing renovation and by the booming real estate market.

Table 25

EMPLOYMENT AND WORKING HOURS IN ITALIAN NON-FINANCIAL PRIVATE SERVICE FIRMS WITH AT LEAST 20 WORKERS
(percentages)

	2003	2004								
		Total	Size class (number of workers)				Geographical area (1)			
			20-49	50-199	200-499	500+	North-West	North-East	Centre	South and Islands
	Payroll employment									
Average employment (2)	1.4	1.7	1.2	2.8	1.7	1.4	1.9	0.9	1.5	3.2
Employment at end of year (2)	1.7	1.1	0.7	1.4	1.4	1.2	0.9	0.4	1.6	2.3
Proportion of fixed-term workers at end of year	9.3	9.5	11.0	11.5	8.9	7.5	9.1	10.8	8.6	9.3
Percentage of immigrants	3.9	4.1	3.2	3.4	5.6	4.8	….	….	….	….
	Turnover (3)									
Turnover (4)	56.8	50.7	55.4	57.9	58.2	40.6	40.5	62.5	51.5	55.7
Hirings	29.2	25.9	28.0	29.7	29.8	20.9	20.7	31.4	26.6	29.0
permanent	11.6	10.3	10.2	9.8	11.7	10.2	8.5	11.3	10.3	13.2
at fixed term	17.6	15.6	17.8	19.8	18.1	10.7	12.2	20.1	16.3	15.8
Separations	27.6	24.8	27.3	28.3	28.4	19.7	19.8	31.0	25.0	26.7
for expiry of fixed-term contract	18.2	16.3	18.5	20.2	17.1	12.2	11.9	22.6	16.6	16.2
for other reasons	9.4	8.5	8.9	8.1	11.3	7.5	7.9	8.4	8.4	10.5
	Actual working hours									
Hours worked per employee (2)	0.5	-0.4	-1.0	-0.1	0.3	-0.3	-0.5	-1.1	0.4	0.1
Overtime (5)	5.6	5.3	4.2	5.3	5.5	6.0	5.5	5.0	5.4	4.8
Temporary employment (5) (6)	0.9	0.8	….	0.4	0.6	1.4	0.8	1.1	0.4	0.5

Source: Banca d'Italia, *Indagine sulle imprese industriali.*
(1) Actual location of employees. – (2) Percentage changes on previous year. – (3) Ratio of hirings and separations in the year to the average of employment at the beginning and at the end of the year. – (4) Sum of hirings and separations. – (5) As a percentage of total hours actually worked by firms' employees. – (6) Total refers only to firms with at least 50 workers.

In services labour input increased by 147,000 units (0.9 per cent), 128,000 (1.2 per cent) in the private sector and 19,000 (0.4 per cent) in the public sector. The increase in the private service sector was due to the strong performance of hotels and restaurants and of household and business services, with rises of 1.9 and 3.3 per cent respectively, more than offsetting the 0.5 per cent contraction in transport and in monetary and financial intermediation.

The Bank of Italy's survey of non-financial private service firms with at least 20 workers found an average increase in staff of 1.7 per cent in 2004 (Table 25). The increase involved all parts of the country but was sharpest in the South and among firms with 50 to 200 workers. It was accompanied by a further small reduction in per capita working hours and a slight increase in the share of temporary and fixed-term employment. Turnover, though remaining above 50 per cent, was significantly lower than in 2003.

The contraction of public employment under way since 1993 continued. Last year general government labour input decreased by 1.7 per cent or 23,000 units, bringing the cumulative fall in the number of jobs in the twelve years to 152,000 (10.3 per cent). Employment in education continued to decline, but the number of persons employed in public health care picked up after the previous year's decrease.

Wages and the cost of labour in Italy

Actual earnings per standard employee labour unit, as measured in the national accounts, increased by 3 per cent year on year, compared with 3.3 per cent in 2003 (Table 26). In real terms, however, the gain was larger than the previous year, 0.8 as against 0.6 per cent. Contractual earnings were again in line with the inflation predictions of Consensus Economics, which in the past three years have supplanted the government's target inflation rate as the guide for wage agreements, in effect altering one of the key incomes policy rules established by the agreements of 1992-93. Between 1994 and 2004 collective bargaining agreements kept the purchasing power of contractual earnings virtually unchanged. Nominal contractual earnings rose by 35 per cent between December 1993 and March 2005 for the private sector and 35.5 per cent for public sector employees covered by collective bargaining, while the general consumer price index rose by 36 per cent. From 1993 to 2004 real actual earnings rose less than productivity (5.2 as against 12.2 per cent), most markedly in the private sector (3.7 as against 12.6 per cent) and among young workers.

The sharper slowdown last year in per employee labour costs than in per capita earnings for the entire economy was due to the non-recurrence of the increase in social security contributions in the private sector and especially in private services in connection with the regularization of immigrant workers in 2003. Labour costs in the public sector were contained by the waning of the effects of the extraordinary increase in social contributions charged to government in 2003. The acceleration in

Table 26

LABOUR COSTS AND PRODUCTIVITY IN ITALY

(annual percentage changes, except as indicated)

	Value added at 1995 base prices	Total standard labour units	Output per standard labour unit	Earnings per standard employee labour unit	Labour costs per standard employee labour unit (1)	Unit labour costs (1)	Labour's share of value added at base prices (1) (2)	Total factor productivity (3)	
								Unad-justed	Ad-justed
					Industry excluding construction				
Average 1981-1985 .	0.1	–2.8	3.0	15.8	16.2	12.8	66.9	1.3	1.8
Average 1986-1990 .	3.2	0.6	2.5	7.3	8.0	5.3	64.6	1.9	0.8
Average 1991-1995 .	1.5	–1.7	3.2	5.8	5.9	2.6	67.2	2.1	1.3
Average 1996-2000 .	1.1	0.1	1.0	3.4	2.6	1.5	64.2	0.4	..
2002	-0.2	-0.5	0.3	3.4	3.1	2.8	62.5	-0.7	0.3
2003	-0.3	0.5	-0.8	2.5	2.2	3.1	63.7	-1.4	-1.1
2004	-1.0	-0.3	-0.6	2.8	3.0	3.7	64.8	-1.3	-1.2
					Construction				
Average 1981-1985 .	0.1	-1.3	1.4	15.9	15.1	13.5	63.5	0.2	–
Average 1986-1990 .	1.9	-0.4	2.3	9.9	10.4	7.9	66.0	2.0	–
Average 1991-1995 .	-1.3	-0.6	-0.6	4.5	4.5	5.2	70.1	-0.5	–
Average 1996-2000 .	1.3	0.8	0.5	3.4	2.3	1.8	70.4	-0.2	–
2002	3.1	4.7	-1.5	2.2	2.1	3.7	71.7	-2.1	–
2003	2.5	2.6	-0.1	1.8	2.4	2.5	71.2	-1.0	–
2004	2.5	2.9	-0.4	2.3	3.2	3.6	71.8	-1.0	–
					Private services (4)(5)				
Average 1981-1985 .	3.0	3.7	-0.7	14.0	13.4	14.2	75.5	-0.6	–
Average 1986-1990 .	3.7	1.7	2.0	7.0	7.3	5.1	71.2	1.4	–
Average 1991-1995 .	1.7	-0.3	1.9	5.7	5.5	3.5	70.3	1.0	–
Average 1996-2000 .	3.4	2.2	1.2	3.2	2.2	1.0	65.4	0.8	–
2002	3.5	2.4	1.0	3.4	3.1	2.1	64.2	0.6	–
2003	1.0	2.1	-1.1	2.2	2.2	3.4	64.7	-1.4	–
2004	0.5	1.5	-1.0	2.2	2.7	3.7	65.2	-1.1	–
					Private sector (5)				
Average 1981-1985 .	1.5	-0.2	1.6	15.4	15.3	13.4	74.5	1.0	–
Average 1986-1990 .	3.2	0.4	2.7	7.4	7.9	5.0	71.3	2.0	–
Average 1991-1995 .	1.4	-1.2	2.6	5.8	5.7	3.0	71.5	1.7	–
Average 1996-2000 .	2.4	0.9	1.5	3.4	2.5	1.0	66.8	1.0	–
2002	2.1	1.5	0.5	3.2	2.9	2.4	65.2	..	–
2003	0.5	1.4	-0.9	2.3	2.2	3.2	65.9	-1.3	–
2004	-0.1	0.7	-0.8	2.6	3.0	3.8	66.6	-1.1	–
					Total economy (5)				
Average 1981-1985 .	1.6	0.5	1.1	15.2	15.1	13.9	77.5	0.6	0.3
Average 1986-1990 .	2.8	0.7	2.1	8.1	8.5	6.3	74.8	1.5	1.2
Average 1991-1995 .	1.2	-0.8	2.0	5.0	5.3	3.1	75.1	1.4	0.9
Average 1996-2000 .	2.2	0.8	1.3	3.5	2.8	1.5	70.9	0.9	0.6
2002	2.1	1.6	0.4	3.5	3.2	2.8	69.4	0.1	..
2003	0.6	1.3	-0.6	2.6	2.5	3.2	69.9	-1.0	-1.1
2004	0.1	0.4	-0.4	3.2	3.8	4.2	70.6	-0.8	-1.1

Source: Based on Istat, national accounts.

(1) The introduction of the regional tax on productive activities (IRAP) and the simultaneous elimination of some employers' contributions in 1998 caused a break in the series. – (2) Percentages. – (3) Total factor productivity represents the growth of output due to technical and organizational improvements; it is calculated as the difference between the rate of growth in value added at factor costs and the rates of growth in labour input and the capital stock, weighted according to their respective shares in the distribution of value added. Adjusted productivity is calculated taking account of the improvement in the quality of labour input (proxied by workers' educational attainment) and, for industry only, also of the change in the number of hours worked and capacity utilization. For 2003 and 2004, partly estimated. – (4) Includes wholesale and retail trade, hotel and restaurant services, transport and communications, financial intermediation services and sundry services to businesses and households. – (5) Net of rental of buildings.

labour cost growth in industry and in construction was in line with the performance of per capita earnings.

The rate of increase in unit labour costs in the private sector declined from 3.5 to 2.6 per cent. This was largely due to the gain in productivity in industry excluding construction, which offset the pick-up in employee earnings (Table 26). The gain was greater than that achieved in industry in France, where unit labour costs remained unchanged after a rise of 0.4 per cent in 2003 (see Table 28). However, it was small compared with that in Germany, where industrial unit labour costs fell by 3.5 per cent, after a 0.6 per cent decline in 2003. The consequent further deterioration in Italian competitiveness depended mainly on productivity trends and only marginally on earnings.

PRICES AND COSTS

The average increase in the harmonized index of consumer prices was unchanged in 2004 at 2.1 per cent in the euro area, while in Italy it declined from 2.8 to 2.3 per cent. Core inflation (net of unprocessed food and energy products) was also broadly stable in the area at 2.1 per cent, compared with 1.9 per cent in 2003. Given moderate economic growth and stable inflation expectations, the rapid rises in the prices of imported inputs, offset only in part by the euro's further appreciation against the dollar (by 10 per cent compared with 2003), were countered by the sharp slowdown in the rate of growth of unit labour costs for the entire economy to an annual average of 0.6 per cent (Figure 13).

A particular contribution to the containment of inflation in the area came from the substantial slowdown in unprocessed food prices to the lowest rate of increase since the end of the 1990s. Internally generated inflation, as estimated by changes in the GDP deflator, slowed to 1.9 per cent in the area and 2.6 per cent in Italy from 2.1 and 2.9 per cent in 2003.

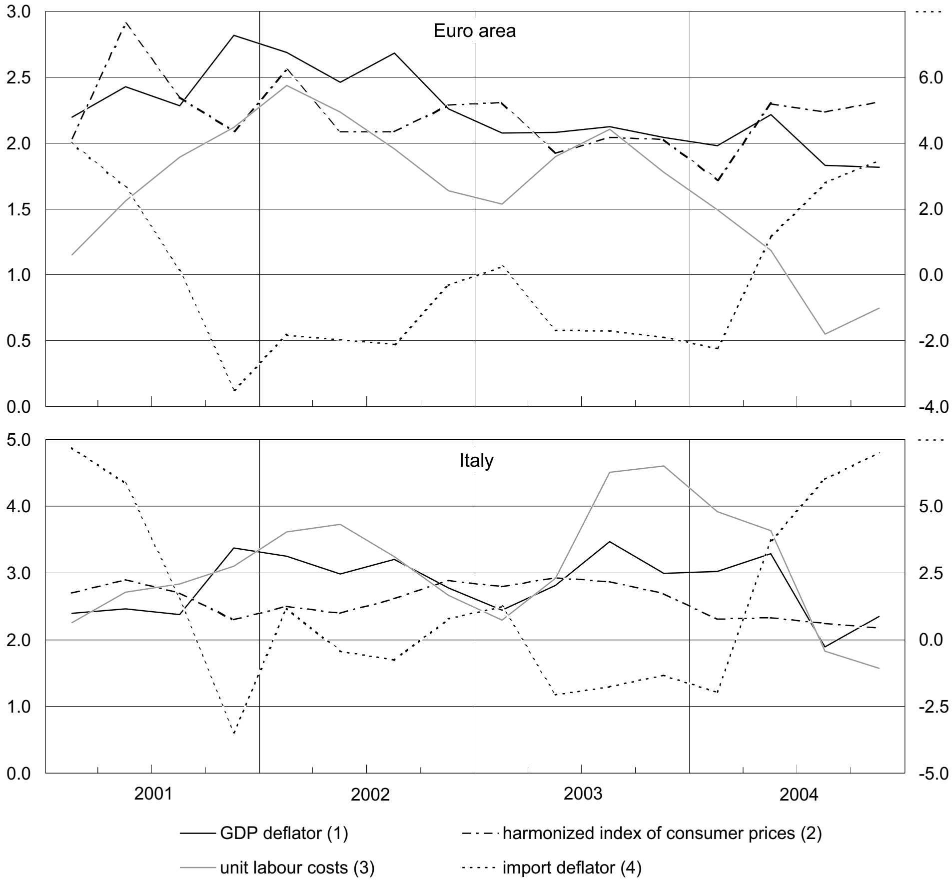
In the first few months of 2005, despite the further rise in oil prices the twelve-month rate of consumer price inflation in the euro area diminished slightly to an average of 2 per cent in the first quarter, compared with 2.3 per cent at the end of 2004. Core inflation fell from 2 to 1.7 per cent. The decline, which was common to all the major countries of the area, reflected cyclical uncertainties and the pressure exerted on national producers by the appreciation of the euro. The decline in the inflation level was also due in part to the end of the effect of increases in some administered prices made in the first quarter of 2004; it was sharpest in France and Germany, where those effects had been stronger.

The substantial closing of the inflation gap between Italy and the euro-area average in 2004, including core inflation (which slowed in Italy from 2.6 to 2.3 per cent), was due in part to the exceptionally sharp fall in mobile telephone prices in Italy and to the more gradual pass-through of oil price changes to administered energy prices (gas and electricity). However, unit labour costs for the economy as a whole rose by 2.3 per cent in Italy, again about 1.5 points more than the euro-area average, owing essentially to the poor performance of productivity.

Figure 13

INFLATION INDICATORS IN THE EURO AREA AND ITALY

(quarterly data; percentage changes on year-earlier period)



Source: Based on Eurostat data.

(1) Left-hand scale. – (2) For Italy, the percentage changes for 2001 are calculated with reference to the harmonized indices that exclude price reductions for special offers. Left-hand scale. – (3) For the entire economy. The changes are calculated from the moving average of the two quarters ending in the reference period. For the euro area, the changes are calculated on the basis of the figures for France, Germany, Italy and Spain; for Italy, unit labour costs are based on standard labour units. Left-hand scale. – (4) Right-hand scale.

Prices and costs in the euro area

Consumer prices. – The twelve-month inflation rate in the euro area rose from an average of 1.7 per cent in the first quarter of 2004 to 2.3 per cent in the second, remaining at that level for the rest of the year. The second-quarter increase was due to the jump in energy prices, which recorded a twelve-month rise of 4.8 per cent compared with a fall of 1.6 per cent in the first quarter. In the second half the further rise in energy prices was offset by a significant reduction in the prices of unprocessed foods, which recorded a twelve-month decline of 0.7 per cent in the fourth quarter. The reduction, which depended on especially favourable weather conditions, was the largest since the end of the 1990s.

Core inflation remained stable at 2 per cent in 2004. The deceleration in internal costs and the rise in the nominal effective exchange rate of the euro countered the upward pressure from rising raw materials prices and sharper rises than in years past in some administered prices, in particular those for hospital services (9.4 per cent), which were concentrated in Germany where the health system was being reformed, and for tobacco products (12.2 per cent).

Table 27

HARMONIZED INDICES OF CONSUMER PRICES IN THE EURO AREA
(percentage changes on year-earlier period)

	Italy			Germany			France			Spain			Euro area		
	2003	2004	Q1 2005	2003	2004	Q1 2005	2003	2004	Q1 2005	2003	2004	Q1 2005	2003	2004	Q1 2005
General index	2.8	2.3	2.0	1.0	1.8	1.7	2.2	2.3	1.9	3.1	3.1	3.3	2.1	2.1	2.0
Core inflation (1)	2.6	2.3	2.1	0.9	1.7	1.2	2.1	2.4	1.3	3.0	2.7	2.8	1.9	2.1	1.7
Processed food	3.4	3.6	2.8	2.4	2.8	4.5	4.7	5.6	-0.5	3.5	4.2	3.8	3.3	3.4	2.3
Non-food and non-energy products	1.8	1.6	1.2	-0.4	0.9	-0.3	0.6	0.4	..	2.1	1.0	0.8	0.7	0.8	0.3
Services	3.1	2.6	2.6	1.3	1.9	1.4	2.6	2.8	2.9	3.6	3.7	3.8	2.5	2.6	2.4
Unprocessed food	3.9	1.9	-1.8	-1.1	-0.9	0.2	1.9	-0.1	1.3	4.5	3.7	3.4	2.1	0.6	0.4
Energy products	3.1	2.4	5.9	4.0	4.0	6.8	2.3	4.7	8.4	1.3	4.8	7.2	3.0	4.5	7.6

Source: Based on Eurostat data.
(1) General index excluding unprocessed food and energy products.

Producer and export prices. – Year on year, the producer prices of manufactured goods sold on the internal market rose by 2.3 per cent in the euro area, compared with 1.4 per cent in 2003. The acceleration reflected that in the prices of non-energy intermediate goods – a rise of 3.5 per cent compared with 0.8 per cent in 2003 – which tend to follow world raw materials prices with a lag. For 2004 as a whole the increase in energy prices was 3.9 per cent, the same as in 2003, but with a significant acceleration in the course of the year. The producer prices of non-food final consumer goods declined by 0.6 per cent, after rising by 0.4 per cent in 2003, with a gradual acceleration from mid-year on.

The appreciation of the euro induced producers to curb their export prices despite the growth of world demand. After falling 1.2 per cent in 2003, the implicit deflator of export goods rose by 0.7 per cent in 2004 as a whole, about 1.5 percentage points less than the rise in internal prices. However, the export pricing policies of producers varied from country to country. While German export prices declined slightly (by 0.1 per cent) and French ones rose by 1.9 per cent, less than the rate of increase in domestic prices, Italian producers responded to the rapid growth of world demand by raising their export prices by 4.1 per cent, much more than the rise in domestic prices.

Costs. – The prices of imported goods and services in the euro area rose by 1.3 per cent in 2004, after falling by 1.7 per cent in 2002 and 1.3 per cent in 2003. With the euro appreciating by about 4 per cent in nominal effective terms, this increase reflected that in raw materials prices in response to rapidly expanding world demand. Oil prices were also affected by demand-side strains due to the reduction in spare capacity in the main oil-producing countries. On the basis of IMF indices the dollar prices of non-energy commodities rose by 18.6 per cent on average for the year. Crude oil (Brent grade) rose by nearly 33 per cent. The rise in oil prices under way since the end of 2003 sharpened at the start of 2005, and in March the price went above $50 a barrel.

Table 28

UNIT LABOUR COSTS AND THEIR DETERMINANTS IN THE MAJOR EURO-AREA COUNTRIES

(percentage changes on previous year)

	Labour costs per employee (1)		Labour productivity						Unit labour costs	
					Value added (2)		Employment (1)			
	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004
	Industry excluding construction (3)									
Germany	2.1	2.1	2.7	5.9	..	4.3	-2.6	-1.5	-0.6	-3.5
France	0.7	2.9	0.2	3.0	-0.4	0.5	-0.6	-2.3	0.4	..
Italy	2.9	3.3	-0.7	0.7	-1.0	0.3	-0.3	-0.4	3.6	2.5
Spain	4.3	3.7	3.2	3.0	1.3	2.1	-1.9	-0.9	1.1	0.7
Euro 4 (4)	2.0	2.6	1.3	3.6	-0.1	2.3	-1.4	-1.3	0.7	-1.0
	Services (5)									
Germany	1.4	-0.4	0.5	0.3	0.4	1.5	-0.1	1.2	0.8	-0.6
France	2.7	3.2	1.5	1.7	1.6	1.9	0.1	0.2	1.2	1.5
Italy	4.0	2.8	0.1	0.3	0.9	1.2	0.8	0.9	3.9	2.6
of which: private	*2.6*	*2.4*	*-0.7*	*-0.8*	*0.9*	*0.5*	*1.5*	*1.3*	*3.2*	*3.2*
public	*5.6*	*3.2*	*1.3*	*2.3*	*0.9*	*2.7*	*-0.4*	*0.4*	*4.2*	*0.9*
Spain	4.4	4.1	-0.8	-0.4	2.1	2.6	2.8	3.0	5.1	4.5
Euro 4 (4)	2.4	1.8	0.3	0.5	1.0	1.7	0.8	1.2	2.1	1.3
	Total economy									
Germany	1.5	0.3	1.1	1.6	0.1	2.0	-1.0	0.4	0.4	-1.3
France	2.5	3.0	1.1	2.1	1.0	2.0	-0.1	-0.1	1.4	0.9
Italy	3.8	2.9	-0.1	0.5	0.3	1.3	0.4	0.8	3.9	2.3
Spain	4.3	4.0	0.2	0.3	1.9	2.5	1.7	2.1	4.1	3.7
Euro 4 (4)	2.3	1.9	0.4	1.2	0.6	1.9	0.2	0.7	1.8	0.6

Source: Based on Eurostat data.

(1) For France, Italy and Spain, based on standard labour units. – (2) At 1995 base prices. – (3) By contrast with the "manufacturing sector", also includes mining and electricity generation and distribution. – (4) Changes calculated on the basis of the sum of the figures for France, Germany, Italy and Spain. – (5) Includes "retail and wholesale trade, transport and communications", "financial intermediation and real estate", and "other" services. For Italy, private services exclude the renting of property.

The rise in the euro prices of imports last year began earlier in Italy than in France and Germany and was more pronounced, owing in part to the greater incidence of raw materials in total Italian imports. Year on year, the implicit deflator of imported goods and services rose by 3.7 per cent in Italy, as against 1.4 per cent in France and virtual stability in Germany.

The cost pressure from imports was moderated in 2004 by the brusque slowdown in that of internal origin. For the four largest euro-area economies, the average rise in unit labour costs for the entire economy was 0.6 per cent, compared with 1.8 per cent in 2003 (Table 28). The improvement reflected a moderate cyclical upturn in labour productivity (a gain of 1.2 per cent compared with 0.4 per cent in 2003), accompanied by a slower rise in nominal per capita earnings (1.9 against 2.3 per cent). The substantial gain in productivity in 2004 as a whole enabled euro-area firms to achieve a slight increase in the share of value going to profits.

The dispersion of inflation rates. – The average inflation rate in Italy declined from 2.8 to 2.3 per cent in 2004, thanks to the more gradual pass-through of the impact effect of oil price increases. The rate held basically stable in France and Spain at 2.3 and 3.1 per cent respectively, while rising sharply in Germany, from 1 to 1.8 per cent, in connection with large increases in the prices of hospital services due to the reform of the health care system. The rise in German inflation to rates comparable with those of the rest of the other countries helped to reduce the dispersion of rates within the euro area as measured by the standard deviation from 1 to 0.8 percentage points.

Prices and costs in Italy

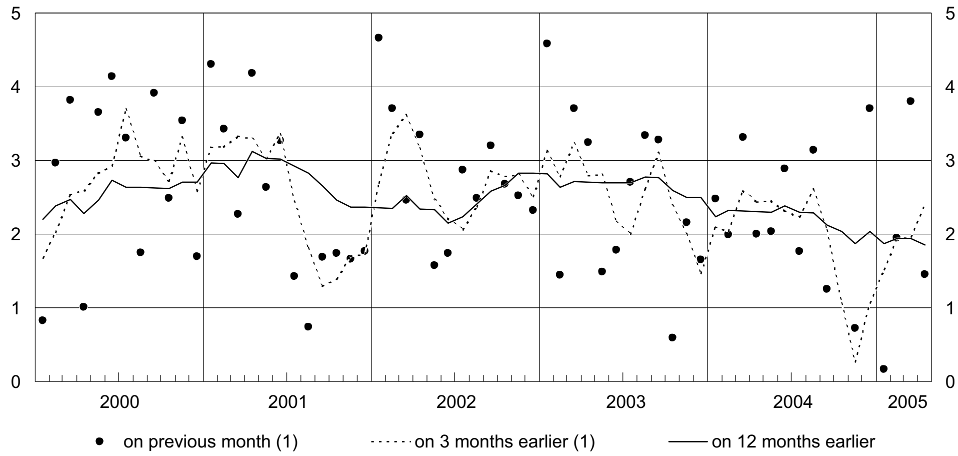
Prices. – Average consumer price inflation in Italy fell from 2.7 per cent in 2003 to 2.2 per cent in 2004, according to the general consumer price index. There was a gradual slowdown in the course of the year from 2.3 per cent in the first quarter to 2 per cent in the fourth. In the first four months of 2005 the rate held steady at 1.9 per cent (Figure 14). This trend stems from weak demand and the slowing growth of unit labour costs (about 2 per cent). Professional forecasters expect consumer price inflation to average just under 2 per cent for the next year.

Italian core inflation (net of energy, fresh and processed foods and administered-price items) also declined in 2004, from an average of 2.7 per cent to 2.1 per cent. This was due above all to the slowdown in the prices of goods (0.8 per cent as against 1.9 per cent in 2003), in connection with the moderation of domestic costs and the nominal effective appreciation of the euro. Unregulated service price inflation, though falling slightly, remained at a significantly higher rate of around 3.5 per cent, partly because unit labour costs in the service sector outpaced those in industry by 0.7 points.

Figure 14

ITALY: GENERAL CONSUMER PRICE INDEX

(monthly data; percentage changes)



Source: Based on Istat data.
(1) Seasonally adjusted and annualized.

The prices of telephones fell by 23.3 per cent in 2004, contributing about 0.2 points to the decline in overall inflation and 0.6 points to that in the component consisting of unregulated-price non-food and non-energy goods. The magnitude of the reduction is exceptional even compared with the other euro-area countries for which comparable data are available. The reduction came to 9.7 per cent in Germany and 14.8 per cent in France.

In Italy the drop in the prices of telephones accounts for the divergent trends in the prices of non-food, non-energy goods and of services as measured by Eurostat's harmonized index and by the general consumer price index. In the harmonized index telephone equipment and telephone services are lumped together in a single item classed as a service, while the Italian index appropriately distinguishes the two. The difference in classification underlies the sharp divergence in 2004 between trends both in non-food non-energy goods prices and in service prices as measured by the national and the harmonized indices.

Producer prices rose by 2.7 per cent on average in 2004, compared with 1.6 per cent in 2003. The acceleration was driven by non-energy intermediate goods (4.9 as against 1.5 per cent). By contrast, the rate of increase in the prices of non-food non-energy final consumption goods declined from 1.1 to 0.6 per cent.

A study of some 71,000 elementary price quotes collected by Istat between January 1997 and December 2001 for 60 non-energy products included in the producer price basket found that about 15 per cent of these prices change every month. However, there were significant differences according to type of good. Price changes are considerably more common for food products (processed foods only) and non-energy intermediate goods, at 26 and 18 per cent respectively; these products tend to follow international commodity prices with a short lag. By contrast only 9 per cent of non-food non-energy final consumption goods and 4 per cent of investment goods change every month.

The consumer inflation rate in Italy in the first few months of 2005 was 1.9 per cent, and core inflation also remained stable at 2 per cent. Producer prices, however, continued to accelerate (to a rate of 4.6 per cent in March), driven by sharp rises in the energy component.

Costs and margins. – In 2004 unit labour costs for the entire economy decelerated sharply, from a rise of 3.9 per cent to one of 2.3 per cent for the year as a whole (Table 28). The main factor was a slowdown from 3.8 to 2.9 per cent in the rise in labour costs per employee, principally in the service sector. Productivity gains were modest (0.5 per cent, following the 0.1 per cent decline in 2003) and confined almost exclusively to manufacturing.

Table 29

UNIT VARIABLE COSTS AND OUTPUT PRICES IN ITALY (1)

(percentage changes on previous year)

	Manufacturing			Services excluding general govrnment		
	% weights in 1995	2003	2004	% weights in 1995	2003	2004
Unit variable costs	100.0	2.1	3.1	100.0	2.7	2.7
Labour inputs	35.9	3.8	2.5	73.6	3.0	2.4
Other inputs	64.1	1.2	3.5	26.4	2.1	3.3
Domestic	38.3	1.7	1.5	19.9	3.0	3.9
Imported	25.8	0.9	5.8	6.5	-0.5	1.7
Output prices	100.0	1.1	3.1	100.0	2.6	2.2
On the domestic market	58.3	2.2	2.3	91.3	2.7	2.2
On the export markets	41.7	0.1	3.8	8.7	1.5	3.0

Source: Istat.
(1) Indicators calculated net of intrasectoral transactions.

More detailed data on costs and profit margins of firms in Italy can be drawn from Istat's input-output price indicators (Table 29). Unit variable costs in manufacturing rose by 3.1 per cent on average, as against 2.1 per cent in 2003, owing to sharper increases in imported input prices that were only partly offset by the slowdown in labour costs. Output prices increased by the same amount. In a context of uncertainty over the strengthening of the cyclical upturn, firms did not widen their unit profit margins, which had been narrowed by about 1 percentage point in 2003. In the service sector margins narrowed slightly in connection with a 2.7 per cent increase in unit variable costs and a rise of 2.2 per cent in output prices.

As world demand expanded, during the course of 2004 Italian firms differed their pricing, with much sharper rises abroad than at home (Table 29). The average unit values in euros of manufacturing exports to EU countries rose by 4.5 per cent, much more than the rise in their local producer prices. And despite the appreciation of the euro, the prices of exports to non-EU countries also increased by more than 4 per cent.

Inflation expectations

The surveys coordinated by the European Commission found that consumers' inflation expectations for the next twelve months were unchanging in Italy and in the euro area. Those of the professional forecasters surveyed in May by Consensus Economics put inflation at 2 per cent in Italy and 1.8 per cent in the area in 2005 (Table 30). The forecasts for 2006 are slightly lower. These expectations assume favourable trends in domestic costs in the main area countries and essentially stable oil prices, as indicated in futures contracts.

Table 30

EXPECTATIONS CONCERNING CONSUMER PRICE INFLATION IN THE EURO AREA IN 2005 AND 2006

(percentage changes on previous year)

	Forecasts for 2005 made in the period indicated				Forecasts for 2006 made in the period indicated	
	January 2004	June 2004	January 2005	May 2005	January 2005	May 2005
Italy	2.1	2.1	2.1	2.0	1.9	1.9
France	1.7	1.7	1.7	1.7	1.7	1.6
Germany	1.2	1.3	1.3	1.4	1.2	1.3
Spain	2.6	2.5	2.8	2.9	2.6	2.7
Euro area	1.7	1.7	1.8	1.8	1.7	1.7

Source: Consensus Economics.

Longer-term expectations, as implied by the prices of government bonds indexed to consumer prices, are for largely stable inflation in the euro area at around 2 per cent, the same level expected by professional forecasters.

Firms' pricing policies in the euro area

As part of the "Inflation Persistence Network" research project sponsored by the Eurosystem, nearly all area central banks have recently completed studies on pricing behaviour using comparable databases and methods. The studies, whose results for Italy were previewed in last year's Annual Report, provide insight into the process of price setting and variation by firms in the entire euro area.

The first line of inquiry is based on surveys in 2003 and 2004 of firms, mostly in manufacturing, in nine countries. Overall, more than 11,000 firms were interviewed. The data offer indications on the way in which firms set and change prices, the main factors in price rigidity and the asymmetry in their upward and downward movements. Some results common to all the countries emerge.

Most firms in the area determine sales prices as a mark-up over production costs, while about a third base their prices mainly on those of their competitors. In revising their prices, firms use a broad range of information, including expectations for the future and data on past and current trends. About half the respondents review their sales prices on the occasion of specific shocks or at regular intervals.

Most firms tend to review their prices, without necessarily modifying them, between once and three times a year. Those in less highly competitive industries do so less often. Actual price adjustments are less frequent (once a year). Among the suggested causes of the rigidity of nominal prices, the survey results assign particular importance to the existence of contracts (explicit or implicit) with buyers that fix nominal prices and situations of tacit collusion in which firms are reluctant to modify their prices for fear of triggering a reaction by competitors.

Prices respond asymmetrically to shocks. That is, the impact of cost changes is greater when the price is to be raised than when it is lowered, while demand induces a larger price reaction downward than upward. Firms in more highly competitive markets respond faster to changes in these variables.

A second line of inquiry examined, for the first time in Europe, a broad set of the elementary price quotes observed monthly by national statistics institutes to calculate the consumer price index.

For the euro area and for the entire sample period (1996-2001) an average of about 15 per cent of the elementary price quotes changed every month. Empirical studies for the United States using similar methodology and covering a similar range of products found a considerably higher rate of variation, 24 per cent.

Significant sectoral differences were found. For non-food non-energy goods and for services the rate of monthly price adjustment is much more limited, under 10 per cent. For energy products and unprocessed food (including meat as well as fresh fruit and vegetables) the frequency of change is much greater; the former tend to change once a month, on the average, and the latter every three months.

Empirical evidence from the national studies suggests that the frequency of price change is limited by a combination of factors: the incidence of traditional retail outlets, the share of prices that are at "attractive" levels, and public price regulation (as in energy prices in some countries). In many countries there was an increase in concomitance with changes in VAT rates, and in January 2002 the cash changeover to euro notes and coins led to an intensification of price adjustments.

THE BALANCE OF PAYMENTS AND THE NET INTERNATIONAL INVESTMENT POSITION

Italy's current account balance improved in 2004, the deficit falling from €17.4 billion to €12 billion and from 1.3 to 0.9 per cent of GDP (Table 31). The relative weakness of domestic demand was a factor in curbing the growth in imports of goods and services with respect to that in exports. Despite the exceptional expansion of world trade, exports, particularly manufactures, were held down by losses of competitiveness deriving in part from the appreciation of the euro and in part from insufficient gains in efficiency in the manufacturing sector. The overall surplus on goods and services rose from €7.6 billion to €10.4 billion as a consequence of the improvement of €3.9 billion in the balance on services, which moved into surplus after two annual deficits. The main factor in this was the growth in the surplus on travel, two thirds of it due to the fall in spending abroad by Italians. The deficit on the income account fell by €3.1 billion while that on current transfers rose slightly, from €7.1 billion to €7.7 billion.

Table 31

ITALY'S BALANCE OF PAYMENTS

(balance in billions of euros)

	2001	2002	2003	2004
Current account	**-0.7**	**-10.0**	**-17.4**	**-12.0**
Goods	17.4	14.0	9.9	8.8
Exports	*273.6*	*267.6*	*263.6*	*283.3*
Imports	*256.2*	*253.5*	*253.7*	*274.5*
Services	..	-3.0	-2.4	1.5
Income	-11.6	-15.4	-17.8	-14.7
Transfers	-6.5	-5.6	-7.1	-7.7
EU institutions	*-5.6*	*-5.7*	*-6.3*	*-6.5*
Capital account	**0.9**	**-0.1**	**2.5**	**2.1**
Intangible assets	-0.3	-0.2	-0.1	..
Transfers	1.2	0.1	2.6	2.1
EU institutions	*1.7*	*1.6*	*3.6*	*2.8*
Financial account	**-3.3**	**8.5**	**17.3**	**8.9**
Direct investment	-7.4	-2.7	6.5	-2.0
Portfolio investment	-7.6	16.1	3.4	26.4
Financial derivatives	-0.5	-2.7	-4.8	1.8
Other investment	11.7	1.0	13.7	-19.7
Banks (1)	*27.6*	*-41.7*	*40.6*	*-10.8*
Change in official reserves	0.5	-3.1	-1.4	2.3
Errors and omissions	**3.1**	**1.5**	**-2.5**	**1.1**

(1) MFIs, excluding the Bank of Italy.

Around €3.6 billion of the reduction in Italy's current account deficit came from the increase in the surplus with non-euro-area countries and around €1.7 billion from the decrease in the deficit with euro-area countries. The bulk of the improvement in the balance on services came vis-à-vis countries outside the area, that in the income account vis-à-vis countries of the area.

The capital account registered a surplus of €2.1 billion (€2.5 billion in 2003), the financial account net inflows of €8.9 billion (€17.3 billion in 2003). The sharp increase in the surplus on portfolio investment (from €3.4 billion to €26.4 billion) and the surplus on financial derivatives (€1.8 billion, compared with a deficit of €4.8 billion in 2003) were offset by deficits on direct investment and "other investment" (€2 billion and €19.7 billion respectively, against surpluses of €6.5 billion and €13.7 billion in 2003). The official reserves diminished by €2.3 billion.

Italy's net international investment position was negative at the end of December for the third consecutive year. Compared with December 2003, the debtor position worsened from 5.3 to 7.3 per cent of GDP. Net liabilities increased from €69.2 billion to €98.6 billion, €8.9 billion of the increase being due to the net inflows on the financial account and the remainder to the smaller revaluation of assets, prevalently denominated in foreign currency, with respect to liabilities in euros.

Merchandise trade. – Exports and imports returned to growth in 2004 after two years of stagnation, rising in value by 7.5 and 8.2 per cent respectively. The trade surplus fell from €9.9 billion to €8.8 billion and from 0.8 to 0.7 per cent of GDP.

The increase in the value of exports and imports reflected both an upturn in volumes and a rise in average unit values. According to foreign trade data on a *cif-fob* basis, the total volume of goods exported rose by 3.1 per cent (against a fall of 2.7 per cent in 2003) mainly reflecting demand from non-EU countries; the increase in their average unit value (4.3 per cent, against 0.8 per cent in 2003), together with an appreciation of the euro in effective terms, made Italian goods less competitive. Merchandise imports rose by 3.5 per cent in volume (0.7 per cent in 2003), prevalently vis-à-vis non-EU countries, as in the case of exports. Total average unit values rose by 4.8 per cent, compared with a decline of 0.3 per cent in 2003; those of goods from outside the EU recorded larger increases, partly owing to price rises for basic materials. The terms of trade worsened by 0.4 per cent.

The recovery of international trade in intermediate goods boosted both exports and imports of basic metals, mechanical and electrical machinery and transport equipment, in which there is a large proportion of intra-industry trade. The already substantial surplus on trade in mechanical machinery and equipment, a traditional sector of specialization for Italy, grew further. The deficit on transport equipment contracted; that on electrical equipment and precision instruments, in which Italy is not specialized, expanded again. The rise in the volume and prices of imported raw materials, crude oil in particular, led to a large increase in the deficit on mining and quarrying products. Both the chemical products and man-made fibre sector and the textile products and clothing sector also registered a deterioration in the balance. Owing to the competition of emerging countries, in the latter sector exports remained broadly unchanged while imports grew by 5.3 per cent. The surpluses on leather products and footwear and on furniture remained close to the previous year's levels.

The growth in the value of exports and imports vis-à-vis euro-area countries (6.9 and 6.7 per cent respectively) translated into an increase of €0.6 billion in the deficit, which mainly regarded Germany, Belgium, the Netherlands and Ireland, as in 2003. The decrease of €0.5 billion in the trade surplus with countries outside the area can be put down to the deterioration in Italy's bilateral balances with its main trading partners among the emerging and raw-material-exporting countries (especially the ten new members of the EU, China and the OPEC countries). By contrast, the balances with advanced countries either remained stable or improved.

The deficit with China rose by €1.5 billion to €6.7 billion as the result of an increase of 15.1 per cent in exports and 22.6 per cent in imports. According to foreign trade data, the growth in exports was led by basic metals, machinery and transport equipment. These same sectors (apart from transport equipment), along with textile products, clothing and footwear, also led the growth in imports, favoured by the appreciation of the euro against the renminbi. There was a further rise in the deficits on textile products and clothing (€2.1 billion), electrical machinery (€2 billion) and leather and footwear (€0.7 billion). Italy's only traditional bilateral surplus, that on mechanical machinery, shrank sharply to just €0.3 billion. With a 4 per cent share of total Italian imports, China became Italy's top non-EU supplier in 2004; taking 1.5 per cent of total exports, it ranks with Japan in importance as an Italian outlet market. In 2000 the corresponding shares were 2.7 and 0.9 per cent respectively.

Italy's trade surplus with the new members of the EU fell to €1.6 billion, as a consequence of a large increase in imports of electrical machinery and transport equipment, set against basically flat exports.

The increase of €1.4 billion in the deficit with the OPEC countries was due to the growth in crude oil imports, partly offset by a rise in exports of basic metals and mechanical and electrical machinery.

Services. – The largest contribution to the improvement in the balance on services (from a deficit of €2.4 billion in 2003 to a surplus of €1.5 billion last year) came from travel, whose surplus rose from €9.4 billion to €12.2 billion and from 0.7 to 0.9 per cent of GDP. The deficit on "other business services" (merchanting and other trade-related services, operational leasing and professional and technical services) fell from €2.9 billion to €1.9 billion. That on transport diminished by €0.4 billion as a result of an increase in both inflows and outflows (20.1 and 10.1 per cent respectively), which were affected by the rise in oil prices.

Most of the improvement in the surplus on travel was due to the reduction in spending abroad by Italians (according to national accounts data, households' spending in Italy on hotel and restaurant services and organized tours also declined).

Total inflows on travel rose by 3.8 per cent; after the peak reached in 2000, they had fallen for three consecutive years. While the number of travelers entering Italy declined by 8.3 per cent, primarily because of the drop in arrivals from the euro area, expenditure rose, thanks above all to the doubling of North American visitors, characterized by higher spending per capita, who in the two years 2002 and 2003 had reduced their propensity to travel abroad.

Outflows for travel contracted by 9.4 per cent, whereas in 2003 they had expanded by 2.4 per cent. The number of Italians going abroad fell by 15.4 per cent, while their expenditure per capita rose by 7.1 per cent. Both outflows and the number of Italian travelers declined in the euro area and, more markedly, outside it. The largest drop in spending abroad was in North America, particularly the United States.

Income. – The deficit on the income account, which had been rising since 1998 (except in 2001), fell from €17.8 billion to €14.7 billion. The deficit on compensation of employees contracted by €0.9 billion, as a consequence of the decline in credits and especially debits. The reduction of €2.2 billion in the deficit on investment income was caused by the decline in the deficits on income from portfolio investment (from €12.5 billion to €10.8 billion) and from "other investment" (from €4.3 billion to €3.4 billion). The balance on income from direct investment turned slightly negative by €0.3 billion, compared with surpluses of €0.1 billion and €0.2 billion in the previous two years.

The deficit on income from portfolio investment was almost entirely due to the shortfall of €12.2 billion vis-à-vis euro-area countries. This was €1.2 billion less than in 2003, thanks to an increase of 8 per cent in credits and a reduction of 1 per cent in debits. The growth in credits can be related to massive investment by Italians in securities of euro-area issuers in 2003 and 2004, the fall in debits to disposals by euro-area residents of Italian securities in 2003, followed by modest net investment in 2004.

Current account transfers. – Italy's deficit on this item rose from €7.1 billion to €7.7 billion. The deterioration was entirely due to the increase in the deficit on public transfers from €5.5 billion to €6.9 billion, which reflected a decrease of €1.1 billion in the surplus with "other non-residents" consequent to the equal reduction in credits for taxes, duties and social security contributions. The deficit vis-à-vis EU institutions rose from €6.3 billion to €6.5 billion. By contrast, net inflows were recorded under private-sector transfers: the position on "other transfers" (which include casualty insurance premiums and claims, taxes and duties paid by residents, pension payments and social security contributions) again improved, going from basic balance to a surplus of €1.9 billion, which more than offset the increase from €0.9 billion to €1.9 billion in net outflows due to emigrants' remittances.

The capital account. – Italy's capital account surplus fell from €2.5 billion to €2.1 billion in 2004. Virtually all of the decline was attributable to the contraction in the surplus on public transfers (from €3.6 billion to €2.8 billion) stemming from the reduction of €0.8 billion in EU transfers from the Regional Development Fund. Debits for debt forgiveness fell to €0.1 billion, from €1.1 billion in 2002 and €0.7 billion in 2003.

Direct investment. – Last year saw a significant increase in Italian investment abroad (from €8 billion to €15.5 billion) and a slight decrease in foreign investment in Italy (from €14.5 billion to €13.5 billion). Most of the change in the balance was accounted for by euro-area countries, with net inflows of €5.7 billion in 2003 giving way to net outflows of €3.4 billion. The surplus with non-euro-area countries rose from €0.8 billion to €1.5 billion.

Direct investment abroad (excluding property) by resident non-banks expanded from €6.2 billion to €14.5 billion, while that in Italy by non-resident non-banks remained broadly stable at around €13 billion. The increase in outward investment involved both industry (from €1.2 billion to €6.1 billion) and services (from €1.6 billion to €4 billion); the energy sector contributed with investment of €4.3 billion, up from €3.1 billion in 2003. The recovery in investment abroad by the industrial sector reflected the robust growth in that by the mechanical products industry (€3.4 billion, against net disinvestment of €1.2 billion in 2003.) In the banking and insurance sector, investment abroad fell from €4.9 billion to €2.1 billion.

The stagnation of foreign direct investment in Italy reflected the fall in industrial investment from €5.3 to €1.6 billion, which offset increases in the energy sector (from €1.8 billion to €3.6 billion) and in services (from €5.9 billion to €7.7 billion). The bulk of the decline in the industrial sector was due to disinvestment of €2.8 billion in the chemical industry (after investment of €1 billion in 2003) and to the reduction from €2.2 billion to €0.3 billion in investment in the food-processing industry; these declines were partially offset by an increase in investment in the engineering industry (from €1.8 billion to €3 billion).

Portfolio investment and derivatives. – Net inflows of portfolio investment and derivatives amounted to €28.3 billion in 2004, compared with net outflows of €1.5 billion in 2003. The improvement was mainly due to smaller net outflows towards euro-area countries (€28.8 billion, down from €58.5 billion), set against broadly unchanged net inflows from non-euro-area countries.

For portfolio investment alone, total net inflows rose from €3.4 billion to €26.4 billion. The drop in outward portfolio investment (from €51.1 billion to €21.1 billion) and the slight reduction in foreign investment in Italian securities (from €54.4 billion to €47.5 billion) were both ascribable to flows of non-equity securities. During 2004 expectations of rising corporate profits favoured investment in equities, while the fall in yields penalized the bond markets.

Italians reduced their net purchases of foreign non-equity securities from €37.3 billion to €8.2 billion and trimmed those of shares from €13.8 billion to €12.9 billion.

Foreigners reduced their net purchases of Italian non-equity securities from €56.6 billion to €34.1 billion, chiefly in the second half of the year. Meanwhile they made net purchases of Italian shares totaling €13.4 billion, against net disposals of €2.2 billion in 2003. The decline in net purchases of non-equity securities was the consequence of the drastic reduction in those of Italian government securities, which fell from €61.9 billion to €9.9 billion. By contrast, net investment in other non-equity securities rose, particularly in the bonds of non-bank issuers, partly in connection with an increase in net issuance.

"Other investment" and the change in the official reserves. – In 2004 net outflows of €19.7 billion were recorded under "other investment", compared with net inflows of €13.7 billion in 2003. "Other investment" abroad by residents rose from €19.4 billion to €37.6 billion, while that in Italy by non-residents fell from €33.1 billion to €17.9 billion. The overall change was almost entirely due to the banking sector, whose net outflows amounted to around €11 billion, compared with net inflows of €40.6 billion in 2003. The faster expansion in domestic funding than in domestic lending

stimulated both lending abroad (€21.6 billion, against net repayments of €0.9 billion in 2003) and a reduction in foreign fund-raising (from €39.7 billion to €10.7 billion).

Italy's official reserves diminished by €2.3 billion in 2004. In 2003 they had increased by €1.4 billion.

The net international investment position and the official reserves. – Between the end of 2003 and the end of 2004 Italy's net external debt grew by over €29 billion (Table 32), from €69.2 billion to €98.6 billion and from 5.3 to 7.3 per cent of GDP (the data for 2003 and earlier years have been revised; see below). Net financial flows accounted for €8.9 billion of the deterioration, price and exchange rate variations for the rest. Since a larger proportion of assets than of liabilities is denominated in foreign currencies (mainly dollars and other currencies of the SDR basket), the appreciation of the euro against the dollar and the yen involved a larger reduction in the euro value of assets than liabilities at end-2004 exchange rates. Other valuation changes (mainly in relation to prices) involved a smaller increase in assets than liabilities. Overall, the adjustments increased assets by €3.1 billion and liabilities by €23.5 billion.

Turning to the main components of the net external position, the official reserves were equal to €45.8 billion at the end of 2004, down from €50.1 billion a year earlier. Flows accounted for €2.3 billion of the reduction and exchange rate and valuation adjustments for €2 billion. Convertible currency reserves diminished by €3 billion, gold reserves by €0.7 billion.

Non-banks' net liabilities rose over the year by €39.3 billion, the result of an increase of €80.3 billion in liabilities and €41 billion in assets. Approximately €58 billion of the increase in liabilities came from new investment flows and just over €22 billion from valuation changes. Among the latter, exchange rate adjustments helped to reduce liabilities by €4.2 billion. "Other adjustments", mainly reflecting the recovery in the prices of equity and other securities and concentrated almost entirely in portfolio investment, increased liabilities by €26.6 billion; such adjustments also affected non-banks' assets, above all increasing the stocks of portfolio investment. The diminution in value due to exchange rate adjustments was larger for assets (€8.2 billion) than for liabilities.

Banks' net external debt declined moderately, from €78.4 billion to €72.4 billion. The change stemmed mainly from flows, as exchange rate adjustments and "other adjustments" virtually offset each other.

The statistics on Italy's net international investment position at the end of 2003 and the previous years have been partially revised to take account of the new data made available by the Italian Foreign Exchange Office's surveys on portfolio and direct investment assets and liabilities. Compared

Table 32

ITALY'S NET INTERNATIONAL INVESTMENT POSITION

(millions of euros)

	Stocks at end-2003 (1) (a)	January-December 2004					Stocks at end-2004 (1) (a)+(d)
		Flows (2) (b)	Value adjustments			Change in stocks (d)=(b)+(c)	
			(c)	Exchange rate (3)	Other		
	Resident non-banks						
Assets	**911,935**	**36,386**	**4,611**	**-8,246**	**12,857**	**40,997**	**952,932**
Direct investment	174,767	15,571	1,140	-1,906	3,046	16,711	191,478
Portfolio investment	563,108	11,670	12,166	-5,860	18,026	23,836	586,944
equities	*249,663*	*11,775*	*8,364*	*-4,127*	*12,491*	*20,139*	*269,802*
Other investment	162,912	8,207	-7,752	-480	-7,272	455	163,367
Derivatives	11,148	938	-943	..	-943	-5	11,143
Liabilities	**964,514**	**57,897**	**22,430**	**-4,205**	**26,635**	**80,327**	**1,044,841**
Direct investment	136,522	13,380	4,594	-29	4,623	17,974	154,496
Portfolio investment	707,165	32,041	21,360	-3,733	25,093	53,401	760,566
equities	*24,616*	*10,833*	*6,343*	*..*	*6,343*	*17,176*	*41,792*
Other investment	113,289	6,881	-2,426	-443	-1,983	4,455	117,744
Derivatives	7,538	5,595	-1,098	..	-1,098	4,497	12,035
Net position	**-52,579**	**-21,511**	**-17,819**	**-4,041**	**-13,788**	**-39,330**	**-91,909**
	Resident banks						
Assets	265,380	34,166	843	-1,698	2,541	35,009	300,389
Liabilities	343,747	27,911	1,144	-3,645	4,789	29,055	372,802
Net position	**-78,367**	**6,256**	**-302**	**1,947**	**-2,248**	**5,953**	**-72,413**
	Central bank						
Assets	64,166	4,736	-2,374	-1,609	-765	2,362	66,528
Liabilities	2,444	-1,636	-41	-41	..	-1,677	767
Net position	**61,722**	**6,372**	**-2,333**	**-1,568**	**-765**	**4,039**	**65,761**
OVERALL NET INTERNATIONAL INVESTMENT POSITION	**-69,224**	**-8,884**	**-20,454**	**-3,662**	**-16,791**	**-29,338**	**-98,561**

(1) At end-of-period prices and exchange rates. – (2) At the prices and exchange rates obtaining on the transaction date. – (3) Calculated on the basis of the currency composition.

with the data published earlier, total portfolio investment assets at the end of 2003 and non-banks' direct and portfolio investment liabilities at the end of 2003 and the previous years have been revised upwards. Non-banks' "other investment" liabilities at the end of 2003 and the previous years have been revised downwards, since the survey data suggested that there had been a misallocation of flow reports by sector.

THE PUBLIC FINANCES

After growing for three years, general government net borrowing in the euro area declined in 2004 by 0.1 percentage points to 2.8 per cent of GDP. According to the programmes submitted by governments, it should have fallen by 0.4 percentage points. The ratio of debt to GDP rose by 0.5 percentage points to 71.4 per cent.

Net borrowing remained in excess of 3 per cent of GDP in Greece, Germany, France and, according to the data released by Istat on 24 May 2005, Italy. In Portugal it was close to the 3 per cent threshold despite extensive recourse to one-off measures; in the Netherlands it was brought below the threshold.

The "excessive deficit procedures" launched against France and Germany in respect of their 2002 budget results are still in place. In 2004 procedures were launched against Greece and the Netherlands in respect of their 2003 budget results; the procedure against the Netherlands is in the process of being wound up.

On the basis of the most recent stability programmes, net borrowing in the euro area should fall by 0.4 percentage points of GDP in 2005. Compared with the previous programmes, most of the countries have set less ambitious objectives for the three years 2005-07.

The European Commission forecasts that the majority of countries will not achieve the new objectives either and that net borrowing in the area will remain virtually unchanged in 2005.

In March 2005 the European Council approved guidelines for the amendment of the Stability and Growth Pact. The main changes regard the objectives that countries must pursue in the medium term and the excessive deficit procedure. The Governing Council of the ECB expressed concern about the new rules: changes in the procedure must be prevented from undermining confidence in the reference framework for budgetary policies, in the sustainability of the public finances and in the euro.

In Italy general government net borrowing remained unchanged in 2004 at 3.2 per cent of GDP. The statistical revisions made by Istat embodied in the data announced on 24 May and the report to the European Commission of 1 March raised net borrowing in 2001-03 by an average of 0.6 percentage points of GDP. The deficit was also in excess of the 3 per cent threshold in 2001.

The objective for net borrowing in 2004 was gradually raised from 1.8 per cent of GDP in July 2003 to 2.9 per cent; the revisions mainly reflected the deterioration in the underlying performance of the accounts, owing partly to less-than-expected economic growth.

One-off measures reduced the deficit in 2004 by more than 1.5 percentage points of GDP, compared with nearly 2 points in 2003. The primary surplus contracted to 1.8 per cent of GDP, from 2.1 per cent in 2003. The ratio of taxes and social security contributions to GDP fell by 0.9 percentage points owing to the reduction in receipts from tax regularization schemes.

The general government borrowing requirement net of privatization receipts declined from 4.3 to 4.2 per cent of GDP. The effects of one-off measures amounted to more than 2 percentage points of GDP, compared with about 2 points in 2003; settlements of past debts were negligible, whereas they had been equal to 0.7 percentage points of GDP in 2003. The gap with respect to net borrowing narrowed slightly, to 1 percentage point of GDP; adjusting for the different impacts of one-off measures, it widened slightly, to 1.5 points. When estimated on the basis of the primary balances, it was wider still.

In the last few years Italy’s public finances have progressively deteriorated. The primary surplus fell from 6.7 per cent of GDP in 1997 to 4.5 per cent in 2000 and to 1.8 per cent in 2004. Measured as the current surplus, general government saving was equal to 1.4 per cent of GDP in 2000 but was negative from 2003 onwards. Excluding the effects of one-off measures, in 2004 net borrowing was just below 5 per cent of GDP and the borrowing requirement slightly above 6 per cent; the primary surplus was virtually nil and in cash terms was negative from 2002 onwards.

Between 2000 and 2004 the deterioration in the primary balance, excluding the effects of one-off measures, was due for nearly 2 percentage points of GDP to the decrease in revenue and for nearly 2.5 points to the increase in expenditure. The fall in revenue was mainly the result of tax reliefs. The rise in expenditure was above all due to current expenditure, which was pushed up by outlays on pensions, health care and public employment. Capital expenditure increased by 0.6 percentage points of GDP.

The ratio of debt to GDP went from 106.8 per cent in 2003 to 106.6 per cent last year. Without the disposal of assets and the bond conversion with the Bank of Italy in 2002, it would have remained virtually unchanged from

2000 onwards. The debt figures have been revised upwards; the largest change, amounting to 0.5 percentage points of GDP, was made in 2004 following Eurostat's decision that loans contracted by Infrastrutture S.p.A. to finance investment in high-speed railway lines should be included in central government debt.

The Economic and Financial Planning Document published in July 2004 set objectives for 2005 of 2.7 per cent of GDP for net borrowing and 2.6 per cent for the primary surplus. GDP growth was forecast at 2.1 per cent. In December a budget adjustment officially estimated at 1.7 percentage points was approved.

The Quarterly Report on the Borrowing Requirement published in April 2005 raised the objective for net borrowing to 2.9 per cent of GDP, following the downward revision of expected economic growth to 1.2 per cent. Taking account of some factors of uncertainty, including the effectiveness of the budget adjustment, it indicated a range for net borrowing of between 2.9 and 3.5 per cent. The Government stated that it would enact corrective measures if the underlying performance of the accounts proved less favourable than expected. The reduction in the ratio of debt to GDP was estimated at 0.5 points, including privatizations and asset sales amounting to about 1.8 points.

The performance of the main macroeconomic aggregates could turn out to be worse than that built into the forecasts of the Quarterly Report. It is also necessary to consider the effects on 2005 of the latest revisions of the figures for net borrowing in 2004. There is a risk that this aggregate will overshoot the range indicated by the Government. Progress in lowering the ratio of debt to GDP may require privatizations on a larger scale than envisaged.

Assuming no corrective measures are enacted or tax reliefs granted, the European Commission forecasts that net borrowing will rise to 3.6 per cent of GDP in 2005 and to 4.6 per cent in 2006. For the latter year the objective set in the November 2004 Stability Programme was 2 per cent.

The high level of debt is the main problem of Italy's public finances; it is important that it continue to decline in relation to GDP and at a faster pace. The deficit must be rapidly brought back to a downward path. Adjustment of the public finances is a necessary condition for improving economic agents' expectations, thereby exerting a positive influence on investment and growth; it will permit an increase in the public sector's contribution to national saving and make greater resources available to upgrade infrastructure. Corrective action must aim at curbing primary current expenditure on a lasting basis; the scale of the required adjustment calls for structural measures in the main fields of expenditure.

BUDGETARY POLICY IN 2004

The euro area

General government net borrowing amounted to 2.8 per cent of GDP in 2004, compared with 2.9 per cent in 2003. This result reflects divergent performances: the budget balance improved appreciably in France, Ireland and the Netherlands; it deteriorated significantly in Greece, Luxembourg and Spain (Table 33). On the basis of the stability programme updates submitted in late 2003 and early 2004, the euro-area deficit should have declined by 0.4 percentage points of GDP. The area's economic growth was in line with the average of the indications in the national programmes.

Table 33

GENERAL GOVERNMENT NET BORROWING AND DEBT IN THE EURO-AREA COUNTRIES

(as a percentage of GDP)

	Net borrowing (1)				Debt			
	2001	2002	2003	2004	2001	2002	2003	2004
Germany	2.8	3.7	3.8	3.7	59.4	60.9	64.2	66.0
France	1.6	3.2	4.2	3.7	57.0	59.0	63.9	65.6
Italy	3.2	2.7	3.2	3.2	110.9	108.3	106.8	106.6
Spain	0.5	0.3	-0.3	0.3	57.8	55.0	51.4	48.9
Netherlands	0.1	1.9	3.2	2.5	52.9	52.6	54.3	55.7
Belgium	-0.4	-0.1	-0.4	-0.1	108.0	105.4	100.0	95.7
Austria	-0.3	0.2	1.1	1.3	66.2	65.8	64.7	64.2
Greece	4.1	4.1	5.2	6.1	114.8	112.2	109.3	110.5
Finland	-5.2	-4.3	-2.5	-2.1	43.8	42.5	45.3	45.1
Ireland	-0.9	0.5	-0.2	-1.3	35.8	32.6	32.0	29.9
Luxembourg	4.4	2.7	2.9	2.9	55.9	58.5	60.1	61.9
Portugal	-6.2	-2.3	-0.5	1.1	7.2	7.5	7.1	7.5
Euro area	1.8	2.5	2.9	2.8	69.6	69.6	70.9	71.4

Sources: For the euro-area countries apart from Italy, based on European Commission data (April 2005); for Italy's net borrowing, Istat (May 2005).
(1) The data do not include the proceeds of sales of UMTS licences but include the effects of swaps and forward rate agreements.

This section refers to the data published by the European Commission in April 2005, except in the case of Italy, for which account is taken of the revisions announced by Istat on 24 May 2005. In some other countries national accounts data are also being revised.

The data presented by the European Commission are consistent with the information submitted by each country at the beginning of March. On that occasion Eurostat did not validate the outturns submitted by Greece and Italy. The checks under way for Greece concern inconsistencies in the recording of transactions with the European Union and the estimates of some expenditure items; they could lead to an upward revision of the deficit. For Italy, see the following section.

The primary surplus of the euro area remained basically unchanged at 0.5 per cent of GDP. Interest payments diminished further, declining from 3.5 to 3.3 per cent.

Deficits in excess of 3 per cent of GDP were recorded in Greece (6.1 per cent), Germany (3.7 per cent), France (3.7 per cent) and Italy (3.2 per cent). In Portugal net borrowing was equal to 2.9 per cent of GDP. In the Netherlands the overshoot recorded in 2003, primarily as a consequence of the deterioration in economic conditions, was followed by a deficit equal to 2.5 per cent of GDP.

The European Commission's estimate of the ratio of the cyclically adjusted deficit to GDP, which does not take account of the latest revisions of the Italian data, was unchanged at 2.3 per cent. Excluding interest payments, there was a surplus equal to 1 per cent of GDP, compared with 1.1 per cent in 2003. Substantial recourse was again made to one-off corrective measures in some euro-area countries (Belgium, Italy and Portugal).

Euro-area debt rose from 70.9 to 71.4 per cent of GDP. The ratio increased by more than a percentage point in Germany, Portugal, France, the Netherlands and Greece. Among the heavily indebted countries (Belgium, Italy and Greece), the ratio fell by 4.3 percentage points in Belgium, where the budgetary position remained close to balance.

The excessive deficit procedures against France and Germany are still in place. In 2004 procedures were launched against Greece and the Netherlands; the procedure against the latter country is in the process of being wound up.

Italy

Budgetary policy. – In 2004 this aimed at countering the tendency for the public finances to deteriorate in a context marked by persistent structural weakness of the economy. One-off measures continued to be used in an attempt to limit the restrictive impact on economic activity. Excluding the effects of these measures, the primary surplus remained basically stable;

the ratio to GDP of taxes (excluding capital taxes) and social security contributions remained virtually unchanged as did the primary current expenditure ratio.

The objective for general government net borrowing in 2004 was gradually raised (Table 34). The Economic and Financial Planning Document of July 2003 indicated a figure of 1.8 per cent of GDP, the result of a primary surplus amounting to 3.1 per cent and of interest payments totaling 4.9 per cent. It was assumed that the economy would grow by 2 per cent. The Document also envisaged a reduction of 1.4 percentage points in the ratio of debt to GDP.

Table 34

PUBLIC FINANCE OBJECTIVES, ESTIMATES AND OUTTURNS FOR THE YEAR 2004

(billions of euros)

	State sector borrowing requirement (1)	General government				*Memorandum items*	
		Net borrowing (1)	Primary surplus	Interest payments	Debt	Real GDP growth rate (%)	Nominal GDP
Objectives							
EFPD (July 2003)	....	....	....	....	....	2.0	1,354.1
as a percentage of GDP	....	*1.8*	*3.1*	*4.9*	*104.2*		
EFPD update (September 2003)	49.5	30.3	38.7	69.0	....	1.9	1,352.5
as a percentage of GDP	*3.7*	*2.2*	*2.9*	*5.1*	*105.0*		
Stability programme update (November 2003)	....	....	....	....	....	1.9	1,352.0
as a percentage of GDP	....	*2.2*	*2.9*	*5.1*	*105.0*		
Estimates released during the year							
QRBR and FPR update (May 2004)	62.0	39.7	29.5	69.2	....	1.2	1,351.5
as a percentage of GDP	*4.6*	*2.9*	*2.2*	*5.1*	*105.9*		
EFPD (July 2004)	62.0	39.6	32.1	71.7	....	1.2	1,350.1
as a percentage of GDP	*4.6*	*2.9*	*2.4*	*5.3*	*106.0*		
FPR and EFPD update (September 2004)	62.0	39.6	32.1	71.7	....	1.2	1,353.9
as a percentage of GDP	*4.6*	*2.9*	*2.4*	*5.3*	....		
Stability programme update (November 2004)	....	....	....	....	....	1.2	1,353.0
as a percentage of GDP	....	*2.9*	*2.4*	*5.3*	*106.0*		
Outturns							
Istat notification (March 2005)	41.3	40.9	27.0	67.9	1,429.9	1.2	1,351.3
as a percentage of GDP	*3.1*	*3.0*	*2.0*	*5.0*	*105.8*		
Istat press release (May 2005)	....	43.7	24.8	68.4	1,440.9	1.2	1,351.3
as a percentage of GDP	....	*3.2*	*1.8*	*5.1*	*106.6*		

Legend: EFPD = Economic and Financial Planning Document; QRBR = Quarterly Report on the Borrowing Requirement; FPR = Forecasting and Planning Report .

(1) Net of settlements of past debts and privatization receipts. The figure for the outturn is taken from the Quarterly Report on the Borrowing Requirement published in April 2005.

The first revision of the macroeconomic planning scenario came in the September update of the Economic and Financial Planning Document.

The size of the budgetary adjustment planned for 2004 was reduced (to 0.8 percentage points of GDP, instead of 1.2 points as indicated in July) and the objective for net borrowing was raised to 2.2 per cent. The budget contained one-off measures on a major scale: property sales were expected to be 0.4 per cent of GDP and additional tax revenue 0.5 per cent.

The performance of the public finances in the early months of 2004 suggested that an overshoot of the objective was likely, as the state sector borrowing requirement was considerably larger than in 2003.

In April the European Commission, acting on a forecast of 3.2 per cent for Italy's net borrowing, proposed that the European Council should serve an early warning.

In the Quarterly Report on the Borrowing Requirement published at the beginning of May the Government raised its estimate of the deficit again, to 2.9 per cent of GDP, partly as a consequence of the further reduction in the forecast of economic growth, from 1.9 to 1.2 per cent. Compared with the objective set in July 2003, the primary surplus was revised downward by nearly one percentage point, to 2.2 per cent; the improvement in the ratio of debt to GDP was cut from 1.4 to 0.3 percentage points. The Quarterly Report acknowledged that achieving the objective for net borrowing in 2004 depended on a series of contingencies, some of which were highly uncertain. The Government nonetheless undertook to adopt the measures needed to keep the deficit below the 3 per cent threshold.

The commitment was confirmed in the meeting of the European Council on 5 July, when the Government outlined the corrective measures to be taken in the second half of the year. Accordingly, the Council decided not to serve an early warning on Italy, but underscored the need for careful monitoring of the performance of its public finances.

In mid-July the Government introduced the corrective measures it had announced. They were officially expected to bring an adjustment of €7.6 billion (0.6 per cent of GDP) and comprised €4.2 billion of reductions in expenditure, €1.3 billion of increases in revenue and €2 billion of administrative measures to be specified subsequently.

In the second half of 2004 the worsening of the borrowing requirement compared with 2003 reversed. At the end of July the Economic and Financial Planning Document for 2005-08 was published. The Government confirmed the figures it had indicated in May for economic growth and net borrowing. They were again left unchanged in September when the update of the Economic and Financial Planning Document and the Forecasting and Planning Report for 2005 were published.

While preparing the budget for 2005, at the end of November the Government modified the measures for 2004 once more. In particular, it postponed payment of the second and third instalments of the building offences regularization scheme to 2005 (€2.2 billion), together with that of the increase in the regional tax on productive activities it had introduced for banks in July (€0.4 billion). To make good the lower revenue in 2004, it provided for payments on account of some indirect taxes (€1.4 billion) and raised the early payments of taxes collected by banks introduced in 2003 from 1 to 1.5 per cent of the taxes they had collected in the previous year (€1.5 billion). Expenditure savings of €0.2 billion were also envisaged.

The update of the stability programme in November confirmed the estimate of net borrowing in 2004 at 2.9 per cent of GDP.

The results. – According to the outturn figures released by Istat on 24 May 2005, net borrowing in 2004 amounted to 3.2 per cent of GDP, with no change on the previous year; interest payments declined by 0.2 percentage points of GDP to 5.1 per cent. The primary surplus declined by 0.3 points to 1.8 per cent (Table 35); on a downward trend since 1998, the latter ratio returned to its level in 1992 (Figure 15).

Table 35

MAIN INDICATORS OF THE GENERAL GOVERNMENT FINANCES IN ITALY (1)

(as a percentage of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Revenue	45.1	45.6	45.8	48.0	46.5	46.7	45.8	45.7	45.3	46.0	45.2
Expenditure (2) (3)	54.3	53.2	52.9	50.7	49.3	48.4	47.7	48.8	48.1	49.2	48.5
of which: interest payments	*11.4*	*11.5*	*11.5*	*9.4*	*8.0*	*6.7*	*6.5*	*6.5*	*5.8*	*5.3*	*5.1*
Primary surplus (3)	2.1	3.9	4.4	6.7	5.2	5.0	4.5	3.4	3.0	2.1	1.8
Net borrowing (3)	9.3	7.6	7.1	2.7	2.8	1.7	1.9	3.2	2.7	3.2	3.2
Total borrowing requirement	9.8	7.2	7.5	1.9	2.6	1.3	2.2	4.3	3.3	3.1	3.6
Borrowing requirement net of privatization receipts.....................	10.1	7.7	7.8	3.0	3.3	3.4	3.6	4.6	3.5	4.3	4.2
Borrowing requirement net of settlements of past debts and privatization receipts .	9.6	7.5	7.1	3.0	3.1	2.8	3.2	3.9	3.1	3.7	4.2
Debt	124.8	124.3	123.1	120.6	116.8	115.6	111.3	110.9	108.3	106.8	106.6

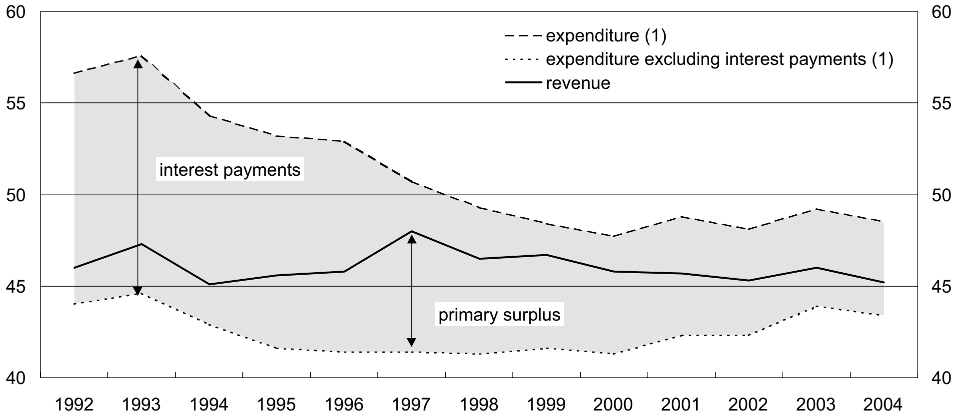
Source: The general government consolidated accounts items are based on Istat data.

(1) Rounding may cause discrepancies. – (2) This item includes, with a negative sign, the proceeds of the sale of public assets. – (3) The figure for 2000 does not include the proceeds of the sale of UMTS licences, which were deducted from expenditure in the national accounts.

Figure 15

GENERAL GOVERNMENT REVENUE AND EXPENDITURE

(as a percentage of GDP)



Source: Based on Istat data.

(1) This item includes, with a negative sign, the proceeds of the sale of public assets. The figure for 2000 does not include the proceeds of the sale of UMTS licences, which were deducted from expenditure in the national accounts.

The general government consolidated accounts for the period 2000-04 have been revised several times with a consequent increase in net borrowing, which is now stated as having been equal to 1.9 per cent of GDP in 2000, 3.2 per cent in 2001, 2.7 per cent in 2002 and 3.2 per cent in 2003 and 2004.

In its report to the European Commission of 1 March 2005 Istat indicated that net borrowing in 2004 had been equal to 3 per cent of GDP. On the same occasion it released some statistical revisions and accounting reclassifications that raised net borrowing for the three years 2001-03 (Table a15). The increases (to respectively 3, 2.6 and 2.9 per cent of GDP) mainly derived from the inclusion among capital transfers of contributions of capital to the State Railways that had previously been included among the financial items, which do not affect net borrowing. This change led to an increase in the deficit of 0.3 percentage points in each of the three years. Other revisions raised the deficit in 2003 by another 0.2 percentage points.

Following its examination of the report, Eurostat felt unable to validate the data provided by Italy and requested additional information on the accounting treatment of specific operations. The issues to be examined concerned: some payments by tax collection agencies; Infrastrutture S.p.A.'s financing of high-speed railway construction works; certain aspects of securitizations of sales of buildings; and the recording of transactions with the EU budget. Eurostat also drew attention to excessive inconsistencies between data on a cash basis and on the accrual basis adopted for the European System of Accounts (ESA95). On some of these matters Eurostat consulted with the Committee on Monetary, Financial and Balance of Payment Statistics.

On 23 May Eurostat announced its decisions: 1) the pre-payments of taxes by tax collection agencies were not to be included in the calculation of net borrowing (they had previously been accounted for so as to reduce that balance by €2.7 billion in 2003 and €1.1 billion in 2004) and were to be added to the public debt; 2) the loans raised by Infrastrutture S.p.A. were to be included in the public debt but not in the calculation of net borrowing; and 3) some costs incurred in connection with securitizations of building sales were to be included in net borrowing for 2004.

On 24 May Istat revised the figures for the public finances in the light of Eurostat's decisions and raised its estimates of the transfers to firms in relation to transactions with the EU and other interventions. All told, compared with the report of 1 March, the revision increased net borrowing in the period 2000-04 by an average of nearly 0.2 percentage points of GDP per year.

The contraction of 0.3 percentage points of GDP in the primary surplus between 2003 and 2004 reflected the reduction of 0.5 percentage points in primary expenditure and that of 0.8 points in revenue. The ratio of taxes and social security contributions to GDP fell by 0.9 points of GDP owing to the reduction of about 0.8 points in receipts from tax regularization schemes included in the calculation of net borrowing. Primary current expenditure declined by 0.1 percentage points of GDP, to 39.3 per cent; capital expenditure decreased by 0.4 points.

Despite the adoption of corrective measures officially estimated at about 1.4 percentage points of GDP, the outturn for the primary balance was slightly below the current programmes projection contained in the Economic and Financial Planning Document of July 2003 (1.9 per cent of GDP). The lower growth than originally forecast and the accounting revisions explain about two thirds of the difference of 1.5 points between the current programmes projection and the current programmes figure implicit in the outturn.

About 0.2 percentage points of the deterioration in the ratio of the primary surplus to GDP between 2003 and 2004 is estimated to have been caused by the poor performance of the economy.

The methods used to prepare cyclically adjusted figures for the public finances permit the homogeneous comparison of data for years that are contiguous or relatively close. They cannot, however, take account of the impact of a change in the growth rate of the economy recorded, for example, between one decade and the next. With reference to Italy, they do not consider the fall in the rate of GDP growth since the early 1990s as cyclical. The cyclical component concerns only the relatively small fluctuations that have occurred around a trend or potential growth rate, which has fallen close to 1.5 per cent in the last ten years.

The different methods used lead to small differences for some years. According to the European Commission's latest estimates, based on a methodology agreed within the EU Economic and Financial Committee and adopted by the Italian Ministry for the Economy and Finance, the performance of the economy reduced the budget deficit in 2001 by 0.9 percentage points of GDP, made no contribution in 2003 and made a negative contribution of 0.6 points in 2004. On the basis of the methodology used by the Bank of Italy, the cyclical impact was positive in 2001 but smaller (0.7 points), declined to about 0.2 points in 2003 and was nil in 2004. The Bank's methodology takes account not only of the level of GDP but also of changes in its composition. The differences with respect to the Commission's estimates partly reflect the shift in the composition of aggregate demand in favour of the domestic component and the positive trend of employment; in the last few years these factors have increased tax revenue and reduced some categories of expenditure, thereby offsetting part of the effect of low growth on the public finances.

In 2004 one-off measures reduced net borrowing by more than 1.5 percentage points of GDP. The reduction was produced by: the extension of the tax regularization schemes introduced in 2003; payments of the substitute taxes on the revaluation of company assets and the capital gains arising from the sale of companies; the building offences regularization scheme; and sales of public buildings.

One-off measures were used on a major scale (about 1 per cent of GDP) in 1997, when the deficit was reduced substantially to ensure compliance with the Maastricht parameters. Their use was gradually phased out in the following years and had been virtually eliminated by 2000, a year in which the public finances benefited, however, from exceptionally large receipts of the capital gains component of the tax on income from financial assets (about 0.7 per cent of GDP), boosted by the rise in share prices in 1999. Since 2001, one-off measures have been used on a major scale again, partly owing to the slower growth of the economy. The effects of these measures rose from about half a percentage point of GDP in 2001 to 1.5 points in 2002 and nearly 2 points in 2003; they were more than 1.5 points in 2004.

Eliminating the effects of one-off measures, net borrowing is estimated to have been about 2 per cent of GDP in 2000, 3.5 per cent in 2001, 4 per cent in 2002, 5 per cent in 2003 and slightly less in 2004. The corresponding primary surplus fell from 4.5 per cent of GDP in 2000 to about 3 per cent in 2001 and to about 1.5 per cent in 2002, remaining below 0.5 per cent in 2003 and 2004. The fall between 2000 and 2004 in the primary surplus adjusted for one-off measures can be ascribed to the reduction in revenue for nearly 2 percentage points and to the increase in expenditure for nearly 2.5 points.

The downturn in revenue was primarily due to the tax reliefs granted in the period 2001-04, together with the lapsing of the exceptionally large receipts in 2000 of the tax on income from financial assets referred to above. On the basis of the official estimates presented when the individual measures were launched, the tax reliefs granted over the four-year period averaged about 0.4 percentage points of GDP per year. More than two thirds of the total effect of the reliefs concerned personal income tax and about one sixth corporate income tax and the regional tax on productive activities. As for indirect taxation, the permanent reductions (amounting to about 0.1 per cent of GDP) concerned the tax on electricity and, for some sectors, VAT and excise duties.

The ratio of primary current expenditure to GDP, which had remained basically stable at around 37.5 per cent between 1996 and 2000, rose by 1.8 percentage points in the following years. The increase was fueled by almost all the main expenditure items: compensation of employees (0.4 points), social benefits in cash (0.5 points) and social benefits in kind, primarily with reference to the health sector (0.3 points). In real terms primary current expenditure grew between 2000 and 2004 at an average annual rate of 2.4 per cent, compared with about 1 per cent for GDP; the growth reflected long-term trends caused by legislation that was enacted in more favourable macroeconomic and demographic conditions. In the period 1980-93 the growth in primary current expenditure averaged 4.2 per cent per year in real terms, in the period 1994-2000 only 1.2 per cent. After falling in the 1990s, the ratio of capital expenditure to GDP rose by 0.6 points of GDP between 2000 and 2004, excluding the proceeds of sales of publicly-owned real estate, which are accounted for with a negative sign under capital expenditure.

Financial balances. – In 2004 the general government total borrowing requirement amounted to €49.3 billion, compared with €39.7 billion in 2003; as a ratio to GDP, it rose from 3.1 to 3.6 per cent (Tables 35 and 36). These results were influenced by the revisions of the statistics carried out following the decisions of Eurostat announced on 23 May 2005 (see the section below on the public debt). Settlements of past debts were especially small at €0.5 billion, compared with €8.5 billion in 2003. Privatization receipts fell from €16.9 billion to €7.7 billion.

Table 36

GENERAL GOVERNMENT BALANCES AND DEBT
(millions of euros)

	2000	2001	2002	2003	2004
Net borrowing (1)	22,615	38,741	34,463	41,755	43,652
Total borrowing requirement	26,027	51,910	41,867	39,694	49,313
Borrowing requirement net of privatization receipts (2)	41,477	56,513	43,797	56,550	56,986
Debt	1,298,670	1,350,948	1,364,880	1,389,575	1,440,855
Memorandum items:					
Settlements of past debts (2)	4,601	9,310	5,328	8,537	533
Privatization receipts (–) (2)	-15,450	-4,603	-1,929	-16,855	-7,673

Source: For net borrowing, Istat.
(1) The figure for 2000 does not include the proceeds of the sale of UMTS licences (€13,815 million). – (2) The figures for settlements of past debts and privatization receipts refer to central government.

As regards the financing of the borrowing requirement, net issues of medium and long-term securities rose from €23.1 billion to €41.2 billion, while for short-term securities there was a swing from net issues of €6.1 billion to net redemptions of €1 billion. The average residual maturity of government securities lengthened from 6 to 6.5 years. Bank loans amounting to €1.3 billion were repaid (€5.3 billion in 2003). The assets held by the Treasury with the Bank of Italy grew by €2.6 billion (after falling by €8 billion in 2003). The funds raised by way of post office current accounts held by the private sector increased by €2.7 billion (after growing by €3.8 billion in 2003). There was also a significant increase in the balance on current accounts held with the Treasury by entities outside general government, above all Cassa Depositi e Prestiti S.p.A.

Excluding privatization receipts and settlements of past debts, the borrowing requirement rose from 3.7 to 4.2 per cent of GDP. Excluding only privatization receipts, it declined from 4.3 to 4.2 per cent. Temporary measures are estimated to have reduced the borrowing requirement net of privatization receipts by more than 2 percentage points of GDP, compared with about 2 points in 2003.

The reduction in the borrowing requirement due to temporary measures has been on a major scale, of the order of 2 percentage points of GDP, in the last three years. If this adjustment is excluded, the average general government borrowing requirement in these three years was of the order of 6 percentage points of GDP. The corresponding primary balance was in deficit from 2002 onwards.

The one-off measures that in 2004 affected the borrowing requirement but not net borrowing include: the transfer to SACE of government claims on the Russian Federation (0.1 percentage points of GDP); securitizations of social security contributions due to the National Social Security Institute (INPS) and government claims in respect of supported loans for scientific research (0.2 and 0.1 points respectively). In addition, tax regularization scheme receipts exceeded those included in the accounts for the purpose of calculating net borrowing (0.1 points).

The discrepancy between the balances.– The difference between the general government borrowing requirement net of privatization receipts and net borrowing amounted to 1 percentage point of GDP, compared with 1.1 points in 2003. Excluding the effects of one-off measures, the gap widens slightly, to about 1.5 points of GDP.

The gap widened significantly in 1999. From an average of 0.5 percentage points of GDP in the period 1994-98, it increased to an average of 1.3 points in the period 1999-2004 (Figure 16a). The gap between the two primary balances was larger still (1.6 percentage points on average between 1999 and 2004).

The gap can be divided into three main components: a) the balance of transactions in financial assets, which affects only the borrowing requirement; b) the gap between the general government borrowing requirement (calculated by the Bank of Italy on the financing side) and the public sector borrowing requirement (calculated by the Ministry on the formation side), which primarily reflects statistical discrepancies; and c) the residual component, the difference between the deficit of the public sector (the borrowing requirement minus the balance of transactions in financial assets) and net borrowing. The latter component mainly reflects the different accounting principles applied (cash basis for the borrowing requirement, accrual basis for net borrowing). Since 1999 the difference has been largely due to the balance of transactions in financial assets (1 percentage point of GDP on average, compared with 0.7 points in the five preceding years). The second component averaged 0.3 points per year in both periods but in 2003 and 2004 was virtually nil. The contribution of the residual component was virtually nil on average in the period 1999-2004, after being negative by 0.5 points in the earlier period.

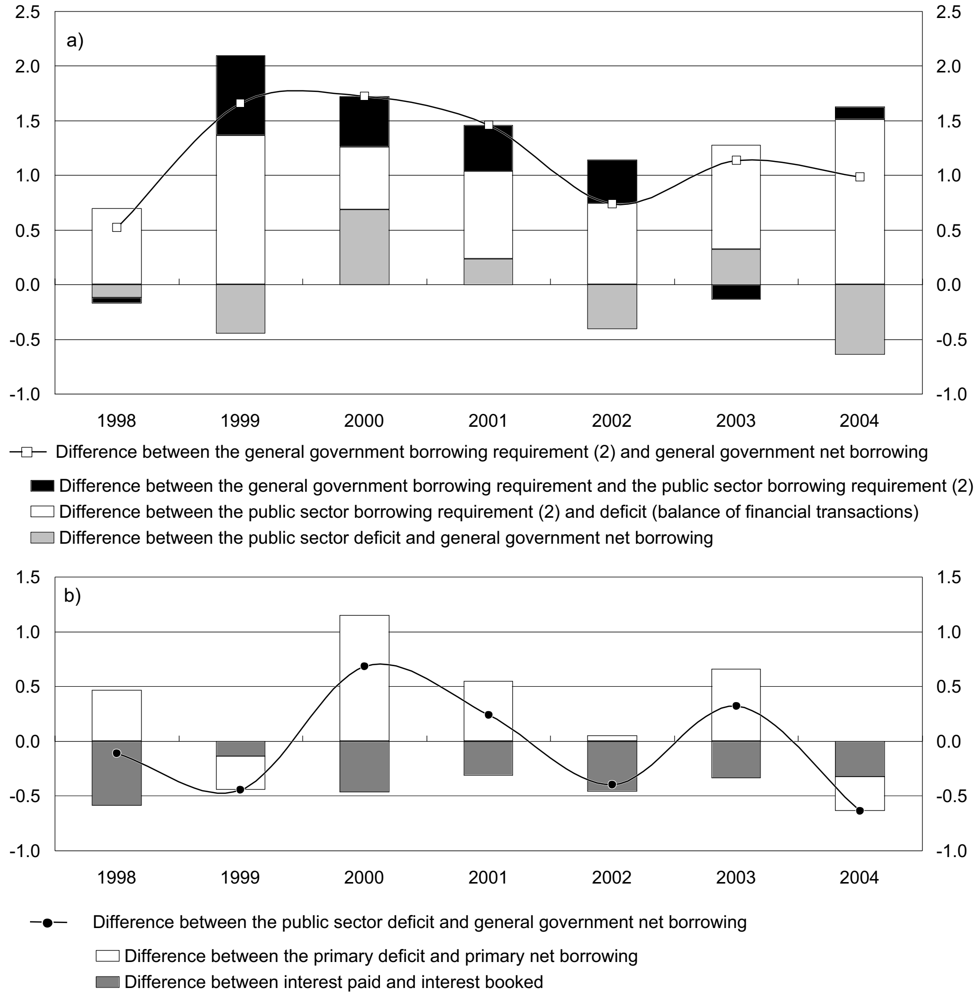
The residual component, attributable mainly to the different accounting principles applied, can be analyzed separately with reference to the primary surplus and interest payments. While the contribution of the primary surplus between 1999 and 2004 was positive on average, that of interest payments was always negative (Figure 16b), primarily in connection with post office savings certificates, accrued interest on which is paid when they are redeemed. In the period under consideration the difference due to the primary balance averaged 0.3 percentage points of GDP per year (0.2

points in the five preceding years), that due to interest payments averaged about -0.3 points per year (-0.6 points in the previous period).

Figure 16

DISCREPANCY BETWEEN THE BORROWING REQUIREMENT AND NET BORROWING (1)

(as a percentage of GDP)



Sources: For the public sector borrowing requirement, balance of financial transactions and deficit, Ministry for the Economy and Finance, *Relazione trimestrale di cassa*, various years. For 2003 and 2004 the data have been amended to take account of the effects of the decisions announced by Eurostat concerning the prepayments made by tax collection agencies and the loans contracted by Infrastrutture S.p.A. to finance the construction of high-speed railway infrastructure. For the general government borrowing requirement, Bank of Italy; for net borrowing, Istat.

(1) The data on the borrowing requirement and net borrowing in 2000 exclude the proceeds of the sale of UMTS licences. – (2) Borrowing requirement net of privatization receipts.

The revisions made to the figures for both balances in the last few years narrowed the gap.

Net borrowing was revised progressively upwards in the last few years by amounts that were sometimes significant. The borrowing requirement was also revised upwards; in this case the main revisions were the result of new information on the size of post office current accounts and the decisions taken by Eurostat with regard to the accounting treatment of securitizations, payments in advance by tax collection agencies, and loans raised by Infrastrutture S.p.A. to finance high-speed railway infrastructure. All told, the revisions narrowed the gap between the two aggregates. For example, the difference for 2001 was equal to 2.3 percentage points of GDP in March 2002 when the outcome for the year was first published; it is now equal to 1.5 points following the upward revision of net borrowing by a total of 1.8 points and the borrowing requirement by 0.9 points (of which 0.5 points deriving from the new information on post office current accounts and 0.2 points from the change in the accounting treatment of securitizations). For the three years 2001-03 the difference averaged about 1.6 percentage points of GDP on the basis of the balances initially announced and about 1.1 points on the basis of the latest figures available.

The public debt.– General government debt rose by €51.3 billion in 2004 (Table 36). The upward impulse imparted by the total borrowing requirement (€49.3 billion) and the increase in Treasury assets held with the Bank of Italy (€2.6 billion) was reduced slightly by the issue of securities above par and the appreciation of the euro (which had a combined effect of €0.6 billion).

The ratio of general government debt to GDP declined from 106.8 to 106.6 per cent (Table 35).

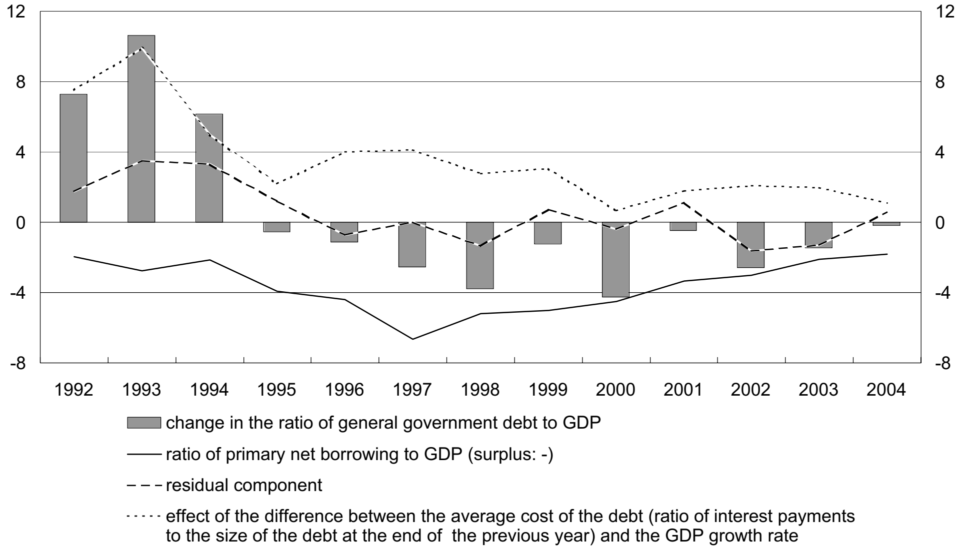
Compared with the data in the report sent to the European Commission on 1 March 2005, the 2001, 2002, 2003 and 2004 debt figures have been revised upward by respectively €2.6 billion, €2.8 billion, €6.5 billion and €10.9 billion (0.2, 0.2, 0.5 and 0.8 percentage points of GDP). The increases in the last two years reflect the decisions taken by Eurostat on 23 May 2005 to: a) reclassify as loans the payments in advance made by tax collection agencies in 2003 and 2004 (respectively €2.7 and €5.2 billion); and b) to consider as central government debt the loans raised by Infrastrutture S.p.A. in 2004 to finance high-speed railway infrastructure (€6.4 billion). In addition, the reclassification of SACE's current account with the Treasury increased the debt by €2.5 billion, €2.7 billion and €3.7 billion in respectively 2001, 2002 and 2003.

The decline of 0.2 percentage points in the ratio of the debt to GDP can be broken down into three factors (Figure 17): the reduction of 1.8 points deriving from the primary surplus; the increase of 1 point attributable to the difference between the average cost of the debt and the GDP growth rate (this was less than the increase in 2003 owing both to the decrease in the average cost of the debt from 5.1 to 4.9 per cent and the acceleration in GDP growth, from 3.2 to 3.9 per cent); and the increase of 0.6 points attributable to the residual component – the difference between the change in the debt and net borrowing.

Figure 17

COMPOSITION OF THE CHANGE IN THE RATIO OF THE PUBLIC DEBT TO GDP IN ITALY (1)

(percentage points)



(1) For the methodology, see the note to Figure 18 in the Abridged Report for the year 2000.

The effects of one-off measures on the change in the debt in the period 2001-04 are estimated to have averaged about 3 percentage points of GDP per year. In addition to those that affected the net borrowing requirement, the measures included privatizations and in 2002 the conversion of bonds held by the Bank of Italy.

In the absence of privatizations, sales of buildings and the bond conversion in 2002, the ratio of debt to GDP would have remained basically stable from 2000 onwards.

REVENUE AND EXPENDITURE IN ITALY

General government revenue

General government revenue grew by 2.1 per cent in 2004, rising to €611.2 billion; in relation to GDP it fell by 0.8 percentage points to 45.2 per cent (Table 37).

Table 37

GENERAL GOVERNMENT REVENUE (1)

(as a percentage of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Direct taxes	14.9	14.7	15.3	16.0	14.4	15.0	14.6	15.0	14.2	13.7	13.6
Indirect taxes	11.8	12.1	11.8	12.4	15.3	15.1	15.0	14.5	14.7	14.4	14.4
Current tax revenue	**26.7**	**26.8**	**27.1**	**28.5**	**29.7**	**30.1**	**29.6**	**29.5**	**28.9**	**28.1**	**28.1**
Actual social security contributions	13.2	13.0	14.6	14.9	12.5	12.4	12.4	12.3	12.5	12.7	12.7
Imputed social security contributions	1.9	1.7	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Current fiscal revenue ..	**41.7**	**41.6**	**42.2**	**43.8**	**42.5**	**42.9**	**42.3**	**42.1**	**41.7**	**41.1**	**41.0**
Capital taxes	0.1	0.6	0.3	0.7	0.4	0.1	0.1	0.1	0.2	1.5	0.7
Tax revenue and social security contributions	**41.8**	**42.2**	**42.5**	**44.5**	**42.9**	**43.0**	**42.4**	**42.2**	**41.9**	**42.6**	**41.7**
Other current revenue	2.9	3.1	3.2	3.2	3.2	3.3	3.0	3.3	3.2	3.1	3.3
Other capital revenue	0.3	0.3	0.1	0.3	0.3	0.4	0.3	0.2	0.2	0.3	0.3
Total revenue...	**45.1**	**45.6**	**45.8**	**48.0**	**46.5**	**46.7**	**45.8**	**45.7**	**45.3**	**46.0**	**45.2**

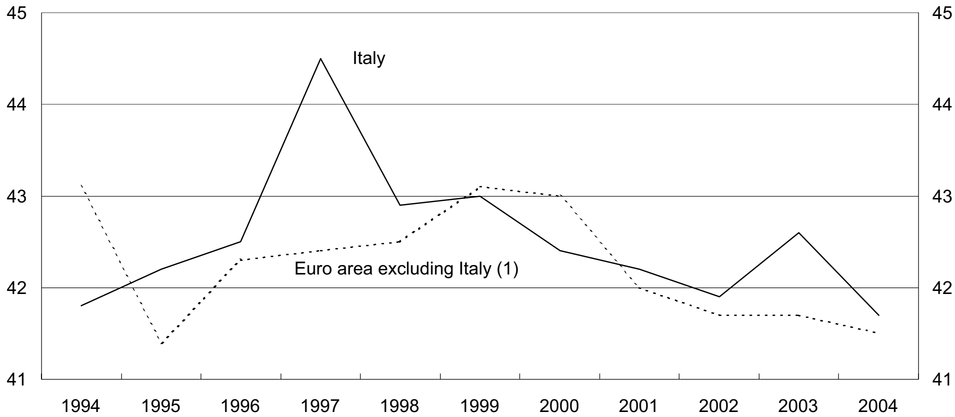
Source: Based on Istat data.
(1) Rounding may cause discrepancies.

Tax revenue and social security contributions fell from 42.6 to 41.7 per cent of GDP, reflecting the reduction of 0.8 percentage points of GDP in capital taxes (Figure 18). Direct and indirect taxes and social security contributions remained basically unchanged in relation to GDP. Excluding the effects of one-off measures, which are estimated to have boosted revenue by more than 1 percentage point of GDP (more than 1.5 points in 2003), tax revenue and social security contributions fell by about half a percentage point of GDP.

Figure 18

TAX REVENUE AND SOCIAL SECURITY CONTRIBUTIONS

(as a percentage of GDP)



Sources: Based on Istat and European Commission data.
(1) GDP-weighted average. There is a break in the series between 1994 and 1995 owing to the switch to ESA95.

Capital taxes fell by more than half as a consequence of the drying up of the revenue produced by the tax regularization schemes introduced by the Finance Law for 2003 and extended by that for 2004.

Direct taxes grew at a lower rate than GDP, 3.4 per cent and 3.9 per cent respectively. The growth was reduced by the first part of the personal income tax reform producing its full effects and the lowering of the rate of corporate income tax. On the other hand, it benefited from the increase in one-off revenue from two flat-rate withholding taxes.

Indirect taxes grew by 4.2 per cent and remained unchanged in relation to GDP. Lotto receipts and the tax on tobacco products recorded particularly large increases.

While gross earnings grew by 3.5 per cent, actual social security contributions increased by 3.7 per cent.

The main taxes. – The following analysis of individual taxes is based on receipts allocated to the State budget on a cash basis.

State budget *direct taxes* grew by €4.4 billion or 2.5 per cent, which was basically in line with the figures on the basis of assessments (€4.6 billion and 2.6 per cent). Excluding the revenue from tax regularization schemes recorded in the State budget, which amounted to €7.8 billion in 2003 and €7.5 billion in 2004, direct taxes grew by 2.8 per cent. The reduction in receipts of self-assessed personal and corporate income tax and in those of the withholding tax on bank deposit interest was accompanied by an increase in receipts of the flat-rate withholding tax on the revaluation of corporate assets and of that on capital gains arising from the sale of businesses.

Personal income tax receipts grew by €3.4 billion or 2.8 per cent. Withholding tax on the incomes of employees and on pensions increased by €4.3 billion or 4.6 per cent. When account is taken of the progressive nature of the tax, this is in line with the growth in gross earnings (3.5 per cent) and pensions (4 per cent). Self-assessed personal income tax receipts contracted by €1.3 billion or 5.9 per cent, as a result of a fall of €0.3 billion in the balance paid and of €0.9 billion in payments on account; the outcome was influenced by the first part of the personal income tax reform, which came into force in fiscal 2003 (see the box "The first step of the reform of personal income tax", *Economic Bulletin*, No. 36, 2003).

Corporate income tax receipts decreased by €1 billion or 3.3 per cent as a consequence of the decline in payments on account. In 2004 these were adversely affected by the reductions in the corporate income tax rate from 36 to 34 per cent for fiscal 2003 and from 34 to 33 per cent for fiscal 2004.

Receipts of withholding tax on interest income and capital gains remained virtually unchanged. The reduction of €0.7 billion in receipts of the tax on bank interest income was offset by the increase from €2.3 billion to €3 billion in those of the tax on capital gains arising from the sale of businesses. The revenue provided by the latter tax, which has been abolished with effect from fiscal 2004, will lapse in 2005.

Other direct taxes grew by €2.2 billion. The result benefited from the increase from €1.4 billion to €3.7 billion in the flat-rate withholding tax on the revaluation of corporate assets and the special payment on account introduced in July 2004 of the tax on the actuarial reserves of insurance companies' life business (€0.8 billion).

State budget *indirect taxes* grew by €11.8 billion or 7.4 per cent, which was basically in line with the figures on the basis of assessments (€10.3 billion and 6 per cent). Excluding the receipts generated directly by tax regularization schemes, which amounted to €3.1 billion in 2003 and €1.3 billion in 2004, indirect tax revenue grew by 8.7 per cent. In particular, increased receipts were recorded by VAT (€4.4 billion), other business taxes and duties (€2 billion), taxes on tobacco products (€0.7 billion), and lotto and lotteries (€7.8 billion). On the other hand, there was a fall of €0.9 billion in excise duties on mineral oils and of €0.4 in those on other energy products.

Lotto and lottery receipts more than doubled, rising from €6.8 billion in 2003 to €14.7 billion in 2004. They were boosted by a new levy on video games that raised €0.4 billion and, above all, by the growth in lotto receipts. The latter result reflected the inclusion in the accounts of prior-year receipts. The growth on an assessment basis, from €6.9 billion to €11.7 billion, was smaller than that on a cash basis, from €5.9 billion to €12.7 billion. Excluding lotto and lottery receipts, the increase in indirect taxes falls from 7.4 to 2.6 per cent.

General government expenditure

General government expenditure amounted to €654.9 billion, an increase of 2.3 per cent on 2003; in relation to GDP it decreased by 0.8 percentage points to 48.5 per cent (Table 38). Excluding the proceeds of sales of public-sector real estate, which are deducted from investment in the accounts, overall expenditure fell by 0.6 percentage points to 48.8 per cent of GDP. Primary expenditure fell by 0.4 points to 43.7 per cent; capital expenditure fell by 0.3 points to 4.4 per cent and current expenditure by 0.1 points to 39.3 per cent (Figure 19).

Table 38

GENERAL GOVERNMENT EXPENDITURE (1)

(as a percentage of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Compensation of employees.........	11.9	11.2	11.5	11.6	10.7	10.6	10.6	10.8	10.8	11.1	11.0
Intermediate consumption	5.2	4.8	4.8	4.7	4.8	4.9	5.0	5.1	5.0	5.1	4.9
Market purchases of social benefits in kind	2.2	2.0	2.0	2.1	2.1	2.1	2.4	2.6	2.6	2.6	2.7
Social benefits in cash	17.3	16.7	16.9	17.3	17.0	17.1	16.8	16.6	17.0	17.3	17.3
Interest payments.........................	11.4	11.5	11.5	9.4	8.0	6.7	6.5	6.5	5.8	5.3	5.1
Other current expenditure	2.7	2.3	2.5	2.2	2.9	2.8	2.8	2.9	3.0	3.3	3.4
Total current expenditure...........	**50.6**	**48.5**	**49.1**	**47.2**	**45.4**	**44.4**	**43.9**	**44.5**	**44.2**	**44.7**	**44.3**
Gross fixed investment (2)	2.3	2.1	2.2	2.2	2.4	2.4	2.4	2.5	1.9	2.6	2.6
Other capital expenditure (3).........	1.5	2.5	1.6	1.3	1.5	1.6	1.4	1.9	2.0	1.9	1.5
Total capital expenditure (2)(3) ..	**3.7**	**4.6**	**3.8**	**3.5**	**3.9**	**4.0**	**3.8**	**4.4**	**3.9**	**4.5**	**4.1**
Total expenditure (2)(3) ..	**54.3**	**53.2**	**52.9**	**50.7**	**49.3**	**48.4**	**47.7**	**48.8**	**48.1**	**49.2**	**48.5**
of which: expenditure excluding interest payments (2)(3) .	*42.9*	*41.6*	*41.4*	*41.4*	*41.3*	*41.6*	*41.3*	*42.3*	*42.3*	*43.9*	*43.4*

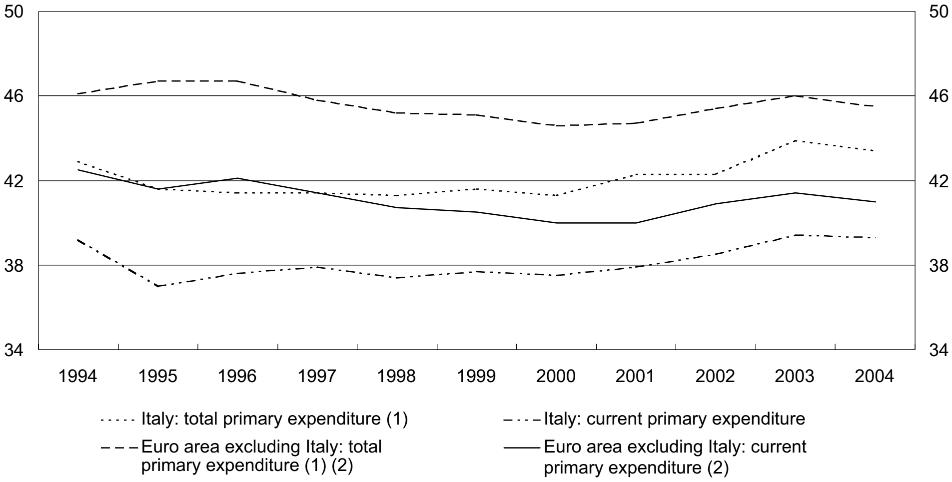
Source: Based on Istat data.

(1) Rounding may cause discrepancies. – (2) The proceeds of sales of public assets are recorded as a deduction from this item. – (3) The figure for 2000 does not include the proceeds of sales of UMTS licences (1.2 percentage points of GDP). In the national accounts these receipts are entered as a deduction from the item “Other capital expenditure”.

Figure 19

TOTAL AND CURRENT PRIMARY EXPENDITURE

(as a percentage of GDP)



Sources: Based on Istat and European Commission data.

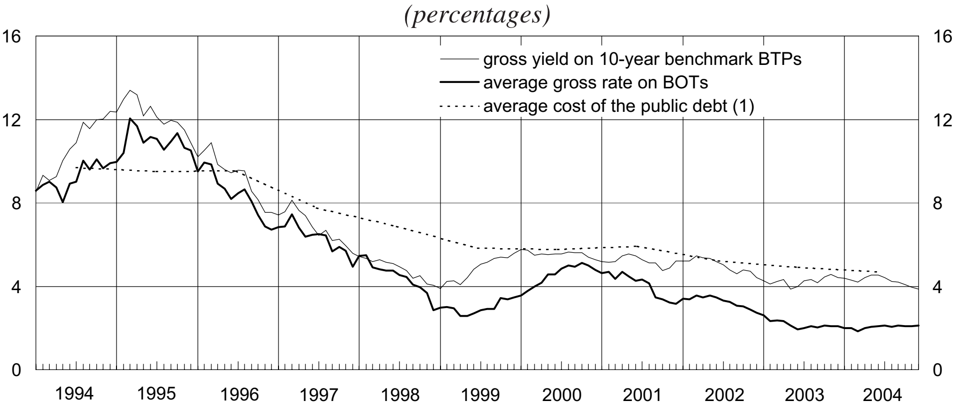
(1) The proceeds of sales of public assets are recorded as a deduction from this item; does not include the proceeds of sales of UMTS licences, which are also entered as a deduction from expenditure in the national accounts. – (2) GDP-weighted average. There is a break in the series between 1994 and 1995 owing to the switch to ESA95.

Interest payments. – This item decreased from 5.3 to 5.1 per cent of GDP; in 2003 and 2002 it had decreased by 0.4 and 0.8 percentage points respectively. The average cost of the debt (the ratio between interest payments and the average stock of liabilities during the year) fell to 4.7 per cent, compared with 4.9 per cent in 2003 and 5.2 per cent in 2002 (Figure 20); last year's decline mainly reflected the redemption of relatively high-yielding securities issued in the early 1990s.

Figure 20

GROSS YIELD ON 10-YEAR BTPs, AVERAGE GROSS RATE ON BOTs AND AVERAGE COST OF THE PUBLIC DEBT

(percentages)



(1) The average cost of the debt is calculated as the ratio of interest payments to the average size of the debt during the year.

Social benefits in cash. – The ratio of these disbursements to GDP remained unchanged at 17.3 per cent; they grew by 4.3 per cent, compared with 4.9 per cent in 2003. Pensions and annuities, equal to 15.6 per cent of GDP, grew by 4 per cent, after rising by 4.5 per cent in 2003. Other social benefits in cash grew by 7.6 per cent (8.5 per cent in 2003).

Expenditure on unemployment benefits and wage supplementation rose by 10.3 per cent, compared with 7.8 per cent in 2003; as a ratio to GDP, it remained unchanged at 0.4 per cent. The fastest-growing component was the expenditure on wage supplementation, which grew by 20.1 per cent, after rising by 16.6 per cent in 2003. This trend reflected the increase in the number of hours of wage supplementation authorized in industry.

Expenditure on family allowances grew by 0.5 per cent, compared with 4.2 per cent in 2003. Outlays for public employees' severance pay rose by 13.8 per cent (5.4 per cent in 2003), those for health, accident and maternity benefits grew by 5.6 per cent (18.4 per cent in 2003). In relation to GDP the total of these items remained unchanged at 1.1 per cent.

Compensation of employees. – Staff costs declined from 11.1 to 11 per cent of GDP, but increased by 3 per cent, compared with 5.5 per cent in 2003. The result was affected by the renewal of a number of labour contracts. Provisional data indicate that the number of employees decreased, albeit slightly, for the first time since 1999, falling to about 3.5 million.

In the ten years 1994-2003 general government gross earnings per labour unit, excluding military conscripts, rose by 43.6 per cent, compared with an increase of about 38 per cent in the private sector. Over the same period the index of consumer prices rose by 33.6 per cent. In the first five years earnings in the public sector increased slightly less than those in the private sector; in the second half of the period the reverse was true and the difference was larger. In 2004 public-sector earnings continued to outpace those in the private sector.

Other current expenditure. – This item rose by 2.9 per cent, compared with 7.3 per cent in 2003; in relation to GDP it declined by 0.1 percentage points to 11 per cent. The decline reflected that from 5.1 to 4.9 per cent of GDP in intermediate consumption, primarily in connection with the reclassification of Cassa Depositi e Prestiti outside general government.

Market purchases of social benefits in kind, attributable almost entirely to the health sector, rose by 7.1 per cent, compared with 2.5 per cent in 2003; in relation to GDP the item increased by 0.1 percentage points to 2.7 per cent. The overall result was mainly due to the increase of 8 per cent in expenditure on pharmaceuticals, following a decrease of 5.3 per cent in 2003.

Capital expenditure. – Excluding the proceeds from the disposal of public real estate, which are deducted from investment in the accounts, this item decreased by 1.9 per cent; in relation to GDP it declined by 0.3 percentage points to 4.4 per cent. Real-estate disposals – by means of sales, securitizations and the creation of real-estate investment funds – rose to €4.5 billion from €2.8 billion in 2003. Excluding the effects of these disposals, investment expenditure increased by 6.6 per cent; in relation to GDP it rose by 0.1 percentage points to 2.9 per cent.

Investment grants contracted by 7.4 per cent, after expanding very slightly by 0.1 per cent in 2003; in relation to GDP they decreased by 0.2 percentage points to 1.3 per cent. The downturn was in connection with the reduction in incentives for firms and disadvantaged areas.

Following the reclassification among capital transfers of contributions of capital to the State Railways, other capital expenditure in the years 2001-03 was revised upwards by an average of 0.3 percentage points of GDP per year (see the box "Recent revisions of the general government accounts for 2001-03", *Economic Bulletin*, No. 40, 2005). Half of the reduction in other capital expenditure from 0.4 per cent of GDP in 2003 to 0.2 per cent in 2004 can be attributed to the fall of 0.1 percentage points of GDP in contributions of capital to the State Railways.

Local government

The net borrowing of local government increased from 0.3 to 0.9 per cent of GDP, primarily owing to the growth in expenditure from 15 to 15.5 per cent.

Total revenue rose by 3.4 per cent to €197.4 billion; in relation to GDP it declined from 14.7 to 14.6 per cent, primarily as a consequence of the curbs placed on the growth in the tax component. Transfers rose from 6 to 6.1 per cent of GDP.

The increase of €10.9 billion or 6.4 per cent in current revenue benefited mainly from the increase in current transfers of €6.9 billion or 11.1 per cent and in other current revenue of €2.1 billion or 12.7 per cent. Tax revenue recorded only a moderate increase: receipts of direct taxes rose by €0.9

billion or 3.5 per cent and those of indirect taxes by €0.5 billion or 0.8 per cent.

Among direct taxes, regional personal income surtax receipts rose from €6.2 billion to €6.7 billion, while those of the equivalent municipal surtaxes remained basically unchanged at about €1.6 billion (Table 39).

Table 39

LOCAL GOVERNMENT CURRENT REVENUE (1)

(millions of euros)

	2002	2003	2004
Direct taxes	**24,102**	**26,133**	**27,042**
Regions (2)	21,603	23,119	23,891
of which: personal income surtax	*4,975*	*6,166*	*6,741*
auto taxes (households)	*3,374*	*3,347*	….
Municipalities	2,499	3,014	3,151
of which: personal income surtax	*1,096*	*1,571*	*1,615*
ICI (buildable land)	*1,044*	*1,076*	….
Indirect taxes	**57,371**	**60,084**	**60,486**
Regions (2)	40,403	42,192	41,651
of which: IRAP	*31,393*	*32,764*	*32,343*
share of excise duty on petrol	*2,885*	*2,911*	*2,727*
auto taxes (companies)	*709*	*656*	….
surtax on methane	*357*	*374*	….
special tax for waste disposal in tips	*248*	*222*	….
Provinces	3,552	3,746	3,882
of which: tax on third-party auto insurance	*1,827*	*2,155*	….
transcription tax	*1,066*	*1,257*	….
Municipalities	13,416	14,146	14,953
of which: ICI (excluding buildable land)	*9,581*	*9,873*	….
tax on advertising and bill posting rights	*347*	*365*	….
Transfers from public entities (consolidated)	**54,205**	**53,194**	**60,437**
Regions	42,921	41,594	47,668
of which: share of VAT	*28,370*	*30,328*	*34,492*
Provinces	2,718	2,698	2,752
of which: share of personal income tax (3)	–	*330*	....
Municipalities	16,024	16,368	17,292
of which: share of personal income tax (3)	*4,349*	*6,179*	....
Other current revenue	**15,201**	**16,844**	**19,175**
Regions	3,074	3,996	4,971
Provinces	1,382	1,765	1,902
Municipalities	10,745	11,083	12,302
Total current revenue	**150,879**	**156,255**	**167,140**

Sources: Istat, the Ministry for the Economy and Finance, Rendiconto generale dell'amministrazione dello Stato and Provincial Offices of the Treasury.

(1) The other regional taxes, not shown in the table, include: the taxes on regional licences and central government licences (under "indirect taxes") and taxes for university attendance and professional qualifications (under "other current revenue"). The other provincial taxes include: the environmental protection tax and the surtax on the consumption of electricity (under "indirect taxes") and the tax on the occupation of public spaces and areas (under "other current revenue"). The other communal taxes include: the surtax on the consumption of electricity (under "indirect taxes"), the tax on the disposal of solid waste and the tax on the occupation of public spaces and areas (under "other current revenue"). – (2) A quantitatively significant part of this item consists of the central government taxes accruing to the special statute regions. – (3) The April 2005 Quarterly Report on the Borrowing Requirement shows the personal income tax accruing to the provinces and municipalities at €6.2 billion.

The increase in local government indirect tax revenue was the result of the growth in that of the provinces, from €3.7 billion to €3.9 billion, and especially in that of the municipalities, from €14.1 billion to €15 billion. By contrast, the indirect tax revenue of the regions decreased, from €42.2 billion to €41.7 billion, owing to the further decline in the regions' share of the excise duty on petrol, from €2.9 billion to €2.7 billion, and the fall in receipts of the regional tax on productive activities (IRAP), from €32.8 billion to €32.3 billion, partly because of the full effects of the reliefs introduced by the Finance Law for 2003.

In recent years the scope for local authorities to change the rates for personal income surtaxes and IRAP has been subject to legislative constraints.

The Finance Law for 2003 suspended the effects of the increases in IRAP and personal income surtax rates approved by regions after 29 September 2002; the suspension also applied to similar measures adopted by municipalities introducing personal income surtaxes or raising the rates of those already introduced. The Finance Law for 2005 reinstated the increases in IRAP and regional surtax rates but exclusively for the purpose of financing deficits in the health sector. The law also permitted increases in municipal surtax rates up to a maximum of 0.1 per cent for municipalities that had not previously taken advantage of this right.

A simulation conducted on the basis of the data for 2003 showed that application of the maximum permitted rates for IRAP and regional surtaxes would boost regional tax revenue by about 10 per cent; similarly, application of the maximum surtax rate of 0.5 per cent by all municipalities would increase their tax revenue by about 5 per cent.

Capital revenue fell in 2004 by €4.5 billion or 20.9 per cent, primarily owing to the reduction of €3.3 billion in transfers from other general government bodies. The decrease of €0.9 billion in capital taxes is attributable to the lapsing of part of the receipts of tax regularization schemes.

Local government expenditure grew by 7.8 per cent to €210 billion. As a percentage of general government expenditure it rose to 32.1 per cent, the highest level since the beginning of the 1980s.

Current expenditure increased by €11.8 billion or 7.4 per cent, fueled by: staff costs, up by €5.8 billion or 10 per cent in connection with the renewal of the labour contracts for local authority and health service employees for 2002-03; intermediate consumption, up by €2.5 billion or 5.4 per cent; and social benefits in kind, up by €2.4 billion or 7.1 per cent.

Capital spending rose by €3.4 billion or 9.7 per cent, as a consequence of the increase of €2.7 billion or 10.2 per cent in fixed investment and, to a lesser extent, that of €0.6 billion or 6.9 per cent in investment grants.

As regards the Domestic Stability Pact, some minor changes were made to the aggregates used for the objectives for 2004, which were expressed in terms of financial balances for provinces and municipalities and as limits on expenditure for regions. For the three years 2005-07 the rules were revised to make the Pact consistent with the 2 per cent limit on the overall growth of general government expenditure established by the Finance Law for 2005. The revision led to provinces and municipalities also being made subject to limits on their expenditure.

In 2004 local government debt rose to 5.6 per cent of GDP (Table a19), an increase in the ratio of 0.2 percentage points, compared with 1.8 points in 2003. Of the latter figure, 1.5 points was attributable to the inclusion among the sector's liabilities of the loans granted by Cassa Depositi e Prestiti S.p.A.

The debt of the regions rose from 2.1 to 2.2 per cent of GDP, that of provinces and municipalities from 2.9 to 3 per cent, and that of other local government entities remained unchanged at 0.4 per cent.

In relation to the GDP of the corresponding macro-regions, the debt of the North rose by 0.2 percentage points to 4.3 per cent, that of the Centre remained basically unchanged at 8.4 per cent and that of the South rose by 0.4 points to 6.1 per cent.

As regards the composition of local government liabilities, the share of bonds grew from 23.6 to 28.1 per cent, while loans from monetary financial institutions fell from 44.2 to 42.1 per cent of the total and the other components, which include loans from Cassa Depositi e Prestiti S.p.A. and securitizations recorded as local government liabilities, fell from 32.2 to 29.8 per cent. The share of debt contracted abroad rose from 20.1 to 22 per cent, as a result of an increase in bond issuance abroad and a decrease in loans disbursed by non-resident intermediaries.

THE OUTLOOK

Budgetary policy in the euro area

According to the latest stability programme updates, euro-area general government net borrowing in 2005 will fall by 0.4 percentage points to 2.4 per cent of GDP (Table 40). The majority of countries will not achieve a budgetary position close to balance or in surplus within the forecasting horizon, which for all countries is at least 2007.

Most countries have set less ambitious objectives than in the past. The revisions were mainly due to the public finances having performed less well than expected in 2004 and a slight worsening in the outlook for economic growth. According to the European Commission's forecasts, the majority of countries will not achieve the new objectives either.

The stability programmes show that the euro-area ratio of debt to GDP should come down by about 0.5 percentage points in 2005 and by another 2.4 points in the two following years, to stand at 68.2 per cent in 2007.

Table 40

GENERAL GOVERNMENT NET BORROWING AND DEBT IN THE EURO AREA

(as a percentage of GDP)

	2004	2005	2006	2007
Net borrowing				
National stability programme objectives	2.8	2.4	1.9	1.3
Outturn and forecasts:				
European Commission	2.7	2.6	2.7	–
IMF	2.7	2.6	2.6	–
Debt				
National stability programme objectives	71.1	70.6	69.6	68.2
Outturn and forecasts:				
European Commission	71.2	71.7	71.9	–
IMF	71.2	71.6	71.5	–

Sources: Based on data published by the European Commission (*Spring Forecasts*, April 2005) and the IMF (*World Economic Outlook*, April 2005) and the updates to national stability programmes submitted in late 2004 and early 2005. For Greece reference is made to the update submitted in March 2005.

According to the European Commission's forecasts on a current programmes basis, released in April of this year, general government net borrowing and the primary surplus will remain basically unchanged in 2005 and 2006. On a cyclically adjusted basis the primary surplus is projected to rise from 1 per cent of GDP in 2004 to 1.2 per cent in 2005, the first increase since 1999.

According to the Commission, the euro-area ratio of debt to GDP is expected to rise by 0.5 percentage points in 2005 and by a further 0.2 points in 2006. Among the high-debt countries, in the two years 2005-06 the ratio is expected to rise by 0.5 points in Italy and to fall significantly in Belgium (by 4 points) and to a lesser extent in Greece (by 1.6 points).

The debate on the need to amend the European budgetary rules intensified in 2004, in part because some euro-area countries find it difficult to comply with them in a context of unfavourable economic conditions. In September 2004 the Commission proposed a series of amendments to make the Stability and Growth Pact more flexible and its application more effective.

In March 2005 the European Council, accepting some of the Commission's proposals, published a report laying down guidelines for the amendment of the Stability and Growth Pact. These will be incorporated in Regulations and Resolutions that will constitute the new text of the Pact. The amendments do not alter the limits established for net borrowing and debt in the Maastricht Treaty. The main changes concern the objectives countries must pursue in the medium term, the excessive deficit procedure and the principles of cooperation and transparency in budgetary policy matters.

The Governing Council of the ECB expressed serious concern about the amendments to the Stability and Growth Pact; it stressed the need to prevent the changes in the excessive deficit procedure from undermining confidence in the reference framework for budgetary policies and the sustainability of the public finances of the euro-area countries.

The guidelines for the reform confirm the fundamental elements of the European budgetary rules. The revision of some aspects of the excessive deficit procedure and the greater discretionality embodied in the new arrangements nonetheless amount to a watering down of the rules. Moreover, the greater complexity of the new arrangements may make it more difficult to verify their implementation and guarantee adequate levels of transparency. The incentives to pursue the medium-term objectives have not been strengthened. There is the risk that the average euro-area debt and deficit levels will remain high or rise. This would reduce the scope for stabilization policies, might lead to upward pressure on interest rates, and would delay the adjustment needed to cope with the costs associated with demographic trends. Only a rigorous application of the new rules by the European Council will make it possible to increase the margins of flexibility in the formulation of budgetary policy without this preventing the objectives of the Treaty and the Pact from being achieved.

Budgetary policy in Italy

The outlook for 2005. – The current programmes projections of the July 2004 Economic and Financial Planning Document indicated that general government net borrowing in 2005 would amount to 4.4 per cent of GDP and the primary surplus to 0.8 per cent (Table 41 and Figure 21). Output was expected to grow by 1.9 per cent and the net state sector borrowing requirement to be 5.9 per cent of GDP.

The Document set a target for general government net borrowing of 2.7 per cent of GDP and for the primary surplus of 2.6 per cent. Debt was to fall to 104.1 per cent of GDP at end-2005 from 106 per cent forecast for end-2004. A budgetary adjustment of the order of €24 billion (1.7 per cent of GDP) was envisaged, of which about €7 billion was to come from one-off measures. The growth in output was expected to rise to 2.1 per cent notwithstanding the planned policies.

The Document also indicated that one-off measures were to be entirely replaced by others of a permanent nature in 2006. In order to reduce the ratio of debt to GDP, provision was made for asset disposals amounting to €100 billion in the four years 2005-08.

In September 2004 the Forecasting and Planning Report and the Planning Document update, submitted to Parliament together with the budget for 2005, confirmed the outlook for GDP growth in 2005 and the targets for net borrowing and the ratio of debt to GDP. While interest payments were expected to fall from 5.3 to 5.1 per cent of GDP, the target for the primary surplus was lowered from 2.6 to 2.4 per cent. The update of the stability programme published in November confirmed the planning scenario and objectives of the Forecasting and Planning Report.

The budget the Government submitted was expected to bring an adjustment of €24 billion. Parliament approved important amendments that nonetheless left the effect on net borrowing almost unchanged. Tax reliefs amounting to €4.3 billion were introduced together with €1.8 billion of additional expenditure, financed by €3.9 billion of additional revenue and €2.2 billion of expenditure cuts.

Table 41

OBJECTIVES AND ESTIMATES FOR THE PUBLIC FINANCES IN 2005

(billions of euros and percentages)

	State sector borrowing requirement (1)	General government				*Memorandum items:*	
		Net borrow-ing	Primary surplus	Interest pay-ments	Debt	Real GDP growth rate	Nominal GDP
Estimates on a current programmes basis							
Planning Document (July 2004)	83.0	62.6	11.3	74.0	....	1.9	1,409.8
as a percentage of GDP	*5.9*	*4.4*	*0.8*	*5.2*	....		
Quarterly Report on the Borrowing Requirement (April 2005)	....	....	....	....	....	....	....
as a percentage of GDP	....	*2.9-3.5*	....	....	....		
Objectives							
Planning Document (July 2004)	....	....	....	....	....	2.1	1,409.0
as a percentage of GDP	*4.2*	*2.7*	*2.6*	*5.3*	*104.1*		
Planning Document update and Forecasting and Planning Report (September 2004)............	61.0	38.7	33.8	72.5	....	2.1	1,413.9
as a percentage of GDP	*4.3*	*2.7*	*2.4*	*5.1*	*104.1*		
Stability programme update (November 2004)	....	....	....	....	....	2.1	....
as a percentage of GDP	....	*2.7*	*2.4*	*5.1*	*104.1*		
Current estimates							
Quarterly Report on the Borrowing Requirement and Forecasting and Planning Report update (April 2005)	44.0	41.0	29.3	70.3	....	1.2	1,394.5
as a percentage of GDP	....	*2.9*	*2.1*	*5.0*	*105.3*		

(1) Net of settlements of past debts and privatization receipts.

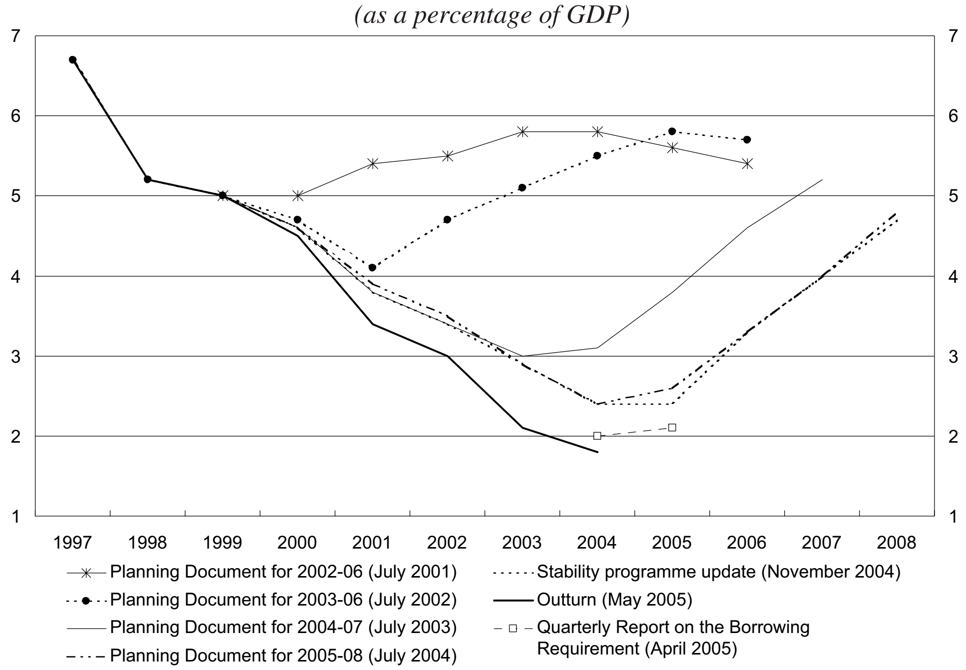
According to official estimates the budget approved by Parliament at the end of 2004 contained measures that would reduce net borrowing by €32.5 billion and others that would increase it by €8.5 billion. Asset disposals were expected to amount to €7.1 billion, interest income in connection with the restructuring of financial assets to €1.5 billion, other additional net revenue to €5.2 billion and net expenditure savings to €8.7 billion. A further €1.5 billion improvement in net borrowing was to come from amendments to the tables attached to the Finance Law.

The measures to increase revenue included: changes to sector studies (€3.6 billion) and other provisions to enlarge and recover tax bases (€1.2 billion); the deferment from 2004 to 2005 of the second and third instalments due under the building offences regularization scheme (€2 billion); and increases in stamp duty and real-estate transfer taxes (€1.1 billion). The reductions in revenue included reliefs for personal income tax (€4.3 billion in 2005 and €5.9 billion from 2006 onwards) and the extension of indirect tax reliefs granted in earlier years (€1.5 billion). Reliefs were also introduced for the regional tax on productive activities that will reduce revenue as of 2006, when the decrease is expected to be €0.5 billion.

Figure 21

PRIMARY BUDGET SURPLUS: OBJECTIVES AND OUTTURNS

(as a percentage of GDP)



On the expenditure side, the savings were to come mainly from the introduction of a 2 per cent cap on the nominal increase in general government expenditure with respect to the amounts indicated in the preliminary outturn for 2004. The cap, which was extended to the two years 2006-07, does not apply to social benefits in cash related to entitlements, transfers to the European Union, interest payments and costs in connection with constitutional bodies. As for local government, compliance with the cap was to be pursued through a revision of the rules of the domestic stability pact.

As in earlier years, a large part of the adjustment was entrusted to one-off measures. Including the residual effects of those adopted in the past, the incidence of such measures can be estimated at about 1 percentage point of GDP, compared with 2 points in 2003 and more than 1.5 points in 2004.

The bulk of this temporary adjustment will consist of the one-off effects of the changes to sector studies, the instalments due under the building offences regularization scheme and the planned disposals of real estate, of which €3 billion deriving from the transfer of part of the road network to companies controlled by the state.

In April 2005 the European Commission estimated that without further corrective measures net borrowing in 2005 would be equal to 3.6 per cent of GDP. The forecast was based on an estimate of GDP growth of 1.2 per cent and a prudent assessment of the effects of some of the measures included in the budget.

The end-April Quarterly Report on the Borrowing Requirement and update of the Forecasting and Planning Report raised the target for general government net borrowing for 2005 from 2.7 to 2.9 per cent of GDP, slightly below the latest estimate for 2004 of 3 per cent. The change mainly reflected the downward revision of expected growth, from 2.1 to 1.2 per cent.

The increase in net borrowing deriving from the deterioration in the outlook for the growth in economic activity was estimated at 0.23 percentage points of GDP. The revision of the target also reflected the deferment from 2004 to 2005 of costs associated with 2002-03 labour contracts (with a net effect equal to 0.09 points) and a decrease of 0.14 points in interest payments.

The revision of the target did not take account of Istat's reclassification of contributions of capital to Ferrovie S.p.A. in the preceding years. Eurostat has been asked to examine the issue, but if the new classification is confirmed, approximately 0.2 percentage points of GDP will have to be added to net borrowing in 2005.

The current programmes projection of net borrowing in 2005 contained in the Quarterly Report on the Borrowing Requirement and the Forecasting and Planning Report update indicated a range between 2.9 and 3.5 per cent of GDP. The higher estimate refers to the case in which Istat's present classification of contributions of capital to Ferrovie S.p.A. is confirmed and all the uncertain events listed in the Quarterly Report occur, including the deferment to 2006 of costs associated with 2004-05 labour contracts. If the trend of the public finances proves unfavourable, the Government has declared that it will take suitable steps to bring net borrowing in 2005 within the limit established by the Maastricht Treaty or at any rate below a level consistent with the new criteria for evaluating that limit recently approved by the European Council.

The uncertain events indicated in the Quarterly Report were: the fact that Anas might continue to be classified as part of general government in 2005 (with the consequent inclusion in net borrowing of costs amounting to 0.14 percentage points of GDP); the possibility that operational difficulties would prevent the completion of the programme of real-estate sales (adding an estimated 0.35 points of GDP to the deficit); the risk that expenditure would exceed the caps established by the Finance Law (0.1 points of GDP); and the possible deferment to 2006 of costs associated with 2004-05 labour contracts (with a favourable effect equal to 0.25 points of GDP).

At the same time as it raised the target for net borrowing to 2.9 per cent of GDP, the Quarterly Report estimated the public sector borrowing requirement in 2005, net of privatization receipts, at 3.7 per cent of GDP, as against 3.5 per cent in 2004.

The ratio of debt to GDP was expected to fall in 2005 by 0.5 percentage points to 105.3 per cent (the Stability Programme submitted in November 2004 had forecast a fall of 1.7 points). This result assumed privatizations and asset sales amounting to €25 billion, or 1.8 percentage points of GDP. In the last four years disposals of securities and real estate amounted on average to 1 percentage point of GDP.

According to the new planning framework, both revenue and expenditure will be lower in relation to GDP in 2005 than in 2004. Revenue is expected to fall by 0.6 percentage points of GDP to 44.7 per cent, reflecting the reduction in taxes and social security contributions (from 41.8 to 41.1 per cent of GDP). Expenditure is forecast to fall by 0.7 points, to 47.6 per cent of GDP; with interest payments remaining basically unchanged, the fall is due entirely to the contraction in primary expenditure. Current primary expenditure is expected to fall by 0.2 points and capital expenditure by 0.6 points to 3.5 per cent of GDP. Half of the latter reduction comes from the increase in real-estate sales (included in the accounts as a reduction in capital expenditure) from 0.3 to 0.5 points of GDP and the exclusion of Anas from general government. The remaining part of the fall reflects the effects expected from the measures included in the Finance Law with the aim of reducing disbursements on capital account.

In addition to the risks indicated in the Quarterly Report, it needs to be considered that the performance of the main macroeconomic aggregates could be less favourable than that underlying the forecasts. There is also the fact that some of the adjustment measures, such as those regarding sector studies, might prove less effective than expected. Lastly, it is necessary to take account of the effects on 2005 of the recent revisions of the 2004 deficit data. All told, there is a danger that net borrowing will exceed the upper limit of the range indicated in the Quarterly Report. The increase in the deficit compared with 2004 might nonetheless be accompanied by a small improvement in the balance excluding the effects of one-off measures.

The sharp slowdown in nominal GDP growth and an increase in the borrowing requirement mean that asset disposals will need to be larger than the Government indicated in April if the process of reducing the ratio of debt to GDP is to continue in 2005. The increase in debt will be influenced by Eurostat's recent decision concerning the financing of the construction of high-speed railways.

The outlook for the medium term. – The Economic and Financial Planning Document of July 2004 envisaged an annual reduction in general government net borrowing of half a percentage point, from the estimate for 2005 of 2.7 per cent to 1.2 per cent in 2008. The primary surplus was forecast to rise from 2.4 to 4.8 per cent of GDP and the ratio of debt to GDP to fall from 104.1 to 98.1 per cent.

The update of the Planning Document published in September 2004 slightly increased the improvement in the balances in the two years 2006-07; in particular, the target for net borrowing in 2006 was reduced from 2.2 to 2 per cent of GDP; the figure for 2008 was lowered to 0.9 per cent. The fall in the ratio of debt to GDP remained virtually unchanged. The update of the stability programme published in November confirmed this planning framework.

The adjustment necessary in the coming years to achieve these objectives appears substantial. In the stability programme, which took account of the planned adjustment in 2005, the gap between the current programmes projections and the objectives was equal to 1.3 percentage points of GDP in 2006, 1.6 points in 2007 and 1.9 points in 2008. The adjustments required in the three years are nonetheless larger for a series of reasons. In the first place it will be necessary to finance the costs of labour contract renewals and new investment projects, which are excluded from the current programmes projections, since these are calculated strictly on the basis of the legislation in force at the time. In addition, the new estimates of net borrowing and economic growth in 2005 contained in the Quarterly Report imply an upward revision of the medium-term deficit projections. Lastly, further corrective measures would be needed to finance the Government's planned tax reductions.

In April 2005 the European Commission produced a current programmes projection of net borrowing in 2006 equal to 4.6 per cent of GDP. On the basis of this calculation, which besides does not take account of further measures to reduce the tax burden, the adjustment needed to achieve the planned level of net borrowing would be equal to 2.6 percentage points of GDP.

Bringing the debt down from its high level is the main problem facing Italy's public finances. A large public debt makes the budget vulnerable to interest rate shocks and harder to use for stabilization purposes; it ties up resources to be used for interest payments and further ahead will increase the problems caused by the ageing of the population. In the stability programme the Government set the target of reducing the ratio of debt to GDP by 6.1 percentage points in the three years 2006-08. This will depend on achievement of the planned levels of net borrowing and the adoption of substantial additional measures of a financial nature. In this respect the stability programme indicated privatization receipts in the three years in question of respectively 2, 1.9 and 0.6 per cent of GDP.

The primary surplus fell to 1.8 per cent of GDP in 2004; net of one-off receipts, the balance was almost nil. The contraction of the primary surplus in the last few years, partly as a consequence of the unfavourable economic conditions, has slowed the process of reducing the debt as a percentage of GDP. This has occurred despite the fall in interest payments and major restructurings of assets and liabilities. In the absence of the latter, the ratio of debt to GDP would have remained basically unchanged. Only a significant increase in the primary surplus can ensure progress in bringing the ratio down.

Strict compliance with the adjustment of the public finances outlined by the Government is a necessary condition for an improvement in business expectations, with a consequent positive effect on investment and growth. Continuation of the reduction in the debt ratio will make it possible to keep the risk premium on government securities at its present low level.

As regards interest payments, only small savings will be possible in the coming years and they will derive almost entirely from the reduction of the debt in relation to GDP. In order to avoid adverse effects on the growth of the economy as a result of increases in the tax burden or an inadequate level of public investment, deficit reduction must be based on curbs on current primary expenditure. The size of the necessary adjustment requires that the caps introduced in the Finance Law be supplemented by structural reforms in the main sectors of expenditure. In addition to a careful review of the activities performed by the public sector, it appears necessary to strengthen the incentives to increase the efficiency of general government and the budgetary rules intended to involve all the different levels of government in the adjustment process.

MONETARY POLICY IN THE EURO AREA, FINANCIAL INTERMEDIARIES AND THE MONEY AND FINANCIAL MARKETS

The prospects of a rapid economic recovery in the euro area faded progressively during 2004. Inflation was held in check by the weakness of economic activity and the appreciation of the euro, despite the rise in oil prices. Long-term inflation expectations remained just below 2 per cent, a level consistent with the definition of price stability adopted by the Eurosystem.

In view of these cyclical conditions, the Governing Council of the European Central Bank maintained expansionary monetary conditions. Eurosystem official rates were left unchanged at the low levels to which they had come down in the middle of 2003 (2 per cent for the minimum bid rate on main refinancing operations). In real terms, short-term yields were virtually nil. At the beginning of 2004 market expectations regarding the monetary policy stance discounted a rise in short-term rates as early as the second half of the year; subsequently, these expectations gradually abated. In April 2005 the prevailing view was that interest rates would remain unchanged over the course of the year.

Abundant liquidity and deteriorating growth expectations were reflected in a further fall in long-term euro interest rates. Partly owing to the more favourable economic outlook in the United States, the negative differential with yields in dollars widened considerably; measured by ten-year interest rate swaps, it grew from a quarter of a percentage point in December 2003 to about one point at the end of 2004.

The euro rapidly gained against the dollar from the summer onwards, reaching a high at the end of December. The dollar's depreciation during these months was mainly due to the market's renewed concerns about the size of the deficit on the US external accounts. Over the year the euro appreciated by 7.8 per cent against the dollar; in effective terms the gain was smaller at 2.1 per cent. In the first few months of 2005 the euro began to weaken again both with respect to the dollar and in effective terms.

The low level of interest rates helped to keep liquidity preference high in the euro area. The M3 money supply, whose expansion had been slowing since 2003, began to accelerate from the spring onwards; its twelve-month rate of growth reached 6.5 per cent at the end of the year.

On the international bond market, borrowing conditions for private-sector companies were favourable across the credit rating spectrum. Yield spreads over government securities fell to the lowest levels since the 1990s for high-risk issuers. Defaults steadily diminished following the collapse of American and European companies in previous years; more optimistic evaluations of firms' riskiness emerged. The narrowing of yield spreads may also have reflected the abundant liquidity in the main monetary areas. Spreads began to widen again in March 2005 in connection with fears regarding the outlook for a number of sectors, notably the automobile industry, and a more cautious valuation of high-risk securities.

In Italy, the financial system proved well able to cope with the prolonged phase of cyclical weakness, maintaining conditions of stability. The balance sheets of households, firms and the banking system remained solid; the latter strengthened its capital base.

Financial saving by the household sector increased. Households' net financial wealth grew by 8.3 per cent in 2004, above all as a consequence of the rise in share prices, increasing to €2.7 trillion, or 2.9 times disposable income. In their financial choices households preferred liquid, low-risk assets such as bank and post-office deposits, government securities and bank bonds. They sold corporate bonds, whose share in total assets nonetheless remained broadly unchanged. On the liabilities side, households continued to increase their debt, particularly in the form of mortgage loans, taking advantage of favourable borrowing conditions. Although household debt has risen sharply, as a ratio to GDP it is still much lower than in the other industrial countries. However, a very large part of it is at variable rates, exposing the borrowers to the risk of a rise in interest rates.

Italian firms' operating profitability remained basically unchanged in 2004 at the moderate levels of the previous year. Their financial deficit was modest in conjunction with a decline in interest expense, which benefited self-financing, and a modest increase in investment.

The financial conditions of Italian firms remain sound despite the weakness of economic activity in the past few years, thanks above all to the low level of interest rates and the moderate pace of investment. Firms' leverage has declined significantly since the first half of the 1990s; after rising slightly between 2000 and 2003, it fell again last year. Corporate sector debt is lower in relation to GDP than the average for the euro area. Interest expense absorbs less than 5 per cent of value added, compared with about 10 per cent at the start of the 1990s. However, the measures of dispersion of companies' financial conditions are increasing; the ranks of companies with a high burden of debt and interest expense include a growing number of manufacturing firms, whose profitability has been lower in recent years.

Italian banks maintained easy lending conditions and low interest rates. The expansion of credit was fueled principally by strong demand from households. The bulk of new lending was connected directly or indirectly with the property market (mortgage loans for households, loans to construction firms and to real-estate service companies). By contrast, there was a contraction in lending to manufacturing firms, mainly in industries where production fell with respect to 2003.

Lending to borrowers in the South and to smaller firms grew especially rapidly. The reduction in large firms' demand for bank credit was due in part to ample recourse by some of them to the bond market.

The lengthening of the maturities of bank credit, under way for some years, continued for firms in all sectors of activity, geographical areas and size classes. The growing demand for long-term financing reflected not only the structure of interest rates but also the restructuring of the bank debt of companies in less solid financial conditions.

The quality of banks' loan portfolios was not affected by the weakness of the economy. Loans amounting to 0.9 per cent of the total outstanding were classified as bad debts, similar to the proportion in 2003 net of the effects of the Parmalat group's collapse that year. Exposures to customers in temporary difficulty declined. Banks' profitability rose. Most notably, value adjustments to loans diminished after the considerable increase recorded the previous year. The banking system's consolidated supervisory capital grew by 7 per cent in the year to December 2004; the solvency ratio rose slightly, to 11.6 per cent.

Italian private-sector bond issuance, which was considerable as a whole, mainly involved banks and some large service corporations; direct recourse to the market on the part of smaller or low-rated companies was limited.

Insurance companies' results for the year improved significantly, despite slower growth in premium income than in the preceding years.

Stock market indices in the euro area began to rise in the summer of 2004 and continued to gain until this April, when they turned downwards. The rise in share prices was fostered both by the fall in real long-term interest rates and by a reduction in investors' risk aversion, as revealed by the behaviour of options prices; it did not correspond to an improvement in forecasts of earnings growth for listed companies of the area, which either did not change significantly or were revised downwards during the period.

The rise in share prices was greater in Italy than in the other main markets. This was primarily due to the gains recorded by the shares of telecommunications and electricity companies, which, given their high debt, benefited more than others from the low level of interest rates and from corporate restructurings. The positive performance of share prices was accompanied by only a modest recovery in new listings and by a decline in the total amount of capital raised on the stock exchange by already listed and newly listed companies.

MONETARY POLICY

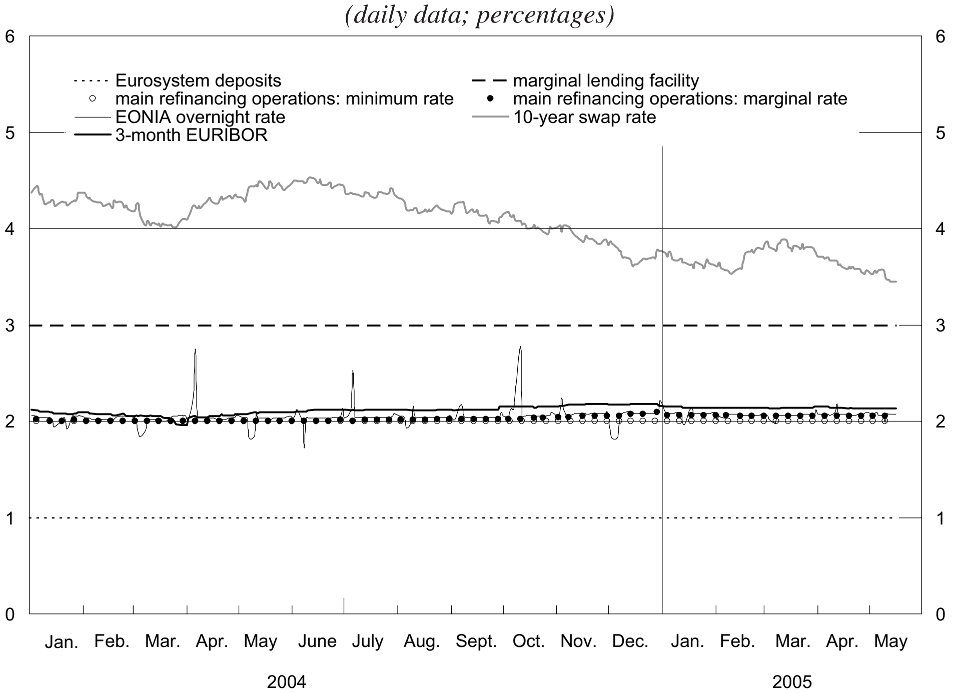
Interest rates and the exchange rate

Short-term interest rates. – In 2004 expectations of economic growth in the euro area became less certain. The subdued recovery in economic activity that had started in 2003 continued throughout the first half of the year, benefiting from the expansion of the world economy. From the summer onwards, the rise in oil prices and the weakening of global economic activity dampened the prospects for faster growth. These factors were compounded in the last quarter of the year by the euro's appreciation against the other main currencies.

Figure 22

OFFICIAL INTEREST RATES AND MONEY AND FINANCIAL MARKET RATES IN THE EURO AREA

(daily data; percentages)



Sources: ECB, Reuters, Telerate.

Consumer price inflation, after declining slightly in the early months of the year, rose to just over 2 per cent. The progressive deterioration of growth expectations and the strengthening of the euro, combined with the moderation of labour cost increases, helped to keep inflation expectations below the 2 per cent mark, despite the rise in prices of energy sources.

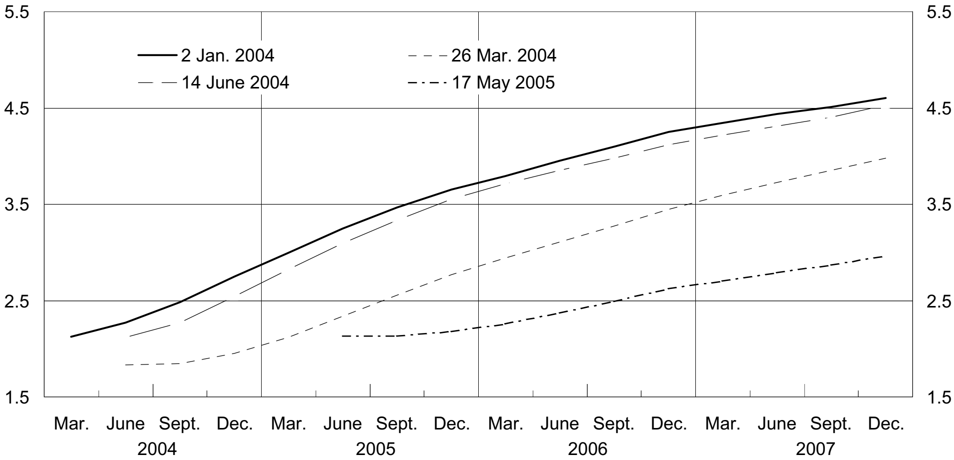
Against this background the ECB Governing Council kept monetary conditions easy, leaving the minimum bid rate on its main refinancing operations unchanged from June 2003, at 2 per cent (Figure 22).

Economic activity continued to be relatively slack in the early months of 2005. International organizations revised their euro-area growth forecasts downwards. Consumer price inflation remained close to 2 per cent, despite the pressure from the further rise in the price of oil, which was attenuated by the strengthening of the euro. At the end of the first quarter crude oil prices in euros were not far from their 2000 levels, while those in dollars had increased considerably.

Figure 23

RATES OF FUTURES CONTRACTS ON 3-MONTH EUROMARKET DEPOSITS (1)

(percentages)



Source: Reuters.

(1) Each curve relates to the trading session indicated in the legend. The horizontal axis shows the settlement dates (around the 15th of each month) for the futures contracts to which the yields refer.

Three-month interest rates held steady during 2004 at around 2.1 per cent, reflecting the level of official rates. Expectations regarding the stance of monetary policy, as inferred from the term structure of yields, changed with the economic situation (Figure 23). At the beginning of the year the yield curve slowly shifted downwards; in the spring it shifted back upwards in response to the small increase in consumer prices following the rise in the price of oil; in mid-June it moved down once more as the prospects of a recovery faded. In the last part of the year the weak economic situation led to expectations of an earlier return to a less accommodating monetary policy stance. Expectations at the end of 2004 were that official rates would remain largely stable throughout the following year.

In the first three quarters of 2004, the real short-term interest rate in the euro area declined as inflation expectations edged up and became slightly negative. Later it became virtually nil. In Italy the average real interest rate was just below zero.

Long-term yields. – Long-term euro rates declined in 2004, although fluctuating in the course of the year. Rates of return on ten-year interest-rate swaps edged downwards in the first three months before rising to a peak of 4.5 per cent in June (Figure 22). They diminished progressively from the summer onwards as signs of a cyclical weakening emerged, reaching 3.8 per cent at the end of the year.

Expectations of slower economic growth in the euro area than in the United States led to a widening of the yield differential between interest-rate swaps in dollars and in euros, from 0.2 percentage points in January to 1 point in December.

Real long-term interest rates fell by about the same amount as nominal rates. The rate of return on French ten-year government bonds indexed to euro-area consumer prices declined from around 2 per cent at the end of 2003 to 1.2 per cent a year later.

In the first four months of 2005 movements in long-term interest rates in euros reflected the conflicting signals from the economy; after rising from mid-February to end-March, rates fell to 3.4 per cent in the middle of May.

The exchange rate. – The euro strengthened in 2004, gaining 7.8 per cent against the dollar and a more modest 3.4 per cent against the yen; the appreciation vis-à-vis sterling was virtually nil. In nominal effective terms the European currency gained 2.1 per cent.

Exchange rate developments were marked by two separate phases. In the first half of the year the euro lost ground against the main currencies. Its depreciation in effective terms during that period was due, in equal measure, to movements in the exchange rate with the dollar, sterling and the Asian currencies. In all likelihood the decline resulted from the more marked improvement in the world than the euro-area economic outlook. The euro began to strengthen once more in the second half of 2004. It appreciated significantly against the dollar, the performance of which reflected renewed market concerns about the persistent and growing US current account deficit.

In the first half of 2005 the nominal effective exchange rate of the euro mainly mirrored the fluctuations against the dollar; by mid-May the euro had depreciated by 3.9 per cent from its level at the beginning of the year. During this period the dollar's performance was determined by the widening of the long-term interest rate differential and the publication of conflicting data on the state of the economy. At some stages the dollar's volatility was further heightened by reports that the Asian central banks intended to diversify the currency composition of their official reserves.

The money supply and credit

The euro area. – In 2004 euro-area M3 continued to grow, but not as fast as in 2003. A deceleration until summer was followed by a gradual recovery. The twelve-month growth rate, after falling to 4.9 per cent in May, picked up to 6.6 per cent in December.

Money supply trends depended on contrasting factors. In the first part of the year financial market uncertainty abated, fostering a shift in portfolio structure towards longer-term and riskier financial assets, to the detriment of more liquid assets and money market funds, which had grown rapidly in previous years. By contrast, the narrowing of the differential between long-term and short-term interest rates continued to fuel demand for monetary assets, resulting in a sharp growth in fixed-term deposits and repos from the summer onwards.

The protracted growth in the money supply in recent years has produced a sizeable build-up of liquidity. In the euro area the ratio of M3 to GDP reached 87 per cent at the end of 2004, 13 percentage points higher than in 1999 at the start of Stage Three of EMU. The abundance of liquidity is partly due to the shift in the structure of households' portfolio towards money market assets following the sharp drop in share prices in 2001. While households' portfolio of financial assets has become more liquid over the years (as expressed by the ratio of banknotes and coins in circulation, sight and other deposits to total gross financial assets), it is not excessively so: according to the financial accounts, at the end of 2003 the ratio stood at 33.2 per cent, lower than the value recorded in the mid-1990s (39.4 per cent). More recently, the growth in the money supply has been fueled to a large extent by the rapid increase in demand not from households, and in particular from non-bank financial companies (insurance companies, pension funds, investment funds, leasing and factoring companies and securitization vehicles).

The value of banknotes and coins in circulation continued to rise steeply, as it has since the euro's introduction in January 2002; in December the twelve-month growth rate was 17 per cent. At the end of the year the value of banknotes and coins was about 17 per cent higher than that implicit in the long-term trend estimated since 1980.

Demand for euro notes and coins by non-residents (particularly, residents in the new EU members and other East European countries) may have caused a structural increase compared with the past. The statistics available indicate that the foreign component of demand for euros increased from 9 per cent in 2003 to between 10 and 15 per cent in 2004.

The low level of interest rates on bank loans fostered a gradual increase in the twelve-month rate of growth of lending to the private sector in the euro area from 5.5 per cent in December 2003 to 7.1 per cent in December 2004.

Italy. – Excluding currency in circulation, the growth in the Italian component of euro-area M3 slowed in the first quarter of 2004, then rose at a fairly steady pace over the rest of the year. In December the twelve-month growth rate was 5.3 per cent. This trend resulted from an increase in bank deposits and a fall in the assets of money market funds.

The twelve-month rate of increase in total credit to the private sector edged up from 7 per cent in January to 8 per cent in December 2004. This mainly reflected the acceleration in the growth of bank lending from 6 to 6.9 per cent and in borrowing abroad from 2.6 to 7 per cent. Domestic bond issues continued to surge.

Monetary policy operations in the euro area

In March 2004 several innovations were made in the operational arrangements for the conduct of Eurosystem monetary policy. The new measures were designed to prevent counterparties underbidding for liquidity when there are expectations of a reduction in official interest rates, a phenomenon that occurred on several occasions in 2003, causing undesirable fluctuations in very short-term interest rates.

Average daily volumes of liquidity provided by the Eurosystem via main refinancing operations rose from €198 billion in 2003 to €242 billion in 2004. The increase stemmed from autonomous factors in monetary base uses, notably the strong growth in demand for banknotes and coins. Excess reserves averaged 0.48 per cent of minimum reserve requirements in the euro area and 0.40 per cent in Italy. The ratio of allotment amounts to bid amounts rose slightly, from 74.4 to 79.8 per cent on average.

As a consequence of the euro-area banking system's increased liquidity needs, the volume of funds allotted at each longer-term refinancing operation (LTRO) rose from €15 billion to €25 billion in January 2004 and then to €30 billion at the start of 2005. The average daily allotment volumes of LTROs thus rose from €45 billion in 2003 to €70 billion last year. On average 159 banks took part in these operations, compared with 130 in 2003. As in previous years, Italian banks were almost entirely absent from LTROs, given the highly volatile nature of their liquidity needs, which makes short-term financing more suitable.

On the whole, central banking operations undertaken at the initiative of counterparties were small in scale; marginal lending facilities and overnight deposits amounted on average to 0.16 and 0.14 per cent respectively of reserve requirements in 2004. In Italy even less recourse is made to these instruments, which accounted respectively for 0.04 and 0.05 per cent of minimum reserves.

THE HOUSEHOLD AND CORPORATE SECTORS

With consumption growing less than disposable income, in 2004 the household sector's financial saving edged upwards from 5.3 to 5.5 per cent of GDP (Table 42). The ratio of financial saving to GDP was lower in both 2003 and 2004 than in the previous two years, reflecting households' greater preference for investment in housing.

Table 42

ITALY: FINANCIAL BALANCES (1)

(millions of euros and percentages)

	2001	2002	2003	2004
Households	101,001	89,979	68,815	73,716
of which: external balance	*22,005*	*-9,980*	*2,000*	*1,195*
Non-financial corporations	-32,549	-43,078	-23,617	-7,494
of which: external balance	*7,532*	*5,010*	*22,058*	*13,549*
General government	-38,875	-38,238	-39,081	-41,365
of which: external balance	*-10,820*	*-25,062*	*-61,365*	*-11,934*
Monetary financial institutions	-8,965	9,938	34,391	20,171
of which: external balance	*-23,469*	*40,008*	*-20,182*	*31,202*
Other financial intermediaries (2)	-14,209	-28,820	-37,654	-33,725
of which: external balance	*-2,737*	*-29,169*	*25,107*	*-52,421*
Insurance companies (3)	-8,707	-3,161	-21,894	-24,518
of which: external balance	*5,184*	*5,813*	*13,341*	*5,193*
Rest of the world account	2,305	13,381	19,041	13,216
	As a percentage of GDP			
Households	8.3	7.1	5.3	5.5
Non-financial corporations	-2.7	-3.4	-1.8	-0.6
General government	-3.2	-3.0	-3.0	-3.1
Financial institutions (4)	-2.6	-1.7	-1.9	-2.8
Rest of the world account	0.2	1.1	1.5	1.0
	As a percentage of GDP, adjusted for inflation (5)			
Households	6.0	5.0	3.2	3.6
Non-financial corporations	-1.7	-2.5	-0.8	0.3
General government	-1.1	-1.1	-1.2	-1.5

(1) Rounding may cause discrepancies in totals. – (2) Includes financial auxiliaries. – (3) Includes pension funds. – (4) Monetary financial institutions, other financial intermediaries and insurance companies. – (5) Only financial instruments denominated in national currencies, with a fixed monetary value at maturity, are taken into consideration in calculating the adjustment for inflation.

The shift in the allocation of households' financial portfolios towards low-risk instruments, which began in 2000 in the wake of the stock-market downturn, continued and indeed gained pace. Households' net borrowing, mainly for home purchases, accelerated for the third consecutive year. The sector's debt remains low by international standards: the ratio of financial assets to liabilities is 6.5 in Italy, compared with a euro-area average of less than 4.

Non-financial firms' operating profits in relation to value added remained stable at lower levels than in the second half of the 1990s. Interest expense diminished further as a consequence of both the reduction in interest rates and the lengthening of the average maturity of debt, leading to an increase in self-financing. The share of investments financed out of cash flow rose and the financial deficit fell. Leverage (the ratio of financial debt to the sum of financial debt and equity) declined from 43.3 to 41.8 per cent, seven percentage points lower than the average for the 1990s.

The dispersion of firms' financial conditions has increased in recent years. While the average situation of firms has improved, firms with high burdens of debt or interest expense have not followed a similar trend.

At the end of 2004 Italy's total stock of financial assets was equal to €9.6 trillion (twice the figure at end-1995) and 7.1 times GDP. More than three quarters of the growth with respect to the middle of the 1990s was due to the formation of new assets and the remainder to the gain in the value of securities, especially shares and other equity.

Over the same period, Italy's integration with the international financial markets increased. In the last decade the share of financial assets and that of liabilities in respect of non-residents both rose by about 3 percentage points, to 14 and 15 per cent respectively.

Household financial saving and debt

The financial surplus of the household sector (comprising consumer households, sole proprietorships with up to 5 workers and non-profit institutions serving households) rose slightly to 5.5 per cent of GDP, or €74 billion, compared with €69 billion in 2003 (Table 43). Net of the loss of purchasing power due to the impact of inflation on the stock of households' net financial assets (1.9 per cent of GDP) it was equal to 3.6 per cent of GDP, against 3.2 per cent in 2003.

The stock of Italian households' net financial assets grew considerably over the year, rising by 8.3 per cent; more than half of the increase was due to the appreciation of shares and other equity. Net of liabilities, households' financial wealth in 2003 was equal to about 2.7 times disposable income in Italy and the United Kingdom, compared with multiples of 2.1 and 3 respectively in the euro area and the United States.

Table 43

FINANCIAL ASSETS AND LIABILITIES OF ITALIAN HOUSEHOLDS (1)

(millions of euros and percentage composition)

	End-of-period stocks			Flows	
	December 2004	Percentage composition		2003	2004
		December 2003	December 2004		
ASSETS					
Cash and sight deposits	513,961	16.5	16.2	35,245	32,475
of which: bank deposits	*447,223*	*14.6*	*14.1*	*25,780*	*23,058*
Other deposits	308,164	10.2	9.7	5,016	14,913
bank	*83,530*	*3.1*	*2.6*	*-10,502*	*-1,960*
post office	*224,634*	*7.1*	*7.1*	*15,517*	*16,873*
Short-term securities	13,358	0.2	0.4	-26,523	6,032
Medium and long-term securities	597,193	18.5	18.9	29,804	40,183
of which: government	*210,690*	*6.6*	*6.7*	*-11,856*	*11,172*
corporate	*48,769*	*1.5*	*1.5*	*20,294*	*-6,302*
bank	*337,734*	*10.3*	*10.7*	*21,365*	*35,313*
Investment fund units	303,012	11.2	9.6	16,311	-15,494
Shares and other equity	686,779	19.9	21.7	-6,616	-9,709
External assets	206,779	6.9	6.5	2,000	1,195
of which: deposits	*1,360*	*0.2*	*0.0*	*-6,479*	*-5,329*
short-term securities	*335*	*0.0*	*0.0*	*-90*	*50*
medium and long-term securities	*88,103*	*3.1*	*2.8*	*5,148*	*-2,044*
shares and other equity	*76,727*	*2.5*	*2.4*	*-71*	*534*
investment fund units	*40,254*	*1.1*	*1.3*	*3,493*	*7,984*
Insurance and pension fund reserves (2)	522,256	16.0	16.5	54,988	54,814
of which: life insurance reserves	*310,795*	*9.3*	*9.8*	*43,544*	*40,806*
Other financial assets (3)	15,831	0.5	0.5	-235	-135
Total assets	**3,167,333**	**100.0**	**100.0**	**109,990**	**124,274**
LIABILITIES					
Short-term debt (4)	52,490	12.1	10.7	-1,204	-1,124
of which: bank	*51,528*	*11.9*	*10.5*	*-1,368*	*-1,015*
Medium and long-term debt (5)	327,294	64.3	66.9	34,274	45,831
of which: bank	*299,545*	*58.3*	*61.2*	*31,248*	*43,466*
Other financial liabilities (6)	109,741	23.5	22.4	8,104	5,852
Total liabilities	**489,525**	**100.0**	**100.0**	**41,174**	**50,559**
BALANCE	**2,677,808**			**68,816**	**73,715**

(1) Consumer households, non-profit institutions serving households, and sole proprietorships with up to 5 workers. Rounding may cause discrepancies in totals. – (2) Includes insurance reserves of both the life and casualty sectors, pension funds and severance pay entitlements. – (3) Trade credit and other minor items. – (4) Includes finance provided by factoring companies. – (5) Includes finance provided by leasing companies, consumer credit from financial companies and other minor items. – (6) Staff pension provisions and other minor items.

Financial assets. – In 2004 households' financial investment was directed towards low-risk instruments. Among domestic assets, they increased their net holdings of bank and post-office deposits by €38 billion and of bank bonds by €35 billion (compared with €21 billion in 2003; Table 43). They also made net purchases of government securities (€17 billion, against disposals of €38 billion in 2003) and insurance and pension products. Investments in deposits, bank bonds and Italian government securities accounted for 73 per cent of the flow of financial assets, considerably higher than the average for the last decade. By contrast, households made net disposals of corporate bonds, shares and other equity and investment fund units totaling €32 billion, compared with net purchases of €30 billion in 2003. The proportion of shares and other equity and investment fund units in the stock of financial assets remained unchanged at 31 per cent.

The flow of financial saving invested in external assets fell to €1.2 billion. Households made net purchases of units of foreign investment funds totaling €8 billion, compared with €3.5 billion in 2003, but they reduced their holdings of deposits and medium and long-term securities. The overall share of external assets in households' total financial assets declined slightly, to 6.5 per cent.

The composition of households' financial portfolio in Italy, which in the 1990s was distinguished by a high proportion of cash, deposits and government securities, has gradually come closer to that in the other euro-area countries. Between 1995 and 2003 the portion invested in deposits and directly held debt securities decreased by 20 percentage points, while the percentage of shares and investment fund units increased, rising above the euro-area average as early as 1998. Assets in respect of insurance companies and pension funds also grew, but their share of the total remains lower than the euro-area average.

Financial liabilities. – Households' financial debt grew by 12.4 per cent in 2004 (compared with 10.2 per cent in 2003) to reach €380 billion. The expansion, concentrated in the medium and long-term component, was driven by strong demand for home mortgage loans. Despite rising sharply in recent years, household debt is still low in Italy by comparison with the other industrial countries. The sector's financial debt is equal to 28 per cent of GDP in Italy (Figure 24), compared with 54 per cent in the euro area and more than 80 per cent in the United States and the United Kingdom.

The financing of firms and their liquidity

Profitability and self-financing. – The weakness of economic activity affected firms' operating profitability. In 2004 gross operating profit was equal to 35 per cent of value added, lower than the average for the second half of the 1990s (37 per cent). The reduction in interest rates and the lengthening of the average maturity of debt caused a further contraction in interest expense, which fell to 4.6 per cent of value added (Figure 24), and an increase in self-financing, from 13.1 to 14 per cent of value added.

Against the background of a moderate increase in gross fixed investment and stocks, the share of investment covered with internal financing rose to 68.3 per cent (Figure 25). The corporate sector's financial deficit declined from €23.6 billion in 2003 to €7.5 billion (Table 44).

Table 44

FINANCIAL ASSETS AND LIABILITIES OF ITALIAN FIRMS (1)

(millions of euros and percentage composition)

	End-of-period stocks			Flows	
	December 2004	Percentage composition December 2003	Percentage composition December 2004	2003	2004
ASSETS					
Cash and sight deposits	135,054	10.9	11.5	8,554	15,082
Other deposits	11,597	0.9	1.0	1,213	1,928
of which: bank	*10,580*	*0.8*	*0.9*	*1,078*	*2,080*
Short-term securities	258	0.0	0.0	-882	-506
Medium and long-term securities	38,135	2.4	3.2	-6,417	11,310
of which: government	*10,996*	*1.0*	*0.9*	*-7,430*	*601*
corporate	*14,552*	*0.5*	*1.2*	*221*	*9,418*
Shares and other equity	405,265	35.2	34.4	20,106	3,266
Investment fund units	4,214	0.4	0.4	227	-215
Trade credit receivable	260,813	23.6	22.1	576	623
Other financial assets (2)	45,812	4.2	3.9	-1,707	571
External assets	277,668	22.4	23.6	17,799	28,017
of which: deposits	*6,723*	*0.6*	*0.6*	*1,616*	*183*
trade credit receivable	*57,970*	*5.1*	*4.9*	*-268*	*1,358*
short-term loans	*48,339*	*2.3*	*4.1*	*5,316*	*23,824*
securities	*17,772*	*1.7*	*1.5*	*2,113*	*-902*
shares and other equity	*137,691*	*11.8*	*11.7*	*8,595*	*3,206*
Total assets	**1,178,816**	**100.0**	**100.0**	**39,468**	**60,076**
LIABILITIES					
Domestic liabilities	**2,135,447**	**89.4**	**88.9**	**67,344**	**53,101**
short-term debt (3)	311,268	14.0	13.0	-3,217	-2,801
of which: bank	*280,870*	*12.6*	*11.7*	*-3,086*	*-2,844*
Medium and long-term debt (4)	398,144	16.4	16.6	48,220	37,244
of which: bank	*328,700*	*13.2*	*13.7*	*44,906*	*35,896*
Securities	42,895	1.7	1.8	12,333	11,299
of which: medium and long-term	*33,536*	*1.5*	*1.4*	*10,489*	*7,660*
Shares and other equity	1,000,513	40.5	41.6	2,426	189
Trade credit payable	266,136	11.8	11.1	588	635
Other financial liabilities (5)	116,491	4.9	4.8	6,994	6,535
External liabilities	**267,916**	**10.6**	**11.1**	**-4,259**	**14,468**
of which: trade credit payable	*25,499*	*1.1*	*1.1*	*-374*	*166*
financial debt	*79,480*	*3.4*	*3.3*	*-6,440*	*3,084*
of which: medium and long-term securities	*16,148*	*0.6*	*0.7*	*-4,921*	*2,423*
shares and other equity	*159,528*	*6.0*	*6.6*	*4,510*	*12,892*
Total liabilities	**2,403,363**	**100.0**	**100.0**	**63,085**	**67,569**
BALANCE	**-1,224,547**			**-23,617**	**-7,493**

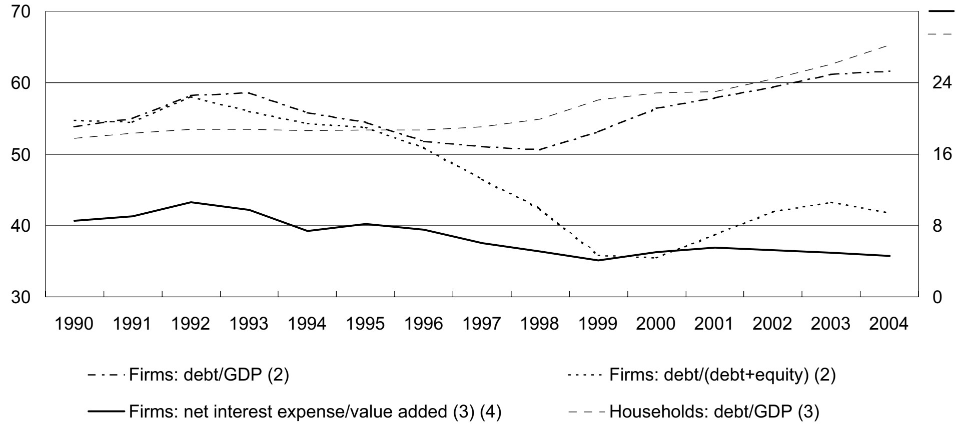
(1) The data refer to non-financial corporations. Rounding may cause discrepancies in totals. – (2) Insurance technical reserves, domestic derivatives and other minor items. – (3) Includes finance provided by factoring companies. – (4) Includes finance provided by leasing companies. – (5) Staff pension provisions and other minor items.

Profitability improved for the listed companies that make up the S&P/MIB Italian stock exchange index (as a rule, large companies, together accounting for about 80 per cent of the market capitalization of all non-financial corporations). The ratio of net operating profit to capital invested and the return on equity both rose by around three percentage points, to 14 and 11 per cent respectively.

Figure 24

THE FINANCIAL DEBT OF ITALIAN HOUSEHOLDS AND NON-FINANCIAL FIRMS (1)

(annual data; percentages)



Source: For GDP and value added, Istat.

(1) From 1995 the data refer to the new definitions of instruments and sectors of economic activity introduced by ESA95. – (2) Left-hand scale. Equity is stated at market value. – (3) Right-hand scale. – (4) Net interest expense is estimated. Value added for 2004 is estimated on the basis of national accounts data.

Debt. – Firms' financial debt grew by €49 billion in 2004. The increase was concentrated in the medium and long-term component in the form of both loans and bond issues. The share of medium and long-term liabilities rose from 52 to 55 per cent. In relation to GDP, financial debt rose slightly from 61.2 to 61.6 per cent.

Leverage declined from 43.3 to 41.8 per cent (Figure 24), partly reflecting the good performance of the stock market, which boosted the value of firms' equity capital.

Equity fund-raising. – Listed companies raised less than €1 billion of new equity capital. Overall, firms increased their equity by €13 billion.

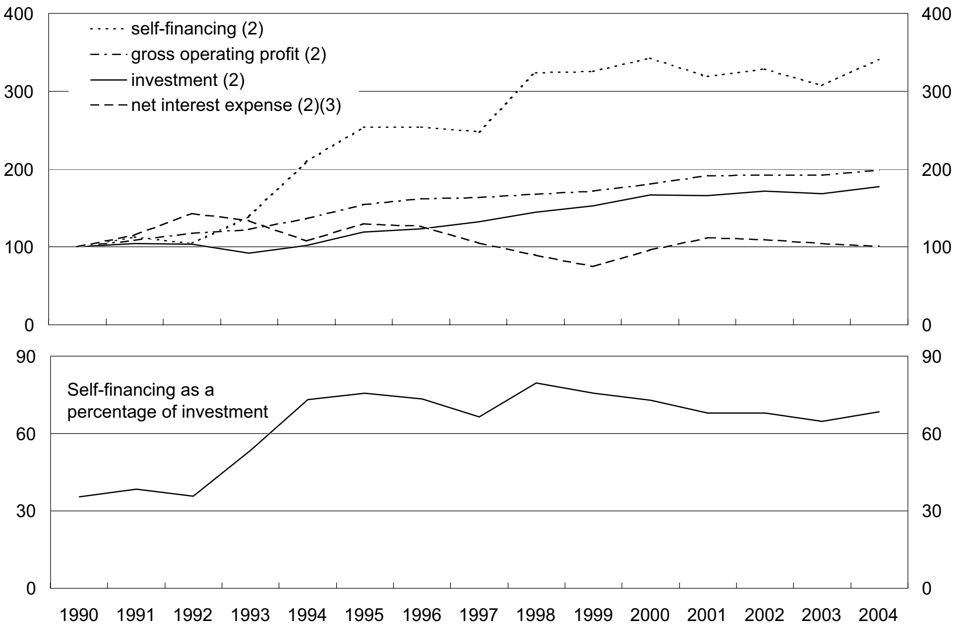
According to the Italian Private Equity and Venture Capital Association, investment in Italy by venture capital firms fell from €3 billion in 2003 to €1.5 billion last year. Venture capital firms' fund-raising also decreased slightly, from €1.9 billion to €1.7 billion; the share raised from banks contracted, while that provided by pension funds doubled to about 20 per cent of the total.

An analysis of a sample of about 200 Italian industrial and service companies in which venture capital firms hold equity interests shows that the bulk of this investment is in companies that inherently find it difficult to obtain external financing, i.e. young firms and small and medium-sized enterprises with relatively few assets that can be used to secure loans. In addition, venture capitalists frequently invest in firms operating in innovative or fast-growing sectors, to which they presumably also offer advisory services. The analysis also suggests that venture capital financing helps to rebalance firms' financial situation, favouring a reallocation of debt toward longer maturities and an increase in the available margin on credit facilities granted by banks.

Figure 25

THE EXTERNAL FUNDING REQUIREMENT OF ITALIAN NON-FINANCIAL FIRMS (1)

(annual data)



Source: Based on Istat data.

(1) Estimate based on national accounts data for the sector "non-financial corporations", 1990-2003. The data for 2004 are estimated on the basis of the national accounts for the year. Investment includes inventories. – (2) Indices, 1990=100. Net interest expense is estimated.

Trade credit payable. – Domestic and foreign trade credit payable rose by almost €1 billion in 2004 (Table 44). The year-end stock was equal to 12.2 per cent of firms' total financial liabilities.

Financial assets and mergers and acquisitions. – Firms' holdings of shares and other equity rose by €6.5 billion in 2004, compared with €28.7 billion in 2003. This more moderate growth was partly a consequence of the decline in mergers and acquisitions in Italy, which fell from 137 to 128 in number and from €9.4 billion to €2.6 billion in value. Italian firms were the counterparty in around half the acquisitions in value terms; 22 per cent of the transactions were concluded with firms resident in other euro-area countries. Italian non-financial firms made €1.5 billion of acquisitions, mainly involving firms in Central and Eastern Europe.

The financial situation of Italian firms

Medium-term trends in debt and profits. – The data on non-financial firms surveyed by the Company Accounts Data Service (a sample of about 40,000 firms, more representative of the population of medium-sized and large companies than of smaller ones) indicate that in the three years 2001-03 operating profitability and profits were lower than in the period 1995-2000.

Given the weak growth in investment and the decrease in interest expense, in the last three years the deterioration in profitability did not have adverse effects on the average financial situation of firms, which remained broadly unchanged with respect to the previous three years. Leverage (calculated on shareholders' equity at book value) stood at approximately 50 per cent, slightly lower than in the previous period. The ratio of self-financing to gross interest expense, a gauge of firms' ability to service their debt from cash flow, decreased slightly but nonetheless remains higher than in the first half of the 1990s.

The share of medium and long-term financial debt rose to 39 per cent, compared with 37 per cent in the previous three years; although the increase was fostered mainly by the low level of interest rates, it can also be attributed to debt restructuring by large companies.

Trends in profitability and financial position differed across sectors. The fall in profits in 2001-03 with respect to the previous three years was more pronounced in manufacturing and high-tech services such as telecommunications and information technology. Financial indicators also deteriorated in these sectors, partly owing to corporate restructuring by some large groups in the telecommunications industry, whose financial situation nonetheless remains better than average. Construction was the only sector in which profitability rose in the three years: the good performance of residential building sustained firms' profits, enabling them to achieve a significant improvement in their financial situation, which nonetheless remains less favourable than the sample average.

Table 45

PROFITABILITY AND DEBT OF ITALIAN NON-FINANCIAL FIRMS (1)

(percentages)

	Total sample				Bottom quartile (2)			
	Gross operating profit/ Total assets (3)	ROE (4)	Leverage (5)	Self-financing/ Interest expense	Gross operating profit/ Total assets (3)	ROE (4)	Leverage (5)	Self-financing/ Interest expense
Total								
1995-1997	10.4	7.4	54.5	170.3	-0.3	-19.7	90.5	-93.1
1998-2000	9.2	8.4	51.9	251.9	-1.3	-20.0	90.8	-141.5
2001-2003	8.1	3.9	50.1	223.4	-2.1	-23.6	90.3	-269.9
Industry excluding construction								
1995-1997	11.1	7.9	52.2	176.7	1.6	-17.0	87.7	-78.8
1998-2000	10.1	8.1	49.1	260.9	0.9	-16.5	88.3	-104.4
2001-2003	8.9	4.2	46.7	239.2	-0.4	-23.5	87.3	-240.7
of which: high-tech sectors								
1995-1997	8.0	-1.8	48.7	94.8	-0.2	-26.7	85.5	-100.2
1998-2000	9.3	6.0	48.2	216.0	-0.1	-27.3	90.5	-217.7
2001-2003	8.7	4.6	47.5	232.3	-1.4	-38.5	90.0	-506.2
of which: traditional sectors								
1995-1997	11.4	8.5	56.2	152.5	2.1	-13.8	88.1	-71.1
1998-2000	10.2	7.5	55.8	218.4	1.3	-15.1	88.4	-81.6
2001-2003	9.2	4.9	53.5	227.4	0.3	-18.6	88.2	-141.6
Construction								
1995-1997	3.9	-1.3	72.4	27.1	-2.5	-41.1	100.4	-94.8
1998-2000	3.8	3.0	74.0	74.5	-1.2	-20.4	96.2	-108.7
2001-2003	4.5	5.8	65.5	143.7	-0.4	-9.2	96.5	-177.7
Services								
1995-1997	10.4	7.5	56.4	194.6	-3.5	-25.4	93.3	-130.9
1998-2000	9.0	9.7	53.3	278.5	-5.0	-27.8	93.4	-228.7
2001-2003	7.6	3.4	52.8	215.6	-4.7	-27.5	93.6	-348.4
High-tech services								
1995-1997	17.8	10.0	43.6	514.7	-4.9	-39.0	94.4	-250.0
1998-2000	14.8	11.8	40.8	594.5	-10.0	-52.4	93.0	-698.8
2001-2003	11.7	0.4	48.1	247.2	-6.2	-45.6	95.6	-695.5
Traditional services								
1995-1997	7.4	5.9	61.8	114.0	-3.1	-22.2	93.2	-111.6
1998-2000	6.5	8.3	59.5	202.2	-3.4	-18.4	93.6	-129.1
2001-2003	5.5	5.8	55.9	193.9	-4.2	-16.5	92.6	-243.6

Source: Based on Company Accounts Data Service data.

(1) Balance-sheet values; averages weighted with the denominator of each ratio. The figures for the total of firms also include data for the agricultural sector. – (2) The bottom quartile of firms in the sample is calculated with reference to each indicator and each sector. – (3) Gross operating profit is equal to the difference between value added and labour costs. – (4) Profit for the year/ shareholders' equity. Profit is gross of accelerated depreciation and other adjustments and revaluations. – (5) Financial debt/ (financial debt+equity).

The dispersion of financial conditions. – The dispersion of individual firms' financial situation around average values is substantial within as well as across sectors and has increased with respect to the mid-1990s. Since then, in contrast with a sharp improvement in the average leverage and interest-expense cover ratio, there has been a deterioration in the financial situation of the firms classified in the bottom quartile of the sample year by year for each of the indicators considered.

An analysis performed on a sample of companies operating in the euro area and the United Kingdom in the period 1994-2003 shows that in firms that are small or young (presumably less transparent for external financiers), in those with few assets that can be used to secure debt and in those with a less favourable financial structure (high debt and interest expense in relation to assets and turnover) investment depends to a greater extent on the availability of internally generated funds. The differences between countries are partly linked to institutional factors: dependence on self-financing is greater in countries whose legal system offers less effective protection for the interests of external financiers (creditors or minority shareholders) than for those of controlling shareholders or insiders.

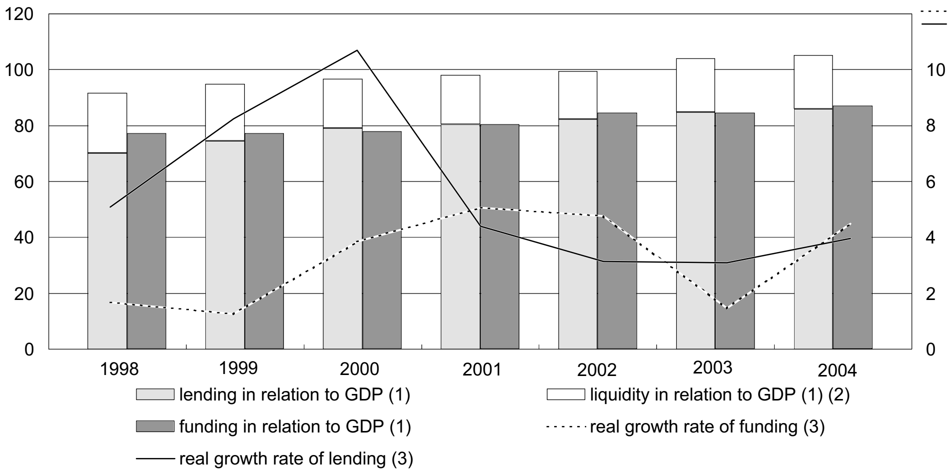
BANKS AND OTHER CREDIT INTERMEDIARIES

Lending by Italian banks continued to grow at a rapid pace in 2004, mainly as a result of the expansion in loans connected with the property market. The ratio of outstanding bank credit to GDP rose by 1.3 percentage points, to 86 per cent (Figure 26).

Figure 26

BANKING INTERMEDIATION IN ITALY

(year-end data; percentages)



Sources: Based on supervisory reports and Istat data.

(1) Left-hand scale. The figure for GDP refers to the whole year. – (2) Cash and securities. – (3) On previous year; right-hand scale. Year-end stocks deflated using the GDP deflator.

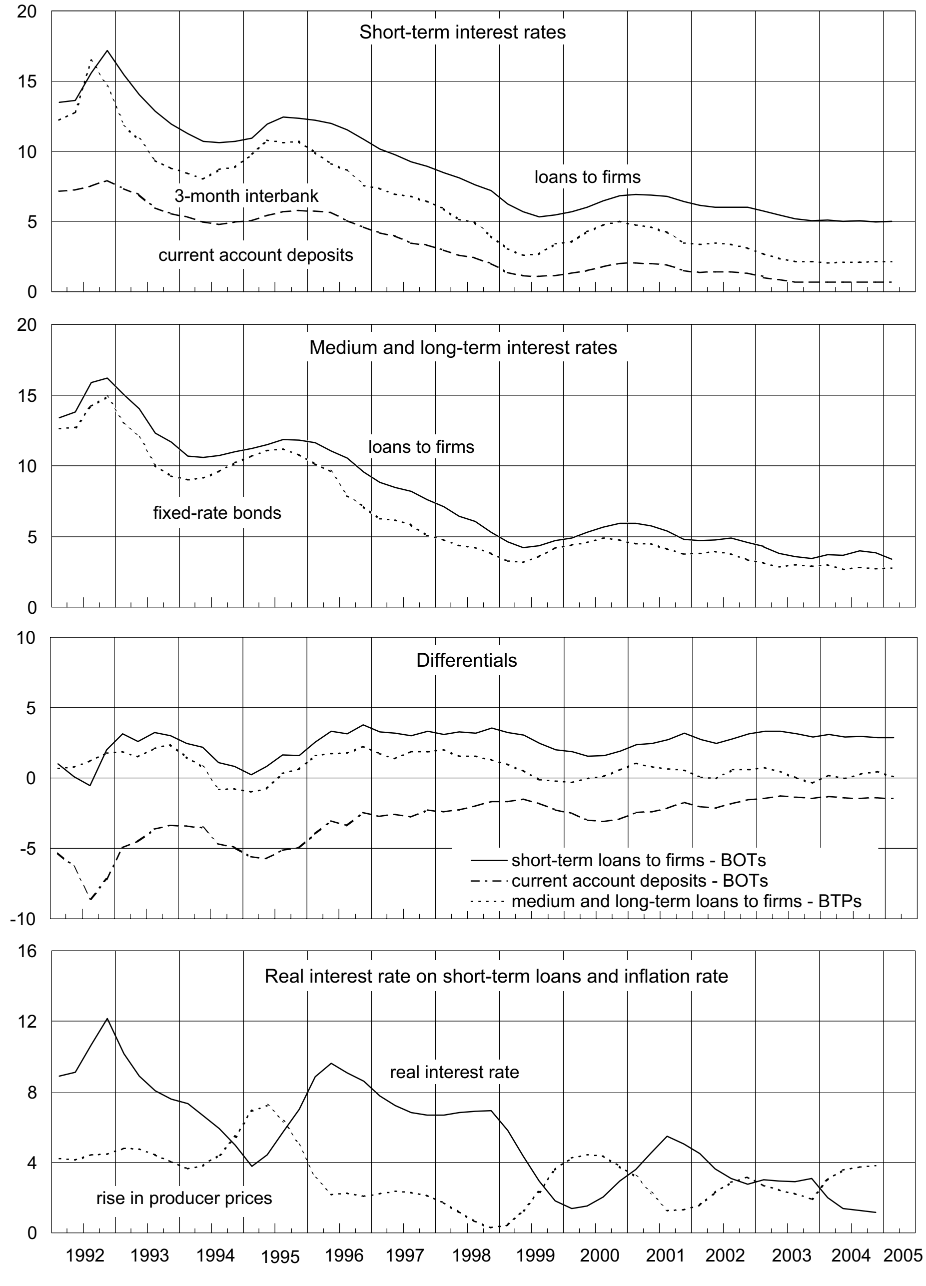
The sluggishness of production activity curbed credit demand on the part of firms, especially in manufacturing; lending to construction and service companies continued to grow strongly. The expansion in lending was greater for firms in the South of Italy. There was further rapid growth in lending to households, to finance the purchase of houses and consumer goods. The share of medium and long-term loans in total credit to non-bank customers rose further, to 60 per cent.

Banks maintained easy lending conditions, although they were more prudent in evaluating loan applications from firms in some sectors of economic activity. The real interest rate on short-term loans to firms continued to decline (Figure 27). The quality of banks' loan portfolios was apparently not affected by the protracted weakness of the economy; the ratio of new bad debts to total loans outstanding fell slightly in all areas of the country.

Figure 27

BANK INTEREST RATES AND DIFFERENTIALS IN RELATION TO YIELDS ON GOVERNMENT SECURITIES IN ITALY (1)

(quarterly data; percentages and percentage points)



Sources: Based on statistical supervisory reports and Istat data.

(1) The yield on Treasury bonds refers to exchange-traded bonds with a residual maturity of at least one year.

Domestic fund-raising, bond issues especially, grew at a rapid pace. Banks' net external debt declined, prevalently vis-à-vis counterparties resident in other euro-area countries; their exposure to exchange rate risk remained modest.

Banks' profitability rose: the return on equity (ROE) improved to 9.5 per cent, compared with 7.2 per cent in 2003. The gain was mainly attributable to the large reduction in value adjustments to loans, which had been up sharply in 2003 owing to the collapse of the Parmalat group. The banking system strengthened its capital base.

Lending

Bank credit grew by 6.7 per cent last year, as in 2003 (Table 46 and Figure 28). The increase was concentrated in the medium and long-term component, reflecting the strong growth in loans to households for house purchases and the shift in the composition of firms' debt towards longer maturities; short-term lending continued to contract.

Table 46

MAIN ASSETS AND LIABILITIES OF ITALIAN BANKS (1)

(*end-of-period data*)

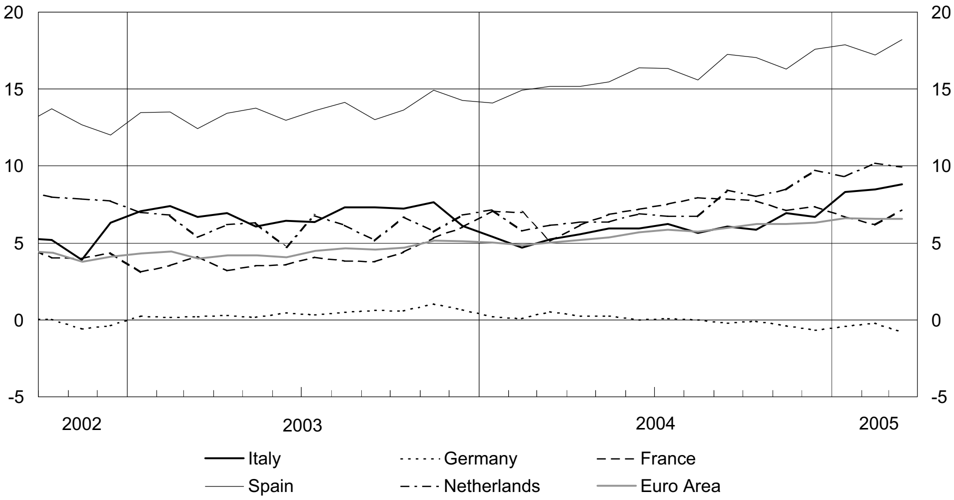
	Percentage changes								Stocks (millions of euros)
	On 12 months earlier			On previous quarter, annualized (2)					
	Dec 2003	Dec. 2004	Mar. 2005	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	December 2004
Assets									
Securities	4.2	-2.8	1.7	-13.6	6.6	4.1	-5.2	1.8	177,086
of which:									
government securities .	*-4.0*	*-12.4*	*-4.6*	*-27.1*	*-2.5*	*-6.2*	*-10.0*	*0.8*	*95,074*
Loans	6.7	6.7	8.9	4.2	7.4	6.4	9.3	12.5	1,160,293
of which: (3)									
short-term (a)	*-2.0*	*-3.8*	*-0.3*	*-6.6*	*-0.8*	*-1.3*	*-5.8*	*7.2*	*436,493*
medium and long-term (b)	*13.6*	*13.8*	*14.5*	*13.6*	*12.3*	*12.3*	*17.0*	*16.3*	*659,720*
(a)+(b)	*6.2*	*6.0*	*8.2*	*4.4*	*6.6*	*6.5*	*7.2*	*12.7*	*1,096,212*
repos (4)	*-1.2*	*88.5*	*471.1*	*-96.2*	*67.2*	*-67.9*	*::*	*222.0*	*5,238*
bad debts (5)	*10.6*	*6.0*	*3.9*	*6.6*	*9.1*	*5.6*	*2.7*	*-1.5*	*54,314*
Memorandum item:									
adjusted bad debts	*7.9*	*-1.2*	*1.9*	*-16.4*	*2.4*	*3.9*	*6.8*	*-12.6*	*22,561*
External assets	1.3	10.8	6.6	11.9	-14.1	23.9	26.5	-4.0	241,783
Liabilities									
Domestic funding (6)	4.4	7.2	7.5	9.8	5.8	7.6	7.4	9.5	1,175,708
Deposits	2.2	5.1	5.2	8.8	4.5	5.1	4.8	6.6	732,714
of which: (7)									
current accounts	*5.9*	*6.2*	*6.0*	*14.9*	*5.7*	*6.8*	*2.0*	*9.8*	*546,142*
with agreed maturity ..	*-10.2*	*-4.0*	*-2.0*	*-9.3*	*-3.5*	*-9.8*	*7.7*	*-1.7*	*41,213*
redeemable at notice .	*5.1*	*4.7*	*4.2*	*8.4*	*4.0*	*4.1*	*2.7*	*6.3*	*67,889*
repos	*-15.7*	*4.7*	*6.0*	*-17.7*	*0.6*	*3.3*	*34.1*	*-10.5*	*70,248*
Bonds (5)	8.6	10.8	11.5	11.5	8.1	11.8	11.8	14.2	442,994
External liabilities	11.2	3.8	5.0	20.4	-8.8	-8.4	15.4	26.3	296,555

(1) The figures for March 2005 are provisional. The percentage changes are net of changes due to reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. – (2) Calculated on data adjusted for seasonal variations where appropriate. – (3) Some minor items are not shown in the breakdown. Short-term loans are those with a maturity of up to 18 months. – (4) The figure for the fourth quarter of 2004 is not reported as it is statistically not significant. – (5) The percentage changes are not adjusted for debt cancellations and assignments of claims. – (5) Including bonds held by non-residents. – (6) Excluding those of central government.

Figure 28

LENDING BY MONETARY FINANCIAL INSTITUTIONS IN THE EURO AREA (1)

(monthly data; 12-month percentage changes)



Sources: Based on ECB data and national statistics.
(1) Lending of monetary and financial institutions (MFIs) of the euro area, excluding the Eurosystem, to non-MFI resident customers.

Lending to firms. – The growth in lending to firms slackened from 6.3 per cent in 2003 to 3.5 per cent. The slowdown was largely attributable to the moderate pace of investment and an increase in self-financing. In the first quarter of 2005 lending picked up again in connection with major corporate actions by some large corporations.

Lending to manufacturing firms contracted by 0.4 per cent overall and considerably more sharply for firms in the textile, clothing and transport equipment sectors (whose output diminished) and the chemical industry. By contrast, credit to construction firms and service companies, especially those engaged in real-estate services, maintained rapid growth.

The slowdown in lending in 2004 involved both smaller firms (sole proprietorships and partnerships with fewer than 20 workers, which account for more than 40 per cent of total employment in industry and services) and larger companies. The growth in bank credit to the latter was slower (4 per cent, against 5.7 per cent for small firms), owing in part to the increase in bond issuance on the Euromarket.

There was a further lengthening of the maturities of bank credit, fueled by the relatively low costs of variable-rate mortgage loans and by debt restructuring for some firms in difficulty.

A total of 75 per cent of the volume of medium and long-term loans to firms and producer households is backed by guarantees or collateral (58 per cent by the latter). The proportions are higher for smaller firms (83 and 65 per cent) than for other companies (72 and 56 per cent).

Lending by smaller banks continued to grow at a significantly higher rate than that by large institutions. In 2004 "small" and "minor" banks together accounted for three quarters of new business; their market share increased both in lending to small firms (from 43 to 44 per cent) and in loans to medium-sized and large companies (from 28 to 30 per cent).

Lending to firms and producer households rose in the South by 7.7 per cent, compared with 4 per cent in the Centre and North. The growth in credit to firms in the South was relatively high in all the main sectors of activity and for firms of every size.

The state of the economy was reflected in the stagnation of the amount of claims sold to banks for factoring and a reduction of 3 per cent in those sold to financial companies. After the slight fall recorded in 2003, leasing credit granted by banks rose appreciably, by 13.7 per cent (Table 47), led by the property sector. Leasing credit granted by financial companies showed modest growth of 1.6 per cent; net of the effect of securitizations, however, the increase was equal to 7.8 per cent.

Table 47

LEASING, FACTORING AND CONSUMER CREDIT IN ITALY

(end-of-period data; millions of euros and percentages)

	Percentage changes on previous year			Outstanding 2004 (1)	Percentage of total
	2002	2003	2004 (1)		
			Leasing		
Total credit	12.5	2.2	4.1	64,220	100.0
Finance companies	11.7	2.8	1.6	49,756	77.5
Banks	15.4	-0.2	13.7	14,464	22.5
			Factoring		
Total credit	2.5	-0.2	-2.6	38,342	100.0
Finance companies	3.7	-2.4	-3.0	33,623	87.7
Banks	-8.9	19.8	0.2	4,719	12.3
			Consumer credit		
Total credit	9.3	12.2	18.1	60,605	100.0
of which: credit cards	*32.4*	*15.7*	*18.0*	*8,354*	*13.8*
Finance companies	10.0	15.9	20.8	24,998	41.2
of which: credit cards	*26.7*	*10.3*	*14.2*	*5,112*	*8.4*
for purchases of motor vehicles	*5.2*	*8.8*	*14.0*	*12,387*	*20.4*
Banks	8.8	9.9	16.3	35,607	58.8
of which: credit cards	*45.4*	*26.2*	*24.5*	*3,242*	*5.3*
Memorandum item: Other bank loans to consumer households except those for home purchases	-3.5	-0.1	2.4	52,680	

Source: Based on supervisory report.
(1) Provisonal.

Lending to households. – Bank lending to households accelerated to growth of 13.6 per cent, well above the euro-area average of 7.9 per cent and second only to Spain among the major countries of the area. These differences are largely attributable to disparate developments in property markets. Although credit to households has grown faster in Italy than in the rest of the euro area in recent years, it still accounts for a smaller share of total bank lending (30 per cent, against 45 per cent).

Bank credit to consumer households alone grew by 15.8 per cent. New loans for house purchases amounted to €49.2 billion, 87 per cent of it at rates indexed to money market yields or renegotiable within a year (the corresponding share at euro-area level is 54 per cent). At the end of the year more than 80 per cent of outstanding mortgage loans to households were at variable rates. In the case of these contracts, the low level of interest rates enables borrowers to limit the size of the initial repayment instalments but they incur the risks associated with a rise in rates.

Consumer credit disbursed by banks and financial companies continued to expand rapidly (Table 47). At the end of the year 57 per cent of the consumer credit granted by Italian banks consisted of personal loans. The remainder was made up of consumer instalment loans for the direct purchase of specific goods; most of these loans were made by international banking groups' subsidiaries specialized in lending through retailers with whom they have agreements. The consumer credit granted by financial companies consisted of consumer instalment loans or credit card loans for 80 per cent and personal loans for the remaining 20 per cent.

Bad debts. – New bad debts (under the broad definition of adjusted bad debts) came to 0.9 per cent of total lending (Figure 29), 0.1 percentage points less than in 2003 net of the effects of the Parmalat group's collapse.

The share of new bad debts diminished both in the Centre and North (from 1.1 to 0.8 per cent) and in the South (from 1.7 to 1.4 per cent). At sectoral level, the ratio of new bad debts rose slightly for consumer households and fell for producer households and firms. It declined on lending to the food-processing and transport-equipment industries and rose on loans to chemical companies.

In 2004, the ratio of the stock of bad debts to total loans remained unchanged at 4.7 per cent. At estimated realizable value, bad debts fell from 2.2 to 2 per cent of total lending; at the end of March 2005 they had declined further, to 1.8 per cent.

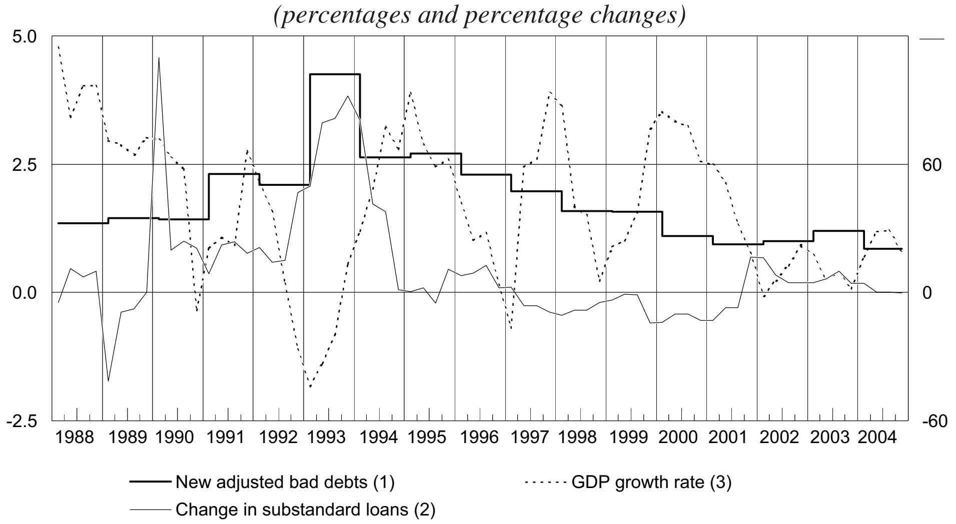
Gross new exposures to customers in temporary difficulty (so-called substandard loans) were equal to 1.7 per cent of lending, compared with 2.1

per cent in 2003. The stock of non-performing loans, which had grown by 4.1 per cent in 2003, fell by 0.3 per cent last year: the decline involved both the Centre-North and the South.

Figure 29

BAD DEBTS AND SUBSTANDARD LOANS OF ITALIAN BANKS

(percentages and percentage changes)



Sources: Central Credit Register, supervisory reports and Istat.

(1) As a percentage of the stock of loans (net of adjusted bad debts) at the end of the preceding year; annual data; left-hand scale. – (2) On the corresponding quarter of the preceding year; right-hand scale. – (3) At constant prices on the corresponding period of the previous year; left-hand scale.

Lending conditions and interest rates

Banks maintained expansionary credit conditions in 2004. The differential between the average and the minimum short-term lending rate, which tends to widen when credit supply is being tightened, narrowed slightly, from 2.7 percentage points at the end of 2003 to 2.6 points. The dispersion of the short-term interest rates applied to different size classes of firms was broadly stable. Undrawn overdraft facilities remained ample for all categories of customers.

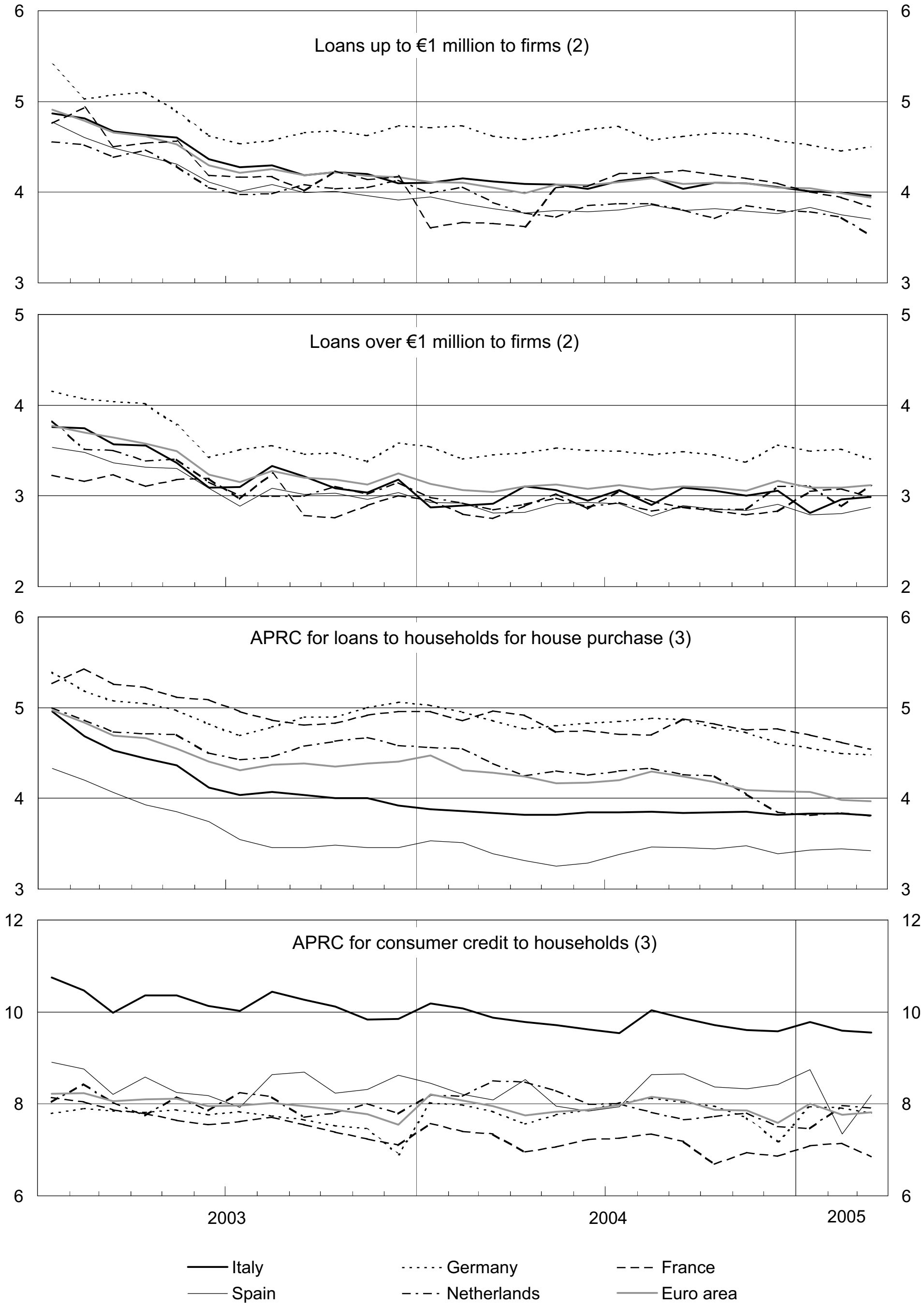
The Italian banking groups taking part in the Eurosystem quarterly survey of bank lending indicated they had made virtually no change in the standards for granting loans to firms and households. All in all, the expansionary impact on credit conditions for firms in 2004 deriving from the pressure of competition was offset by the restrictive effects of the risks connected with general economic conditions.

Interest rates. – In 2004 the average bank lending rate, calculated on stocks, was 4.4 per cent for firms and 5.7 per cent for households, in line with the euro-area averages.

Figure 30

HARMONIZED INTEREST RATES ON NEW LOANS IN THE MAJOR EURO-AREA COUNTRIES: NEW BUSINESS (1)

(monthly data; percentages)



Sources: Based on ECB data and national statistics.

(1) New contracts concluded during the reference period or contracts renegotiating previous terms and conditions. – (2) Average lending rate to non-financial firms across all maturities, weighted by loan amounts. The loan amounts refer to single operations. – (3) The annual percentage rate of charge includes accessory expenses (administrative expenses, loan examination fees and insurance). It is calculated as the average rate across all maturities, weighted by loan amounts. Households include producer households and non-profit institutions serving households.

The interest rate on new fixed-term loans up to €1 million, which proxies the credit conditions applied to smaller companies, was 4.1 per cent both in Italy and in the euro area (Figure 30); that on loans larger than €1 million was 3 per cent in Italy and 3.1 per cent in the area.

The differential between the rates on short-term loans to firms in the South and in the rest of Italy, adjusted for the sectoral and size characteristics of the borrowers, increased by around 0.2 percentage points, to 1.5 points, reflecting the stronger growth in loan demand in the South.

The annual percentage rate of charge (APRC) on new loans to households for house purchases fell in Italy by 0.1 points to 3.8 per cent. This was lower than the euro-area average (4.1 per cent), owing to the higher incidence in Italy of variable-rate loans, which are initially less costly when there is an upward sloping yield curve. Considering only mortgage loans indexed to market rates, the interest rate on new business in Italy is in line with the euro-area average (3.5 per cent). The APRC on consumer credit granted by banks fell by 0.3 points, to 9.6 per cent; in the area it held steady at 7.6 per cent (see the box "The cost of bank credit in Italy and the euro area", *Economic Bulletin* No. 40, March 2005).

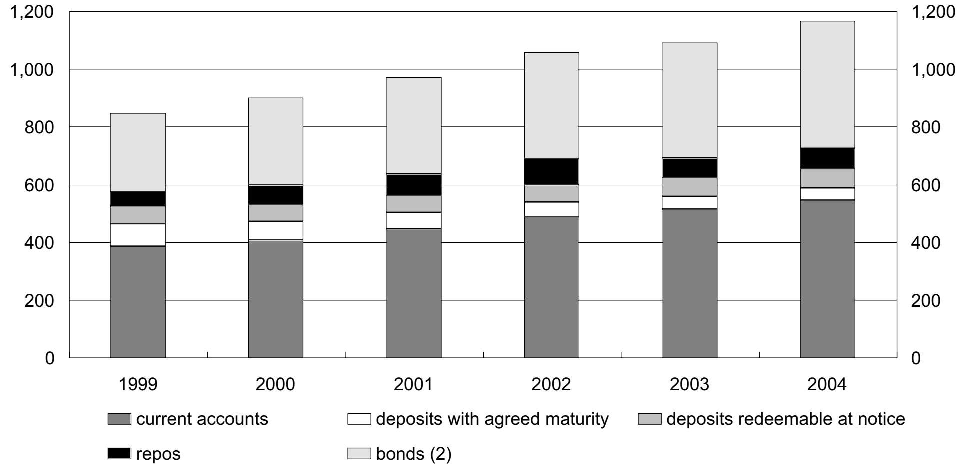
Domestic funding

Banks' domestic funding grew by 7.2 per cent, in line with the increase in the euro area. The pick-up with respect to 2003 was mainly due to the increase in bond issues (10.8 per cent) and the recovery in repos (up by 4.7 per cent, following a contraction of 15.7 per cent in 2003).

Figure 31

BANK FUND-RAISING IN ITALY (1)

(year-end data; billions of euros)



Source: Supervisory reports.
(1) Excludes deposits of central government. – (2) Total debt securities including bonds held by non-residents.

The expansion in current account deposits was equal to 6.2 per cent, three fifths of it attributable to consumer households; that in deposits redeemable at notice was 4.7 per cent. In the latter segment, the growth was entirely ascribable to deposits with Italian branches of foreign banks, which offer innovative high-yielding accounts on which transactions can be put through at short notice online or by telephone.

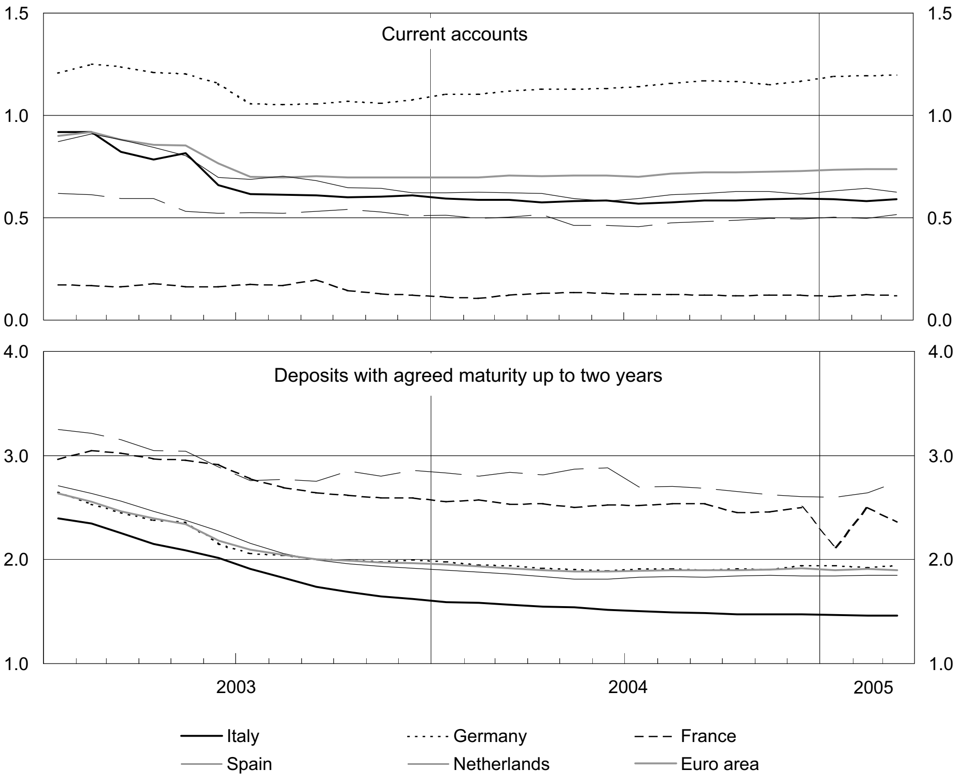
Bonds represent 37.7 per cent of total bank funding (Figure 31). A third of the new issues were placed on the Euromarket; 30 per cent are at fixed rates.

The average interest rate on households' current account deposits remained unchanged in 2004 at 0.6 per cent in Italy and 0.7 per cent in the euro area (Figure 32); in December the average interest rate on all of households' deposits was 0.83 and 1.77 per cent respectively.

Figure 32

HARMONIZED INTEREST RATES ON HOUSEHOLDS' DEPOSITS IN THE MAIN EURO-AREA COUNTRIES

(monthly data; percentages)



Sources: Based on ECB data and national statistics.

The yield on fixed-rate bank bonds fell by 0.2 percentage points, to 3 per cent; the yield differential between five-year BTPs and bank bonds, which had been positive by 0.4 points in December 2003, fell to nil at the end of 2004.

Banks' securities portfolio and net external position

The securities portfolio. – Net of the effects of price changes, the value of banks' securities portfolio declined by 2.8 per cent in 2004 (Table 46). The fall only involved government securities holdings, whose value decrease by 12.4 per cent and whose share in the total portfolio contracted by nearly 5 percentage points, to 54 per cent. Securitization instruments made up 9 per cent of the portfolio, compared with 7 per cent in 2003.

At the end of 2004 the market value of Italian banks' holdings of shares and other equity issued by euro-area corporations amounted to €116.5 billion, or 5.7 per cent of total assets (excluding interbank claims). The corresponding proportions were 7.8 per cent in France, 5.6 per cent in Germany and 5.4 per cent in Spain. Fifty per cent of Italian banks' equity interests consisted of holdings in other banks, comparable to the figure recorded in France (43 per cent) and significantly higher than in Germany and Spain (14 and 16 per cent respectively).

The net external position. – Excluding the effects of exchange rate variations, Italian banks' net external debt diminished by €12.7 billion to stand at €54.8 billion at the end of the year. The net external position was positive by €18.4 billion vis-à-vis euro-area countries and negative by €73.2 billion vis-à-vis other countries.

The reduction in banks' net external debt resulted from a larger increase in assets than in liabilities (€23.6 billion and €10.9 billion respectively). The improvement mainly regarded positions in euros and vis-à-vis residents of other euro-area countries. Approximately two thirds of the Italian banking system's net liabilities are owed to residents of the United Kingdom, up from about one half in 2003.

Profit and loss accounts

According to financial reports not consolidated at group level, in 2004 Italian banks' net interest income rose by 1.5 per cent, compared with 0.8 per cent in 2003 (Table 48). This was the result of an increase in the volume of business and a reduction in the costs of hedging interest rate risk, while the spread between the average lending rate and the average cost of funds actually narrowed slightly, to 3.5 percentage points.

Income from services grew by 6.4 per cent, compared with 1 per cent in 2003. The increase was largely attributable to the distribution of third-party services and, to a lesser extent, professional asset management. Fees

Table 48

PROFIT AND LOSS ACCOUNTS OF ITALIAN BANKS (1)

	2001	2002	2003	2000	2001	2002	2003	2004
	As a percentage of total assets				**Percentage changes**			
Net interest income (a)	**1.93**	**1.91**	**1.77**	**1.67**	**5.6**	**4.9**	**0.8**	**1.5**
Non-interest income (b) (2)	**1.75**	**1.46**	**1.42**	**1.32**	**4.1** ***(-3.7)***	**-12.0** ***(-8.2)***	**5.7** ***(8.9)***	**-0.7** ***(-0.8)***
of which: trading	*0.13*	*0.07*	*0.13*	*0.07*	*-18.0*	*-42.9*	*95.4*	*-41.8*
services	*0.67*	*0.59*	*0.55*	*0.55*	*-12.7*	*-7.7*	*1.0*	*6.4*
other financial operations (2)	*0.67*	*0.51*	*0.43*	*0.39*	*34.7* *(17.4)*	*-19.0* *(-10.1)*	*-7.7* *(-4.4)*	*-3.1* *(-5.3)*
Gross income (c=a+b) (2)	**3.68**	**3.37**	**3.19**	**2.99**	**4.9** ***(1.5)***	**-3.1** ***(-0.6)***	**2.9** ***(4.0)***	**0.5** ***(0.6)***
Operating expenses (d) (3)	**2.03**	**2.02**	**1.95**	**1.81**	**4.0**	**4.5**	**4.9**	**-0.1**
of which: banking staff costs (3)	*1.11*	*1.10*	*1.07*	*0.98*	*1.0*	*4.9*	*5.2*	*-1.3*
Operating profit (e=c-d) (2)	**1.65**	**1.36**	**1.25**	**1.18**	**6.1** ***(-2.2)***	**-12.5** ***(-8.6)***	**-0.1** ***(2.3)***	**1.6** ***(1.8)***
Value adjustments, readjustments and allocations to provisions (f)	**0.66**	**0.56**	**0.52**	**0.28**	**91.3**	**-10.2**	**0.8**	**-41.1**
of which: in respect of loans	*0.37*	*0.38*	*0.42*	*0.31*	*11.0*	*7.5*	*21.1*	*-20.0*
Profit before tax (g=e-f) (2)	**0.99**	**0.80**	**0.73**	**0.90**	**-17.9** ***(-34.2)***	**-14.1** ***(-7.0)***	**-0.7** ***(3.8)***	**31.8** ***(42.7)***
Tax (h) (5)	**0.39**	**0.30**	**0.22**	**0.25**	**-14.4**	**-18.8**	**-21.5**	**20.5**
Net profit (g-h)	**0.59**	**0.50**	**0.51**	**0.65**	**-20.1**	**-11.0**	**12.1**	**36.6**
Dividends distributed	0.39	0.33	0.34	0.38	-3.7	-11.5	11.5	21.7
	Other indicators							
	Profit before tax				**Net profit**			
Profit as a percentage of capital and reserves (ROE) (4)	14.5	10.5	10.4	13.1	8.8	6.2	7.2	9.5
	Amounts				**Percentage changes**			
Total assets *(millions of euros)*	1,889,724	1,998,624	2,170,483	2,327,988	5.5	5.7	8.5	7.3
Average total number of employees	345,193	342,555	339,377	337,973	0.5	-0.7	-1.1	-0.4
of which: banking staff	*342,279*	*340,560*	*338,288*	*336,979*	*0.8*	*-0.4*	*-0.8*	*-0.4*
Total assets per employee *(thousands of euros)*								
at current prices	5,474	5,835	6,396	6,888	5.0	6.5	9.7	7.7
at constant prices (5)	4,723	4,911	5,242	5,524	2.2	3.9	6.8	5.4
Staff costs per employee *(thousands of euros)*								
at current prices (6)	61,1	62,4	64,2	65,6	0.8	2.0	3.0	2.2
at constant prices (5) (6)	52,7	52,5	52,6	52,6	-1.9	-0.6	0.4	0.0
Memorandum items: (7)								
Total assets *(millions of euros)*	1,893,413	2,006,179	2,174,905	2,334,279	5.8	6.0	8.4	7.3
Total number of employees (8)	343,814	341,615	337,684	337,162	-0.2	-0.6	-1.2	-0.2
of which: banking staff (8)	*341,297*	*340,440*	*336,649*	*336,205*	*0.1*	*-0.3*	*-1.1*	*-0.1*

(1) Rounding may cause discrepancies. The data for 2004 are provisional. – (2) The rates of increase calculated net of dividends on shareholdings in other banks, if included in the aggregate, are shown in brackets. – (3) Comprises wages and salaries, costs in respect of severance pay, social security contributions and sundry bonuses paid to banking staff; also includes the extraordinary costs incurred in connection with early severance incentive schemes. The number of banking staff is obtained by deducting tax collection staff and staff seconded to other entities from the total number of employees and adding employees of other entities on secondment to banks. – (4) Profit includes the net income of foreign branches and the change in the fund for general banking risks. – (5) Deflated using the general consumer price index (1995=100). – (6) Excludes the extraordinary costs incurred in connection with early severance incentives. – (7) Data for the entire banking system, including banks that have not reported information on their profit and loss accounts. – (8) End-of-period data.

from collection and payment services rose by 2.2 per cent; the slowdown from 6.4 per cent growth in 2003 was due to the slackening in debit card transactions.

Net income from securities and foreign exchange trading fell by 41.8 per cent, owing to the contraction in income from interest rate derivatives. Net income from other financial operations diminished by 3.1 per cent, reflecting the fall of 2.2 per cent in dividends on shareholdings.

Gross income, excluding dividends on shares and other equity in banks (around half of total dividends), grew by 0.6 per cent (4 per cent in 2003).

Staff costs, which had risen by 5.2 per cent in 2003, fell by 1.3 per cent as a consequence of the sharp decline in expenditures for early retirement incentives; net of this expense, staff costs increased by 1.8 per cent. The number of bank employees fell by 0.4 per cent. Costs per employee rose by 2.2 per cent to €65,600; the increase was largely due to allocations to provisions for wage increases under the impending new national labour contract for the banking industry.

In February 2005 agreement was reached on both the economic and normative terms of the national labour contract for the period 2004-05. For the two years, the agreement set an increase of 5.8 per cent in average contractual wages. For the difference between actual and target inflation in the period 2002-03, it granted an increase of 1.9 per cent, paid as a lump sum in February 2005. From the same month, it also provided for an increase of 2 per cent to recoup the loss of purchasing power in 2004. Lastly, two additional increases will kick in starting in July and December (0.9 and 1 per cent respectively) to cover target inflation for 2005.

Total operating costs remained virtually unchanged. Operating profit rose by 1.8 per cent, compared with 2.3 per cent in 2003.

Net value adjustments to assets and allocations to provisions fell by 41.1 per cent and absorbed 24 per cent of operating profit (42 per cent in 2003).

The reduction in net value adjustments to assets is ascribable to two factors. First, write-downs and provisions for loan losses were reduced by 20 per cent, after the increase caused in 2003 by the Parmalat collapse. Second, banks conformed with the provisions of Legislative Decree 37 of 6 February 2004, which eliminated the possibility of making value adjustments and provisions in application of tax laws and requires them to reverse the effect of those made in previous years and to state the amount of these corrections under extraordinary items. This resulted in a sharp increase in net extraordinary income.

Profit after direct taxes rose by 36.6 per cent. Return on equity, which is calculated including the sum of profits plus the change in the fund for general banking risks (-€63 million) and the net income of foreign branches (€292 million), rose from 7.2 to 9.5 per cent.

The banking system strengthened its capital base. At December 2004 supervisory capital on a consolidated basis amounted to €149.2 billion, 7 per cent more than a year earlier; the solvency ratio (supervisory capital over risk-weighted assets) had risen slightly, standing at 11.6 per cent.

INSTITUTIONAL INVESTORS

Italian institutional investors' consolidated net fund-raising fell by 17.5 per cent to €59 billion in 2004 (Table 49). Partly as a consequence of the rise in share and bond prices, consolidated net assets under management rose by 7.8 per cent to €1,176 billion; as a percentage of GDP, they increased by 3.2 percentage points to 87 per cent.

Table 49

ITALIAN INSTITUTIONAL INVESTORS:
NET FUND-RAISING AND ASSETS UNDER MANAGEMENT
(millions of euros; percentages)

	Net flows		End-of-period stocks			
					Percentage composition	
	2003	2004 (1)	2003	2004 (1)	2003	2004 (1)
Investment funds (2)	11,381	-15,212	403,618	399,882	34.2	31.9
Insurance companies (3)	46,670	43,848	330,240	374,088	28.0	29.8
Pension funds (4)	1,713	1,717	29,115	30,832	2.5	2.5
Individually managed portfolios	5,364	14,296	418,128	448,661	35.4	35.8
Total ...	**65,128**	**44,649**	**1,181,101**	**1,253,463**	**100.0**	**100.0**
Consolidated total (5)	**71,130**	**58,691**	**1,090,393**	**1,175,861**	**–**	**–**
as a percentage of GDP	*5.5*	*4.3*	*83.8*	*87.0*	–	–

Sources: Based on Bank of Italy, Isvap, ANIA and Covip data.
(1) Provisional. – (2) Italian investment funds and SICAVs. – (3) Technical reserves. – (4) Total balance sheet assets. – (4) Net of investments in Italian harmonized investment funds and SICAVs by the other categories of intermediary.

In Italy 29.9 per cent of households' total financial assets were entrusted to institutional investors at the end of 2004, a relatively low level by comparison with other leading countries; at the end of 2003 the corresponding figures were 35.6 per cent in Germany, 39 per cent in France and 41.8 per cent in the United States (Table 50). Between 2000 and 2004 the share of Italian households' portfolio managed by institutional investors fell slightly, with a decline in investment funds partly offset by an increase in insurance policies and individually managed portfolios. By contrast, in the other leading euro-area countries and in the United States the share entrusted to institutional investors rose as a result of a moderate increase for investment funds and the growth of insurance policies.

Table 50

SHARE OF HOUSEHOLDS' FINANCIAL ASSETS ENTRUSTED TO INSTITUTIONAL INVESTORS IN THE MAIN EURO-AREA COUNTRIES AND THE UNITED STATES

(end-of-period data; percentages)

	1999	2000	2001	2002	2003	2004 (1)
			Italy			
Investment funds (2)	18.6	16.6	14.3	12.0	12.2	10.3
Insurance companies	6.1	6.9	8.1	9.2	10.3	10.4
Pension funds	0.9	0.9	0.9	1.0	1.0	0.9
Other institutions (3)	7.7	6.7	8.0	8.6	8.6	8.3
Total	**33.3**	**31.1**	**31.3**	**30.8**	**32.1**	**29.9**
as a percentage of GDP	*78.2*	*73.8*	*70.6*	*67.9*	*72.0*	*73.5*
			France			
Investment funds (2)	8.7	9.2	9.4	9.4	9.2	10.0
Insurance companies	21.8	24.4	26.4	29.4	29.8	33.9
Total	**30.5**	**33.6**	**35.8**	**38.8**	**39.0**	**43.9**
as a percentage of GDP	*71.2*	*73.1*	*73.6*	*72.3*	*76.7*	*77.4*
			Germany			
Investment funds (2)	10.1	11.2	11.7	11.5	11.8	....
Insurance companies (4)	19.5	20.6	21.4	24.3	23.8	....
Pension funds (4)	1.9	1.9	1.9	....	....	....
Total	**31.5**	**33.7**	**35.0**	**35.8**	**35.6**	**....**
as a percentage of GDP	*56.0*	*59.6*	*61.7*	*61.7*	*64.4*	....
			United States			
Investment funds (2)	11.0	11.3	11.8	11.4	11.7	12.1
Insurance companies	7.4	7.9	8.6	9.8	9.5	9.8
Pension funds (5)	19.9	19.5	18.6	17.2	17.9	18.0
Other institutions (6)	3.3	3.3	3.0	2.8	2.7	2.6
Total	**41.6**	**42.0**	**42.0**	**41.2**	**41.8**	**42.5**
as a percentage of GDP	*155.7*	*143.9*	*133.2*	*117.4*	*129.7*	*133.2*

Sources: Based on Bank of Italy, Banque de France, Deutsche Bundesbank, Federal Reserve and OECD data.

(1) Provisional. The figures for France refer to the third quarter. – (2) Includes foreign funds. – (3) Individually managed portfolios net of investments in investment fund units; includes the portfolios of institutional sectors other than households. – (4) From 2002 onwards, pension funds are included with insurance companies. – (5) Private, state and local pension funds; excludes federal government pension systems. – (6) Individual trusts and real estate trusts.

In concomitance with a strong recovery in households' direct purchases of government securities, there were sizable net redemptions of units of harmonized investment funds (the traditional open-end funds that invest primarily in listed securities). At the same time, Italian hedge funds, exchange-traded funds (ETFs) and closed-end real estate funds continued to grow.

Harmonized investment funds made substantial net sales of public-sector securities and foreign securities. Their average yield was 3.5 per cent, basically unchanged from 2003.

Individually managed portfolios recorded an increase in net fund-raising, after two years of very small inflows. Their managers invested mainly in bonds and government securities. Their average yield was 3.9 per cent.

The premium income of insurance companies continued to rise, but far more slowly than in the preceding years. Insurance companies' results for the year improved significantly.

Pension funds' assets continued to grow, thanks to the expansion of those established after the 1993 reform. Occupational pension funds and open pension funds had average returns of 4.5 and 4.3 per cent, respectively.

Investment funds

Fund-raising and net assets. – In 2004 Italian harmonized investment funds recorded net redemptions of €30.6 billion, compared with net subscriptions of €6.6 billion in 2003 (Table 51). By contrast, net inflows to foreign investment funds controlled by Italian intermediaries remained close to the previous year's level (€14 billion, compared with €15.6 billion in 2003).

Table 51

ITALIAN INVESTMENT FUNDS: MARKET STRUCTURE (1)
(amounts in millions of euros)

	Number of funds (2)		Net assets		Net fund-raising	
	2003	2004	2003	2004	2003	2004
Harmonized open-end funds	1,015	968	378,781	358,292	6,628	-30,632
Open-end hedge funds	81	137	5,768	11,728	3,263	5,500
of which: funds of funds	*72*	*126*	*5,426*	*11,284*	*3,016*	*5,411*
Other types of open-end fund	188	199	13,305	19,996	1,221	6,173
of which: funds of funds	*162*	*157*	*7,809*	*12,544*	*1,196*	*4,535*
Total open-end funds ...	**1,284**	**1,304**	**397,854**	**390,016**	**11,112**	**-18,959**
Closed-end security funds	35	50	1,350	1,781	65	340
of which: reserved to qualified investors	*21*	*37*	*432*	*951*	*15*	*336*
Closed-end real estate funds	19	31	4,414	8,085	204	3,407
of which: reserved to qualified investors	*4*	*11*	*979*	*2,977*	*204*	*2,150*
Total closed-end funds ...	**54**	**81**	**5,764**	**9,866**	**269**	**3,747**
Total ...	**1,338**	**1,385**	**403,618**	**399,882**	**11,381**	**-15,212**

(1) Includes SICAVs. – (2) Funds in operation at the end of the year indicated.

The net redemptions of Italian fund units are attributable in part to banks' supply strategies, aimed at selling customers investment funds operated by management companies that they themselves have set up in foreign financial centres where the taxation of business income is lower. The outflow of resources from Italian funds also reflected Italian savers' growing propensity to invest directly in government securities.

Investment funds' net fund-raising was positive in the other main euro-area countries except for Germany, where there were outflows of about €6.7 billion (Table 52). In the European markets, investors showed a preference for bond funds and equity funds, while money-market funds recorded net redemptions almost everywhere.

Table 52

NET FUND-RAISING AND NET ASSETS OF INVESTMENT FUNDS IN THE MAIN EUROPEAN COUNTRIES AND THE UNITED STATES (1)

(annual data)

	Italy	Germany	France (2)	Luxembourg and Ireland (3)	*of which: controlled by Italian inter-mediaries*	Euro area (4)	United Kingdom	United States
				Net fund-raising *(millions of euros)*				
Total								
2003	**6,628**	**5,620**	**66,234**	**76,836**	**15,581**	**193,648**	**14,452**	**-33,745**
2004	**-30,632**	**-6,670**	**54,920**	**93,328**	**13,951**	**152,052**	**7,027**	**38,148**
Equity funds								
2003	-4,680	2,379	22,842	29,080	3,420	69,143	4,484	120,568
2004	-6,627	-2,238	20,800	47,769	3,502	74,125	3,091	130,321
Bond funds								
2003	1,523	4,884	10,800	46,351	9,193	73,554	8,890	24,527
2004	-13,499	2,371	17,260	40,061	9,409	59,869	3,202	-7,535
Balanced funds (5)								
2003	-3,458	-1,130	11,363	7,728	435	9,673	995	25,797
2004	-1,299	-129	120	6,667	-1,651	16,449	1,461	31,247
Money-market funds								
2003	13,243	-513	21,229	-6,323	2,533	41,278	83	-204,637
2004	-9,207	-6,674	16,740	-1,169	2,691	1,609	-727	-115,884
				Year-end net assets *(billions of euros)*				
Total								
2003	**379**	**219**	**909**	**1,160**	**119**	**3,163**	**314**	**5,870**
2004	**358**	**217**	**1,007**	**1,368**	**139**	**3,518**	**362**	**5,952**
as a % of GDP								
2003	*29.1*	*10.3*	*58.4*	–	–	*43.5*	*20.1*	*67.4*
2004	*26.5*	*10.0*	*62.2*	–	–	*46.5*	*22.0*	*69.1*

Sources: Based on Bank of Italy, EFAMA, ICI and Assogestioni data.

(1) The data refer to open-end investment funds that invest in securities and are offered to the public (for EU countries, harmonized funds). Funds of funds are not included, except as indicated. – (2) Net assets include those of funds of funds. – (3) For net fund-raising, refers only to Luxembourg. – (4) For net fund-raising, does not include Belgium, Ireland and the Netherlands. For net assets, the data for the Netherlands refer to September 2004. – (5) For Italian funds and for Luxembourg and Irish funds controlled by Italian intermediaries, includes flexible funds.

The net assets of Italian harmonized investment funds fell by 5.5 per cent to €358 billion in 2004. Including funds established abroad, at the end of December the net assets of funds controlled by Italian intermediaries amounted to about €500 billion (the same as a year earlier), equal to 14.1 per cent of the resources entrusted to harmonized investment funds in the euro area.

Supply. – The number of Italian harmonized funds diminished again in 2004, mainly as a consequence of mergers between management companies. In line with a trend common to the major industrial countries, hedge funds, ETFs and closed-end real estate funds continued to expand.

Average daily turnover in ETFs on the Italian stock exchange doubled with respect to 2003; the bid-ask spreads were very narrow. The number of ETFs listed on the Italian stock exchange rose to 20 at the end of 2004, from 13 a year earlier. They included 16 benchmarked to equity indices (euro-area, US and international market indices), three linked to the performance of euro-area government securities and one that replicates an index of euro-area corporate bonds. Last year also saw a significant expansion of these products in the other euro-area markets: the number of listed ETFs rose from 55 to 63 on the German stock exchange and from 48 to 57 on the Euronext market.

Closed-end real estate funds. – The growth of Italian closed-end real estate funds intensified in 2004. At the end of the year their net assets amounted to €8 billion, equal to 2 per cent of the total resources of Italian investment funds and, according to trade association data, 6 per cent of the euro-area market in real estate funds. Sixteen of the 31 operational funds were listed on the stock market.

The first real estate funds became operational in Italy at the end of the 1990s following important legislative changes. In the years since then, marked by acute strains on financial markets and rapidly rising property prices, both the number of funds and their total assets have grown swiftly. The sector's expansion has been facilitated by the favourable tax regime.

In Italy real estate funds must by law take the closed-end form. Their duration may not exceed thirty years, but there is no required minimum. Closed-end real estate funds may be listed; investors in listed funds can sell their units on the stock exchange before the fund's expiry date, but by doing so they expose themselves to the risk of a capital loss. Closed-end real estate funds may not make loans (except in specific cases), engage in short-selling or invest in the construction of buildings. In addition, they are subject to a series of constraints designed to govern conflicts of interest. On the other hand, they may contract loans within certain limits.

Closed-end real estate funds are subject to municipal property tax but exempt from income tax, the regional tax on productive activities and withholding taxes on profit from financial operations (with limited exceptions). Investors pay a 12.5 per cent withholding tax on realized profits (dividends distributed and any capital gains on sales of units) rather than on accrued profits, as is the case for most investment funds. Non-resident investors are exempt from the withholding tax.

At the end of 2004 Italian closed-end real estate funds' property portfolio was equal to 85.5 per cent of their total assets; three quarters of the portfolio consisted of office buildings, most of which were located in the North-West and Centre of the country. For listed funds, total annual management expenses amounted on average to 1.8 per cent of year-end net assets (1.6 per cent in 2003).

In the four years 2001-04 the units of listed real-estate funds returned an average of 5.1 per cent on an annual basis, with generally high volatility. The returns to individual funds displayed a wide dispersion.

Units of listed real estate funds are normally traded at a discount to their book value. This discount can vary significantly over time. In the four years 2001-04 the stock exchange discount on Italian closed-end real estate funds was approximately 25 per cent; it was influenced by such features as the fund's residual duration and leverage. Overall, listed Italian real estate funds showed a low correlation with the general index of the Italian stock exchange; this suggests they could be used for the diversification of portfolio risk.

Asset allocation. – In 2004 Italian harmonized investment funds made net sales of securities amounting to €13.4 billion, compared with net purchases of €22.6 billion in 2003. Disposals of BTPs and foreign shares and bonds were especially large. Net purchases only concerned BOTs and CTZs, and were intended to reduce the duration of the portfolio during a phase in which interest rates were expected to rise; these expectations progressively faded in the second half of the year.

Over the year the proportion of foreign securities in harmonized investment funds' portfolio fell slightly to 49 per cent. At the same time that of Italian equities rose to 5.7 per cent, as a consequence of the strong performance of share prices. The proportion invested in Italian bonds and government securities remained stable at 45.2 per cent.

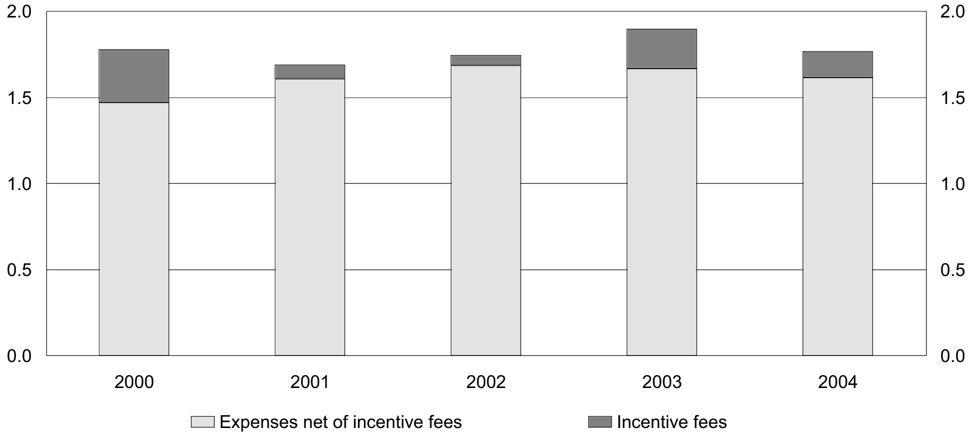
Returns and fees. – In 2004 the average return of Italian harmonized investment funds was 3.5 per cent, against 3.6 per cent in 2003. The differentials between returns of the main categories of fund were limited by comparison with the past. The best results were achieved by the categories that were able to benefit from the rise in stock market indices: equity funds, flexible funds and balanced funds returned an average of 7.2, 4.7 and 4.6 per cent respectively, compared with 2.3 per cent for bond funds and 1.3 per cent for money-market funds.

In 2004 total operating expenses paid by Italian harmonized investment funds (management fee, incentive fee, fees to depositary banks, securities brokerage fees and other minor items) amounted to €4.8 billion; €4.2 billion of this was paid to fund management companies. The ratio of expense – net of brokerage fees, for comparison with the data of previous years – to average annual net assets fell slightly, from 1.89 to 1.76 per cent (Figure 33). The decline was mainly due to the reduction in management and incentive fees paid to management companies (down by 0.04 and 0.06 percentage points, respectively).

Figure 33

ITALIAN SECURITIES INVESTMENT FUNDS: OPERATING EXPENSES (1)

(percentages)



(1) Simple average of operating expenses of the individual funds, calculated as the percentage ratio of annual operating expenses to average annual net assets. For comparability with the data for the three years 2000-02, expenses do not include brokerage fees. The data are for harmonized investment funds and SICAVs. The data for the last two years are provisional.

The expense ratio (net of brokerage fees) fell by 0.19 percentage points to 2.25 per cent for equity funds and by 0.15 points to 1.79 per cent for flexible funds, while it remained basically stable for bond, balanced and money-market funds at 1.22, 1.87 and 0.66 per cent, respectively.

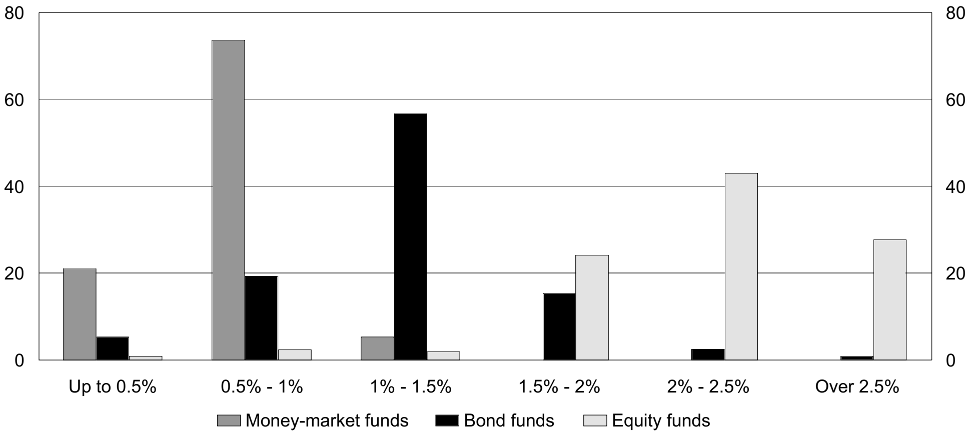
For three quarters of money-market funds annual expenses range between 0.5 and 1 per cent of average annual net assets (Figure 34). For bond funds the dispersion is greater: the majority pay expenses of between 0.5 and 2 per cent. In the equity segment, expense ratios are higher than 1.5 per cent for nearly all funds and exceed 2.5 per cent for about a third.

According to Borsa Italiana S.p.A., at the end of 2004 the total expense ratios of ETFs listed in Italy averaged 0.42 for those replicating equity indices and 0.17 per cent for those replicating indices of bonds and government securities.

Figure 34

ITALIAN SECURITIES INVESTMENT FUNDS:
DISTRIBUTION OF INDIVIDUAL FUNDS' EXPENSE RATIOS IN 2004 (1)

(percentages)



(1) Relative frequency distribution of annual expenses (net of brokerage fees) paid by the individual funds belonging to the investment category indicated. Expenses are expressed as a percentage of average annual net assets. The data refer to harmonized investment funds and SICAVs.

Individual portfolio management

Net flows of savings into individually managed portfolios rose substantially, from €5.4 billion in 2003 to €14.3 billion last year (Table 53). Total assets under management grew from €418 billion to €449 billion. The market share of investment firms remained unchanged at 5 per cent, while there was a shift away from banks to the benefit of asset management companies owing in part to the centralization of banking groups' asset management services at asset management companies: banks' market share declined from 40 to 33 per cent, asset management companies' rose from 55 to 62 per cent.

In the asset allocation of individually managed portfolios, the share of Italian investment funds fell by 4.3 percentage points to 14.3 per cent, while those of foreign investment funds, foreign bonds and Italian equities rose to 25.4, 16.5 and 3.4 per cent respectively and the combined share of Italian bonds and government securities remained virtually unchanged.

In 2004 the sector's financial result (measured by the ratio of the increase in net assets less funds raised to start-of-period net assets, which approximates the return on the portfolio on the assumption that all income is reinvested) rose to 3.9 per cent, from 2.3 per cent in 2003.

Table 53

ITALIAN INDIVIDUALLY MANAGED PORTFOLIOS:
SECURITIES PORTFOLIO

(millions of euros and percentages)

	2003	2004 (2)	2003	2004 (1)
	Net flows		**End-of-period stocks** (*percentage composition*)	
Italian governnment securities and private-sector bonds	**-10,569**	**8,214**	**38.0**	**38.1**
Short-term and variable-rate	1,835	-447	12.6	11.8
BOTs	3,035	1,283	1.9	2.1
CCTs	-1,200	-1,730	10.7	9.7
Medium and long-term	-12,404	8,661	25.4	26.3
CTZs	210	813	1.3	1.3
BTPs	-14,825	3,909	18.2	18.5
Other	-437	1,406	0.9	0.9
Private-sector bonds	2,648	2,533	5.0	5.6
Italian equities	**-225**	**2,169**	**2.7**	**3.4**
Italian investment fund units	**-7,785**	**-13,297**	**18.6**	**14.3**
Foreign securities	**32,336**	**23,131**	**40.3**	**43.8**
Government securities and private-sector bonds	14,610	10,093	15.3	16.5
Equities	1,421	889	2.1	1.9
Investment fund units	16,305	12,149	22.9	25.4
Other financial assets	**-418**	**-662**	**0.4**	**0.4**
Total portfolio ...	**13,339**	**19,555**	**100.0**	**100.0**
Memorandum items:				
Net fund-raising	**5,364**	**14,296**	**–**	**–**
Banks	-1,373	-18,037	–	–
Investment firms	-13,108	265	–	–
Asset management companies	19,845	32,068	–	–
Portfolio	**–**	**–**	**402,998**	**436,208**
Total assets under management ...	**–**	**–**	**418,128**	**448,661**

(1) Provisional.

Insurance companies and pension funds

Insurance companies. – In 2004 the premium income of insurance companies increased by 4.2 per cent (Table 54), well below its average annual growth of 11.9 per cent in the four years 2000-03. The deceleration was attributable to the life sector, which registered slower growth in premium income from for-profit policies (8.3 per cent, compared with 16.5 per cent in 2003) and a contraction of 7.8 per cent in that from unit- and index-linked policies, which had increased by 8.1 per cent in 2003.

Table 54

ITALIAN INSURANCE COMPANIES:
MAIN ASSETS AND LIABILITIES (1)

(balance sheet values; end-of-period data in millions of euros)

	Assets						Liabilities		*Memorandum item:* premium income (5)
	Deposits and cash (2)	Securities (2)	Loans & annuities (3)	Real estate	Other net assets	Total	Technical reserves (4)	Net worth	
				Life sector					
2001	5,723	201,275	995	1,889	5,522	215,404	196,099	19,305	46,329
2002	5,070	231,984	1,133	903	9,308	248,398	228,214	20,184	55,294
2003	5,177	278,803	1,137	823	8,763	294,703	272,096	22,607	62,780
2004 (6)..	5,502	318,100	1,048	808	11,470	336,928	312,783	24,145	65,627
				Non-life sector (7)					
2001	2,883	54,969	-3,454	5,909	7,988	68,295	52,657	15,638	29,926
2002	2,965	58,746	-2,814	4,581	9,095	72,573	55,355	17,218	32,415
2003	2,571	63,418	-2,569	3,711	9,748	76,879	58,144	18,735	34,213
2004 (6)..	2,485	67,540	-3,208	4,042	11,263	82,122	61,305	20,817	35,411
				Total					
2001	8,606	256,244	-2,459	7,798	13,510	283,699	248,756	34,943	76,255
2002	8,035	290,730	-1,681	5,484	18,403	320,971	283,569	37,402	87,709
2003	7,748	342,221	-1,432	4,534	18,511	371,582	330,240	41,342	96,993
2004 (6)..	7,987	385,640	-2,160	4,850	22,733	419,050	374,088	44,962	101,038

Sources: Based on Isvap and ANIA data.
(1) Excluding branches of companies based in other EU countries and including those of companies based in non-EU countries. – (2) Including assets invested in individually managed portfolios. – (3) Net of corresponding liabilities. – (4) Net of reinsurance. – (5) Italian direct insurance; includes premium income of branches in other EU countries. – (6) Partly estimated. – (7) Includes companies engaged solely in reinsurance.

In March 2005 Isvap, the supervisory authority for the insurance industry, issued a circular amending and collating the provisions governing transparency of life insurance policies. Under the new rules, insurance companies are to prepare not only the information note, as before, but also a fact-sheet summarizing the main features of the contract, including guarantees, if any, costs and financial risks; in addition, rules of conduct governing the supply of insurance products and for the management of possible conflicts of interest were introduced.

Insurance companies' technical reserves increased by 13.3 per cent to €374 billion. In the life sector they grew by 15 per cent and in the non-life sector by 5.4 per cent. The shares of assets consisting of liquidity, securities and real estate remained relatively stable at 1.9, 92 and 1.2 per cent, respectively.

In insurance companies' securities portfolio, the proportion of euro-denominated bonds and equities rose to 34.2 and 13.5 per cent respectively, while that of Italian government securities (especially BTPs), investment fund units and foreign-currency securities fell to 35.7, 15.2 and 1.4 per cent, respectively (Table 55).

Table 55

ITALIAN INSURANCE COMPANIES: SECURITIES PORTFOLIO (1)
(balance sheet values; end-of-period data in millions of euros)

	Securities denominated in euros					Securities denominated in non-euro-area currencies		Investment fund units	Total
	Fixed-income securities			Equities (2)	Total		*of which: equities* (2)		
	Public-sector securities	Private-sector bonds	Total						
	Life sector								
2001	81,981	58,967	140,948	18,713	159,661	6,441	1,756	35,173	201,275
2002	94,294	74,920	169,214	17,648	186,862	5,079	1,031	40,043	231,984
2003	100,278	101,770	202,048	20,133	222,181	4,875	964	51,747	278,803
2004 (3)...	111,277	118,824	230,101	26,417	256,518	4,880	856	56,702	318,100
	Non-life sector (4)								
2001	21,724	8,880	30,604	21,153	51,757	1,706	856	1,506	54,969
2002	25,170	8,879	34,049	22,057	56,106	1,280	672	1,360	58,746
2003	25,047	12,346	37,393	23,665	61,058	846	365	1,514	63,418
2004 (3)...	26,416	13,005	39,421	25,693	65,114	535	281	1,891	67,540
	Total								
2001	103,705	67,847	171,552	39,866	211,418	8,147	2,612	36,679	256,244
2002	119,464	83,799	203,263	39,705	242,968	6,359	1,703	41,403	290,730
2003	125,325	114,116	239,441	43,798	283,239	5,721	1,329	53,261	342,221
2004 (3)...	137,693	131,829	269,522	52,110	321,632	5,415	1,137	58,593	385,640

Sources: Based on Isvap and ANIA data.
(1) Including assets invested in individually managed portfolios. The portfolio of assets in respect of pension funds, unit- and index-linked products and companies engaged solely in reinsurance is partly estimated. Excluding branches of companies based in other EU countries and including those of companies based in non-EU countries. – (2) Shares and other equity. – (3) Partly estimated. – (4) Includes companies engaged solely in reinsurance.

Between the beginning of 2004 and the end of April 2005 the prices of the shares of Italian insurance companies rose substantially, by 19 per cent, in line with the general index of the Italian stock exchange.

The largest gains were recorded in the final part of last year. The performance of insurance shares was probably boosted by companies' positive results for the year, due in particular to an increase in profits from financial operations deriving from investment in the equity markets. In the non-life sector, the increase in the result of the technical account (the difference between income and expense specific to the management of insurance risks) also reflected a very modest increase in claims incurred. Insurance companies' shares also posted considerable gains in France and Spain (25 and 26 per cent respectively), while in Germany they fell by 5 per cent, owing to the income and financial difficulties of some companies belonging to major insurance groups.

On the international markets, in recent years the development of innovative financial instruments such as credit derivatives and asset-backed securities has given rise to a transfer of credit risk from the banking to the insurance sector.

Pension funds and non-INPS social security funds. – The assets managed by pension funds grew by 5.9 per cent to €30.8 billion in 2004 (Table 56). Those managed by pension funds set up before the reform of 1993 remained basically unchanged, while the resources managed by newer pension funds rose from €6.3 billion to €8.2 billion. The assets of non-INPS social security funds decreased slightly, from €23 billion to €22.3 billion.

Table 56

ITALIAN PENSION FUNDS AND NON-INPS SOCIAL SECURITY FUNDS: MAIN ASSETS (1)

(balance sheet values; end-of-period data in millions of euros)

	2003				2004 (2)			
	Pension funds			Non-INPS social security funds (4)	Pension funds			Non-INPS social security funds (4)
		Set up before the reform of 1993	Set up after the reform of 1993 (3)			Set up before the reform of 1993	Set up after the reform of 1993 (3)	
Liquidity	**2,842**	**1,792**	**1,050**	**1,439**	**2,409**	**1,709**	**700**	**1,500**
Securities portfolio	**20,170**	**14,897**	**5,273**	**8,197**	**22,159**	**14,671**	**7,488**	**7,681**
Fixed-income securities	13,701	10,391	3,310	6,638	14,522	9,690	4,832	6,416
Equities	2,447	1,129	1,318	1,099	3,070	1,284	1,786	814
Investment fund units	4,022	3,377	645	460	4,567	3,696	871	452
Loans and other financial assets	**2,488**	**2,492**	**-4**	**3,430**	**2,769**	**2,791**	**-22**	**3,431**
Real estate	**3,616**	**3,616**	**–**	**9,935**	**3,496**	**3,496**	**–**	**9,651**
Total assets	**29,115**	**22,796**	**6,319**	**23,001**	**30,832**	**22,666**	**8,166**	**22,263**

Sources: Based on Bank of Italy, Covip, UIC and social security fund data.
(1) The composition is partly estimated. – (2) Provisional. – (3) Includes the Bank of Italy and UIC employees' pension funds. The item "Loans and other financial assets" is net of liabilities. – (4) Data for 13 funds.

The share of securities in pension fund assets rose substantially, to 71.9 per cent, while that of liquidity fell to 7.8 per cent and that of real estate to 11.3 per cent. The share of loans and other assets remained broadly unchanged, at 9 per cent. Within the securities portfolio, an increase in the proportion invested in equities and investment fund units was set against a decrease from 67.9 to 65.5 per cent in that invested in fixed-income securities.

According to estimates by Covip, the Pension Fund Supervisory Authority, in 2004 the average return of occupational pension funds was 4.5 per cent, one percentage point lower than their benchmarks. The average return of open pension funds was 4.3 per cent, about 1.5 points lower than the sector's benchmark.

THE SECURITIES MARKETS

Share prices rose considerably in Italy in 2004. As in the other main euro-area countries, the increase was mainly attributable to the fall in real interest rates and the reduction in investors' risk aversion, which was also reflected in the decline in share price volatility to very low levels. In Italy equities also received a boost from an improvement in the earnings of listed companies and the consolidation of the financial structure of some large groups. The ratio of current earnings to prices remained above the average for the period 1990-2003.

The nominal long-term yields of Italian government securities fell further, as in the other main euro-area countries. At the end of 2004 they stood at 3.8 per cent for the ten-year maturity. The real ten-year interest rate declined by about one percentage point to 1.2 per cent. The fall in yields reflected the weakness of economic activity and the absence of inflationary pressures. The yield spread between ten-year BTPs and Bunds narrowed slightly; it decreased further in 2005 before regaining the levels recorded in mid-2004.

The cost of borrowing in euros on the international bond market continued to diminish. At the end of 2004 the yield spread between bonds of non-financial corporations and government securities had narrowed to 0.6 percentage points; in March 2005 it reversed direction, widening to 0.8 points.

In the euro area net issues of bonds by banks grew, while those by non-financial corporations contracted sharply. The decrease in firms' recourse to the bond market reflected the weakness of investment and the high level of self-financing. In Italy, by contrast, net bond issues by non-financial corporations were substantial; this issuance was largely attributable to financial restructuring operations involving some large firms. The cost of financing for Italian issuers remained generally in line with that for corporate borrowers of other countries.

Public-sector securities

Supply and demand. – Net issues of Italian public-sector securities turned upward, rising to €38.3 billion from €21.2 billion in 2003 (Table 57). The volume of net issues, which exceeded the overall general government borrowing requirement, led to an increase in the balance on the Treasury's

Table 57

BONDS AND PUBLIC-SECTOR SECURITIES: ISSUES AND STOCKS IN ITALY (1)

(millions of euros and percentages)

	Gross issues		Net issues		Stocks	
	2003	2004	2003	2004	December 2003	December 2004
Public sector	**454,505**	**444,106**	**21,248**	**38,263**	**1,174,439**	**1,213,190**
BOTs	214,093	221,300	5,905	-895	119,645	118,750
CTZs	31,185	27,128	-7,907	-8,198	52,636	45,603
CCTs (2)	38,313	34,527	-16,315	325	196,348	196,243
BTPs	144,882	134,803	31,711	33,556	700,655	734,713
Republic of Italy issues	21,998	13,980	5,582	2,468	83,762	85,654
Other (3)	4,034	12,367	2,272	11,007	21,393	32,227
Banks	**116,815**	**120,462**	**31,560**	**42,575**	**399,958**	**442,994**
Firms	**42,678**	**50,705**	**24,479**	**25,075**	**147,377**	**172,363**
Total ...	**613,997**	**615,272**	**77,287**	**105,913**	**1,721,774**	**1,828,547**
	Percentage composition (4)					
Public sector	**74.0**	**72.2**	**27.5**	**36.1**	**68.2**	**66.3**
BOTs	47.1	49.8	27.8	-2.3	10.2	9.8
CTZs	6.9	6.1	-37.2	-21.4	4.5	3.7
CCTs (2)	8.4	7.8	-76.8	0.8	16.7	16.2
BTPs	31.9	30.4	149.2	87.7	59.7	60.6
Republic of Italy issues	4.8	3.1	26.3	6.4	7.1	7.1
Other (3)	0.9	2.8	10.7	28.8	1.8	2.6
Banks	**19.0**	**19.6**	**40.8**	**40.2**	**23.2**	**24.2**
Firms	**7.0**	**8.2**	**31.7**	**23.7**	**8.6**	**9.5**
Total ...	**100**	**100**	**100**	**100**	**100**	**100**
As a percentage of GDP	*47.2*	*45.5*	*5.9*	*7.8*	*132.3*	*135.3*

(1) Rounding may cause discrepancies. – (2) Comprises only variable-coupon Treasury credit certificates. – (3) Comprises securities issued in 2004 by Infrastrutture S.p.A. to finance the infrastructure for the high-speed/high-capacity rail network. – (4) The figures for the various types of public-sector securities are percentage ratios of total public-sector securities.

payments account with the Bank of Italy. The ratio to GDP of outstanding public-sector securities fell by 0.5 percentage points to 89.8 per cent.

Compared with the end of 2003, the average residual maturity of outstanding government securities lengthened by 5 months to 6 years and 5 months and their average duration by 3 months to 4 years and 4 months. Net issues of BTPs increased from €31.7 billion to €33.6 billion, while those of CCTs were practically nil. There were net redemptions of CTZs (€8.2 billion) and BOTs (a very small amount). Over half of the net issues of BTPs consisted of securities linked to the euro-area consumer price index.

In 2004 the Treasury continued to make issues of five-year BTPs indexed to euro-area consumer prices and for the first time also issued 10-year and 30-year index-linked BTPs (in February and October respectively). At the end of the year a total of €27.9 billion of such securities was outstanding, 14.3 per cent of it consisting of thirty-year paper. Recourse to securities of this type is also widespread in the rest of the euro area: total gross issues rose from €28 billion in 2003 to €43 billion in 2004, with €98.9 billion outstanding at the end of the year.

After falling in 2003, net Italian local government bond issues rose to €5.1 billion. The year-end stock of €22.8 billion accounted for 1.9 per cent of the total amount of public-sector securities outstanding, up from 1.5 per cent at the end of 2003.

In contrast with net disposals of public-sector securities by banks and investment funds, there were substantial net purchases by non-resident investors, who held nearly 49 per cent of the outstanding stock at the end of 2004, while Italian households and firms held 18 per cent.

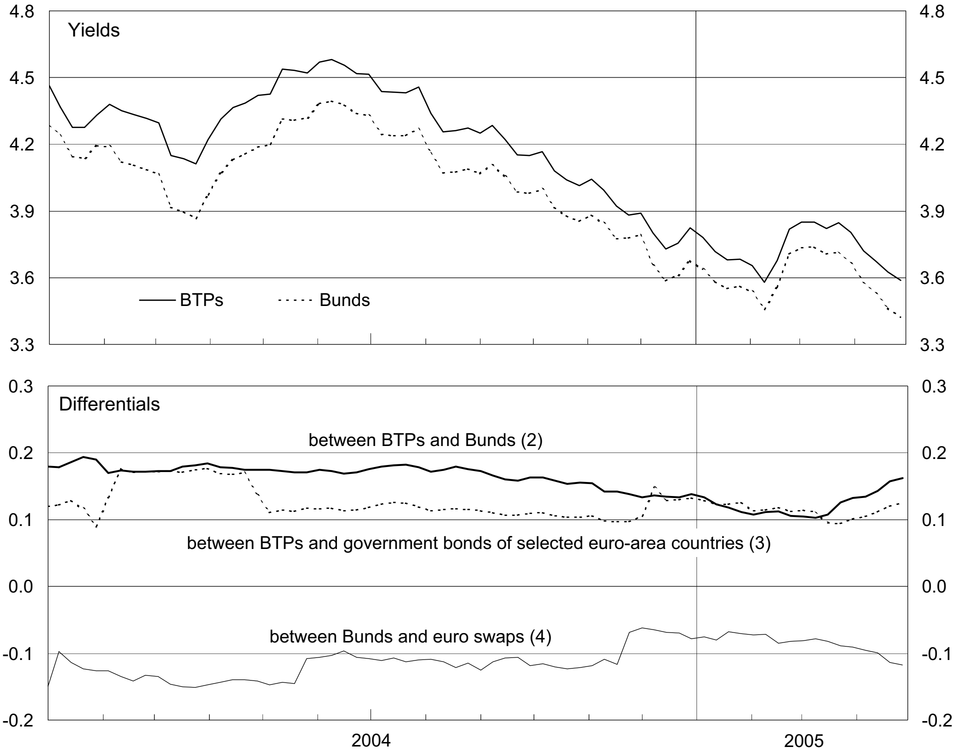
Interest rates. – Interest rates on medium and long-term government euro securities rose moderately in the first half of 2004 and then turned down again (Figure 35). The largest declines were recorded on the longest maturities. Over the year, the yield on the three-year benchmark BTP fell by 0.3 percentage points to 2.7 per cent and that on the ten-year benchmark BTP by 0.6 points to 3.8 per cent. In a context of stable inflation expectations, the decline in yields reflected the downward revision of the growth forecasts for the euro-area countries. A contributing factor may have been the further fall, to very low levels, of expected volatility as derived from the prices of options on futures on ten-year Bunds.

In 2004 the yield spread between ten-year benchmark BTPs and Bunds diminished from 19 to 14 basis points; it was unaffected by the downgrading of Italian government securities (from AA to AA-) announced in July by an international rating agency. After narrowing further at the start of 2005, the spread returned to the level recorded in mid-2004, in concomitance with a widening of bond spreads across the board.

Figure 35

GROSS YIELDS ON TEN-YEAR ITALIAN AND GERMAN GOVERNMENT BONDS AND MAIN INTEREST RATE DIFFERENTIALS (1)

(weekly averages; percentages and percentage points)



Source: Based on Bloomberg data.

(1) Yields on benchmark ten-year bonds. – (2) Differential between BTPs and Bunds, adjusted to take account of differences in the residual life of the two securities. – (3) Simple average of yield differentials between ten-year BTPs and the corresponding government securities of the countries that recorded a budget surplus in 2003 (Belgium, Finland and Spain). – (4) Differential between ten-year Bunds and ten-year euro swaps.

The yield spreads between Italian local and central government bonds remained stable in 2004. For a sample of euro-denominated, fixed-rate local government bonds that are sufficiently liquid on the secondary market, they averaged about 0.1 percentage points.

Real long-term yields, derived from the prices of French government securities linked to the euro-area consumer price index, stood at 1.2 per cent at the end of 2004, compared with 2 per cent a year earlier.

Average daily turnover in ten-year Bund futures remained virtually unchanged at the previous year's high levels in 2004, while trading in options grew by more than 10 per cent. Turnover in three-month euro-deposit futures increased by 14 per cent, while that in options decreased by 10 per cent.

Bank bonds and corporate bonds

Issuance. – Total net bond issues in the euro area amounted to the considerable figure of €360.4 billion, in line with the previous year (Table 58). Net issues by non-financial corporations contracted markedly, however, from €49.4 billion to €13.2 billion, reflecting the protracted weakness of investment and the improvement in corporate earnings.

Table 58

MEDIUM AND LONG-TERM BONDS OF BANKS AND FIRMS IN ITALY AND THE EURO AREA (1)

(at face value; millions of euros)

	Net issues (2)			Stocks			As a % of GDP
	2002	2003	2004	2002	2003	2004	2004
				Italy			
Banks	33,239	32,036	43,048	367,785	399,820	442,868	33
Other financial corporations	25,167	25,571	14,659	86,463	111,912	126,543	9
Non-financial corporations	6,502	-1,060	9,984	37,082	35,981	45,819	3
Total ...	**64,908**	**56,547**	**67,691**	**491,330**	**547,713**	**615,230**	**46**
Memorandum item: International market (3) ...	36,102	42,542	54,243	249,670	289,652	342,415	25
				Euro area (4)			
Banks	115,095	185,310	267,462	2,762,511	2,927,380	3,192,112	42
Other financial corporations	111,358	123,520	79,790	555,618	666,576	742,839	10
Non-financial corporations	29,626	49,357	13,163	454,321	494,818	502,964	7
Total ...	**256,079**	**358,187**	**360,415**	**3,772,450**	**4,088,774**	**4,437,915**	**59**
Memorandum item: International market (3) ...	423,553	541,132	534,899	2,802,990	3,240,858	3,738,756	50

Sources: Based on Bank of Italy, ECB and BIS data.

(1) The nationality and sector refer to the issuer and not to its parent company, except as indicated. Only includes securities with a maturity at issue of more than one year. – (2) Difference between the face value of issues and redemptions. – (3) The nationality and sector refer to the issuer's parent company and not to the issuer. Includes medium term notes with a maturity at issue of less than one year. The international market consists of bonds sold partly to residents of countries other than that of the issuer. – (4) The data do not cover some segments of the euro-area market, including securities issued by companies resident in Luxembourg and Ireland.

Net issues by Italian borrowers rose from €56.5 billion to €67.7 billion and from 15.8 to 18.8 per cent of the euro-area total. Net issues by banks increased from €32 billion to €43 billion, while those by other financial corporations diminished but remained very substantial. Unlike the rest of the area, Italy registered abundant net issues by non-financial corporations (€10 billion, compared with net redemptions of €1.1 billion in 2003). The increase was attributable to two large borrowers, mainly in connection with reorganization and consolidation of their financial structure.

At the end of 2004 Italian households' held 75 per cent of all bank bonds in issue, a slightly higher proportion than a year earlier; there was no change in the shares held by banks (12 per cent), insurance companies and pension funds (7 per cent) and non-financial corporations (3 per cent).

According to data released by the Bond Market Association, gross issues of asset backed securities in Europe remained very substantial last year: €453 billion, compared with the record high of €468 billion in 2003. The issues consist of securitizations and covered bonds. The composition of outstanding issues changed with respect to 2003 as a result of a further increase of 12 per cent in securitization transactions and a decrease of 17 per cent in gross issues of covered bonds, whose share of the total thus fell from 54 to 46 per cent.

In Italy net issues by financial companies in connection with securitization transactions were down sharply from €24.6 billion to €14.5 billion as a consequence of the high volume of securities reaching maturity. As in past years, securitizations were originated by banks and, to a lesser extent, some public-sector entities; the largest issue (€3.6 billion) involved the securitization of INPS credits.

Covered bonds were issued for the first time in Italy in 2004. The issues, totaling €6.5 billion, were made by Infrastrutture S.p.A., a company operating in major public works, which is entitled by law to issue securities of this type. With the passage of Law 80 of 14 May 2005, Italian banks as well may now issue covered bonds.

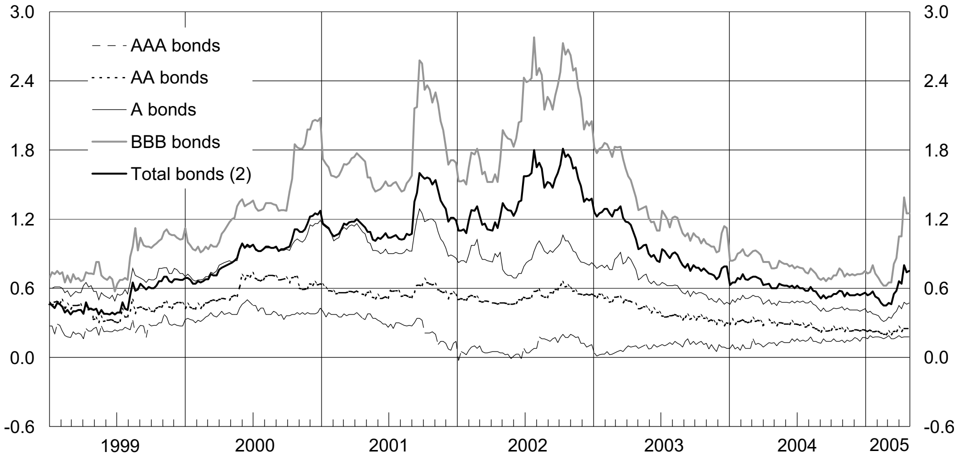
Gross securitization issues in Italy accounted for 14 per cent of the European market in 2004, compared with 43 per cent in the United Kingdom, 13 per cent in Spain and 3 per cent in Germany and France. On the basis of Dealogic data for the international market, around 60 per cent of euro-area securitization issues in 2004 were backed by bank assets; in turn, 60 per cent of the latter consisted in mortgages. In Italy the proportions were 51 and 45 per cent respectively. In the past few years an important role has been played by collateralized debt obligations (CDOs), debt securities that are divided into different risk classes and backed by a portfolio of loans, bonds or credit default swaps (CDSs). In 2004 CDOs accounted for 11 per cent of securitizations in the euro area and 5 per cent in Italy.

Yields. – Yields on investment grade euro-denominated bonds issued on the international market by non-financial corporations continued to fall in 2004 and by mid-February 2005 averaged 3.3 per cent, 0.8 percentage points less than at the end of 2003. The yield spread over government securities of comparable maturity narrowed further from the low levels they had reached at the end of 2003 to stand at 0.6 points at the end of last year (Figure 36). The reduction involved, in particular, the telecommunications and media sectors, where the spreads contracted to 0.5 and 0.6 points respectively.

Figure 36

YIELD DIFFERENTIALS BETWEEN EURO-DENOMINATED CORPORATE BONDS AND GOVERNMENT SECURITIES (1)

(weekly data; percentage points)



Source: Merrill Lynch.

(1) Fixed-rate euro-denominated Eurobonds with a residual term to maturity of not less than one year issued by non-financial corporations resident in countries whose long-term foreign currency debt bears a rating not lower than BBB- or Baa3. The differentials are calculated with reference to French and German government securities of corresponding duration. – (2) Includes all high-rated bonds (i.e. rated at least BBB- or Baa3).

At the end of 2004 the yield spread of high-rated corporate bonds was in line with that recorded at the end of the 1990s. By contrast, for high-yield bonds it had fallen to very low levels (around 2.8 percentage points). This narrowing was associated with the strong growth in issuance of high-yield securities in the euro area. To go by the experience of the US market, an increase in the share of securities issued by riskier firms is followed by an increase in the default rate on the bond market, with risks of significant losses for investors who do not adequately diversify their portfolios.

Yields on Eurobond issues by Italian companies were in line with those of securities of comparable rating and duration issued by borrowers of other countries. On the secondary market, the yields of some bonds of large Italian telecommunications and energy companies were lower than those of foreign securities with similar characteristics. For high-yield and unrated Italian securities, the yield spreads with respect to the benchmarks diminished as a whole, after the sharp increase that occurred at the beginning of 2004 following the collapse of the Parmalat group.

The favourable borrowing conditions on the international bond market mainly reflect the improvement in issuers' financial strength and profitability, against the backdrop of a strengthening cyclical upswing at international level and abundant liquidity. This resulted in a marked fall in the default rate and an appreciable improvement in the credit ratings assigned by rating agencies: in the second half of the year rating upgrades outnumbered downgrades. In a phase in which investment growth was weak and the availability of internal resources plentiful, the narrowing of spreads may also have been due in part to the contraction in net issues by non-financial firms. In addition, the limited volatility of bond prices and the low level of short-term interest rates are likely to have favoured purchases of securities financed by borrowing on the money market (the so-called carry trade).

Finally, it is likely that yield spreads were also reduced by the rapid diffusion of financial instruments for the transfer of credit risk, such as CDOs and CDSs. These allow investors to diversify credit risk, thereby reducing the premiums demanded by bondholders; furthermore, they also stimulate demand for securities by specialized operators and so affect liquidity premiums.

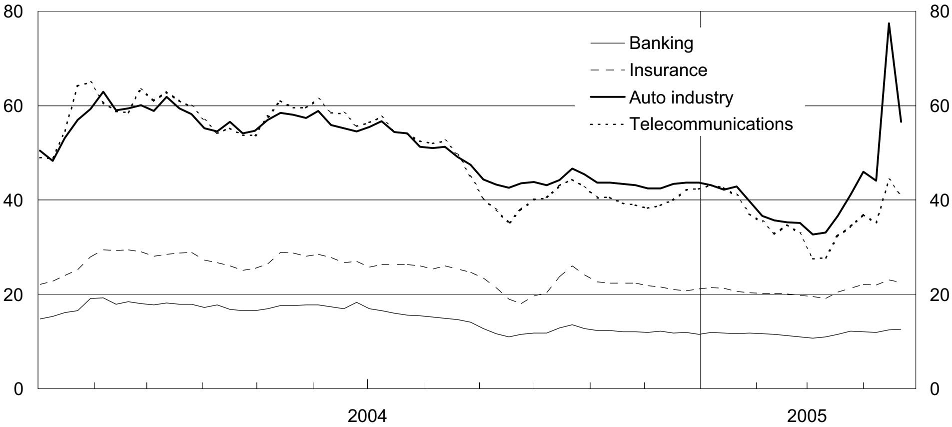
After initially decreasing further in the early months of 2005, yield spreads between corporate bonds and government securities recorded a significant increase, largely fueled by fears concerning the outlook for the automobile industry at international level. Between the end of 2004 and the beginning of May the worsening financial and economic conditions of the two leading US automobile companies, among the largest borrowers on the international bond market, convinced some rating agencies to downgrade their debt progressively until they were reduced to "high-yield". The downgrades caused a pronounced widening in the yield spread of their bonds over government securities. At the same time the spreads of bonds issued by some of the leading European car makers also widened. Between the middle of March and the middle of May the spreads of the automobile sector as a whole widened by 1.5 percentage points, returning to their end-2002 levels.

The credit derivatives market. – The credit derivatives market continued to expand rapidly last year. According to an estimate by the International Swap and Derivatives Association, the notional value of these derivatives more than doubled in 2004 to over €8.4 trillion, more than half of it consisting in CDSs. The premiums on CDSs fell again in all the leading euro-area countries, in line with the trend in bond yield spreads. The reduction was sharpest for non-financial companies (Figure 37). Premiums turned back upward in March 2005, notably for the automobile and telecommunications sectors.

Figure 37

PREMIUMS ON CREDIT DERIVATIVES FOR SELECTED EURO-AREA SECTORS (1)

(end-of-week data; hundredths of percentage points)



Source: Based on Bloomberg data.

(1) Simple averages of premiums on 5-year credit default swaps written on senior debt in euros of the main euro-area companies belonging to the sector indicated.

CDS premiums are a better indicator of credit risk than are bond yield spreads, in that they are not as strongly affected by other factors, such as liquidity premiums and tax differences between investors' countries of residence. An econometric estimate for 2002-04 indicates that CDS premiums for the main international non-financial corporations are correlated with the corporation's leverage, with the variability of its share price, and with the risk-free interest rate. These variables explain changes in the CDS premiums better than they do bond yield spreads. Their explanatory power is greater for telecommunications corporations (where CDS premiums are relatively high), lesser in the energy sector and public utilities (where CDS premiums are generally low).

The average premium on CDSs written on the senior debt of Italian banks diminished last year, bringing it closer to those for the largest international banks.

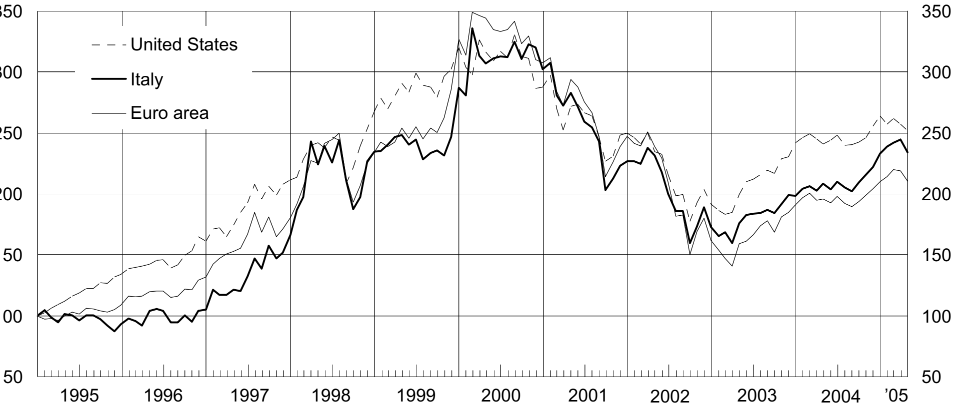
The equity market

Share prices and trading. – Share prices in the euro area held relatively stable until August last year before starting to rise again. The Dow Jones Euro Stoxx index of the shares of the area's largest companies in terms of market capitalization gained 10 per cent for the year (Figure 38). The rise was sharpest in Spain and Italy (19 and 17 per cent respectively), more limited in Germany and France (8 and 7 per cent). Share prices in the United Kingdom and the United States rose by 9 per cent, in Japan by 10 per cent.

Figure 38

SHARE PRICES (1)

(end-of-month data; indices, 31 December 1994=100)



Source: Bloomberg.
(1) Indices: MIB for Italy, Dow Jones Euro Stoxx for the euro area, Standard & Poor's 500 for the United States.

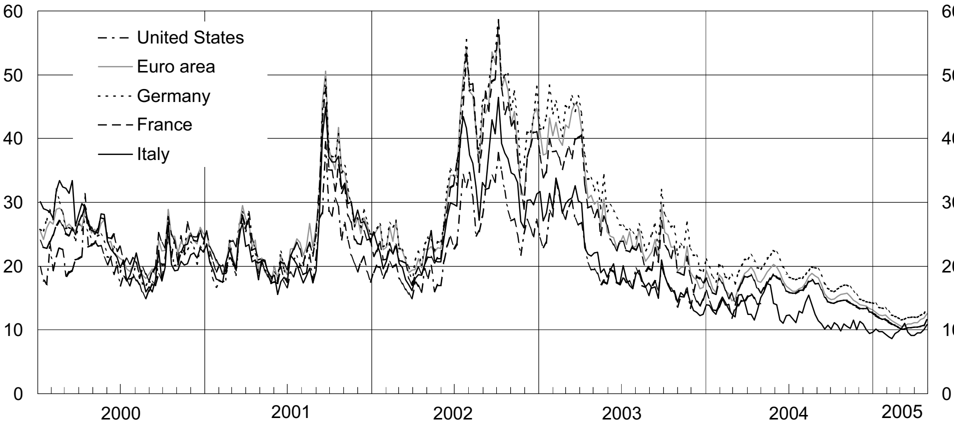
New market share indices rose everywhere, but in significantly differing measure. The UK Techmark index rose by 18 per cent, Nasdaq in the United States by 10 per cent, TechSTAR in Italy by 4 per cent and Nouveau Marché in France by 3 per cent.

Share prices continued to gain in the first three months of 2005 before falling sharply in April. For the first four months of the year share indices were unchanged in the euro area as a whole (with small gains in France, Italy and Spain and a fall in Germany).

Figure 39

EXPECTED VOLATILITY OF SHARE PRICES ON THE MAIN INTERNATIONAL STOCK MARKETS (1)

(end-of-week data; percentages)



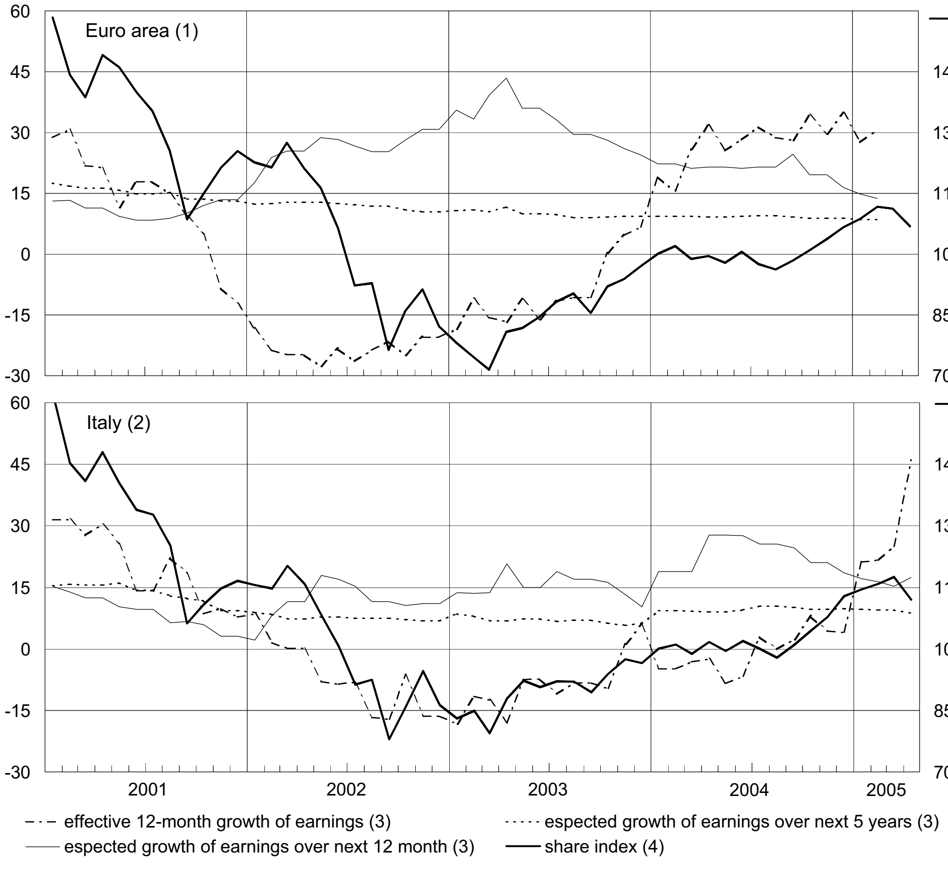
Source: Based on Bloomberg data.
(1) Volatility implied by stock index options.

The rise in equity prices in the euro area can be ascribed first of all to the further fall in real interest rates in the second half of the year as growth forecasts were revised downwards. It presumably also reflects a reduction in risk aversion, which can be inferred from option prices, and declining uncertainty over the outlook for the equity market in the light of the broad improvement in the finances and earnings of listed companies (Figure 39). At the same time, trends in earnings expectations apparently had only limited impact on equity prices (Figure 40). Data on the Euro Stoxx index firms collected by IBES indicate that between the end of 2003 and the first quarter of 2005 the expected short-term rise in profits fell from 24 to 14 per cent (in the US, from 13 to 10 per cent), owing in part to rising oil prices. Forecasts for profit growth in the medium term were also lowered, falling below 9 per cent in all the main area countries.

Figure 40

SHARE INDICES AND ACTUAL AND EXPECTED EARNINGS OF LISTED COMPANIES

(end-of-month data; percentage changes; indices, January 2004=100)



Source: Based on IBES data.

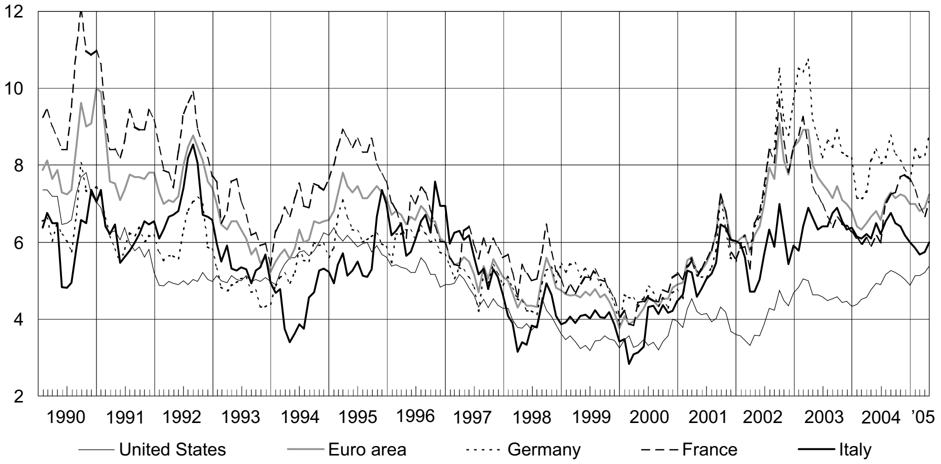
(1) Earnings per share of companies listed in the Dow Jones Euro Stoxx index. – (2) Earnings per share of companies listed in the BCI 30 index. – (3) Left-hand scale. – (4) Right-hand scale.

At the end of March 2005 the earnings/price ratios of the main euro-area stock markets ranged from 5.7 to 8.3 per cent; in the United States it was 5.2 per cent. In Italy it was 5.7 per cent, just above its average for the period 1990-2003 (Figure 41) and precisely at that average when gauged by expected rather than current earnings. The rise in share prices in 2004 was accompanied by a rise in dividends, so that the ratio of dividend payments to market capitalization remained unchanged.

Figure 41

CURRENT EARNINGS/PRICES RATIOS IN SELECTED INDUSTRIAL COUNTRIES

(end-of month data; percentages)



Source: Thomson Financial.

Within the euro area, the largest gains in 2004 were posted by firms in the electricity industry (32 per cent), pharmaceuticals (25 per cent), telecommunications (18 per cent) and banking (15 per cent). Smaller rises were registered in insurance (10 per cent) and the auto industry (4 per cent). Share prices in high-technology industries fell.

The gain for Italian equities was led by the largest capitalization companies in the electricity, telecommunications, energy and insurance sectors, with gains of 41, 31, 25 and 20 per cent respectively. Shares in these sectors outperformed not only the overall index but also the corresponding sectoral indices for the euro area. In media, banking and the auto industry, by contrast, the Italian rise was smaller than in the other area countries. A particularly good performance (up 24 per cent) was turned in by the STAR segment of mid-capitalization firms that meet high standards of transparency for investors and corporate governance.

In Italy, the low level of interest rates benefited above all the more highly leveraged firms, especially in electricity and telecommunications. The rise in the share price for the largest electricity company was also spurred by the beginning of a substantial plan for spin-offs of non-core business. The shares of oil and natural gas companies benefited not only from higher world oil prices and the euro's appreciation against the dollar but also from improved earnings, thanks to a financial consolidation begun in years previous. The largest telephone company carried out a major corporate reorganization. Insurance shares benefited above all from rising profits in the second half of the year. Bank shares did worse than the general stock market index in the first half of 2004 but recovered strongly in the second half, partly on the strength of an improved earnings outlook for the year.

Average daily turnover of Italian shares increased, reflecting the rise in share prices. As a ratio to average market capitalization, it remained unchanged at 0.5 per cent. The proportion of trading accounted for by shares in the new S&P/MIB30 blue-chip index fell from 92 to 89 per cent.

Supply and demand. – In Italy the rise in equity prices was accompanied by a modest upturn in new listings, which numbered 8 in 2004 (4 in 2003), including 2 on the Expandi market designed to accommodate the listing of SMEs. For the second year there were no new listings on the Nuovo Mercato (Table 59). Total fund raising by the newly listed companies and by those already listed was less than in 2003, a very modest €3.2 billion, or 0.2 per cent of average capitalization over the year. The exchange-traded funds segment continued to grow.

The euro area also registered a modest upturn in new listings, from 30 in 2003 to 72 last year. In the United States the increase was from 71 to 194.

At the end of the year the Italian Stock Exchange had 269 listed companies, down from 271 twelve months earlier. Thanks to the rise in prices, total market capitalization rose from €487 billion to €569 billion and from 37 to 43 per cent of GDP; in 2000 it had been over 70 per cent. The ratio was 40 per cent in Germany, 72 per cent in the four Euronext countries (Belgium, France, Netherlands and Portugal), 127 per cent in the United Kingdom and 139 per cent in the United States. The relative size of stock market capitalization in the main countries has remained basically stable over the past fifteen years.

On 20 September the old MIB30 was replaced by the S&P/MIB as the main Italian Stock Exchange index. The new index embraces 40 equities that account for more than 70 per cent of total market capitalization. The individual shares are weighted by their float (volume negotiable in the exchange), not by their market capitalization.

Table 59

MAIN INDICATORS OF THE ITALIAN STOCK EXCHANGE

(millions of euros, except as indicated)

	1999	2000	2001	2002	2003	2004
Annual change in prices (1)	22.3	5.4	-25.1	-23.7	14.9	17.5
Listed Italian companies (number at end of year)	264	291	288	288	271	269
of which: on the Nuovo Mercato	*6*	*39*	*44*	*44*	*41*	*37*
Total market capitalization (2)	726,566	818,384	592,319	457,992	487,446	568,901
of which: on the Nuovo Mercato	*6,981*	*22,166*	*12,489*	*6,438*	*8,265*	*6,674*
as a percentage of GDP	*65.6*	*70.2*	*48.6*	*36.3*	*37.5*	*43.1*
percentage breakdown: (3)						
industry	*20*	*21*	*23*	*25*	*23*	*23*
insurance	*11*	*14*	*13*	*11*	*12*	*12*
banking	*23*	*25*	*23*	*22*	*26*	*25*
finance	*3*	*3*	*3*	*3*	*4*	*3*
services	*43*	*37*	*39*	*39*	*35*	*37*
Total	**100**	**100**	**100**	**100**	**100**	**100**
Gross share issues (4)	22,543	9,148	6,171	3,894	8,710	3,197
of which: on the Nuovo Mercato	*280*	*4.402*	*222*	*115*	*5*	*65*
Market value of newly-listed companies (5)	189,822	29,764	10,554	5,142	1,412	5,999
of which: foreign companies	*119,415*	..	..	*2,067*	..	..
of which: on the Nuovo Mercato	*1,345*	*22,108*	*458*	..	..	..
Dividends distributed (6)	10,052	15,711	15,889	18,650	17,030	22,517
Earnings/price ratio (7)	3.4	4.5	6.0	5.9	6.4	6.0
Dividend yield (7)	1.5	2.1	2.8	3.8	3.4	3.4
Turnover:						
spot market (8)	*504,070*	*845,193*	*620,004*	*572,940*	*580,703*	*641,376*
MIB index futures (9)	*905,841*	*984,392*	*829,416*	*673,836*	*527,024*	*467,122*
MIB index options (9)	*264,181*	*323,166*	*246,555*	*176,513*	*153,998*	*152,839*
Turnover ratio (10)	83	109	88	109	123	121

Sources: Based on data from Borsa Italiana, Mediobanca and Thomason Financial Datastream.

(1) Percentage change in the MIB index during the year. – (2) Italian companies; at end of period. – (3) Excludes the Nuovo Mercato, the Expandi Market and the Mercato Ristretto (which closed in October 2003). – (4) The value of share issues is obtained by multiplying the number of shares issued by the issue price. Italian companies. – (5) Sum of the market values of each company at the IPO price. – (6) Source: Mediobanca. As of 2004, based on Borsa Italiana data. – (7) End-of-period data. Percentages. Current earnings and dividends. – (8). Italian companies. – (9) As of September 2004 replaces previous contract on MIB30 index. – (10) Turnover as a percentage of average market capitalization for the year. Total gross dividends for the financial year preceding that indicated in the table. Italian companies.

The derivatives market. – The average daily number of trades in S&P/MIB futures and mini-futures fell by 31 and 46 per cent respectively compared with those in MIB30 futures in 2003. The decline was due in part to the uncertainty engendered by the introduction of the new derivatives based on the new index. The total value of option contracts remained unchanged, while that of futures on individual equities rose from €2 billion to €8 billion. Their share of total futures trading remains small, however, having increased only from 0.3 to 1.5 per cent.

SUPERVISION OF BANKS AND OTHER INTERMEDIARIES

This section of the Report fulfils the Bank of Italy's obligation to publish an annual report on its supervision of banks and other intermediaries pursuant to Article 4 of Legislative Decree 385 of 1 September 1993; in particular, it sets out the criteria and methods followed in the Bank's supervisory activities and describes the actions taken in 2004.

In 2004 financial stability was one of the main subjects addressed by international organizations; analyses were made of the potential factors of vulnerability of financial systems.

The Financial Stability Forum examined the magnitude and methods of transfer of credit risk between operators in the banking, securities intermediation and insurance sectors. It highlighted the need for intermediaries to possess adequate risk control systems. The Forum also recommended that the national authorities work closely together to establish consistent supervisory standards for the various sectors.

In Europe there was a move to promote the drafting of a memorandum of understanding to cover the case of banking crises involving more than one member state.

The process of harmonizing legislation and establishing forms of cooperation among supervisory authorities, central banks and finance ministers proceeded within the committees set up following the "Lamfalussy reform".

The Action Plan for Financial Services launched in 1999 has almost reached completion; 39 of the 42 planned legislative provisions have been issued.

In July 2004 the European Commission approved the proposals for a directive on new capital adequacy requirements for banks and investment firms; they are basically in line with the document approved by the Basel Committee in June of that year. The European Council and the European Parliament are expected to complete their codecision procedure by the end of 2005. The Bank of Italy is already making preparations to incorporate the new rules when they come into force on 1 January 2007; for banks that adopt the more advanced methods of calculating credit risk, the rules will apply starting from 1 January 2008.

The Committee of European Banking Supervisors has taken steps to foster the uniform application of the new capital adequacy requirements by all member states. Guidelines are now being drawn up for the development of common reporting systems, the transparency of supervision and the verification of risk-measurement systems for the calculation of minimum capital requirements.

Last year the main amendments to Italian banking and financial legislation concerned the transposition of Community directives and the application of the reform of company law to the financial sector.

The directive on the reorganization and winding-up of banks was transposed into Italian law; it regulates crisis procedures for banks present in more than one member state. It was followed, in April of this year, by the transposition of the market abuse directives, which aim to tighten measures against actions that distort the proper operation of the financial markets.

Legislative Decrees 37 of 6 February 2005 and 310 of 28 December 2004 coordinate the reform of company law with the legislation governing the banking and financial sectors. They also lay down how the new rules apply to cooperative banks and mutual banks. The decrees subject supervised intermediaries to the amended company law, while retaining some of the specific features of the sectoral legislation.

In connection with the implementation of the decrees the Bank of Italy plans to introduce regulations ensuring that supervisory action remains effective under the new legislation. In addition to matters of organization and corporate governance, which are governed by a Bank of Italy regulation of August 2004, the measures relate to the requirements for corporate officers, shareholdings in banks and other intermediaries, risk assets and related parties, and fund-raising by non-bank intermediaries.

At the level of secondary legislation, the main development was the reform of collective asset management. The most salient aspects concerned the provisions relating to the administrative and accounting organization and internal controls of asset management companies. The information content of fund management rules destined for the general public was increased. Mechanisms were introduced to ensure proper correlation between the incentive fee paid to the asset management company and the value effectively created through the management of the fund. The procedures for the approval of fund regulations were simplified.

Spurred by competition, the banking system proceeded with its reorganization, particularly as regards the rationalization of group structures. There were 17 mergers and acquisitions of controlling interests, involving banks that held 0.4 per cent of the banking system's total assets.

On the whole, Italy's banking system is in line with those of the other main countries as regards concentration and geographical distribution. It is characterized by a high proportion of listed banks. There is a large and diversified presence of foreign intermediaries.

At the end of last year there were 33 listed banks, accounting for 77 per cent of the system's total assets. In the other main countries of continental Europe the proportion of listed banks does not exceed 50 per cent. This year, Italian and foreign banks have made moves to acquire major interests in two listed Italian banking groups; in order to obtain control, the intermediaries have made public tender offers.

At the end of 2004 external assets represented 8 per cent of Italian banks' total assets and 11.3 per cent in the case of the six leading groups. The largest domestic groups are increasing their penetration of Central and Eastern Europe, and medium-sized banks are expanding their presence abroad. Sixty branches of foreign banks and 15 subsidiaries of foreign groups operate in Italy, accounting overall for nearly 8 per cent of the banking system's total assets. The largest market shares of foreign intermediaries in Italy are in securities trading, asset management, corporate finance and consumer credit.

The reorganization of the financial system focused particularly on the non-bank intermediation sector in 2004. The centralization of investment services in the banks or asset management companies of banking groups led to a further reduction in the number of investment firms in operation. Excluding special purpose vehicles for securitizations, there was a further drop in the number of financial companies entered in the special list.

Despite the consolidation that has occurred, the leading Italian asset management companies operate on a small scale compared with their European counterparts and are highly specialized in retail products. Foreign competitors are a growing force in the supply of innovative products.

In 2004 the banking system again provided substantial resources to the economy. Bank loans grew by 6 per cent, as in 2003. The highest growth rates were recorded for loans to customers resident in the South and Islands (10.5 per cent, compared with 7.8 per cent in 2003) and for those to households (15.8 per cent, compared with 11.1 per cent in 2003). The limited expansion in economic activity led to slower growth in corporate loans (3.8 per cent, compared with 6.5 per cent in 2003), mainly owing to the 1 per cent fall in loans to larger firms.

The quality of loans remained at the high levels of recent years, thanks both to the improvement in banks' risk selection and management techniques and to the basic stability of firms' financial conditions. The ratio of bad debts to total loans was unchanged at 4.7 per cent; new adjusted bad debts were equal to 0.9 per cent of the value of the stock of performing loans at the beginning of the year, in line with the average in recent years. The ratio between writedowns and the nominal value of bad debts rose by about 2 percentage points to 57 per cent.

The profitability of the banking system in terms of ROE improved by four percentage points, rising from 6.7 to 10.7 per cent; at 12.5 per cent the figure for the main groups was above the average for the banking system as a whole.

The higher earnings were primarily due to the smaller volume of allocations to loan loss provisions and the reduction in extraordinary expense. On the other hand there was a significant 5 per cent increase in non-interest income, especially asset management fees, and a modest rise of 0.9 per cent in net interest income, accompanied by a fall of 37 per cent in profits on financial transactions.

Banks continued to strengthen their capital adequacy. Greater self-financing and capital increases raised the solvency ratio from 11.4 to 11.6 per cent for the banking system as a whole and from 10.8 to 11.4 per cent for the main groups.

In the off-site analyses conducted by the Bank of Italy in 2004 the number of banks that received unfavourable overall assessments declined further to 89; these banks accounted for 9.2 per cent of the banking system's total assets. The improvement largely reflected the strengthening of banks' organizational structures and capital bases. The assessments were consistent with the results of on-site inspections; in the case of the main banking groups these concerned specific lines of business.

There was again a high level of supervisory activity in connection with the application of the new capital adequacy rules. The measures adopted by banks to bring their systems into line with the forthcoming quantitative and qualitative requirements were evaluated for a first group that accounted for 58 per cent of the banking system's total assets. The checks involve the examination of the statistical documentation the banks have been asked to submit, interviews with corporate officers, and on-site controls on the progress made in carrying out the necessary works and creating procedures.

Analyses have been carried out in cooperation with the banking industry to determine the impact on banks' financial statements of the introduction of the new international accounting standards as of this year; the simulations conducted indicate that on average the effects on banks' balance sheets will be limited.

Supervision of compliance with the rules on transparency has been intensified. In 2004 the branches of the Bank of Italy carried out inspections at 844 branches of 158 banks; since the beginning of this year they have carried out inspections at 450 branches of 120 banks.

In the field of non-bank intermediation, last year brought an improvement in the profitability of asset management companies, especially those specialized in the management of hedge funds, closed-end securities funds and real-estate funds, and in that of investment firms belonging to banking groups and engaged in dealing for customer account and the distribution of financial products. As for financial companies entered in the special list referred to in Article 107 of the Consolidated Law on Banking, there was an expansion in the volume of leasing credit and a further increase in consumer credit, albeit less pronounced than in 2003. Overall, the quality of the credit provided by financial companies improved and their earnings more than doubled.

The improvement in the conditions of financial intermediaries led to a reduction in the number found to be in an anomalous situation. The number of asset management companies and investment firms that the supervisory authorities rated as unsatisfactory fell from 41 to 37, while for financial companies, the number fell from 36 to 30.

In 2004 communications made pursuant to Article 129 of the Consolidated Law on Banking concerning 1,600 issues of securities were examined; in 110 cases (58 in 2003) the issues did not go ahead following the intervention of the Bank of Italy.

THE REGULATORY FRAMEWORK

International cooperation and Community legislation

International cooperation. – Financial stability is the focal point of analysis and proposals in the international fora of supervision on intermediaries and markets.

In its meetings of September 2004 and March 2005 the Financial Stability Forum noted that the balance sheets of financial institutions had strengthened with the improvement in economic conditions. Forum participants observed that intermediaries needed to continue to monitor the evolution of risks, including through stress-testing of exposures to adverse scenarios.

In September 2004, on the basis of the experience acquired by the International Monetary Fund and the World Bank through the Financial Sector Assessment Program, the Forum called on the competent international organizations – the Basel Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) – to review the implementation of regulatory standards with special reference to intersectoral problems.

In March 2005 the Forum examined IOSCO's report on fraud in securities markets. The report recommends vigorous implementation of international standards and greater cooperation among authorities to ensure compliance with the standards.

Lastly, the Forum reconsidered its strategy on offshore financial centres. In light of the progress made in many jurisdictions in applying international supervisory standards, the Forum decided that the list of non-cooperative offshore financial centres had served its purpose. In the future the Forum will develop its action on this front by encouraging the IMF assessment process, supporting initiatives by the standard-setting bodies to improve international cooperation and information exchange, and inviting national supervisory authorities to apply pressure on non-cooperative centres. The Forum will check the results of the initiatives under way and adopt specific measures vis-à-vis non-cooperative centres.

At Community level, with regard to financial stability, the Economic and Financial Committee continued its analyses of the situation of the EU countries' financial systems. Steps were also taken to enhance cooperation and information exchange between authorities; in particular, a mandate was given for the preparation of a protocol for coordination between the central banks, supervisory authorities and finance ministries in the event of systemic financial crises with effects in more than one EU country.

In November the ESCB's Banking Supervision Committee published its reports on the structural evolution and stability of the EU countries' banking systems; for the first time they covered the new EU member states. The reports were incorporated in the *Financial Stability Review*, which the ECB will publish annually; the first edition appeared in December 2004.

The reform of the capital adequacy rules. – In June 2004 the central bank governors and the heads of the banking supervisory authorities of the G10 countries approved the Revised Capital Framework drafted by the Basel Committee at the end of an extensive consultation.

In April 2005 the Basel Committee published a consultation document containing proposals for amending the capital adequacy rules now in force for banks, with a view to bringing the treatment of market risks into line with the new framework.

In parallel with the work of the Basel Committee, in July of last year the European Commission adopted two proposals for amendments to Directive 2000/12/EC on banking and Directive 1993/6/EEC on the capital adequacy of banks and investment firms. The procedure for codecision between the Council and the European Parliament was subsequently initiated, and the Council made some changes to the text of the proposals, on which an agreement was reached in the Ecofin Council meeting of 7 December 2004. The provisions should be approved by the end of this year and are to enter into force on 1 January 2007; for intermediaries that adopt the more advanced methods of measuring credit and operational risks, they will take effect from 1 January 2008.

The proposed Community legislation is basically consistent with the text of the document proposed by the Basel Committee. The differences concern the scope of the provisions, the reduction of national discretion, coordination between the supervisory authorities of the different member states to validate advanced risk measurement systems in the case of banking groups with foreign subsidiaries, and the treatment of some types of credits and guarantees.

Community legislation. – The goal of completing the Financial Services Action Plan by 2005 has fundamentally been achieved, with 39 of the 42 planned legislative measures already in place. The Community institutions and member states are now engaged in producing the related secondary legislation and developing convergence of supervisory practices, a field in which the committees set up under the Lamfalussy reform play an important role.

Last year the Committee of European Banking Supervisors worked above all on developing criteria for convergence and cooperation between authorities, with a view to fostering consistent application of the new capital adequacy rules by the member states. The Committee published a consultation document with guidelines concerning the transparency of prudential control, the preparation of common reporting formats and the application of the new international accounting standards. The Committee is also studying cooperation between authorities in the context of the supervision of groups with branches and subsidiaries in another member state, the validation of internal ratings for credit and operational risks and the process of prudential control.

In the securities field, the Committee of European Securities Regulators drafted proposals for secondary legislation related to Directive 2004/39/EC.

The modernization of European company law moved forward along the lines indicated by the action plan on company law and corporate governance and the action plan on accounting that the Commission had prepared in 2003. The objective of promoting convergence towards more efficient governance structures is pursued by providing for a set of harmonized principles for the protection of shareholders and third parties, enhanced transparency and the attenuation of restrictions on the mobility of enterprises within the single market. The existing differences between the governance models of the EU countries render this convergence process complex and the efficacy of the solutions adopted uncertain.

Italian legislation

The reform of company law. Coordination with the provisions governing cooperative banks. – Legislative Decree 310/2004 introduced several measures to coordinate the reform of company law with the Consolidated Law on Banking, completing the coordination work initiated earlier in the year with Legislative Decree 37/2004.

Legislative Decree 310/2004 brings cooperative banks and mutual banks within the scope of the new rules of company law, provided these are not incompatible with substantive aspects of the special provisions governing such banks. It also amends the Consolidated Law on Banking with regard to its definition of banking group and its provisions concerning the ownership structures of banks, to make them consistent with those of company law regarding the direction and coordination of companies.

Incorporation into Italian law of the directive on the reorganization and winding-up of credit institutions. – Legislative Decree 197/2004 transposed Directive 2001/24/EC on the coordination of national rules concerning crises of banks having branches in more than one EU member state. The new rules aim at ensuring the unitary and universal nature of procedures through mutual recognition of the reorganization and winding-up measures adopted by the bank's home country authority and the application of the related rules, with specific exceptions (with regard, for example, to employment contracts, rights in property and financial instruments, and novation and netting agreements).

The same legislation, implementing a specific mandate, coordinated the provisions on crisis procedures contained in the Consolidated Law on Banking and the Consolidated Law on Finance with Legislative Decree 231/2001 concerning the liability of legal persons for administrative offences resulting from the commission of a crime.

Incorporation of the directive on financial collateral arrangements into Italian law. – Legislative Decree 170/2004 transposing Directive 2002/47/EC introduced provisions governing financial collateral arrangements supplementing the Civil Code's general provisions regarding guarantees. The new legislation establishes simplified rules for the conclusion of such arrangements and mechanisms that ensure the certainty and rapidity of their enforcement.

Application of IAS/IFRS to the accounts of banks and companies in the financial sector. – Legislative Decree 38/2005 exercised some of the options left open to EU member states by Regulation (EC) 1606/2002, which requires listed companies to prepare their consolidated accounts as of the financial year starting on or after 1 January 2005 in accordance with the International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) adopted within the European Union.

The decree lays down that banks, financial holding companies, financial intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking, electronic money institutions, Italian investment firms and asset management companies must prepare their consolidated accounts in conformity with IAS as of the 2005 financial year and their company accounts as of the 2006 financial year, with the option to fulfil the latter requirement as of the 2005 financial year. The decree also states that the Bank of Italy's regulatory powers with regard to the technical forms of the accounts of banks and companies in the financial sector are to be exercised in compliance with the international accounting standards.

Incorporation of the market abuse directives into Italian law. – Law 62/2005 (the 2004 Community Law) transposed the Community measures on market abuse (Directive 2003/6/EC and the related implementing directives issued by the Commission) by introducing rules aimed at countering behaviour likely to distort the proper functioning of the financial markets. The rules, included in a new title of the Consolidated Law on Finance, provide for two types of administrative and criminal offences: insider trading and market manipulation. Under the new rules, violations also entail the administrative liability of legal persons.

Secondary legislation

Company organization and corporate governance. – In a decree dated 5 August 2004, the Minister for the Economy and Finance, acting as Chairman of the Interministerial Committee for Credit and Savings on a proposal from the Bank of Italy, issued provisions concerning the organization and corporate governance of banks. The measure lays down the general criteria banks must comply with in defining their corporate governance systems, taking account of the latter's importance for sound and prudent management and competitiveness.

Transposition of the Revised International Capital Framework. – In March 2005 the Bank of Italy notified the banking system of the start of work on the transposition of the revised capital framework drawn up by the Basel Committee and the subject of proposals for EU directives. At the same time the Bank announced that a consultation would be held with intermediaries and trade associations on the most important aspects of the new regime. In this connection the Bank has released its preliminary evaluations of matters that the international rules leave to national discretion. Recommendations have also been made with regard to the analyses and checks banks will have to make in relation to the new prudential regime.

Cassa Depositi e Prestiti. – Cassa Depositi e Prestiti S.p.A., in conformity with the indications of the Minister for the Economy and Finance and after obtaining the opinion of the Bank of Italy pursuant to Article 8 of a ministerial decree dated 5 December 2003, has established the criteria underlying the organizational and accounting division between the "separate section" – entrusted with the business of financing central government and local authorities using funds raised by Poste Italiane S.p.A. and guaranteed by the State – and the remaining intermediation business. These criteria, intended to ensure compliance with Community law on state aid and competition, are also important for the objectives of transparency and economic equilibrium laid down for the "separate section" by Law 326/2003, which provided for the transformation of the Cassa.

At the same time a start has been made on the collection of information for the evaluation of the company's activity and organization with a view to the preparation of supervisory rules pursuant to Article 5.6 of Law 326/2003. The rules will be set within a supervisory framework basically equivalent to that applicable to banks, with account taken of the special institutional and operational features of Cassa Depositi e Prestiti S.p.A.

Regulation of banking foundations. – In Ministerial Decree 150/2004 the Minister for the Economy and Finance issued new regulations for banking foundations. The most important innovations concern matters examined by the Constitutional Court in Sentence 301/2003: the composition of the board, the incompatibilities applicable to the officers of foundations and joint control of a bank by more than one foundation.

Minimum duration of certificates of deposit. – In July 2004 the supervisory instructions concerning the duration of bank CDs and savings certificates were amended and provision made for them to have a duration of between 1 month and 5 years, thereby shortening the minimum duration, which had previously been set at 3 months.

Business continuity in the event of a disaster. – In July 2004, following a lengthy consultation launched in 2003, regulations were issued on business continuity in the event of a disaster. The new rules, which are in addition to the supervisory instructions concerning internal controls, were made necessary by the growing complexity of banking, the intensive use made of IT systems and the new risks facing banks.

New EU member states. – In November 2004 regulations were issued concerning the prudential treatment of exposures to residents of the ten countries that had joined the European Union. Under the new rules it is possible to apply the weightings established by the prudential regime in force for residents of Zone A countries, while the supervisory instructions on the minimum adjustments for country risk no longer apply, even where the new EU member states are not members of the OECD, unless they have restructured their sovereign debt in the last five years.

Securities and financial intermediaries. Alignment with the reform of company law. – In June 2004 the Bank of Italy issued regulations concerning the measures that investment firms, asset management companies and financial intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking are required to adopt as a consequence of the entry into force of the new company law; it also provided indications regarding the prudential rules deriving from the legislative innovations.

Asset management companies and investment funds. – A measure adopted in April 2005 revised the whole body of regulations issued by the Bank of Italy governing asset management on a collective basis and completed the transposition of the UCITS Directives (2001/107/EC and 2001/108/EC).

The most important aspects of the regulations governing asset management companies concern administrative and accounting procedures and internal control mechanisms. They provide indications regarding the tasks of governing bodies and top management, outline the measures to be taken to ensure proper management of the risks to which asset management companies and the assets under management are exposed, and lay down rules for the outsourcing of corporate functions.

As regards depositary banks, specific organizational requirements have been introduced for the case in which they intend to perform the task of calculating the value of fund units, as the Consolidated Law on Finance now permits.

The rules governing investment funds and SICAVs have been brought into line with the new Community provisions and allow asset management companies to run funds more flexibly.

Under the new regime the format and minimum content of fund rules are graded according to the different types of UCITS, distinguishing between funds aimed at the general public and those aimed at qualified investors. For the former the fees charged by asset management companies for the management of open-end funds can include an incentive fee in addition to the management fee calculated as a percentage of the fund's net assets.

Mechanisms have been introduced to ensure that incentive fees reflect the actual creation of value through management activity. For example, the benchmarks used to calculate incentive fees must be consistent with the fund's investment policy; moreover, such fees may not be charged more frequently than once a year; and the fund rules must set an upper limit on the total amount of management and incentive fees that can be charged.

The new regulations further simplify the procedures for the approval of the rules governing the operation of UCITS, thus reducing the time needed to bring new products to market.

A measure adopted in February 2005 reorganized the statistical and supervisory reports that must be submitted by UCITS set up under foreign law. Provision has been made for all the different types of funds (both harmonized and non-harmonized) to use the same form for their reports and for these to be made on a half-yearly basis. The new reporting system will be effective from December 2005.

Financial intermediaries. – A measure adopted in June 2004 laid down guidelines concerning the ways in which financial intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking are to include securitizations of their own credits and securities they hold of third-party securitizations in their financial statements and supervisory reports. The measure also specifies the related prudential rules.

In January 2005 changes were made to the information financial intermediaries are required to provide concerning restructured loans.

THE STRUCTURE OF THE FINANCIAL SYSTEM

At the end of 2004 the Italian financial system comprised 778 banks and 653 investment firms, asset management companies and other financial companies entered in the register established by Article 107 of the Consolidated Law on Banking, as well as the Bancoposta division of Poste Italiane S.p.A. The financial system also includes Cassa Depositi e Prestiti, which Law 326/2003 transformed into a company limited by shares (Table 60).

Table 60

THE STRUCTURE OF THE ITALIAN FINANCIAL SYSTEM

	31 December 2003			31 December 2004		
	Number of Intermediaries			Number of Intermediaries		
	Group members	Non-group	Total	Group members	Non-group	Total
Banking groups			**82**			**83**
Banks	**225**	**563**	**788**	**227**	**551**	**778**
limited company banks	*197*	*47*	*244*	*198*	*44*	*242*
cooperative banks (banche popolari)	*18*	*20*	*38*	*18*	*19*	*37*
mutual banks (banche di credito cooperativo)	*10*	*435*	*445*	*11*	*428*	*439*
branches of foreign banks		*61*	*61*		*60*	*60*
Investment firms	**35**	**97**	**132**	**25**	**90**	**115**
Asset management companies and SICAVs	**66**	**87**	**153**	**69**	**93**	**162**
Financial companies entered in the register referred to in Article 106 of the Consolidated Law on Banking	**206**	**1,288**	**1,494**	**213**	**1,306**	**1,519**
of which: entered in the special register referred to in Article 107 of the Consolidated Law on Banking...........	*98*	*261*	*359*	*99*	*277*	*376*
Other intermediaries (1)	**–**	**–**	**–**	**–**	**2**	**2**

(1) Bancoposta and Cassa Depositi e Prestiti.

There were 83 banking groups at 31 December 2004, one more than a year earlier, encompassing, among other intermediaries, 227 Italian banks, 94 Italian investment firms and asset management companies, 213 Italian financial companies and 30 holdings companies (including 5 parent companies). Foreign intermediaries numbered 302, including 75 banks.

At the end of the year banks and other supervised intermediaries administered respectively €1,700 billion and €690 billion of financial assets belonging to non-financial customers (including €920 billion and €660 billion of assets held for safekeeping or under management) and held or administered €1,475 billion and €390 billion of claims on these same customers. Banks had total staff of 336,000 and other financial intermediaries 22,000. Bancoposta's funding at the end of 2004 consisted of €32 billion of current accounts and €220 billion of savings books and savings certificates; during the year Bancoposta placed €3.7 billion of securities issued by third parties.

A total of 231 banks began operations during the last decade, 14 of them in 2004. At the end of last year banks operated through 31,000 branches, a slight increase with respect to the end of 2003, and 33,000 financial salesmen. The number of bank branches in relation to the population is approaching the euro-area average. At the end of 2003 Italy had 52 branches for every 100,000 inhabitants, compared with the euro-area average of 54; in 1999 the corresponding figures had been 47 and 59 respectively. Utilization of remote banking services is continuing to grow, with Internet banking services expanding fastest.

Banks and banking groups

Between 1994 and 2004 the average assets of banking groups and stand-alone banks, excluding mutual banks and branches of foreign banks, rose from €5.4 billion to €13.6 billion whereas the total volume of banking assets grew by 41.8 per cent. Over the same period the six largest groups' share of system assets rose from 39.6 to 54.6 per cent.

Last year saw limited further consolidation of the banking industry. There were 17 mergers and acquisitions, involving banks with 0.4 per cent of the system's total assets (Table 61).

Ownership of banking groups and banks. – At the end of 2004 there were 33 listed banks, of which 27 headed banking groups; they accounted for 77.2 per cent of the Italian banking system's total assets. In the other major countries of continental Europe, the corresponding proportion ranges from 40 to 50 per cent.

Banking foundations held an average of 20.7 per cent of the capital of the top ten banking groups, Italian and foreign insurance companies 4.4 per cent and investment funds 2.3 per cent. Considering only equity interests of more than 5 per cent, which require authorization by the Bank of Italy

Table 61

MERGERS AND ACQUISITIONS IN THE ITALIAN BANKING SYSTEM (1)

	Number of banks (operational)		Mergers				Acquisitions of majority control	
		of which: mutual banks	No. of transactions	*of which: mutual banks*	Assets (2)	*of which: mutual banks*	No. of transactions	Assets (2)
1995	970	619	47	28	1.57	0.10	19	4.50
1996	937	591	37	25	0.47	0.05	19	1.08
1997	935	583	24	12	0.80	0.05	18	3.42
1998	921	563	28	19	2.65	0.09	23	11.02
1999	876	531	36	23	0.39	0.06	28	14.35
2000	841	499	34	23	1.51	0.09	24	4.86
2001	830	474	31	21	0.08	0.06	9	1.55
2002	814	461	18	16	0.06	0.05	12	5.06
2003	788	445	20	14	0.20	0.05	7	1.47
2004	778	439	10	7	0.04	0.02	7	0.35
Total (3) ...			**285**	**188**	**7.77**	**0.53**	**166**	**34.13**

(1) If the merger is subsequent to the acquisition it is not counted unless it comes in the same year, in which case the acquisition is not counted. Excludes transactions with branches of foreign banks and intragroup transactions. For acquisitions of control, the relevant date is that of official registration as member of the group; for mergers, the date on which the deed takes effect. Assets are at December of the year preceding the transaction. In mergers, the figure for assets refers to those of the smaller bank; those of the larger are not counted. Transfers of assets and liabilities are treated as mergers. – (2) As a percentage of total system assets. – (3) For assets, the total is calculated as the ratio of the assets at December 1994 of the banks merged or acquired during the period 1995-2004 to total system assets at the same date.

under Article 19 of the Consolidated Law on Banking, at the beginning of 2005 banking foundations held interests of more than 50 per cent in 20 banks with 9.1 per cent of the system's consolidated assets; they also had shareholdings in another 41 banks. Foreign investors were present in the capital of 36 banks, including 17 parent companies and 9 members of banking groups. Italian and foreign insurance companies held interests in 23 banks; their holdings exceeded 50 per cent of the capital in 9 banks representing 0.6 per cent of the system's total assets. Unlike other countries, in Italy the presence of institutional investors remains modest, owing in part to the slow growth of pension funds.

This year Italian and foreign banks have moved to acquire significant holdings in two listed Italian banking groups; with a view to acquiring control, they have launched tender offers.

In conformity with Community legislation, the rules in Italy governing the acquisition of holdings of capital in banks (Title II, Chapter III of the Consolidated Law on Banking and the related Supervisory Instructions) are aimed at safeguarding the sound and prudent management of banks. They establish disclosure and authorization requirements for persons intending to acquire control of banks or significant holdings in their capital. Like the legislation in force in other European countries, the Consolidated Law on Finance and Consob Regulation 11971/1999 specify and govern the cases in which going above a given threshold of the capital of a listed company makes it mandatory to launch a takeover bid.

Supervisory examination of the applications for authorization takes account of the quality of the applicants, the business plan to be served by the acquisition and the situation of the target bank. The time it takes to issue authorizations depends in part on the size of the interest to be acquired.

The criteria and procedures followed by the Bank of Italy in evaluating applications are neutral with respect to the method of acquisition chosen and the nationality of the persons involved. If the prospective acquirer is an EU bank, Community legislation provides for prior consultation with the competent home-country authorities. Where the preconditions subsist, the transaction is submitted for approval by the European Commission as far as the safeguarding of competition is concerned.

The adequacy and feasibility of the plans for obtaining the resources needed to carry out acquisitions by Italian banks are carefully evaluated by the Bank of Italy with a view to the authorizations required. Compliance with prudential rules is verified using banks' periodical statistical reports. In accordance with the provisions of Directive 2000/12/EC, any shortfalls must be promptly eliminated.

Internationalization of the system. – The main Italian banking groups' penetration of the markets in Central and Eastern Europe is increasing; in Italy, foreign institutions hold growing market shares in the various sectors of financial intermediation.

At the end of 2004, 25 Italian groups were established abroad, up from 23 a year earlier, with 75 branches and 75 subsidiaries. The share of external assets in Italian groups' total assets was 8 per cent at 31 December 2004, compared with 9 per cent a year earlier. Funds raised abroad accounted for 14.7 per cent of their total funding, compared with 15.2 per cent in 2003.

The presence of Italian banking groups in Bulgaria, Croatia, Poland and the Slovak Republic is substantial in terms of both total assets and the relative importance of the banks acquired in their respective national markets (Table 62). There is also stepped-up expansion in neighboring markets, such as Turkey and Russia.

Table 62

PRESENCE OF FOREIGN BANKS IN SELECTED CENTRAL AND EASTERN EUROPEAN COUNTRIES

(at 31 December 2003)

	New EU members					EU candidates			
	Czech Republic	Hungary	Poland	Slovenia	Slovak Republica	Romania	Bulgaria	Croatia	Turkey
Number of banks (1)	35	36	60	22	21	33	34	41	50
of which: foreign-controlled	*26*	*27*	*45*	*5*	*17*	*23*	*23*	*11*	*12*
of which: Italian-controlled	*1*	*2*	*1*	*1* (2)	*2*	*2*	*1*	*8*	*1* (3)
Total assets (billions of euros)	79.5	54.4	105.4	21.6	23.8	15.0	6.3	27.5	136.0
share held by foreign-controlled banks (percentage)	*86.1*	*74.4*	*55.1*	*12.7*	*73.1*	*53.6*	*52.0*	*43.4*	*2.8*
share held by Italian-controlled banks (percentage)	*1.9*	*8.9*	*12.7*	*6.0*	*23.2*	*1.4*	*23.0*	*47.6*	*5.2*

Sources: ECB, national central banks and supervisory authorities, and Bankscope.

(1) Includes commercial banks, savings banks, mortgage banks, building societies and branches of foreign banks. – (2) This is a bank in which an Italian bank holds a 60 per cent interest but which is not included in the Italian group's consolidated accounts owing to a temporary order by the local supervisory authority. – (3) The bank is not included in the Italian group, because the holding is equal to 50 per cent.

Sixty foreign banks and 15 subsidiaries of foreign groups are active in the Italian banking system, with 104 and 371 branches respectively and an aggregate 7.7 per cent share of the total assets of units operating in Italy, up slightly from 7 per cent in 2003; the share pertaining to Community intermediaries is equal to 7.2 per cent.

Foreign banks' activity in Italy is diversified. They hold significant market shares in trading of unlisted securities on behalf of third parties (30 per cent of the total turnover) and individual portfolio management (10.6 per cent). About one third of the dealers on the interbank deposit market are foreign and they handle 38 per cent of the total volume of trades. Foreign banks also play an important role in corporate financial services: in the period 2000-04 they handled 72 per cent of the value of the 212 Euromarket issues by Italian firms.

Asset management companies

Intermediaries. – There were 159 registered asset management companies and 3 registered SICAVs at the end of 2004 (Table 63). During the year 14 new asset management companies were entered in the register and 5 deleted. About 45 per cent of the registered intermediaries belonged to Italian banks or banking groups, with 86 per cent of Italian investment funds' total assets under management. Thirty-four asset management companies were controlled by individuals, 8 by insurance groups and 7 by public-sector bodies, while 14 had mixed shareholders. The asset management companies controlled directly or indirectly by foreign residents numbered 26 and managed 6.5 per cent of Italian investment funds' total assets.

Table 63

ASSET MANAGEMENT COMPANIES AND SICAVS

	31 December 2003		31 December 2004	
	Total	*of which: bank investee companies* (1)	Total	*of which: bank investee companies*
Asset management companies and SICAVs	**153**	**93**	**162**	**92**
of which, specializing in:				
open-end funds	*71*	*46*	*66*	*40*
closed-end securities funds	*32*	*17*	*40*	*19*
closed-end real-estate funds	*11*	*6*	*17*	*8*
open-end and closed-end funds	*10*	*6*	*10*	*7*
hedge funds	*29*	*18*	*29*	*18*
Memorandum items:				
Companies offering individual portfolio management	63	43	68	43
Companies managing funds instituted by others ...	16	12	16	12
Companies instituting open pension funds	16	13	15	13
Foreign management companies and SICAVs (2)	**264**		**278**	
of which: SICAVs	*188*		*202*	

(1) Companies at least 50 per cent of whose equity is held by Italian or foreign banks. – (2) Companies that market their units/shares to the general public in Italy pursuant to Legislative Decree 58/1998, Article 42.

The leading Italian fund managers are smaller than the major European operators in the sector, mainly because of the relative underdevelopment of retirement saving in Italy. Italian asset management companies have specialized prevalently in products for the retail market (harmonized investment funds and individually managed portfolios), which are distributed almost exclusively through the sales network of the asset management company's group, with limited marketing abroad. At the same time, to an increasing extent foreign competitors are penetrating the Italian market with innovative as well as traditional products; foreign groups' share of the exchange-traded fund segment of the Italian stock exchange exceeds 85 per cent.

A comparative analysis suggests that with unit margins in the industry under pressure, a larger scale of operations than that found in the Italian system is needed in order to attain satisfactory levels of efficiency and ensure the competitiveness of the products supplied.

Collective investment portfolios. – At the end of the year the assets of collective investment portfolios amounted to about €580 billion, nearly a third of it attributable to Community undertakings for investment in transferable securities (UCITS) marketed in Italy by companies with registered offices in other EU countries.

As regards harmonized investment funds, Italian intermediaries are increasingly distributing funds managed in Luxembourg or Ireland by the groups to which they belong. Such funds accounted for 27.9 per cent of total assets under management at the end of the year, compared with 23.8 per cent at the end of 2003; for the top four intermediaries, which had a 55 per cent market share, funds managed in Luxembourg or Ireland accounted for 38.7 per cent of assets under management, compared with 31.2 per cent at the end of 2003.

Hedge funds and closed-end real estate funds grew strongly, with year-end assets of €11.7 billion and €8.1 billion respectively, up from €5.8 billion and €4.4 billion twelve months earlier. More moderate growth (from €1.4 billion to €1.8 billion) was recorded by closed-end securities funds. For these funds, many of which are reserved to qualified investors, the amounts subscribed but not yet called were equal to approximately €4 billion.

Italian collective investment undertakings. – The number of Italian collective investment undertakings rose by 59 over the year to 1,623 at 31 December 2004 (Table 64). The rationalization of the supply of harmonized open-end funds proceeded through mergers (14 authorized transactions), the simplification of the product range or the revision of investment policies.

Last year 33 closed-end funds were established: 21 real estate funds and 12 securities funds. Real estate funds are offered both to small savers, through listing on regulated markets, and to qualified investors, interested primarily in real estate conversion projects.

At the end of the year the real estate funds held properties worth €10.6 billion, against which they had taken out loans equal to about 37 per cent. The rules of 16 funds allow units to be subscribed for through the contribution of properties; the largest transaction of this kind was concluded towards the end of the year by Fondo Immobili Pubblici, a fund promoted by the Ministry for the Economy and Finance, to which government office buildings valued at more than €3.3 billion were contributed.

Table 64

COLLECTIVE INVESTMENT UNDERTAKINGS

	31 December 2003	31 December 2004
Italian collective investment undertakings: total (1)	**1,564**	**1,623**
of which:		
Harmonized open-end funds and SICAVs	**1,134**	**1,074**
of which: equity	*471*	*438*
bond and money-market	*394*	*376*
other	*150*	*154*
not operational	*119*	*106*
Non-harmonized open-end investment funds	**249**	**253**
of which: non-reserved funds of funds	*197*	*183*
funds of funds reserved to qualified investors	*7*	*9*
other non-reserved funds	*6*	*10*
other reserved funds	*39*	*51*
Closed-end investment funds	**76**	**105**
of which: non-reserved securities funds	*16*	*15*
securities funds reserved to qualified investors	*35*	*45*
non-reserved real estate funds	*18*	*25*
real estate funds reserved to qualified investors	*7*	*20*
Hedge funds	**105**	**191**
of which: funds of funds	*90*	*167*
Foreign funds and sub-funds marketed in Italy	**3,118**	**3,183**

(1) Sub-funds are considered individually.

The operating flexibility of closed-end funds reserved to qualified investors induced many private-equity managers, international as well as Italian, to operate in Italy through Italian funds rather than via the vehicles established in offshore centres that they had previously utilized. Most of these funds invest mainly in unlisted small and medium-sized industrial and service companies that require financial and managerial resources to carry out expansion plans.

Foreign harmonized collective investment undertakings. – Last year 114 notifications were received for the marketing in Italy of Community funds or sub-funds (120 notifications in 2003). More than 3,000 such funds or sub-funds are now marketed in Italy. The resources raised in Italy by foreign harmonized UCITS, excluding those controlled by Italian intermediaries, amounted to around €41 billion. In addition, the first branch of a harmonized asset management company was established in Italy in 2004.

Investment firms

At 31 December 2004 there were 115 registered investment firms (including 9 trust companies), down from 132 a year earlier. The reduction, which mainly involved bank-controlled firms, confirms the ongoing process of group rationalization as investment services are centralized in banks and asset management companies. Firms concentrating on individual portfolio management numbered 38; another 33 specialized in the marketing of third-party products and 13 in trading. Those offering combinations of these types of service numbered 31.

A total of 90 notifications (up from 63 in 2003) were received concerning the provision in Italy by EU investment firms of services subject to mutual recognition; in 8 cases services were to be provided through the establishment of a branch (compared with 3 in 2003).

Financial companies

At 31 December 2004 there were 376 financial companies in the special register referred to in Article 107 of the Consolidated Law on Banking, an increase of 17 from a year earlier as a result of 38 additions and 21 deletions (Table 65). Most of the new entries were securitization vehicles. Last year also saw the first 5 deletions of such vehicles following the redemption of the asset-backed securities issued.

The number of registered intermediaries other than special-purpose vehicles was reduced by the reorganization of banking groups and the progressive withdrawal of merchant banks. The reorganization under way in the merchant banking sector reflects an option in favour of closed-end investment funds, which enjoy greater operational flexibility.

The banking system further strengthened its role in the consumer credit market, in part through financial subsidiaries. In the three years from 2002 through 2004 the latter's share of the market rose from 23 to 28 per cent. A similar trend was recorded in leasing and factoring, where banking groups continue to do business mainly through intermediaries listed in the special register.

Table 65

SPECIAL REGISTER OF FINANCIAL COMPANIES

	Number of companies				
	31 December 2003		Registrations	31 December 2004	
		of which: bank investee companies			*of which: bank investee companies*
Principal activity (1):					
Financing	142	68	3	139	68
Leasing	*59*	*38*	*1*	*54*	*36*
Factoring	*38*	*14*	*0*	*35*	*13*
Consumer credit	*19*	*9*	*1*	*20*	*11*
Other	*26*	*7*	*1*	*30*	*8*
Equity investment	16	7	1	9	3
Credit cards	12	2	0	11	2
Securitization under Law 130/1999	8	2	1	9	2
Foreign exchange intermediation	3	0	0	2	0
Total	**181**	**79**	**5**	**170**	**75**
Special purpose vehicles under Law 130/1999 (2)	178	37	33	206	43
Total	**359**	**116**	**38**	**376**	**118**

(1) Determined by statistical reports and inquiries conducted during the year; companies may thus move from one category to another. – (2) Special purpose vehicles as defined by the Bank of Italy's regulation of 16 December 2002 are entered ina a special section of the special register.

As for publicly owned financial companies, the volume of public resources administered increased by 15 per cent to €3 billion at the end of 2004; 87 per cent of this was in connection with investments not involving own risk, for which the financial companies provided only project evaluation and credit approval services.

PROFITABILITY, RISKS AND CAPITAL ADEQUACY OF INTERMEDIARIES

Banks

In 2004 the Italian banking system provided substantial finance for economic activity. The growth in lending outpaced that of nominal GDP, while credit to firms increased at a slower pace, mainly owing to the trend in demand; lending to households accelerated, rising particularly fast in the mortgage loan sector.

Although output grew at a moderate pace, the average quality of loans remained virtually the same, partly thanks to the progress made in recent years in credit risk evaluation and management.

The operating profits of the banking system improved moderately, but that of the leading groups deteriorated. The growth in profits and the strengthening of banks' capital base was mostly due to the reduction in provisions for loan losses and in extraordinary expense.

Lending. – Italian banks' outstanding loans to resident customers rose by 6 per cent, similar to the increase recorded in 2003 (Table 66).

Table 66

BANKS: LENDING AND RISK INDICATORS (1)

(end-of-period data; millions of euros and percentages)

	Loans			Bad debts as a percentage of total loans (3)	Adjusted new bad debts (4)	Amount of securitizations (5)	
	Performing loans		Bad debts (2)			Performing loans	Bad debts
		Substandard loans					
2001	925,503	19,572	45,432	4.7	0.9	12,013	7,644
2002	980,440	20,486	46,326	4.5	1.0	12,461	2,426
2003	1,038,673	21,335	51,252	4.7	1.2	12,244	80
2004	1,096,051	21,269	54,346	4.7	0.9	12,602	335

(1) Lending to resident customers by banks operating in Italy. – (2) Includes unpaid and protested bills. – (3) Loans include bad debts and unpaid and protested bills.– (4) Adjusted new bad debts during the year as a percentage of performing loans at the end of the previous year net of repos, net interest to be debited to customers and adjusted bad debts. – (5) Annual amount.

The rate of increase in lending to customers in the South rose from 7.8 to 10.5 per cent, while that in lending to customers in the Centre and North declined from 6 to 5.3 per cent.

The slowdown in output and investment growth was reflected in a decline in the rate of increase in lending to non-financial corporations, from 6.5 to 3.8 per cent.

A breakdown of lending to firms by loan size indicates that the slowdown mainly affected credit to large companies: exposures to firms with credit lines in excess of €25 million fell by 1 per cent.

The low level of interest rates continued to stimulate the demand for credit by consumer households, which increased by 15.8 per cent, compared with 11.1 per cent in 2003. Loans for home purchases grew by more than 20 per cent.

Credit quality. – The rate of increase in bad debts was equal to 6 per cent; taking into account the effects of the collapse of the Parmalat group, it was virtually unchanged with respect to 2003.

Loans newly classified as adjusted bad debts amounted to 0.9 per cent of outstanding performing loans at the end of 2003, in line with the average values of recent years. The ratio of adjusted bad debts to accounting bad debts fell from 108.5 to 106.9 per cent (Table a31).

The ratio of bad debts to total loans held steady at 4.7 per cent. Net of writedowns, bad debts amounted to €23.5 billion, equal to 15.8 per cent of supervisory capital, compared with 16.4 per cent in 2003.

Substandard loans, consisting in exposures to customers in temporary difficulty, which had risen by 4.1 per cent in 2003, remained virtually stationary last year.

Trading in derivatives with firms. – In recent years Italian banks have expanded their business in derivatives. In December 2004 the notional value of contracts outstanding was €6,700 billion, compared with €2,000 billion at the end of 2000.

Despite this growth, transactions in derivatives with non-financial corporations remain limited, the notional value of contracts outstanding having risen from 2.1 per cent of the total value in 2000 to 3.4 per cent in 2004.

An analysis of the new Central Credit Register reports introduced this year indicates that in January 2005 non-financial corporations with amounts due to banks and financial companies in connection with derivatives numbered 45,000, equal to 4 per cent of the firms surveyed. Banks' and financial companies' exposure to firms for the same instruments totaled €5.1 billion, or 2 per cent of total credit to the corporate sector.

Italian firms made use of derivatives to hedge financial risks, mainly arising from their heavy recourse to short-term bank loans and loans indexed to money market yields.

Concentration risk. – The banking system's large exposures (those which, on a risk-weighted basis, exceed 10 per cent of a bank's supervisory capital), which are subject to specific prudential regulations, decreased by 11 per cent, to €58.6 billion. The decline was most marked among the main banking groups. As a ratio to risk-weighted assets, large exposures fell from 5.3 to 4.6 per cent.

Foreign exposure and country risk. – Italian banks' exposure to developing countries increased by 3.7 per cent last year, to €71 billion. Their share of the corresponding market fell from 3.2 to 2.9 per cent.

The exposure to developing countries involving non-OECD countries, which is subject to specific prudential rules, decreased by 3.3 per cent, to €39 billion, and was equal to about 2 per cent of Italian banks' total assets. The non-guaranteed exposure, adjusted in accordance with supervisory rules on country risk, amounted to €9.6 billion, 9 per cent less than in December 2003.

At the end of 2004 prudential value adjustments amounted to €1 billion, 11.6 per cent less than in 2003, and represented 0.7 per cent of supervisory capital, compared with 0.8 per cent in 2003. The decline in these value adjustments reflected a general improvement in the situation of the developing countries, especially oil-exporters, and the shift in the exposure towards less risky countries.

Profitability. – The profitability of the banking system improved last year, mainly owing to the reduction in provisions for loan losses and in extraordinary expense. Return on equity rose by 4 percentage points, to 10.7 per cent on a consolidated basis. The main banking groups' ROE increased from 9.2 to 12.5 per cent (Table 67).

Gross income rose by half a percentage point to €66 billion. The increase was entirely due to the 0.9 per cent rise in interest income. Other income remained stationary; the 5 per cent increase in net commissions

Table 67

PROFIT AND LOSS ACCOUNT
OF ITALIAN BANKS AND BANKING GROUPS (1)
(millions of euros; growth rates and percentage indicators)

	Banking system				Main banking groups (1)			
	Amount	Growth rate			Amount	Growth rate		
	2004	2004	2003	2002	2004	2004	2003	2002
Net interest income (a)	**40,332**	**0.9**	**-1.2**	**3.2**	**20,603**	**-2.6**	**-6.6**	**1.3**
Non-interest income (b)	25,686	0.0	9.5	-12.9	15,257	-5.4	13.7	-15.8
of which: commissions	*22,393*	*4.9*	*4.0*	*-4.5*	*13,655*	*2.6*	*2.6*	*-8.7*
financial operations and other income	*3,293*	*-24.3*	*48.5*	*-46.4*	*1,602*	*-43.1*	*131.4*	*-53.9*
Gross income (c=a+b)	**66,018**	**0.5**	**2.8**	**-2.7**	**35,861**	**-3.8**	**1.2**	**-6.1**
Operating expenses (d)	38,531	-0.5	-0.1	-0.1	20,972	-1.9	-3.5	-2.9
of which: banking staff costs	*25,303*	*0.8*	*1.2*	*0.8*	*14,015*	*-1.1*	*-2.6*	*-1.8*
Operating profit (e=c-d)	**27,487**	**2.0**	**7.1**	**-6.5**	**14,889**	**-6.4**	**8.4**	**-10.5**
Value adjustments, readjustments and allocations to provisions	15,184	-15.8	-3.6	5.4	6,804	-22.8	-18.3	-0.2
of which: in respect of loans	*7,543*	*-21.1*	*1.4*	*8.1*	*4,424*	*-17.0*	*-22.3*	*7.3*
Ordinary profit (g=e-f)	**12,303**	**38.1**	**38.2**	**-29.7**	**8,084**	**14.1**	**82.5**	**-30.5**
Extraordinary profit (h)	5,860	48.7	-30.8	11.5	1,781	41.5	-38.2	-7.3
Gross profit (i=g+h)	**18,164**	**41.4**	**5.9**	**-14.9**	**9,866**	**18.2**	**40.9**	**-23.9**
Tax (l)	6,212	19.6	5.8	-16.4	3,058	-6.8	39.5	-23.5
Profit after tax (m=i-l)	**11,952**	**56.2**	**5.9**	**-13.9**	**6,808**	**34.5**	**41.9**	**-24.2**
Minority interest (n)	1,032	72.3	-7.8	-40.9	607	107.9	-3.9	-57.8
Profit for the year (o=m-n)	**10,920**	**54.8**	**7.2**	**-9.8**	**6,201**	**30.0**	**46.2**	**-18.2**
Indicators								
Ratio of non-interest income to gross income		38.9	39.1	36.7		42.5	43.3	38.5
Cost-income ratio		58.4	59.0	60.7		58.5	57.3	60.2
Value adjustments in respect of loans as a percentage of gross operating profit		27.4	35.5	37.5		29.7	33.5	46.8
ROE		10.7	6.7	6.4		12.5	9.2	5.9

Sources: Consolidated reports for banking groups and individual reports for banks not belonging to groups.
(1) Six largest groups by total assets.

from asset management and bancassurance was offset by a 37 per cent decrease in revenues from financial operations.

Operating expenses amounted to €38.5 billion, 0.5 per cent less than in 2003, notwithstanding the 0.8 per cent rise in staff costs. The cost-income ratio fell from 59 to 58.4 per cent. Operating profit rose by 2 per cent to €27.5 billion.

Ordinary profit increased by 38.1 per cent, thanks to the large reduction in loan loss provisions and value adjustments. Adjustments in respect of loans, totaling €7.5 billion, declined by 21.1 per cent, owing to the waning of the effects of the Parmalat crisis and the modest volume of newly classified bad debts.

The marked expansion in extraordinary profit also contributed to the result for the year; extraordinary expense, including outlays for early retirement incentives, declined. After tax and minority interests, profit for the year amounted to €10.9 billion, over 50 per cent higher than the year before. Allocations to increase supervisory capital more than doubled, to €7.2 billion (Table a32).

Capital adequacy. – In 2004 the banking system's supervisory capital increased by 6.7 per cent, to €149.2 billion (Table 68).

Table 68

CAPITAL ADEQUACY
OF ITALIAN BANKS AND BANKING GROUPS (1)
(millions of euros)

	Banking system		Main banking groups (2)	
	2003	2004	2003	2004
Allocations to supervisory capital	3,229	7,248	2,037	3,093
Capital increases (3)	2,546	1,670	10	109
Supervisory capital	139,829	149,157	72,825	78,198
Solvency ratio (%)	11.4	11.6	10.8	11.4
Capital excesses	42,482	47,457	19,876	23,781
Capital shortfalls	–	5	–	–

(1) Consolidated reports for banking groups and individual reports for banks not belonging to a group. Excludes the Italian branches of foreign banks. – (2) Six largest groups by total assets. – (3) Capital increases for cash net of redemptions.

The strengthening of the system's capital base, which was most marked for the main banking groups and for the cooperative banks, was attributable not only to self-financing and capital increases but also, although to a smaller extent, to subordinated liabilities (Table a33).

The overall solvency ratio edged up from 11.4 to 11.6 per cent, while that of the main banking groups rose from 10.8 to 11.4 per cent. Capital in excess of minimum requirements amounted to around €47 billion, €5 billion more than in 2003.

Capital requirements for market risks were in line with the previous year at 5.4 per cent of total supervisory capital.

For a number of years the supervisory authorities have performed macro-prudential tests to assess the stability of single banks and the ability of the banking system to withstand shocks. Stress tests designed to simulate exceptionally serious events have become one of the most important instruments at their disposal.

A sample of some 530,000 firms, representing 96 per cent of lending to non-financial corporations in December 2004, was analyzed to assess the impact on banks of a 45 per cent increase in the likelihood of loans being classified as bad debts within a year. Basically, this replicates the extremely risky situation of firms in the first half of the 1990s. The capital requirement for credit risk – calculated according to the criteria set out in the third revision of the Basel Committee's Capital Accord – would increase by 20 per cent as a result; at the end of 2004 capital was almost one and a half times the minimum requirement under current regulations.

Further analyses identified the macroeconomic variables most likely to trigger a deterioration in lending in the various sectors of the economy. The results indicated that the evolution of loans into bad debts is mainly connected with developments in GDP, the exchange rate and inflation.

Asset management companies

Profitability. – Asset management companies made net profits of €427 million in 2004, compared with €402 million in the previous year (Table 69). Companies specialized in the management of hedge funds increased their profits from €11 million to €30 million and those specialized in the management of closed-end securities and real-estate funds from €15 million to €31 million.

There were 42 loss-making companies (46 in 2003), with losses amounting to €65 million; more than half were intermediaries in operation for less than two years.

The improvement came mainly from the increase in net commissions (from €1,598 million to €1,694 million) and in dividend income (from €11 million to €85 million), while extraordinary expense rose from €23 million to €172 million.

Operating costs increased by 3 per cent, particularly those for IT outsourcing and internal controls. Value adjustments of tangible and intangible fixed assets decreased by 20.6 per cent.

Capital and risks. – At the end of 2004 the supervisory capital of asset management companies amounted to €1,335 million, compared with €1,129 million in 2003, and consisted almost entirely of tier-one elements.

Table 69

PROFIT AND LOSS ACCOUNT OF ASSET MANAGEMENT COMPANIES

(millions of euros and percentages)

	2003		2004	
	Amount	Percentage (2)	Amount	Percentage (2)
Revenue from management of own products	5.439	340.4	5.689	335.8
of which: from open-end funds	*4,795*	*300.1*	*4,962*	*292.9*
Revenue from management of others' products	276	17.3	297	17.5
of which: from open-end funds	*91*	*5.7*	*112*	*6.6*
Free payable	4,117	257.6	4,292	253.4
of which: maintenance fees	*3,026*	*189.4*	*3,113*	*183.8*
Gross operating profit	**1,598**	**100.0**	**1,694**	**100.0**
Administrative expenses	904	56.6	965	57.0
of which: staff costs	*386*	*24.2*	*405*	*23.9*
Value adjustments to tangible and intangible fixed assets	126	7.9	100	5.9
Other operating expenses (–)	19	1.2	17	1.0
Total operating costs	**1,049**	**65.6**	**1,082**	**63.9**
Other operating income	93	5.8	91	5.4
Net operating profit	**642**	**40.2**	**703**	**41.5**
Result on financial operations (1)	**57**	**3.6**	**129**	**7.6**
Result on ordinary activities	**699**	**43.7**	**832**	**49.1**
Extraordinary income/expense	7	0.4	-131	-7.7
Net change in provision for general financial risks	3	0.2	12	0.7
Taxes	307	19.2	286	16.9
Net profit (loss) for the year	**402**	**25.2**	**427**	**25.2**

(1) Includes net income from management of companies' proprietary portfolios. – (2) Amount as a percentage of gross operating profit.

Minimum requirements amounted to €511 million (€465 million in 2003), of which two thirds was for the amount of assets under management and the remaining third in respect of "other risks" (equal to 25 per cent of the fixed operating costs stated in the accounts for the last financial year).

Investment firms

Profitability. – Italian investment firms made profits of €103 million. The result was affected by the structural changes the sector has been undergoing in recent years and in particular by the leading groups' centralization of own-account trading within bank members.

The number of loss-making firms remained large (43 out of the 108 investment firms in operation), although average losses were lower than in 2003, at around €1 million compared with €2.8 million. The majority of investment firms with financial difficulties were small-sized, privately-owned and specialized in trading on customer account and portfolio management.

Capital and risks. – At the end of 2004 the supervisory capital of investment firms amounted to €716 million, compared with €1,382 million a year earlier; around 96 per cent consisted of tier-one elements. The decline was due to the elimination of firms from the register: taking a constant sample, supervisory capital increased from €645 million to €692 million.

The total capital requirements of investment firms amounted to €161 million, compared with €357 million in 2003.

Financial companies

Credit risk. – On 31 December 2004 the gross loans of financial companies entered in the special register, excluding securitization vehicles, amounted to €111.5 billion; with reference to a constant sample they increased by 1.4 per cent.

Although total lending (including bad debts) grew moderately, leasing activity picked up and there was a further expansion in consumer credit.

There was a slight improvement in the quality of credit disbursed by financial companies. The ratio of new positions classified as bad debts to total outstanding loans at the end of 2003 declined from 1.8 to 1.3 per cent in the leasing segment and from 3.4 to 1.8 per cent in factoring; in consumer credit the ratio was stable at 1.8 per cent.

Profitability. – Financial companies made net profits of €1.1 billion, more than double the previous year's figure. The improvement was largely due to the increase in extraordinary profits for the year and to the decrease in loan-loss provisions.

Net interest income increased by 5.9 per cent, to €3.3 billion: securitizations contributed to a decrease in interest income that was more than offset by savings on the cost of funds.

Operating costs rose by 6.1 per cent, mainly in connection with the growth in staff costs. Almost half of financial firms outsourced all or part of their internal auditing and information systems.

SUPERVISORY ACTIVITY

Supervision of banks and banking groups

Evaluations of banks' situations and supervisory interventions. – The supervisory evaluations performed in 2004 were favourable for 309 banks, partially favourable for 313 and unfavourable for 89; the latter, fewer than in 2003, accounted for 9.2 per cent of the banking system's total assets. The evaluations were made with reference to the 2003 financial year and, in most cases, the information available as of the third quarter of 2004.

The overall improvement in evaluations reflects the improvement in banks' efficiency during the reference year and the strengthening of their organizational structures and capital bases.

The top 13 banking groups made further progress towards reaching the target capital ratios the Bank of Italy had recommended in 2001 (6 per cent of risk-weighted assets for tier 1 capital and 10 per cent for total capital). As of December 2004 nine groups satisfied the target ratio for core capital, compared with four in December 2000, and seven that for total capital, compared with none in December 2000. For the 13 groups as a whole, the average core capital ratio was 6.9 per cent and the average total capital ratio 10.9 per cent, compared with 5.4 and 8.7 per cent four years earlier.

As regards liquidity, a reduction was found in banks' holdings of marketable assets, especially in the last two financial years examined; this was mainly due to the low yields on debt securities.

The slight worsening in credit risk can be put down largely to the introduction of an analytical method that takes changes in credit quality into account more rapidly.

Supervisory interventions regarding the different technical profiles were carried out at 444 banks through action letters or meetings called with banks' corporate officers. A total of 435 of such meetings were held, 228 at the Head Office and 207 at the Bank's branches. The most frequent interventions concerned the format and content of financial reports and internal procedures for the management and control of market risks.

Although the number of banks displaying acute operational anomalies declined, supervisory action with respect to such banks remained substantial.

With regard to market risks, the calculation of the capital requirements was checked both for banks that have prepared internal models and for those that follow the standardized method.

For two of the largest Italian banking groups, whose internal models had been validated, last year saw the completion of the validation procedures permitting the application of their respective models to other group companies or other types of financial asset. The analyses for initial validation of two other banks' internal models continued during the year.

Concerning liquidity, meetings were held with leading banking groups to verify their risk measurement and control systems, their organizational models for centralized treasury management at group level, and the degree to which they used stress-testing in order to face possible liquidity strains.

In June 2004 the Bank of Italy published the results of a joint study conducted with Isvap, the supervisory authority for the insurance industry; the study showed that the extent of credit risk transfer between banks and insurance companies was limited in Italy.

The study covered credit derivatives and securitizations as well as traditional assignments of claims and credit guarantees issued by insurance companies to banks. It found that as of June 2003 Italian insurance companies held limited quantities of securities deriving from the securitization of bank credits; most of those held were part of low-risk senior tranches. Italian banks did not hold any such securities issued by Italian insurance companies.

Steps to apply the new capital adequacy rules. – With regard to credit risk, for the purposes of prudential evaluations the Bank of Italy urged banks to align themselves in a timely manner with the international standards concerning the classification of past due and overdrawn positions among doubtful debts (defaults).

The rules on credit risk lay down that positions that are past due or overdrawn continuously for more than 90 days are to be included among defaulted loans; for firms classified as corporate borrowers, the time limit is extended to 180 days for a period of five years from the entry into force of the rules.

The amount of the exposures that can be classified among defaulted loans is substantial in Italy, owing to the length of time it takes to settle commercial transactions and banks' practice of allowing prolonged use of overdraft facilities beyond the agreed limit.

The two sample surveys performed in 2004 showed that some past due and overdrawn positions were truly at risk, while others were destined to be regularized within the subsequent months; accordingly, if banks' practices do not change so as to avoid persistent late payments or overshoots in credit relationships, a significant share of exposures could be improperly classified as defaulted loans and attract higher capital requirements. Correct classification of past due and overdrawn positions is considered an especially important requisite for the utilization of internal ratings.

The Bank of Italy is closely monitoring the activity of the largest banks with a view to ensuring that the new rules are applied properly from the start. Banks whose projects are well advanced will be asked to calculate the capital requirements under the new methods as well (parallel calculation).

Analysis of the state of progress of the projects of 13 leading banking groups allowed a first set of groups to be identified for which supervisory validation will begin by the end of 2005. The groups in question account for around 58 per cent of the banking system's total assets.

Validation is directed towards verifying the operational, organizational and methodological developments of the intermediary's risk management and control system over time; it will initially cover a significant portion of each group's credit risk and will be extended progressively to other portfolios and other group companies.

Compliance with qualitative and quantitative criteria designed to ensure the effective integration of the systems in the organization of the business will be verified and the reliability of the estimates of the risk parameters checked. More in detail, the evaluation will cover the organizational arrangements and the processes for managing exposures, the methods used to estimate the parameters for calculating capital requirements, and the characteristics and structure of the archives and databases supporting the models and procedures for calculating the requirements.

Validation will be based on: the documentation submitted by banks concerning the functional and statistical features of their rating models; meetings with the heads of the corporate functions involved in the project; and direct examination of the state of progress of the project and the organizational processes.

Under the new rules banks may calculate the capital requirements for operational risk using different methods: the basic indicator, the standardized method and advanced models.

To ascertain Italian banks' orientations on the choice of method and the state of progress of the projects under way, last year further meetings were held with the leading banking groups and a survey was performed of the 10 banks and 21 banking groups that participate in the collection of structured data on operational losses organized by the DIPO consortium established at the Italian Bankers' Association (ABI). In addition, a contact group on operational risks was set up together with ABI and the leading groups.

Following the issue in July 2004 of the new legislation on banks' business continuity, the Bank of Italy conducted two surveys to check the preparedness of the banking system (September 2004) and large banking groups (March 2005). Significant progress was found in September 2004 with respect to the results of the system-wide survey carried out in 2002: only a small minority of banks, with 10 per cent of the system's total assets, did not yet have a disaster recovery plan for information systems, many of them because their contracts with IT providers did not contemplate this service.

The application of the new international accounting standards will inevitably have a major impact on the way the assets and liabilities, profits and losses and financial position of banks and banking groups are reported.

The changeover from the existing standards to IAS/IFRS is governed by a specific international standard (IFRS 1: First-time adoption of International Financial Reporting Standards), which makes it obligatory to present not only the annual accounts for 2005 but also those for 2004, both of them drawn up using the IAS/IFRS in force at 31 December 2005. The valuation differences arising from the application of these standards to assets and liabilities existing at 1 January 2005 are to be included directly in shareholders' equity.

During 2004 two simulations were performed of the impact of the new accounting standards on the accounts of the main Italian banking groups (at 31 December 2003 and 30 June 2004 respectively). The results were analyzed and discussed with the groups concerned.

The simulations showed a generalized increase in write-downs of bad and doubtful debts, due to the discounting of expected cash flows on the basis of the transactions' original effective rates, in addition to latent capital gains on buildings and, in some cases, shareholdings. The finance area (securities, derivatives and foreign exchange), which is largely marked to market and subject to high turnover, showed values basically in line with those conforming with IAS/IFRS. For performing loans and for fund-raising, banks still have to decide their accounting policies as regards the fair-value option, pending the issue by the International Accounting Standards Board of the final version of the relevant standard.

The impact of IAS/IFRS on the calculation of supervisory capital and capital ratios was the subject of recommendations on the part of both the Basel Committee and the Committee of European Banking Supervisors. These indicated the need to apply some adjustments (prudential filters) in order to safeguard the quality of supervisory capital and reduce its potential variability following the application of the new standards.

Supervision of asset management companies and investment firms

Analysis of intermediaries' situations. – There was a slight improvement with respect to 2003 in the supervisory evaluations of investment firms and asset management companies. The increase in favourable overall evaluations was primarily a consequence of the moderate recovery of profitability, after several years of modest results due in part to the prolonged uncertainty prevailing in the securities markets. The 84 intermediaries awarded a favourable evaluation accounted for 51 per cent of investment firms' total gross revenues and 66 per cent of asset management companies' total assets under management.

Compared with 2003, the number of intermediaries found to have anomalous situations fell from 41 to 37 (27 investment firms and 10 asset management companies); they accounted for a small share of investment firms' gross revenues (18.5 per cent) and a fraction of asset management companies' total assets under management (0.12 per cent).

Supervisory interventions. – In 2004 the Bank of Italy's Head Office and branches sent 172 action letters and held 128 meetings with corporate officers. These 300 interventions, up from 241 in 2003, concerned 178 intermediaries (97 asset management companies and 81 investment firms), or about 64 per cent of such intermediaries. The plan of supervisory interventions, which are programmed annually, takes account of periodic meetings with Consob.

In the case of investment firms, many of the interventions – 48 letters and 36 meetings – focused on the efficacy of the firms' control bodies; where a firm's level of business activity was not likely to allow it to remain in the market, encouragement was given to the entry of new shareholders capable of developing its operations by expanding its customer base or contributing specialized skills.

Asset management companies, in turn, were frequently called on to adopt operational procedures that would constantly ensure effective and efficient management and autonomous investment decisions.

The survey on the risk management function. – To gain a better understanding of the procedures with which investment firms and asset management companies control financial and operational risks, in 2004 a survey was conducted of the risk management function at supervised intermediaries, excluding asset management companies specialized in closed-end and hedge funds.

The survey found a multiplicity of organizational solutions for the control of these risks. The largest intermediaries and investment firms that trade for own account have autonomous organizational units endowed with specific skills and specialized resources. Within banking groups the function is commonly decentralized at securities intermediaries, particularly asset management companies, taking account of the autonomy of the management process and the specific nature of the skills and instruments employed. Delays in defining the function were found at smaller intermediaries and at investment firms that engage in door-to-door selling through financial salesmen. On the whole, the involvement of the board of directors in setting up the risk management system was limited.

Supervision of financial companies

Analysis of companies' situations. – In 2004 the financial companies that received favourable evaluations increased both in number (from 28 to 30) and in terms of their share of total assets (from 10.3 to 11.6 per cent). Those whose situations showed anomalies decreased in number from 36 to 30, while their share of total assets fell from 13.4 to 9.8 per cent, thanks to the improvement in the technical situation of some intermediaries belonging to industrial groups.

Further progress was made during the year in establishing methods of analysis for the various categories of intermediaries. In cooperation with the Bank of Italy's branches, investigations were carried out into risk management control mechanisms and the treatment of anomalous positions.

As regards securitizations, monitoring of servicers continued while a procedure was established for the control of special purpose vehicles based on the analysis of their financial statements, supervisory reports and the transparency of the information disclosed to the market.

Supervisory interventions. – A total of 186 supervisory interventions were carried out in 2004, compared with 149 in 2003. The majority of interventions (121) consisted in meetings with corporate officers. A total of 65 action letters were sent (up from 58 in 2003), most of which concerned the quality of loan portfolios and internal control mechanisms.

As regards public-sector intermediaries, meetings were held with representatives of the owners with the aim of arriving at a clearer definition of the companies' strategies.

There were further interventions concerning the outsourcing of the internal audit function; some intermediaries were invited to provide more information in their financial reports and to improve the quality of their supervisory returns.

The emergence of significant anomalies in technical situations and operational structures required the adoption of extraordinary measures in respect of 3 intermediaries specialized in providing guarantees.

Inspections

On-site activity. – The Bank of Italy initiated 209 inspections in 2004 (compared with 217 in 2003), with those performed by Bank of Italy branches increasing from 137 to 141. Inspections lasted 47 days on average, in line with the figure for the previous year.

Inspections, almost all comprehensive, were started at 180 banks accounting for 14 per cent of the banking system's total assets (22.3 per cent in 2003). In the three years 2002-04 inspections were initiated at 541 banks accounting for more than half the banking system's total assets (52.3 per cent). This compares with 518 banks in the three years 1999-2001, when the proportion of assets involved was much the same.

Most of the results of the inspections concluded were either favourable or partially favourable (42 and 45 per cent respectively). The unfavourable assessments concerned 22 small banks that accounted for 0.25 per cent of the banking system's total assets; in 2003 they had concerned 27 small banks.

As in the last few years, inspections were of two main types: comprehensive for banks with traditional organizational and operational structures in order to arrive at an overall assessment of the business, and restricted to specific sectors of activity or individual subsidiaries in the case of banking groups.

The results of the inspections carried out at large groups showed that the implementation of the programmes aimed at their reorganization and strategic repositioning in the market is at an advanced stage and has permitted a generally satisfactory level of protection against credit and market risks.

In the case of investment services, it was found that increasing attention was being paid to reputational risks.

In general the inspections carried out at smaller banks other than mutual banks found situations that were satisfactory.

As for mutual banks, which are normally inspected once every three years, growth in business in certain segments of the market, such as larger customers and the property sector (mortgage loans and the financing of building works), was sometimes found to have led to increased concentration of exposures by customer and sector.

The inspections carried out pursuant to the Consolidated Law on Finance numbered 14 (as in 2003) and concerned 9 investment firms and 5 asset management companies. A total of 15 inspections were carried out at financial companies (compared with 19 in 2003); eight of these were carried out by branches of the Bank of Italy. In addition, three inspections were ordered to check on the performance of depositary bank functions.

Crisis and other special procedures

Special administration and compulsory administrative liquidation of banks. – Two special administration procedures were initiated in 2004 at mutual banks as a consequence of operational irregularities in their credit intermediation business and large losses.

Six special administration procedures were concluded during the year. In one case the bank was placed in compulsory administrative liquidation, in three cases the bank was taken over by another mutual bank and in two cases the bank was returned to normal administration.

As just mentioned, last year saw one bank placed in compulsory administrative liquidation. At 31 December 2004 there were 23 such procedures under way.

The compulsory administrative liquidation of Sicilcassa continued with the recovery of claims, as in the past primarily through out-of-court settlements that permitted faster results than legal proceedings. Recourse was also made to amicable procedures to settle claims on the liabilities side.

At 31 December 2004 the liquidation had recovered a total of around €452 million, of which €41 million in 2004, compared with total net assets of €1,196 million at 6 September 1997, when the liquidation procedure was initiated.

Other special procedures. – The collection company SGA continued to recover the impaired assets it had acquired from Banco di Napoli and Isveimer. SGA's annual accounts for 2004 closed with a net profit of approximately €12 million.

At the end of 2004 a total of €3,708 million had been recovered in respect of the claims acquired from Banco di Napoli. At the same date the residual net claims on customers amounted to approximately €1,375 million, the sum due by SGA to Banco di Napoli to €805 million, and the residual net claims on customers acquired from Isveimer to approximately €151 million.

The bodies responsible for the voluntary liquidation of Isveimer, initiated in April 1996, continued to realize assets and extinguish liabilities.

At the end of the year Isveimer had approximately €193 million of residual assets, consisting mainly of the financing provided to SGA, deposits with banks and claims on the tax authorities. The residual liabilities amounted to €115 million and included €109 million of provisions for liabilities and charges.

Special administration and compulsory administrative liquidation of investment firms. - One special administration procedure was initiated in 2004 for serious irregularities and violations of the law in the provision of investment services.

At the end of the year eleven compulsory administrative liquidation procedures involving investment firms were under way; the statement of liabilities had been drawn up for all these procedures and in eight cases partial allotments and restitutions had been made.

The protection of transparency in banking and financial transactions

Action was intensified to verify compliance with the legislation on transparency, as amended by the provisions that came into force on

1 October 2003. The Bank of Italy's branches ran checks at 844 branches of 158 banks in 2004, compared with 683 branches of 134 banks in 2003.

A total of 16 sanction procedures were opened for serious violations of the rules concerning disclosure (3 in 2003). As for less serious offences, 62 banks (44 in 2003) were invited to take steps to remove their causes and to comply more scrupulously with the rules.

Sanctions were also imposed on 25 banks for failing to comply with the rules on the information to be provided to customers by changing the economic conditions of accounts with retroactive effect and unilaterally changing the frequency of notices. The banks in question subsequently regularized their customer relationships.

Since the start of this year around 450 transparency checks have been carried out at branches of 120 banks.

The transparency controls performed as part of ordinary on-site inspections in 2004 found irregularities at 54 mainly small banks and 4 financial companies entered in the special register (respectively 35 and 3 in 2003). Sanction procedures were initiated in 13 cases (8 in 2003).

Access to the securities markets

The checks made on access to the securities market pursuant to Article 129 of the Consolidated Law on Banking and the related implementing provisions focused on the structural features of newly-issued financial instruments offered in Italy. Supervisory action sought to foster the orderly development of financial innovation, in conformity with the objective of ensuring the stability and efficiency of the market for debt securities.

Notices of around 1,600 issues and offerings of securities in Italy were examined in 2004, compared with 1,700 in 2003. In 110 cases (58 in 2003) the transactions notified did not take place; this was mostly because the proposed indexation mechanism was excessively complex or not easily comparable with those of other financial instruments in issue; a few transactions did not comply fully with the applicable rules.

In the case of securities issued by Italian and foreign banks, prior examination of the transaction was supplemented by scrutiny of the information sheet prepared pursuant to the rules on transparency of the contractual terms and conditions of banking transactions and services.

The supervisory authority focused on how the economic function of the securities was presented, whether there was a clear indication of the return obtainable in adverse circumstances and whether the commissions implicitly paid by subscribers were specified.

The bonds issued by Italian banks on the domestic market amounted to €113 billion, an increase of 2.8 per cent. Issues of securities by non-banks rose from €3.2 billion to €5.6 billion, primarily as a consequence of the bond issues made by some large industrial companies.

Banks' bond issues consisted mainly of securities with a simple financial structure (either a fixed rate or a rate indexed to money-market parameters). After rising for several years issues of structured bonds, which combine the guaranteed redemption of the principal amount at maturity with yields related to the performance of markets, declined from 25 to 12 per cent of banks' total bond issues.

Prompted by the Bank of Italy, issuers continued to simplify the derivative components of their structured products; the payment of guaranteed minimum yields became more common.

In 2004 foreign securities amounting to €73.7 billion were placed in Italy, down from €89.3 billion in 2003. Of the securities placed, 46.3 per cent were issued by banks, while private and public-sector issuers of OECD countries and supranational organizations together accounted for 51.2 per cent; securities of emerging countries accounted for 2.5 per cent. Nearly all the foreign securities offered in Italy paid a fixed rate or coupons indexed to the most commonly used market parameters.

The Bank of Italy received 52 notifications of securitizations under Italian law. The value of the asset-backed securities issued rose slightly, from €28.3 billion to €29.1 billion. The securities, placed largely in international markets, were nearly all backed by performing assets. The securitized assets consisted almost entirely of public-sector claims, residential mortgage loans, leasing instalments and consumer credit.

Sanctions

The proposals submitted by the Bank of Italy to the Ministry for the Economy and Finance for the imposition of pecuniary administrative sanctions for irregularities discovered in the course of supervision declined from 84 to 63. They concerned 46 banks, 3 asset management companies, 5 investment firms, 7 financial companies entered in the special register, and one stockbroker. There was also one case of the unauthorized use of banking names.

Cooperation with the judicial authorities and other governmental bodies. The prevention of financial crime

Last year saw a substantial increase in the requests for cooperation made to the Bank of Italy by the judiciary and the investigative bodies responsible for preventing and repressing criminal activity in the financial sector.

The most important requests concerned alleged irregularities on the part of the banking system in the placement and trading of securities and in offering innovative financial products.

The Bank transmitted 23 reports to judicial authorities on suspected penal offences discovered in the course of supervisory controls. Four inspection reports were turned over to the Bureau of Antimafia Investigation under special cooperation agreements.

The Bank sent Consob 26 reports concerning irregularities in the performance of investment services by intermediaries or in the conduct of financial salesmen that had been found in the course of supervision.

As regards the drive to combat the financing of international terrorism, the Bank of Italy informed the Financial Security Committee of a number of elements that emerged during the performance of its supervision and took steps to make it easier for intermediaries to transfer resources that had been frozen to the Development Fund for Iraq.

The fight against unauthorized banking and financial activity used new instruments in addition to the traditional cooperation with the competent investigative bodies. A special section was inserted in the Bank's website with information on unauthorized operators identified in the course of its supervision.

COMPETITION POLICY IN THE BANKING SECTOR

The development of competition

Since the beginning of the 1990s conditions have been created in Italy favourable to an increase in competition in financial markets. Contributory factors include amendments to the law, which created the basis for the liberalization and privatization of the banking system, the growing integration of the markets, and the role of the Bank of Italy in promoting and safeguarding competition.

Competition helps to ensure the stability of intermediaries and of the system as a whole; it encourages banks to base their actions on principles of efficiency and to curb costs, develop new fields of business and improve credit selection procedures. The supervisory authorities seek to ensure that competitive pressures prompt credit institutions to strengthen their organizational structure and capital base in a context of sound and prudent management.

The increase in competition has stimulated a rapid process of consolidation and reorganization within the banking system. This has not led to the creation of dominant positions at local level and consequently has not diminished competition.

In the last ten years the average number of banks per province has risen from 30 to 35; in December 2004 there were around 31,000 branches of banks in Italy, over 7,500 more than ten years earlier. This is equivalent to some 5 branches per 10,000 inhabitants, which is in line with figures for the main euro-area countries. The Herfindahl-Hirschman index of concentration for the regional lending market on a consolidated basis has declined by around 20 per cent from its peak at the end of the 1990s; in provincial deposit markets, it has dropped by 12 per cent.

The average interest rate on bank loans in Italy is in line with the value prevailing in the euro area. At the end of 2004 the rates on new loans up to €1 million, which proxy those applied to small enterprises, stood at around 4.1 per cent in Italy and the euro area.

The safeguarding of competition

Since 1990 a total of around 750 concentrations have been examined and 56 investigations launched, a considerable number not only by international standards but also compared with other sectors of the national economy. The investigations looked into 23 concentrations, 28 agreements between intermediaries and 5 alleged abuses of a dominant position. Decisions took account of the opinion of the Antitrust Authority and were based on the principles laid down at the Community level; cooperation has been enhanced with the European Commission on cases having a European dimension.

The Bank of Italy performs its task of safeguarding competition in the banking sector with the aid of the supervision database and other information acquired in the performance of supervisory inspections. The Bank's branches play an increasingly important role, contributing their direct knowledge of local situations.

The investigations of agreements between intermediaries focused in particular on the standard format of contracts for customer transactions and services drawn up by trade associations.

Ad hoc enquiries were held into agreements concerning the dividing up of markets and information flows between intermediaries. In the cases in which a serious restriction of competition was found, the offenders were ordered to cease and desist and, where provided for by law, were further ordered to pay a fine.

About half the enquiries into agreements concerned the payment system; in the case of the most widely used services the object was to assess whether interchange fees were consistent with costs. In the interests of promoting efficiency and containing the prices charged to customers, in a number of cases it was ruled that these fees should be reduced.

Enquiry into banking and financial services. – In a competitive market it should be easy for customers with specific needs to break off relations with a bank. If intermediaries restrict customers' mobility by following particular operating procedures or by charging heavy fees, they create rents that keep the price of retail services high.

The enquiry into banking and financial services was opened in December 2004 and conducted in close cooperation with the Antitrust Authority. Its purpose is to verify whether there exist restrictions on competition in the form of impediments to customer mobility. For this task the Bank of Italy also relies on the contribution of its branch offices, with their specific knowledge of the local environment.

The enquiry is a follow-up to the survey of the economic and other contractual terms and conditions applied to closures of households' current accounts conducted between the end of 2003 and the beginning of 2004 through a questionnaire sent to banks.

The activity of safeguarding competition in 2004

Concentrations. – In 2004 a total of 27 concentrations were notified to the Bank of Italy under Law 287/1990; nine did not fall within the scope of the antitrust provisions. The concentrations that were examined involved fairly small banks and did not give rise to investigations.

Agreements between intermediaries. – Seven investigations were completed in 2004 and the beginning of 2005.

The Pagobancomat investigation. – The investigation was opened when the Bancomat Convention (CO.GE.BAN) presented a request for authorization, by way of derogation from the ban on agreements restricting competition, regarding the interchange fee for the Pagobancomat service.

On the basis of the methodology developed by the Bank of Italy during previous investigations and of a sample survey of the costs borne by the banks issuing Pagobancomat cards, CO.GE.BAN proposed an interchange fee of €0.20, plus 0.1039 per cent of the amount of the transaction. This figure was lower than the fee applied in 2003. At the end of the investigation the Bank of Italy authorized, for a period of five years, the revised Pagobancomat interchange fee agreed among CO.GE.BAN members (Decision no. 49 of 1 July 2004).

The investigation into the rules of operation for the Pagobancomat service. – This investigation looked first of all at the general contractual terms drawn up by CO.GE.BAN to regulate relations between banks and retailers and between banks and card-holders. In the course of the investigation, at the request of the Bank of Italy, CO.GE.BAN eliminated all the provisions potentially restricting competition.

Following a complaint submitted by several large retailers, the enquiry also examined a circular letter written by CO.GE.BAN in April 2003, regarding the rules governing the organization and operation of the Pagobancomat service. In particular, the circular letter asked all retailers to deal with only one bank, for reasons of security, so that retailers were unable to direct transactions made with Pagobancomat cards to the bank that had issued the card.

A thorough assessment was made of the system's security and reliability and of the reasons that had persuaded CO.GE.BAN to issue the circular letter. It emerged that, in its present form, the Pagobancomat system, designed to minimize the risk of fraud, had been modified as regards the aspects managed by retailers, making it less secure. However, no evidence was found indicating that the multi-bank system increased the risk of fraud or misuse of the cards.

The Bank of Italy issued an order for CO.GE.BAN to withdraw its circular letter of April 2003 on the grounds that it was the expression of an agreement between intermediaries under Law 287/1990, and to set up a new system based on multi-bank principles within six months (Decision 54 of 30 March 2005).

The CartaSì-American Express investigation. – This investigation looked into an agreement between CartaSì S.p.A. and American Express Services Europe Ltd. to set up a joint venture, under the name Iconcard, for the production and distribution of credit cards directed at high-income individuals and small and medium-sized enterprises. The enquiry was later extended to two further agreements covering arrangements with retailers for acceptance of American Express credit cards and the processing and accounting of transactions data.

As a result of the Bank of Italy's investigation, CartaSì S.p.A. and American Express Services Europe Ltd. amended the Iconcard agreement to remove any elements that might be detrimental to competition.

At the close of the investigation, authorization for the Iconcard joint venture was granted until the end of 2007 by way of derogation from the ban on agreements restricting competition. By contrast, authorization was denied for the arrangements with retailers, while the agreement relating to data processing was deemed not to restrict competition (Decision 52 of 30 July 2004).

The investigations concerning Federazione piemontese delle banche di credito cooperativo/Banca di Credito Cooperativo di Boves and Federazione marchigiana delle banche di credito cooperativo/Banca di Credito Cooperativo di Ostra Vetere. – These two investigations were ordered as a result of circumstances that came to light in the course of supervisory inspections. Their purpose was to examine the actions of the federations of mutual banks of the Piedmont and Marche regions and associated credit institutions to ascertain whether the objective was to divide up the markets.

Analysis of the level of competition in the markets concerned and of existing geographical overlapping between the mutual banks showed that the actions investigated had not in fact significantly restricted competition.

The investigation concerning ABI: general terms and conditions of contract for the use of credit cards and for investment services. – The investigation was opened after ABI had submitted standardized contracts for the use of credit cards and the provision of investment services agreed with a number of consumer associations. Following the Bank of Italy's recommendations, ABI made some amendments to the model contracts under investigation, as a result of which they were no longer deemed to restrict competition.

The investigation concerning ABI: general terms and conditions of contract for third-party guarantees for bank transactions. – The investigation was opened after ABI had submitted a standardized contract covering third-party guarantees for bank transactions, called the "omnibus" guarantee, agreed with various consumer associations.

The contract regulates the surety's guarantee for any obligation, present or future, entered into by the debtor. The guarantee is for a predetermined maximum amount and can be collected by the bank upon a simple written request; the surety is obliged to pay the amount first, before raising the same defence against the bank as the debtor ("first request" clause). The investigation highlighted the importance of this clause, which enables households and small firms without a credit rating to obtain finance. This view is borne out by a comparison with the situation in other countries and by the rules on banks' capital requirement established by the Basel Committee. According to these rules, the "first request" clause is essential for the recognition of personal guarantees as a means of mitigating risk. The investigation also found that the clause was necessary for guarantees to fulfil their economic function and therefore not detrimental to competition. Regarding the other clauses, the Bank of Italy ordered their removal from the model contract drawn up by ABI (Decision 55 of 2 May 2005).

MARKET SUPERVISION

This section of the Report gives an account of the Bank of Italy's supervisory activities pursuant to Part III of the Consolidated Law on Finance.

In 2004 international trading, settlement and guarantee systems for financial instruments continued to grow stronger and improve their efficiency, including through increased use of new technologies. Progress was made with projects to integrate technological platforms and harmonize operating rules.

The mergers taking place among companies operating market structures are directed at achieving economies of scale and scope, although problems of competition may arise. Their goal must always be the pursuit of the overall efficiency of markets and services by ensuring that users enjoy fair conditions of access and satisfactory levels of service and by adopting transparent and balanced forms of corporate governance.

Increasingly, competition between the companies managing trading services focuses on the provision of services to institutional investors. International information providers are increasingly interested in acquiring electronic platforms that will enable their customers to participate directly in trading.

The possibilities opened up by technological progress and product standardization are creating favourable conditions for the introduction of electronic trading in over-the-counter derivatives as well. Intermediaries are making greater recourse to central counterparties, which offer the advantages of anonymity in trading, more efficient management of default risk and the benefits of multilateral clearing.

In Italy the range of trading and post-trading services was further enlarged and the operational and technological infrastructure was strengthened. Progress in these areas is particularly important with a view to future participation in the integration of European markets.

The Express II settlement system became fully operational, taking over from the Bank of Italy's securities settlement service. The central counterparty service provided by Cassa di Compensazione e Garanzia S.p.A. was fully extended to the cash markets.

The company managing the screen-based secondary market in government securities conducted an exercise to assess its future prospects, with the assistance of a specialized consultant. The findings indicated a need to form strategic alliances, partly in consideration of the mergers under way among the companies managing trading services. The new platform for the interbank deposit market (e-MID) offered more flexible methods of trading and facilitated the introduction of new products.

International cooperation

The international dimension of intermediaries' and investors' activities and the increasingly widespread use of electronic platforms for multilateral access to services highlight the need for the authorities of the countries concerned to work together to improve market efficiency and stability by harmonizing regulations and rules of conduct.

Cooperation mainly takes the form of establishing principles and issuing standards and recommendations. Recourse is made on a wide scale to rules accepted by the financial community and to recognition of best practices adopted by intermediaries.

The "Recommendations for Central Counterparties" were approved and published by the G10 central bank governors and by the International Organization of Securities Commissions in November last year. Their purpose is to ensure not only that central counterparties exercise tight control over the risks they take on but also that the performance of their functions and the operation of the markets are informed by principles of efficiency and transparency.

The G10 central bank governors also published a report on "Central Bank Oversight of Payment and Settlement Systems", laying down some of the general principles governing the supervision of payment and settlement systems and setting out guidelines for cooperation between authorities.

Since the terrorist attacks of 11 September 2001 the supervisory authorities of the leading countries have periodically conducted a careful review of the procedures set up by the companies responsible for managing vital functions of the financial system to ensure business continuity in emergencies, including major disasters.

As part of the Financial Sector Assessment Programme, in 2004 the IMF began to evaluate whether the regulation, oversight, organization and operation of Italy's financial markets and related services comply with international standards. The final report is expected to be ready early in 2006.

European legislation

In Europe, work continued on the creation of a legal framework for the single market for financial services, which in May 2004 had to incorporate the new member states of the European Union. At the beginning of 2005, 39 of the 42 measures envisaged in the Financial Services Action Plan had been implemented.

Consultation was conducted on a document examining the results achieved in the first four years by the simplification of the Community legislative process (the so-called Lamfalussy Procedure).

According to the Commission, the preparation of European legislation concerning securities markets appears to be more transparent; cooperation among the institutions involved has been strengthened; and the production of rules speeded up and their quality improved.

Following the adoption of Directive 2004/39/EC on markets in financial instruments, work to ensure its implementation proceeded at Community level.

In October 2004 the ECB Governing Council and the CESR approved the "ESCB – CESR Standards for Securities Clearing and Settlement in the European Union". These standards represent the European version of the "Recommendations for Securities Settlement Systems" published by the Committee on Payment and Settlement Systems of the Bank for International Settlements and by the International Organization of Securities Commissions.

At the end of July public consultation on the European Commission communication on clearing and settlement ended. The prevailing opinion favoured a directive defining a common regulatory and supervisory framework.

Italian legislation

In October 2004 the Bank of Italy issued guidelines for ensuring the business continuity of market infrastructure (trading and post-trding); as of 2007 the companies managing the main trading, settlement and guarantee services will be obliged to abide by them. The guidelines are part of a set of measures adopted by the Bank of Italy, in agreement with Consob, to reinforce the security of Italy's financial system.

Two regulations were issued by the Governor of the Bank of Italy pursuant to Legislative Decree 210/2001 transposing Directive 98/26/EC (the Settlement Finality Directive).

The regulation of 9 June 2004 governs the keeping of the lists at the Bank of Italy of the participants in Italian and foreign designated systems. The regulation of 18 June 2004 revoked the designation of the securities settlement system, replaced by Express II; in addition, it designated the securities transfer system detached from the transfer of cash (known as free-of payments), managed by Monte Titoli as part of its central securities depository services.

In March 2005 the Bank of Italy granted Consob approval for amendments to Consob Regulation 11768/1998 on markets concerning the centralized management of securities, including the exercise of the right to attend shareholders' meetings and the abolition of the register of liens.

Banking foundations were authorized to participate in BondVision following an amendment to the market authorization decree.

The wholesale market in government securities

The cash market. – The drop in the volume of trading did not affect either the liquidity or the efficiency of the MTS cash market, which recorded a further small decrease in the bid-ask spread. Although there was a decline in the number of market participants, competition remained lively; the number of listed instruments grew, as did that of intermediaries using the central counterparty service; turnover on the grey market expanded further.

The decline in inter-dealer trading in government securities was for the most part due to the low volatility of prices; earnings from market-making diminished again. Market participants, mainly among the smaller ones, continued to switch to markets managed by large international intermediaries and to those directed at institutional investors, which have lower membership costs and are increasingly transparent and liquid.

The average bid-ask spread fell from 3.7 to 3.5 basis points. The intraday distribution of the bid-ask spread and of volumes traded confirms that the MTS cash market is highly liquid throughout the trading day; there is a brief slackening between 2.30 p.m. and 4 p.m. when data and reports on the US economy are published.

The reduction in the number of MTS participants is part of a trend that is common to other European inter-dealer platforms.

In 2004 the number fell from 141 to 130 (including 90 Italian members) while that of primary dealers fell from 33 to 31. The figure of primary dealer in BOTs was introduced and attracted 6 Italian banks. This change is intended to provide greater flexibility, increase the liquidity of less frequently traded securities and mark a shift towards specialization by type of security.

The top five primary dealers (three of which are Italian) handled 30 per cent of turnover (compared with 39 per cent in 2003) and the top ten 51 per cent (as against 63 per cent). The distribution by type of security also indicates a greater dispersion of trading: the top 5 securities accounted for 15 per cent of trading (22 per cent in 2003) and the top 10 for 26 per cent (35 per cent in 2003).

Specialists in government securities continued to make a major contribution to the efficiency of the secondary market in terms of bid-ask spreads, trading volumes and number of securities quoted and traded. The Ministry for the Economy and Finance amended the criteria for their assessment, giving greater importance to qualitative aspects of their conduct.

Turnover on the grey market recorded a further increase. The difference between market prices and issue prices was often negative, largely owing to the fierce competition between specialists in relation to the assessment by the Ministry for the Economy and Finance of their conduct in auctions.

The share of trades on MTS settled through the central counterparty service declined from 11 to 9 per cent following the withdrawal of two important foreign intermediaries, which was only offset in part in volume terms by new entries (of which 4 were Italian).

The repo market. – The increase in turnover on the MTS repo market was in line with the overall growth that occurred on a European scale. There was a strengthening of the correlation between the Eurepo rate and that of the general collateral contract on Italian government securities; the rates on special repo contracts were effective in signaling the liquidity conditions of individual securities on the secondary market.

The increase in turnover reflected the transfer to the electronic platform of part of the business previously conducted over the phone and banks' greater efforts to reduce their exposure to credit risk. Another contributory factor was the extension of the trading hours for contracts for same-day settlement following the entry into full operation of the new Express II settlement system. Business continues to be concentrated on the shorter maturities with an intraday distribution of trades that is now firmly established.

In 2004 the close for trading of the overnight maturity was progressively extended from 9.15 a.m. to 4 p.m. Trading increased substantially and the average daily turnover was more than €1,000 million, compared with €45 million in 2003. In the first quarter of 2005 it doubled again to more than €2,300 million. The turnover on this maturity accounted for 2 per cent of the total, whereas spot-next and tom-next accounted for respectively 76 and 20 per cent, compared with 75 and 23 per cent in 2003.

The differentials between e-MID rates and the corresponding MTS repo rates, which reflect the utility and cost of the guarantee in securities, widen significantly with the duration of the contract.

The special repo rate, which was sometimes negative, was effective in signaling tensions in the secondary market. In most cases these were caused by a shortage of securities with particular characteristics and the low propensity of institutional investors to engage in securities lending.

BondVision. – In its third year this regulated competitive auction market linking banks, asset managers and insurance companies via the Internet recorded substantial growth, with an increase in trading in euro-area benchmark government securities. The transparency and cheapness of interconnection are the main factors underlying the take-up of this platform by intermediaries.

Average daily turnover more than doubled compared with 2003, rising from €680 million to €1,300 million.

At the end of 2004 participants numbered 198 (159 in 2003); those with remote access to the market, mainly institutional investors, rose in number from 111 to 145 and market makers from 29 to 32. The top five participants accounted for 19 per cent of turnover and the top ten for 35 per cent.

EuroMTS and other national MTSs. – The creation of new segments for the trading of inflation-linked instruments and short-term European government securities did not prevent a sharp contraction in total EuroMTS turnover. The government securities of the smaller countries did not achieve significant levels of liquidity. Turnover also fell considerably on the other markets operated by the MTS group.

Average daily turnover on EuroMTS was equal to €1,445 million, compared with €2,400 in 2003. The share of Italian securities rose from 17 to 26 per cent of the total, while that of the securities of the main European countries (Italy, Greece, France and Spain) rose from 54 to 57 per cent. Turnover in securities issued by the other countries remained basically unchanged, despite the addition to the list during the year of the securities of the Czech Republic, Denmark, Hungary, Lithuania, Slovakia and Sweden.

The over-the-counter market. – Analysis of the OTC trading of a sample of intermediaries in 2004 confirmed that the bulk of secondary-market trading in Italian government securities continued to be carried out on MTS, since price formation benefits from the greater transparency and efficiency of the regulated market.

The survey was conducted on a sample of 14 intermediaries (7 of which resident in Italy) accounting for more than 50 per cent of trading on MTS. Considering the total volume of trading in Italian government securities, the OTC market accounted for 37 per cent of cash transactions and MTS for the remaining 63 per cent.

***The interbank deposit market* (e-MID)**

The liquidity of the market gained from a substantial increase in trading volumes and the addition of some large foreign intermediaries. Bid-ask spreads remained very narrow, in both absolute terms and in relation to those of the OTC segment.

The 16 per cent growth in turnover was almost entirely attributable to the overnight maturity, in line with the trend discernible in the euro-area money market. The increase benefited from the entry into full operation of the new Express II settlement system and the changes made to the arrangements for implementing monetary policy.

Average daily turnover rose to €20,500 million, compared with €17,800 million in 2003; overnight deposits accounted for 90 per cent of the total. In the first quarter of 2005 the daily figure rose to €22,300 million. Average daily turnover in dollar funds rose to $1,570 million, compared with $1,400 million in 2003.

The increase in the number of participants in e-MID consisted of foreign intermediaries that access the market remotely. This led to further growth in the large-deal segment, where the minimum trading lot is €100 million. The degree of concentration of trading volume remained relatively low and basically in line with that of the euro-area money market.

Moments of tension – marked by a sharp fall in turnover and a widening of the bid-ask spread – occurred on the closing days of the reserve maintenance periods, especially in the first few months following the introduction of the new arrangements for implementing monetary policy. In the second part of the year, more frequent recourse to fine-tuning operations and changes to the information on euro-area bank reserves provided to the market by the Eurosystem made it possible to limit the intraday volatility of the overnight interest rate, especially in the last few days of the reserve maintenance periods.

Supervision of trading systems

As part of the supervision of trading systems, the Bank of Italy examined the documents submitted by market operating companies in accordance with its Supervisory Instructions and verified compliance with those of most importance for the orderly functioning of the markets. Meetings were also held with the corporate officers of these companies.

On 2 August a leading foreign intermediary engaged in anomalous trading on the market for euro-area government securities. In a very short period it sold a very large quantity and then made a partial repurchase using the national circuits managed by the MTS group, notably on the Italian MTS platform, the Spanish Sedaf platform and the Greek HDAT platform.

The transactions, which were unusual for their size and short time span, were part of a strategy aimed at taking advantage of the greater liquidity and depth of the markets of the MTS group compared with those for Bund futures and Bobl futures (Eurex).

Investigations are still under way not only by MTS but also by Italian and European judicial and regulatory authorities.

Central securities depositories

Monte Titoli's business expanded substantially and it maintained its position as the third largest securities depository in Europe. At the end of 2004 Monte Titoli held securities with a market value of €2,215 billion, up by 8.4 per cent on the end of 2003. The corresponding figure for Euroclear was €13,100 billion and for Clearstream International €7,600 billion, up by respectively 10.2 and 3.5 per cent.

The number of intermediaries signed up with the Italian central securities depository continued to decline, falling from 473 at the end of 2003 to 421 at the end of 2004. More specifically, banks decreased from 253 to 223, Italian investment firms from 30 to 23, stockbrokers from 5 to 3 and foreign intermediaries from 11 to 5. By contrast, the number of issuers using the system rose from 1,396 to 1,546.

The range of services supplied by Monte Titoli expanded further. In particular, last year saw the introduction of the Monte Titoli Internet Communication System, known as MT-X, which uses Internet technology for the exchange of messages concerning securities held by the central depository.

Settlement of securities transactions

During the year Monte Titoli completed the development of the Express II settlement system, which meets the financial markets' need for integration and provides advanced operating procedures in line with international standards.

The introduction of Express II marked the completion of the privatization of Italy's settlement systems. On 26 January 2004 net settlement was started for all securities and supplements the gross settlement system in operation since 2000. The architecture of the net system was established in cooperation with intermediaries, markets and infrastructure operators and its implementation monitored by the Express User Group, a consultation group set up at ABI.

The system is designed to minimize the number of transactions that are not settled for lack of securities or cash. In the overnight cycle settlement also draws on the flows of cash deriving from the redemption of government securities and payment of the related interest. Access to the intraday credit supplied by the Bank of Italy is achieved automatically by exploiting financial instruments that are already available to market participants (firm collateralization) or that they are in the process of acquiring (self-collateralization); the credit obtained is used to settle cash balances in the same cycle.

The efficiency of a settlement system depends on its ability to carry out, within the time foreseen, the bulk of the transactions in arrival. In 2004 Express II made orderly settlement possible even when volumes were particularly large or there was tension with respect to an individual security. Both the number and the value of fails were small; on average they wait less than two days before being settled.

The average daily value of transactions entered into the system was €170 billion; 98.9 per cent of the total value was settled on the due date. The overnight netting cycle accounted for 90.6 per cent of the volume of transactions handled; this percentage rose to 96.3 per cent by the end of the daytime cycle. The gross settlement system settled another 2.6 per cent by 4 p.m. In the last two quarters the proportion of transactions settled in the overnight cycle declined.

The number of intermediaries participating in the settlement system decreased, in line with the trend of the last few years. The degree of concentration remained high. In its supervisory activity the Bank carefully monitors the distribution of the volume of business, in order to reduce the risks associated with potential difficulties at the most active intermediaries.

The gross settlement system. – 2004 saw significant growth of the gross component of Express II. Unlike the earlier securities settlement system, in which fails were handled by participants on a bilateral basis, Express II transfers net settlement fails automatically to the gross settlement system, which consequently received a significant boost.

The average daily number of transactions settled rose from 466 in 2003 to 2,269 in 2004 and their value from €5 billion to €19 billion. The concentration of transactions per participant was higher than for the net settlement system and the proportion of transactions settled directly on the cash accounts of agent banks rose.

Clearing and guarantee systems

In line with the other main European clearing houses, Cassa di Compensazione e Garanzia S.p.A. recorded further growth in its business in 2004.

The average daily initial margins requested by the Italian central counterparty rose to more than €1,050 million (€974 million in 1993). The 8 per cent increase was the result of the extension of the service to MTS, the rise in the value of open positions, and the upward trend of prices in 2004.

The Cassa maintained a prudent approach, especially as regards margining requirements. The procedure for intraday margins was activated on 94 days (23 in 2003) in relation to the performance of the market and the opening of large individual positions.

With the extension of the central counterparty service to the cash equity market in 2003, the Cassa had introduced a default fund based on participants' contributions as an additional form of protection. If the margins of a defaulter are insufficient to cover the losses, the Cassa draws on the other participants' contributions to the default fund. With the introduction in 2004 of the central counterparty service on the cash and repo markets operated by MTS S.p.A., the Cassa set up a dedicated default fund. At the end of the year these default funds amounted to respectively €101.6 million and €6 million.

The agreement between the Cassa and LCH.Clearnet for the supply of central counterparty services on MTS provides for the exchange of an initial margin instead of participation in their respective default funds, so as to prevent each organization from being exposed to the risk of default of the participants of the other.

With the launch of Express II and the consequent possibility for the system to handle fails, the Cassa took steps to ensure the final settlement of transactions by introducing procedures for the mandatory execution of contracts that fail for lack of securities (buy-in) or cash (sell-out).

Supervisory action with respect to central securities depositories and clearing and guarantee systems

Supervision of the operating companies focused on compliance with the relevant rules and regulations and on the adequacy of their organizational arrangements, ICT infrastructures and risk-control mechanisms. As provided for by the Supervisory Instructions, among other things the Bank examined the reports the companies submitted in these fields.

Ten interventions were carried out to investigate and correct anomalous situations. In addition, seven meetings were held with corporate officers that allowed the Bank to obtain information on the companies' planning activities, organizational arrangements and risk limitation procedures.

Measures aimed at ensuring business continuity were an important part of the Bank's supervisory activity. The companies involved were asked to draw up a document indicating the steps to be taken to bring their business continuity plans into line with the guidelines issued in October 2004.

In agreement with Consob, the Bank also approved some amendments to the operating rules of the settlement services and the central counterparty guarantee system.

PAYMENT SYSTEM OVERSIGHT AND SERVICES

With a view to reliability and efficiency in payment systems, central banks acted last year to strengthen and integrate infrastructures. Increasing attention was paid to new technologies and to the needs of end-users (market players, the public administration and citizens). In Europe, this commitment extended to the completion of the single payments market, the integration of financial markets and the enlargement of the European Union.

The Bank for International Settlements (BIS) completed its general principles for payment system oversight, contained in the May 2005 report endorsed by the G10 Governors. The Report lays down ten general principles, five bearing on the organization of the oversight function at national level and five on procedures for international cooperation.

At the same time the Governors approved two other reports: a consultation document containing guidelines for the development of payment systems, to serve as reference for countries engaged in reform; and an analysis of the configuration that large-value payment systems have taken on in recent years, describing the new functions made available to banks and their impact on risk and cost profiles. A set of new interactive functions give banks more complete information on payments in real time and allow for more flexible management of incoming and outgoing flows of funds.

The complex revision of the institutional framework for oversight of SWIFT was completed in 2004, to strengthen controls on the operational risks of this systemically important network infrastructure. The review concerned the composition and structure of the oversight bodies designated by the various central banks, the definition and extension of their tasks and the criteria for access to and use of the required data.

Internationally, there is increasing attention to the efficiency of cross-border retail payments. The BIS, together with the World Bank, has begun a study on international remittances. The OECD's Financial Action Task Force has focused on the impact that measures to prevent money laundering and the financing of international terrorism may have on the efficiency of payment systems.

The ECB Governing Council made important decisions involving the TARGET2 project. It agreed to the proposal of the Banque de France, the Deutsche Bundesbank and the Bank of Italy for the creation and operation of the single shared platform (SSP) to offer in TARGET2. The possibilities for central management of intraday liquidity within the euro area were defined, as well as the forms of connection with the SSP by the various EU ancillary systems. The timetable for gradual migration of national financial marketplaces to TARGET2 was set.

ESCB action to hasten the integration of retail payment markets was stepped up. The creation of shared standards at European level and of substitutes for national infrastructures turned out to be more complicated than expected, in part because of resistance from national banking industries and the late involvement of end-users (firms, governmental bodies, consumers, retailers). The Eurosystem invited the European banking community to draft an appropriate schedule for creating the Single Euro Payments Area (SEPA). At the same time it proceeded with its inquiry into the requirements of final users and its monitoring of national migration to European standards and infrastructures. Here there is a growing role of national central banks, which must involve and guide domestic agents and users.

The initiatives taken by the ECB and the banking system were flanked by those of the European Commission, which moved for effective application of the principle of the single European market to retail payments by seeking to overcome the residual barriers and regulatory uncertainties. The plan for a directive setting out a new legal framework for retail payment services is crucial here.

In Italy, the key to oversight activity remains adaptation of payment instruments and infrastructures to the Single Euro Payments Area plans. In parallel, action to modernize the payment system in response to growing economic needs has been intensified, focusing on electronic invoicing for more efficient payment and collection, which depends on reinforced linkage between banks and firms.

To foster competition and a level playing field in retail payments, the Bank of Italy has decided to take part in the STEP2 system from January 2006, although only for the execution of cross-border payments. In keeping with the drive for greater efficiency through gradual opening to the market, the Bank has begun a review of its BI-COMP clearing system. Once the revision is completed, starting in 2006 the Bank itself will only calculate multilateral clearing balances, leaving funds transfer activities to the market.

The computerization of the public payment system and the integration of the state treasury with interbank services proceeded along the lines defined by the Bank of Italy as settlement agent of the Italian public sector. In particular, the classification codes for the receipts/payments of major public sector bodies (regional and local authorities, universities, etc.) were defined and data transmission by treasurers was tested.

Oversight activities

The legal framework. – The European Commission proceeded with the drafting of a proposal for a directive on the provision of retail payment services. The aim is to overcome the remaining segmentation of the European payment market and thereby support the efforts of Eurosystem banks to create the Single Euro Payments Area.

A check is under way on the application of EC Regulation 2560/2001, which mandates equal conditions for domestic and cross-border payments within the EU. As to credit transfers, following on questions raised by the Italian Bankers' Association (ABI) the Bank of Italy's Payment System Oversight Office asked the Commission to clarify the correct notion of "correspondent payments" given various pricing options (OUR, SHARE, BEN). The Commission's answer was transmitted to the banking system via ABI.

Domestically, implementation began on the provisions issued by the Bank of Italy on 24 February 2004 concerning payment system oversight under Article 146 of the Consolidated Law on Banking. Article 6 of the provisions requires banks to notify the Oversight Office promptly of initiatives relevant to the orderly operation of the national payment system, especially activities promoted by banking associations or representative organizations. Instructions are being drafted to specify the rules of conduct for participants in the various areas of interest to the oversight function (systems, infrastructures, instruments). A significant first step in this work has been the release of guidelines for business continuity for the main national infrastructures.

A Regulation issued on 16 March 2005 modifies the Bank of Italy Regulation of 29 January 2002 governing the interbank database on irregular cheques and payment cards. The new version mandates express procedures for reporting and for consulting the database by the local offices of central government and the courts. It also lays down rules for the suspension (temporary deletion) of a report from the database under an order from the courts or the privacy authority.

Cooperation with the various Italian authorities involved in the payment sector continued. The main developments were: *i)* cooperation with the Ministry for the Economy and Finance to define the regulatory framework for a database to prevent payment card fraud; *ii)* work in cooperation with the Banking and Financial Supervision Department on the transposition of Directive 2002/65/EC on distance selling of financial services, with special regard to payments; *iii)* collaboration with the National Centre for the Computerization of the Public Administration, in the role assigned to the Bank by Presidential Decree 137 of 7 April 2003 in setting the rules for electronic funds transfers between private parties, between government bodies, and between the latter and the former; *iv)* assistance to the Equal Opportunity Ministry, in cooperation with the Banking and Financial Supervision Department, in drafting a law against child pornography, and specifically concerning prevention of the use of payment cards to purchase such illegal pornographic material.

Traditional payment instruments. – The number of transactions settled using non-cash bank and postal instruments increased by 6.1 per cent in 2004. The use of all instruments except cheques increased, most notably POS transactions using debit and credit cards. The number of non-cash transactions per capita thus rose from 56.1 to 59.5. Reversing recent trends, the number and the value of ATM cash withdrawals both fell marginally.

Among bank instruments, which account for the bulk of total payments, there was a decline of 4.4 per cent in the number of cheques and banker's drafts and increases of 6.3 and 9.4 per cent in credit transfers and direct debits. Debit cards remained the most common instrument, accounting for some 610 million POS transactions and posting an annual increase of 7.2 per cent. The number of debit cards rose by a million to about 26 million.

While the number of credit cards in use remained roughly unchanged at 12 million, the number of transactions increased by 15.9 per cent to 430 million. The increase was due to an expansion of consumer credit business at some large banks and purchases of goods and services on-line.

Poste Italiane S.p.A. further strengthened its presence in the payment services industry, increasing the number of postal current accounts by 600,000 while those of the banking system decreased by 400,000.

As in the previous years, the Bank of Italy conducted surveys of banks concerning the use of some payment instruments (cheques and credit transfers) and the charges levied on end-users (Table 70). The survey found improvements in transparency and a reduction in handling time.

ABI's "PattiChiari" project set 8 working days (reduced to 7 in October 2004) as the limit for making the funds from negotiated cheques available to the beneficiary. In March 2005, of the 84 banks participating in the project (which account for 72 per cent of the banking system's customer current accounts), 66 made the funds available in 7 days, 13 in 6 days and 5 in 5 days.

Table 70

HANDLING TIME FOR CHEQUES AND CREDIT TRANSFERS

(number of working days)

	Average			Minimum			Maximum		
	2002	2003	2004	2002	2004	2003	2002	2003	2004
Cheques									
Value date	3.9	4.0	3.9	2.1	2.1	2.0	6.9	6.1	6.1
Availability of funds	6.8	6.4	6.4	5.6	5.4	5.3	7.9	7.5	7.5
Finality	9.6	9.3	9.1	8.4	7.9	7.5	11.0	10.5	10.4
Credit transfers									
Value date	2.3	2.0	1.4	2.1	1.8	1.6	4.0	2.8	2.7
Availability of funds	2.0	2.4	1.8	1.3	1.9	1.3	2.9	3.7	3.4

Source: Surveys conducted in March 2003, 2004 and 2005 (data for 2004 are partly estimated).

There was a shortening of handling time for credit transfers and an improvement in value dating. Both were reduced to less than two days last year. There was also a reduction in the charges for credit transfers (Table 71), due in part to customers' increased use of Internet transactions and automated credit transfers.

Table 71

CHARGES FOR DOMESTIC CREDIT TRANSFERS

(in euros)

	Ordered via Internet	Payments via Freccia bank form	Ordered via telephone	Standing payment order	Ordered at branch with current account debit	Ordered at branch for cash
Average	0.90	1.33	1.40	1.85	3.34	5.03
Maximum	4.00	3.60	5.00	5.00	5.00	10.33

Source: ABI - PattiChiari (March 2005).

For cheque funds, notwithstanding the improvement, the time to availability remains longer than the average for the main industrial countries (2 to 3 days) and longer than allowed by interbank procedures. For credit transfers the aim is to institute rules and mechanisms for certainty consistent with what is being done for cross-border credit transfers in Europe.

The Oversight Office and the Competition Department worked together last year on a project aimed at introducing the "multibank system" to the PagoBancomat POS circuit. The system enables retailers to use more than one bank for the collection of amounts due on payment card purchases.

European and national authorities are engaged in an effort to design a regulatory framework that can effectively repress payment card fraud. The central office to combat falsification of payment instruments at the Ministry for the Economy and Finance has almost completed work on a computer databank of information on the risk of fraud at points of sale. In response to several frauds involving payment card circuits, the Oversight Office began an inquiry into their security procedures with a view to possible adjustments. The statistical reports of banks and other intermediaries indicate that credit card fraud represented 0.1 per cent of the value of transactions in 2004. Most cases (just over half the value) involved forgery or cloning of credit cards; over a third involved theft, loss or non-delivery of cards.

As is being called for by the EPC (European Payments Council) and the Eurosystem, Italy plans the migration of payment cards and POS and ATM terminals to smart card technology, which should enhance security appreciably.

Innovative payment instruments. – Internet payments increased in proportion to total payments last year, mainly because of on-line use of such traditional instruments as cards and credit transfers. On-line transactions using credit cards, the most commonly used instrument, accounted for 8.8 per cent of the total, an increase of 1.5 points. Credit transfers ordered on-line rose by 8 million to over 23 million (5.7 per cent of all credit transfers).

By contrast, the incidence of on-line payments by means of prepaid bank instruments and e-money decreased from 2.3 per cent in 2003 to 1.5 per cent in 2004. The demand for prepaid cards appears to be limited to people without bank accounts who want to make small-value payments with instruments other than those ordinarily linked to deposits. The same customer segment is interested in prepaid postal cards, which increased fourfold last year and now outnumber prepaid bank cards. Although there is significant on-line use of the latter, the fastest growth in the entire sector involves POS payments and ATM cash withdrawals.

The Bank of Italy continued to monitor initiatives involving multi-purpose prepaid instruments and to evaluate new schemes submitted for its approval. In March 2005, a total of 30 schemes were in operation, compared with 28 a year earlier. Most are instruments usable on national and/or international circuits. There is only marginal use of restricted, or proprietary, spending circuits, which testifies to users' clear preference for broadly usable instruments. Nearly 800,000 prepaid bank cards were in circulation at the end of 2004, an increase of more than 15 per cent. Counting those using prepaid postal cards as well, the number of transactions increased sixfold compared with 2003, while their average amount fell from €80 to €50.

The initial findings of the survey on the use of ICT for electronic payments indicate increasing use of e-banking. By comparison with 2002, last year there was greater use of on-line banking by service firms, 78 per cent of which used such facilities in 2004. The proportion of firms effecting on-line collections and payments rose from 49 to 64 per cent of the total, while those checking account information on-line rose from 71 to 75 per cent. Of the firms surveyed, 28 per cent made purchases and reservations on-line, more than twice the percentage effecting sales. Among manufacturing firms, 16 per cent made on-line purchases or sales; of these, 41 per cent used electronic payment services. A quarter of service firms received electronic invoices from other firms. Over half the respondent service firms maintained that the persistence of accounting and administrative procedures based on paper documents or requiring the physical presence of the customer at the bank branch impedes the further development of on-line banking services.

The problem of lack of integration of payment services between businesses and banks was examined and evaluated, from a strategic intersectoral point of view, by the National Economic and Labour Council, (CNEL) with the collaboration of representatives from the academic world, banking and industry. A document offering a series of observations and suggestions – the fruit of a broad examination of the needs of the various players, the problems and prospects for development – was approved by the CNEL. There was a broad consensus on the necessity for Italy to develop totally automated, integrated processes between banks and businesses in the various phases of trade and financial operations, extending Straight Through Processing to the entire value chain. To this end, the CNEL reaffirmed the need for strategy guidelines to foster access to on-line services and effective liaison between the parties. Alignment with the standardization projects sponsored by the EU, SWIFT and the UN was considered essential to facilitate international integration between electronic invoicing and payments.

Payment infrastructures and systems. – Operational continuity of systemically important infrastructures is essential. Last year the Oversight Office issued its "Guidelines for business continuity of systemically important payment infrastructures" based on the orientations that emerged in the fora for national coordination procedures and the responses to the consultation procedures. The guidelines are based on the provisions issued by the Bank of Italy on 24 February 2004, which expressly mandate the obligation to guarantee operational continuity.

The guidelines impose a set of requirements on systemically important infrastructures, which are coordinated with those issued by the Banking and Financial Supervision Department and the Market Oversight Office, to foster synergy between infrastructures and the main financial intermediaries and institutions. The requirements include minimum deadlines for recovery and resumption of operations, depending on the importance and the technical and procedural characteristics of the services; operation of back-up sites; effective liaison with system operators and outsourcers. Special attention must be devoted to the development, implementation and monitoring of the business continuity plans. This requires the direct involvement of decision-making bodies, the clear assignment of tasks and responsibilities and the effective communication of the essential features of the plan throughout the organization.

In implementation of the Eurosystem's shared oversight policy and consistent with the requirements for systemically important infrastructures laid down in Article 4 of the provisions implementing Article 146 of the Consolidated Law on Banking, the Bank of Italy continued its monitoring of the safeguards against operational risks instituted by the SIA as supplier of the technological infrastructure of STEP2, the first pan-European automated clearing house. In this framework the Bank adapted Principle VII of the BIS's "Core Principles for Systemically Important Payment Systems" to these specific infrastructures. Special attention was paid to the interrelations between the security domains of the persons involved, which represent critical points for the entire system. Systematic liaison with the ECB for the correct inclusion of the Bank of Italy's assessments within the broader evaluation conducted by the Eurosystem was initiated.

ABI's FARO project to monitor the functioning of the ATM circuit, which had been launched as a prototype in 2003, became fully operational last year.

Direct provision of payment services

Cash settlement. – The flow of funds handled by the Bank of Italy's clearing and settlement systems amounted to nearly €37 trillion in 2004, or 27.3 times Italy's GDP, an increase of 2.8 per cent compared with 2003. Last year saw a significant reduction in the number of bank mergers, which in the previous two years had reduced interbank payments. The BI-REL gross settlement system handled 85.9 per cent of all payments, by value, processing 43,500 transactions a day worth €140 billion (Table 72). Payments channeled through the BI-COMP retail clearing system accounted for 8.2 per cent of total payments and the multilateral cash balances of the securities settlement system for 5.9 per cent.

TARGET is by far the biggest of the large-value euro payment systems. In 2004 it handled a daily average of over 267,000 transactions worth more than €1.7 trillion; this corresponded to 58 per cent of all the funds transfers of the main EU systems by number and 88 per cent by value (Table 72).

Table 72

LARGE-VALUE GROSS AND NET SETTLEMENT SYSTEMS IN THE EU

(average daily flows in billions of euros)

System and country	2003				2004				Total percent-age change 2004/2003
	TARGET				TARGET				
	Domestic (1)	Cross-border outgoing	Cross-border incoming	Total (1)	Domestic (1)	Cross-border outgoing	Cross-border incoming	Total (1)	
Gross settlement (TARGET)									
Italy	63.9	33.2	33.2	130.3	76.2	32.2	32.2	140.6	7.9
Germany	363.6	140.5	140.5	644.6	344.7	143.1	143.2	631.0	-2.1
France	302.3	75.5	75.5	453.3	337.9	80.7	80.6	499.2	10.1
Spain	255.2	20.1	20.1	295.4	265.0	22.6	22.6	310.2	5.0
Netherlands	37.2	46.6	46.6	130.4	41.4	49.7	49.7	140.8	8.0
Other EMU	61.7	108.0	108.0	277.7	58.9	115.4	115.4	289.7	4.3
Total EMU	**1,083.9**	**423.9**	**423.9**	**1,931.7**	**1,124.1**	**443.7**	**443.7**	**2,011.5**	**4.1**
Non-EMU countries	29.4	113.0	113.0	255.4	25.9	120.4	120.4	266.7	4.4
Total EU	**1,113.3**	**536.9**	**536.9**	**2,187.1**	**1,150.0**	**564.1**	**564.1**	**2,278.2**	**4.2**
Net settlement									
Paris Net Settlement (PNS)				70.5				67.5	-4.3
Servicio Español de Pagos Interbancarios (SEPI)				1.2				0.9	-25.0
EBA Euro Clearing System (Euro1)				175.4				170.4	-2.9
Total other systems				**247.1**				**238.8**	**-3.4**

Sources: ECB and Bank of Italy.

(1) The comparison of figures for domestic payments is affected by specific features of the national gross settlement system architecture in some countries that allow transfers of liquidity between different accounts held by the same institution with no underlying transaction. Such payments are possible in Germany, France and Spain.

The central banks of the countries that joined the EU in May 2004 can have access to TARGET either through settlement systems of their own or by other arrangements such as opening a correspondent account with a Eurosystem central bank. In December 2003 the Polish central bank adopted this latter course, requesting to link into TARGET via BI-REL. The connection went operational on 7 March 2005. It is the most significant change in TARGET since its inception in 1999 and may foreshadow analogous decisions on the part of other recent and prospective EU members.

Within Italy, the migration to the New BI-REL system, begun on 16 June 2003, was completed in May 2004. At the end of March 2005 the system had 119 direct participants, compared with 661 settlement account holders in the old system. At the end of the migration period, BI-REL introduced an optimization mechanism for queued domestic interbank payments. From then to March 2005 an average of 900 payments worth €4 billion were settled daily via the optimization procedure.

The average use of intraday liquidity increased by 50 per cent in 2004 to €3.5 billion a day. The increase was related to the final phasing-in (26 January 2004) of the EXPRESS II securities settlement system. The banks' treasury departments made intensive use of the liquidity reserve for urgent payments, drawing an average of €5.7 billion a day, or over 40 per cent of the intraday funds available to the entire system.

The contribution of ancillary systems. – Most of the payments entered for settlement into BI-REL come from ancillary systems (BI-COMP and EXPRESS II), from the electronic interbank deposit market (e-MID) and from international payment systems (CLS and Euro1). All these types of payments increased in 2004.

The clearing balances of BI-COMP amounted to over €300 billion, an increase of 11 per cent compared with 2003.

On 26 January 2004, with the termination of the Bank of Italy's old securities net settlement procedure (LDT), the EXPRESS II system went fully operational. From then to the end of the year the value of the clearing balances settled by intermediaries through BI-REL in the two EXPRESS clearing cycles averaged €8.2 billion a day (€6.1 billion of it in the overnight cycle). The securities transactions rejected during the overnight cycle for lack of funds and re-submitted during the daytime cycle generated a flow of BI-REL payments averaging €5.1 billion a day.

The gross component of EXPRESS II generated 760 payment orders a day to BI-REL for transactions other than monetary policy repos, compared with 410 a day in 2003, for a value of over €9.9 billion (€4.2 billion in 2003).

In 2004 the value of BI-REL debit and credit transactions in settlement of monetary policy repos came to €330 billion (€181 billion in 2003). The increase was due mostly to the changes in the operational framework for the conduct of monetary policy introduced in March 2004.

Transactions on e-MID between domestic counterparties settled automatically through BI-REL diminished by 1.4 per cent to €5.68 trillion. At the same time transactions on that market between residents and remote participants, settled through BI-REL via incoming and outgoing cross-border payments, increased by 17 per cent to more than €1.7 trillion.

Payments effected within the CLS multicurrency foreign exchange settlement system by the two Italian banks that are direct participants in it and settled via BI-REL increased to an average of some €300 million a day.

The Italian banks participating in the Euro1 system recorded a net credit position. The debit balances settled through BI-REL averaged just under €500 million a day, about half the average value of credit balances.

Analysis and monitoring of BI-REL and BI-COMP. – Late last year the ESCB released its TARGET Oversight Guide, a compilation of the contents of papers on TARGET oversight approved by the ECB Governing Council. The Guide provides central banks with a minimum common framework for performing the oversight function. In line with the Guide's indications, the Bank of Italy drafted a manual laying down standards and methods for oversight of BI-REL as regards the control of the various types of financial, technical and operational risk.

An impact assessment was made of the connection to TARGET of the Polish SORBNET-EURO payment system via BI-REL. The results established that the connection has not affected BI-REL's level of compliance with the Core Principles. As for security and technical and operational reliability, level 2 risk analysis of BI-REL was performed at the start of 2004.

The Bank of Italy has classified BI-COMP as a system of pre-eminent importance under the methodology devised by the ESCB and had it evaluated for compliance with European oversight standards for retail payment systems. BI-COMP was found to be fully compliant in terms of legal soundness, security and operational reliability, criteria for access and governance. Following this evaluation, at the end of 2004 contract-letters and the pricing scheme were revised, and in January 2005 an updated version of the users' guide was released.

TARGET2. – The European TARGET2 project is now at the implementation stage. In 2006 central banks, market infrastructures and participants will be gradually involved in the demanding testing phase. At its meeting of 16 December 2004 the ECB Governing Council formally accepted the platform provided jointly by Bank of Italy, Deutsche Bundesbank and Banque de France as the single shared platform in TARGET2 and assigned those three central banks to institute and operate the new pan-European system. In January 2005 the governors of all EU central banks except the Swedish confirmed their participation in the single shared platform.

The December meeting also made decisions on other important aspects of TARGET2. Risk considerations led the Governing Council to opt for gradual migration to the new system by groups of countries rather than a pan-European "big bang".

In view of the strategic importance of the project, a working group, coordinated by the Bank of Italy, has been set up to lead the migration of the Italian marketplace to TARGET2. In response to the ESCB's request to postpone the migration of the Italian financial community to the third wave, the Bank agreed and the group endorsed it.

Correspondent banking services. – Last year the Eurosystem defined the features of its Reserve Management Services, which NCBs may provide on the Eurosystem's behalf, in a framework of harmonized rules and prices, to the new EU Member States and to central banks and government bodies in non-EU countries.

Together with five other central banks the Bank of Italy began offering this service on 1 January 2005. In addition to the traditional payment and collection services, foreign institutions with liquidity at the Bank of Italy can either invest it directly with the Bank or give the Bank a mandate to invest it in the money and financial market. Correspondents can use a broad set of reserve management services: custody and settlement of securities issued in the euro area, investment of funds in the interbank deposit market, execution of orders in the secondary securities market, and foreign-exchange trading of G10 currencies against the euro.

Payments. – Including those performed on account of general government, in 2004 collection and payment transactions through correspondent accounts numbered over 27,000, an increase of 10 per cent over 2003. Most involved the payment of salaries and pensions. In 2006 the Bank plans to begin using the STEP2 system, in which some EU central banks already participate, for its low-value cross-border payments and those of banks using its services.

The Correspondent Central Banking Model (CCBM). – The average daily value of securities posted with the CCBM as collateral for Eurosystem credit operations increased by 25.4 per cent, from €260 billion to €326 billion. The Bank of Italy continues to play a major role within the CCBM, handling about one fifth of the securities posted, by value.

Cashier's cheques and deposits against banker's drafts. – The issue of cashier's cheques and banker's drafts diminished again last year in connection with the continuing replacement of paper with electronic instruments. The Bank of Italy's issues of ordinary and special cashier's cheques fell in number from 568,465 to 413,055 and declined in value from €8.9 billion to €8 billion.

The interbank database on irregular cheques and payments cards. – At the end of last year the database listed 59,953 persons for irregular cheques, down 3.4 per cent from a year earlier. Reports of bank and postal cheques returned for lack of funds or authorization numbered 241,779 for a total value of €1.02 billion, a reduction of 1 per cent in number but an increase of 8 per cent in value compared with the end of 2003. The share of persons reported more than once during the year rose; these repeat offenders accounted for 2.5 per cent of the persons on register, compared with 1.5 per cent in 2003. The ratio between the value of bad cheques in the database and that of cheques regularly debited on accounts held steady at 0.24 per cent.

The database registered 72,230 persons for improper use of payment cards in 2004, an increase of 28.7 per cent. At the end of the year 124,963 names were on register; 40 per cent were domiciled in the South and the island regions. A total of 4,220,197 payment cards were lost, stolen or revoked.

Government payment services. – The Bank of Italy acted last year to consolidate and extend the computerization of the public payment system, further integrating the state treasury service into interbank payment procedures. At the same time, work to adapt the legal framework to the development of electronic treasury management proceeded. To serve the need of the Ministry for the Economy and Finance for full and prompt information on trends in public entity accounts, significant advances were made in the realization and utilization of the information system on transactions of public sector entities.

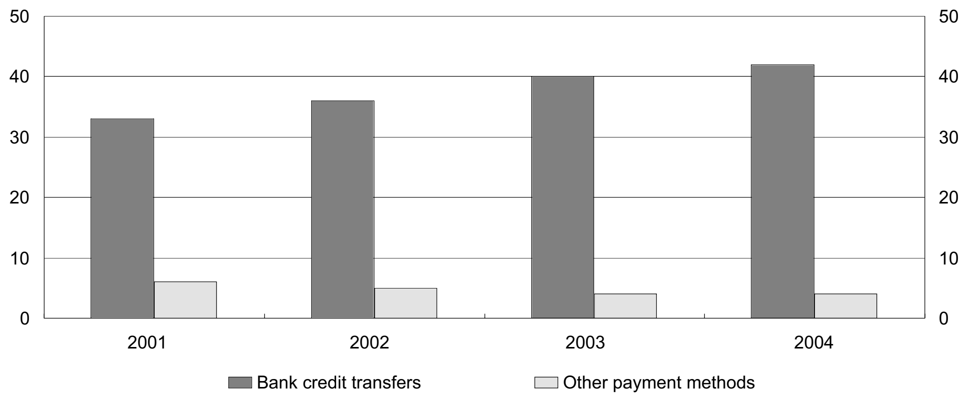
The participation of central government departments in the Computerized Public Administration Payment System is now very far along. Since the inception of the procedures regarding recurrent expenditures and computerized current accounts, 92 per cent of payment orders have been transmitted electronically. The constitution of the electronic state treasury under the System's architecture has laid the groundwork for introducing, together with the Ministry and with ABI, a procedure for checking and automatically correcting the bank account numbers of the Public Administration's creditors, thus reducing the number of unsuccessful payments. As part of the creation of the Single Euro Payments Area for retail payments, the Bank's initiative made it possible for public payments also to use IBAN codes, the recognized European standard for bank account numbers.

The project for crediting paper spending instruments to creditors' accounts via credit transfer was completed last year, enabling banks and the Post Office to receive information and accounting data on payments electronically. Credit transfers will soon be included among the eligible instruments for treasury payments automatically directed to their final destination account. In 2004 the interbank channel was used for 92 per cent of the 45 million state treasury payments. The unified tax payment form was used to make credit transfers for tax and contribution payments worth €362 billion (Figure 42).

Figure 42

CHANNELS OF TREASURY PAYMENT SETTLEMENT

(number in millions)



In cooperation with the Ministry for the Economy and Finance, work continued towards the realization of the information system on transactions of public sector entities, operated by the Bank of Italy. After the definition of the classification codes for expenditures of central government bodies, the Ministry issued decrees establishing codes, procedures and the timetable for the implementation of the system by regional and local governments and universities, designated by a working group in which the Bank also participated. Work continues on the coding of transactions of other public bodies, first of all the local health units.

The Finance Law for 2005 mandates a period of experimenting with the total abrogation of the single state treasury system for some local bodies, to be designated by ministerial decree, that have the capability of linking into the information system on transactions via their own treasury. With a view to this testing, trials of the application for the transmission of coded data were conducted with selected banks. The bodies taking part in the experiment and their treasurers will soon be engaged in the final testing of the procedure.

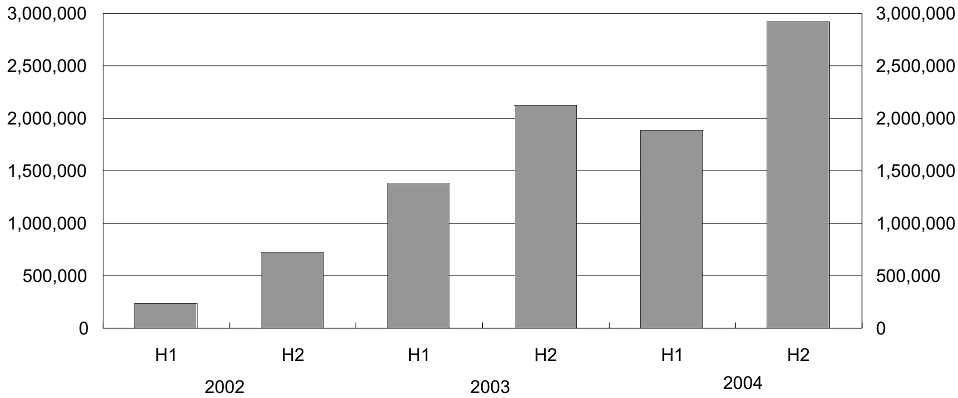
In concert with the Ministry, the procedures for access to the transaction information system are being finalized. The studies under way are designed to determine the aggregates and data breakdowns that must be made available to the Ministry, public bodies and the other entities involved to permit prompt checking of cash flows and the construction of significant indicators of public expenditure. Special attention is being paid to information security and confidentiality.

Legally, the instructions on cashier services now being drafted will incorporate the new administrative procedure for the telematic acquisition of tax revenues and the disbursement of public expenditure. The new legal framework defers procedural matters to protocols of understanding and technical agreements between the Bank of Italy, the Ministry for the Economy and Finance and the individual central government departments. Conventions of this sort are particularly well suited for rapid, flexible incorporation of technological changes into spending procedures.

Figure 43

CASHIER SERVICE PAYMENTS

(number)



About 11,000 electronic payments were executed last year under the procedures for state collections and payments abroad within the EMU laid down in Presidential Decree 482 of 15 December 2001. About the same number of VAT refunds were paid by the Revenue Agency, for which purpose it temporarily relies on the Italian Foreign Exchange Office. A project for automatically channeling transactions to EMU area payment systems is under study.

The Bank's agreements for the performance of cashier services for tax agencies were renewed last year, and conventions were signed with INPS for the payment of temporary benefits to some classes of beneficiaries and with INPDAP for the payment of pensions within the EMU.

The cashier service made some 4.8 million payments in 2004, an increase of 37 per cent compared with 2003 (Figure 43).

THE GOVERNOR'S CONCLUDING REMARKS

THE GOVERNOR'S CONCLUDING REMARKS

The city of Rome was recently at the centre of world attention as heads of state and government, representatives of the world's religions and millions of men and women gathered to honour the Pontiff, a man who left an indelible mark on history.

They did so in acknowledgement of their shared ideal of mutual understanding and their aspiration to live together in fellowship and peace.

To his successor, a man of eminent learning, a son of the humanism ingrained in Europe, let us convey our best wishes that he may continue to work for a fuller collaboration among the peoples and nations of the world, fostering universal human and civil progress.

The Bank of Italy and its employees again worked with dedication in the service of the nation and its regional and local communities.

Cooperation with the other central banks in the European system and worldwide has continued to be intense and demanding, both in technical matters and in developing guidelines and policy measures to the benefit of the financial community and the international economy.

Supervision is performed through central and local units to safeguard financial stability and competition and the efficiency of intermediaries' services to the productive economy.

In the payment sector, with the entry into service of the new BI-REL system, which now also embraces Poland, efforts focused on the development of the single shared platform for the euro-area payment system together with the central banks of France and Germany.

The new information system supporting the operations of public entities will permit analytical, real-time observation of central and local government outlays and receipts. It is an essential source of knowledge in an institutional context in which decentralized activity is increasingly important.

The Bank's departments and branches are actively engaged in systematic data collection, analysis and research. The findings are placed at the disposal of government, the business and financial community and citizens.

International recognition of the professionalism, rigour and quality of the Bank's activity is unanimous and well-established.

For their great efforts, our gratitude goes to the economists and officers of the Economic Research Department, the Supervision Department and the other departments involved in preparing the Annual Report, a valuable source of analysis and information on the economy and finance.

On behalf of the Board of Directors and the Directorate, and personally, I wish to thank the entire staff, who, identifying with the action and objectives of the Bank, contributed their professional skill and diligence to the work of the Head Office and the branches.

The world economy

In 2004 the liquidity of the world economy continued to increase, albeit at a slower pace than in the past few years. The money supply in the seven leading industrial countries, which had stood at 66 per cent of GDP in 1998, rose to 75 per cent last year.

Short-term interest rates, adjusted for consumer price inflation, were about 3 per cent in 1998. They then declined rapidly, turning negative by half a percentage point in 2003 before returning close to zero in the second half of 2004.

Real long-term yields fell to around 1 per cent.

The robust expansion of the money supply fueled world economic growth.

The recession in the United States in 2001, the terrorist attacks in September of that year and the subsequent armed conflicts in the Middle East had triggered a sharp slowdown in economic activity in the industrial countries.

The turnaround was due to the stimulus from fiscal policy in the United States. The exceptionally low level of interest rates revived investment in construction and fostered demand for consumer durables. In the course of 2003 business investment in capital equipment also resumed.

Risk premiums fell. Flows of capital and investment to the emerging economies began to increase again.

World output expanded by 4 per cent in 2004 in real terms. Weighting national GDP figures according to purchasing power parity, growth came to 5.1 per cent, the highest figure in more than two decades.

The monetary expansion did not have any appreciable inflationary effect. In 2004 consumer prices rose by an average of 2 per cent in the leading industrial countries and by 2.7 per cent in the United States. The protracted deflation in Japan was attenuated. In the euro area prices rose by 2.1 per cent.

In recent years productivity gains in the industrial economies have more than offset increases in employee compensation. Within Europe, Spain and Italy are exceptions in this respect.

The growth in world demand has nevertheless generated strains in the prices of raw materials, especially energy. Oil prices have more than doubled in real terms from their average in the 1990s. This has affected producer prices in the advanced economies, despite the reduction in unit labour costs.

In the emerging economies inflation remains higher on average than in the industrial countries. It has subsided markedly from its level in earlier years.

In the United States the threat of an increase in inflationary pressures prompted the Federal Reserve to raise interest rates gradually beginning in mid-2004. So far the Fed has increased rates by a total of 2 percentage points, to 3 per cent. In the euro area, the cyclical slowdown over the course of the year and expectations of lower inflation led the monetary authorities to leave the official reference rate unchanged at 2 per cent.

In a number of countries the expansion of liquidity has been reflected in property values. In the United States house prices rose by 37 per cent between 2000 and 2004. In the United Kingdom the rise was particularly rapid until 2003; since the end of that year it has been countered by a more restrictive monetary policy stance, although prices still rose by 85 per cent between 2000 and 2004. In Italy house prices increased by 46 per cent over the period, in Spain by 86 per cent.

In Germany the downward trend in property prices, caused by over-investment in the early 1990s, came to a halt. In Japan property values continued to decline, albeit less steeply than in the past.

Between the spring of 2003 and the early months of this year, equity prices rose by between 40 and 50 per cent in all the main markets. They were sustained by the decline in interest rates and the substantial increase in corporate earnings. Greater liquidity and low yields spurred investors to take riskier positions. The volatility of prices fell sharply.

Yields on 10-year government securities in the US and European markets rose in the first half of 2004 but then fell to very low levels. In the first few months of 2005, price volatility increased, as did risk premiums on corporate bonds and the issues of the emerging countries. Yields on government bonds rose temporarily.

Yields on long-term government securities remain low. The yield on 10-year bonds is 4.1 per cent in the United States and 3.3 per cent in the euro area. These rates signal expectations of moderate inflation, but also slow growth, in the coming years. The yield on indexed securities is 1.6 per cent in the United States and 1 per cent in the euro area.

Short-term developments

In the United States gross domestic product grew by 4.4 per cent in 2004, up from 3 per cent the previous year.

The expansion in domestic demand under way since 2002 had been triggered by the increase in government spending and the reduction of the tax burden of households and firms over a period of years.

The increase in households' disposable income, which was associated with the expansion in the budget deficit, was rapidly translated into a stimulus to consumption; the saving rate fell to an extremely low level, presumably to some extent reflecting confidence in the continuation of favourable economic conditions.

The recovery was sustained by the markedly expansionary stance of monetary policy. Purchases of durable goods increased by 7.4 per cent in 2003 and 6.7 per cent in 2004; investment in housing rose by 8.8 per cent in 2003 and 9.7 per cent last year.

Since 2003 investment by firms has also risen substantially. Expenditure on capital equipment and software grew by 13.6 per cent in 2004 at constant prices; of this, investment in computers and electronic equipment jumped by 33 per cent in 2003 and a further 27 per cent in 2004. Investment in transport equipment, which had fallen steadily between 2000 and 2003, accelerated briskly, growing by 12.5 per cent in real terms.

Exports of goods and services expanded by 8.6 per cent in volume.

Corporate profits rose thanks to the increase in output and productivity gains, which had continued during the recession. The recovery in employment that began in mid-2003 lent additional support to households' disposable income and consumption.

The pronounced acceleration in investment during 2004 reflected the sound financial situation of firms, tax incentives and, more fundamentally, the outlook for economic growth.

Investment has continued to expand this year, although at a more moderate pace.

In the first quarter of 2005 GDP increased by 3.5 per cent on an annualized basis. Productivity and employment continued to grow. The increases in the target rate decided by the Federal Reserve have been perceived by the market as aimed at stabilizing inflation expectations in the medium term.

At current exchange rates the leading industrial countries account for 65 per cent of world GDP. The United States produces just under half of the output of these economies and 30 per cent of the world total.

In 2003 and 2004 economic activity in the industrial countries and the emerging economies was sustained by consumption and investment demand in the United States. Imports from the rest of the world increased by 4.4 per cent in 2003 and 9.9 per cent in 2004.

World trade in goods and services expanded in volume terms by 4.9 per cent in 2003 and 9.9 per cent last year. China's contribution to the increase was equal to 1.5 percentage points in 2004.

Japan's exports of goods and services rose by 9.1 per cent in 2003 and 14.4 per cent last year. In Germany, they expanded by 1.8 and 9 per cent respectively. In France and especially Italy the increases were much smaller.

As in previous years, a significant contribution to world economic growth came from the emerging and developing economies. In China GDP expanded by 9.5 per cent, in India by 7.1 per cent. In the newly industrialized Asian economies growth came to 5.6 per cent.

In Japan productive investment rose by about 6 per cent both in 2003 and 2004, buoyed by foreign demand. Investment in residential building began to grow again after three years of decline. GDP increased by 2.7 per cent in 2004; this year growth will be slower.

Output in the euro area rose by 2.1 per cent.

Structural imbalances

The budgetary policy adopted in 2001 has produced a significant deterioration in the public finances in the United States. The expansion of the economy, which exceeded its potential growth rate last year, made it possible to stabilize the federal budget deficit at 3.6 per cent of GDP. The amount of federal debt held by the public rose to 37 per cent of GDP at the end of 2004.

The US Administration has pledged to reduce the deficit by 2010.

Over a longer time horizon the US economy will be burdened by the upward trend in pension expenditure and, above all, in that on health care, where costs are rising exceptionally fast.

The deterioration in the external accounts and low interest rates are at the root of the weakening of the dollar since 2002.

Since the middle of the 1990s external liabilities have grown sharply; at the end of 2003 they amounted to $10.5 trillion, half of which was accounted for by foreign portfolio investment and a quarter by direct investment in the United States.

External assets amounted to about $8 trillion at the end of 2003, a third of which consisted of direct investment abroad by multinational companies and another 30 per cent of portfolio investment.

The net debtor position of the United States, which had been equal to 5 per cent of GDP in 1996, rose to 25 per cent at the end of 2004.

The portion of the external deficit on current account that is not financed by inflows of direct investment or a reduction in US residents' non-dollar financial assets denominated in foreign currencies translates into an increase in dollar-denominated monetary assets, bonds and equities held by the rest of the world. The expansion in dollar assets held by non-residents is also the counterpart to US direct and portfolio investment in the rest of the world.

Between 1999 and 2004 the volume of deposits and private- and public-sector bonds denominated in dollars increased by 50 per cent, from \$24 trillion to \$35.9 trillion.

Over the same period, money and securities in euros expanded by 51 per cent, from €11.9 trillion to €18 trillion. Yen-denominated assets rose by 27 per cent.

The performance of the exchange rate of the dollar has major implications for global economic and financial equilibrium.

The comparative figures above do not reveal a growing imbalance between the volume of financial assets denominated in dollars and that of assets denominated in euros.

Owing to Japan's large current account surpluses, the quantity of financial instruments denominated in yen is much smaller than those denominated in the other two major currencies. Short-term yields close to nil have prevented an excessive appreciation of the yen.

The dollar stopped weakening in the first few months of this year, partly owing to the increase in official rates. Since mid-March it has appreciated by 8 per cent against the euro and by 3 per cent in effective terms.

The external deficit of the United States and the expanding supply of dollars fundamentally reflect America's faster growth by comparison with the other industrial countries. Between 1994 and 2004 consumption and investment demand increased by 45 per cent in real terms, while output, thanks in part to rapid productivity gains, rose by 38 per cent.

In Europe and the other industrial countries domestic demand and output both rose by 24 per cent during the decade.

In 2004 net national saving in the United States amounted to 2 per cent of GDP. In recent years the reduction in private-sector saving and the widening government deficit have prompted ever greater recourse to the savings of Europe, Japan and the emerging countries.

About three quarters of the US external current account deficit is matched by the persistent, substantial surpluses of Japan, the oil-producing countries, China and the other emerging countries of Asia. These countries cannot, or at any rate do not, invest all their saving in their own economies. The difference goes where investment is safer and where current and expected returns are adequate.

The ability of the international markets to finance the sometimes large disequilibria between saving and investment in the leading economies has increased in the last few years.

Up to now the United States has had no trouble in financing its external deficit on current account, thanks to foreign capital inflows attracted by high productivity and high investment yields as well as by a secure and stable economic and institutional environment.

The dollar assets held by the authorities of Asian countries amount to some $2 trillion. Some of these countries have net external debtor positions, which suggests a further accumulation of foreign exchange reserves, including dollars. The exchange rate of the dollar is bolstered by the progressive raising of US official interest rates.

A fall in the value of the dollar would harm the orderly working of the international financial system.

Looking ahead, a reduction in these imbalances is essential. An increase in US national saving and faster economic growth in the other industrial countries and worldwide are needed to help adjust the US deficit on current account.

Prerequisites for achieving sustainable development, for fully exploiting the opportunities for world economic growth, are closer economic and financial integration of the backward economies into the world trading system and a reduction in poverty, which remains deep-seated in vast areas of the globe.

The international community is pursuing these objectives.

The strategy is based on opening the markets of the developed countries to the goods produced by the poor countries, on official development assistance, on the cancellation of the foreign debt of heavily indebted countries and on institutional reform in beneficiary countries.

We look forward confidently to the meeting of the ministers of the World Trade Organization in Hong Kong in December, which is a crucial passage towards completing the Doha agenda for trade liberalization by the end of 2006. Aid must be made more effective. Innovative mechanisms and instruments of finance to increase the volume of resources, now smaller than planned, are under study. The Heavily Indebted Poor Countries initiative has made some progress, but there are still many countries with highly unstable internal conditions unable to benefit from debt reduction.

Broader participation in the use of resources and in the benefits of globalization lays the basis for economic and social advance under conditions of international harmony.

The Italian economy

Gross domestic product in the twelve countries of the euro area expanded by 5.1 per cent between 2000 and 2004.

In France economic activity was sustained by household spending. GDP grew by 6.6 per cent in the four years and exports by 5.4 per cent, or a quarter of the rate of expansion in world demand. Productive investment, after two years of contraction, returned to growth in 2004.

In Germany GDP expanded by 3 per cent over the four years, or by 0.7 per cent per year. Growth was led by exports; these increased by 23 per cent in volume, with gains in world market share. Consumption slowed sharply by comparison with the previous decade, reflecting households' uncertainty in connection with social security reform and employment trends.

German investment in capital goods diminished in 2001 and 2002; it recovered somewhat in the second and third quarters of 2004 but fell again in the last part of the year. The transfer of production to the countries of Central and Eastern Europe continues apace. Since 2000 construction investment has fallen by 4 per cent per year; in residential building, the contraction of activity has proceeded in parallel with the decline in prices.

The German economy is weighed down by the limited progress made in modernizing industry in the eastern regions; despite massive transfers from the federal government and lower labour costs, this is still not sufficiently competitive.

In Italy too the expansion of output has been unsatisfactory. Since 2000 the average annual growth rate has been less than 1 per cent. The increase in consumption, despite employment growth and budgetary stimulus, has been of the same order of magnitude.

Economic activity has been sustained by investment in residential building, favoured by low interest rates on mortgage loans and tax benefits for home renovation.

Business investment in capital goods contracted in 2003. A recovery in the first half of 2004 was followed by renewed decline in the third and fourth quarters.

The greatest weakness of the Italian economy continues to be its inadequate international competitiveness.

Between 2000 and 2004 world demand for goods increased by 20 per cent in real terms.

Italian exports were less in 2004 than in 2000. At constant prices, Italy's share of the world market fell from 4.6 per cent in 1995 to 3.5 per cent in 2000 and 2.9 per cent in 2004.

At the start of the decade the Italian economy, like the others of the euro area, was affected by the world cyclical slowdown. In the last two years it has not managed to take advantage of the sharp acceleration in economic activity in North America, Asia and Latin America.

Industry

The competitive difficulties of Italian industry first became manifest in the second half of the 1990s.

Between 1995 and 2000 there was virtually no gain in total factor productivity in manufacturing. Labour productivity rose by 1 per cent per year, against 3.2 per cent in Germany, 4.3 per cent in France and 3.9 per cent in the United States. In the five years the index of industrial production rose by 8 per cent, compared with 14 per cent in Germany and France.

These divergent trends have continued in the last few years.

Between 2000 and 2004 industrial production increased by 1.2 per cent in France and 2.6 per cent in Germany, while in Italy it contracted by 3.8 per cent. Essentially because of the failure to increase productivity, unit labour costs in Italian manufacturing rose by 12.6 per cent; over the same period they fell by 2.8 per cent in Germany and rose by 2.6 per cent in France.

The decline in industrial activity can be ascribed mainly to the machinery and electrical and electronic equipment sectors, whose output fell by 26 per cent between 2000 and 2004, and transport equipment, where the reduction came to 17 per cent. The contraction in these medium-high technology sectors explains 3.6 percentage points of the decrease in the overall index.

The performance of the textile and leather industries, those most directly affected by the competition of the emerging Asian economies, accounts for 1.9 points of the overall decline. Activity expanded, by contrast, in food processing, paper, metal and wood products, which like textiles and leather can be classified as low technology.

Areas of excellence and success stories, present in practically every branch of Italian industry, are founded upon innovative capacity and product quality. But in view of their limited scale, they are not enough to revive the entire industrial sector.

It is essential that these outstanding producers remain rooted in Italy. They can and must transmit the stimulus to improve quality and production to other enterprises.

Firms and technology

In the 1980s the expansion of Italian firms abroad aimed at acquiring interests in or control of European and non-European firms whose products were similar or complementary.

In those years foreign investment was mainly the preserve of Italian firms in medium-high technology industries with significant economies of scale that were seeking market outlets. In the mid-1980s such firms employed three quarters of Italian manufacturing's 260,000 workers abroad. Another 10 per cent worked for high-technology firms interested in exploiting synergies for the development of new products and advanced production techniques. Most of these foreign workers were employed in Western Europe and North America.

Starting in the 1990s, in order to recoup competitiveness that had been undermined by a deterioration in their price-quality balance, textile, clothing, leather and footwear manufacturers, including many small firms, began to shift some of their production to countries where labour was cheaper.

By January 2004 the number of workers of foreign companies controlled by Italian firms had risen to 870,000, equal to 18 per cent of total manufacturing employment in Italy. A third of these workers were located in Eastern Europe and Asia.

According to the data on foreign direct investment gathered by the nascent company register kept by the Italian Foreign Exchange Office, Italian firms with significant activity in other countries number 1,450; of these, 390 head international enterprises. The expansion is concentrated in high- and medium-high technology sectors and located above all in France, Spain and the United States. Investment in Romania, Poland, Croatia and the Czech Republic is mostly by firms in low-technology industries.

Scant is the presence abroad of medium-low technology companies, which account for a substantial portion of Italian manufacturing.

Bank of Italy surveys have found that, on average, firms with production abroad produce 9 per cent more value added per worker than other Italian firms. Their investment per worker is higher too. In medium-technology sectors, the outward relocation of production does not appear to affect employment in Italy or actually has a positive impact. In traditional industries, shifting part of production abroad is a defensive move; it reduces employment but enables the company to bear up under international competition.

Italian manufacturing industry employs some 5 million workers; in Germany the figure is twice as high, in France 20 per cent lower.

Most workers in Italy are employed in low-tech industries. The share of workers in textiles, leather products and footwear fell from 18.6 per cent in 2001 to 16.6 per cent in 2004. In France and in Germany the shares in 2001 were 6.5 and 3.1 per cent respectively. For Italy, the competitive pressure from the emerging economies is greater. It is essential to step up the response by improving the quality of output and increasing its creative content.

Medium-high technology products, including automobiles, account for 26 per cent of industrial employment in Italy, compared with 30 per cent in France and 42 per cent in Germany.

This is the sector that is the key to Germany's strong export growth.

Food processing, paper and printing and wood products account for 27 per cent of industrial employment in France, 22 per cent in Germany and 19 per cent in Italy. In Italy these industries have enjoyed productivity gains thanks to reorganization and restructuring, which have also improved product quality. Demand is chiefly domestic.

High-technology sectors account for 7 per cent of Italian industrial employment and 10 per cent of value added. In France the employment share is 11 per cent, in Germany 9 per cent, in the United States and Japan around 15 per cent.

International demand for technologically advanced products is growing much faster than for other goods. Given the quality and specific nature of these products, the elasticity of demand with respect to price is lower, and firms can obtain prices that permit adequate remuneration of the productive factors.

The slowness in modernizing the productive apparatus in medium-high technology sectors and the underdevelopment of high-tech industries are responsible for the slower growth in Italian productivity and competitiveness compared with industry abroad.

In March 2002 the European Council set an objective for R&D spending to reach 3 per cent of GDP by 2010.

Comparison with other countries shows that Italy is lagging behind.

The quality of some scientific research in Italy is very high by international standards.

Direct public-sector spending on R&D in the form of activities carried on in universities and research institutes is less than 0.6 per cent of GDP. In France and Germany it is about 0.8 per cent.

The comparison is even more unfavourable for the private sector.

In Italy private entities allocate 0.5 per cent of GDP to R&D; in France and Germany 1.4 and 1.7 per cent respectively.

Total spending on R&D amounts to 1.1 per cent of GDP in Italy, 2.5 per cent in Germany and 2.2 per cent in France. In the United States it is equal to 2.7 per cent and in Japan to 3.1 per cent.

The effectiveness of research in terms of the fallout for economic activity depends on the volume of expenditure; it is greatest in the largest firms and economies.

It is essential that synergies be created within the European Economic Area in order to give effect to the guidelines laid down by the Lisbon European Council.

The fragmentation of industry weighs upon the Italian economy, restricting its capacity for growth. Limited size is an obstacle to investment in research; it increases the difficulty of strategies to expand abroad and gain significant positions in international markets.

Even without counting sole proprietorships, 99 per cent of firms have fewer than 50 workers. Numerous newly created companies operate in high or medium-high technology sectors.

Drawing also on the experience of other major European countries such as France, Germany and Spain, action must be taken to reinforce the policies in favour of high-tech firms, in particular through public-sector contributions to start-up capital, the creation of consortiums, and incentives for technology transfers from public-sector research centres to productive activities. Productivity gains can be achieved by making greater use of intranet connections between firms within Italy and abroad.

The various tax incentives and other measures to improve competitiveness that have already been enacted, and the planned reduction in the regional tax on productive activities, can be of great assistance.

The banking system should support the most dynamic firms and promote the merger and consolidation of others by exploiting the information in its possession.

It is crucial that firms themselves should take steps in this direction.

Broader recourse to forms of venture capital is needed in order to foster initiatives in innovative sectors, in which the expected return is high, but also the attendant risk.

Employment

Between 2000 and 2004 GDP grew by 3.7 per cent; thanks to wage moderation and the introduction of new forms of flexibility, the number of people in work rose by 5.9 per cent.

In the absence of robust expansion in economic activity, less stable and less well-paid forms of employment have developed. The past decade has seen an increase in the number of fixed-term contracts. There are now 400,000 people working under coordinated and continuous collaboration contracts, equivalent to 2.4 per cent of total payroll employment; the Biagi Law makes provision for the transformation of such contracts into less precarious forms of employment. The number of part-time workers has increased, partly in response to the demands of the workforce itself; compared with the other major European economies, the proportion of such workers is still small.

The gap between entry wages and average pay has widened. The proportion of low-paid workers is estimated to be 18 per cent, with full-time employees accounting for 11 per cent and part-time workers for 7 per cent.

The cost of labour per employee has been kept down, but the entry of new workers in marginal activities has depressed productivity growth.

The incidence of the underground economy remains high, especially in the South.

As a result of greater female participation, 57.5 per cent of the working-age population is in employment, compared with 62.8 per cent in France, 64.3 per cent in Germany and 71.2 per cent in the United States.

The increase in employment has been concentrated in the Centre and the North.

In the South, compared with the mid-1990s there has been a resumption of migration of people with higher educational qualifications towards the central and northern regions. The drop in the unemployment rate in the last two years has been due to a contraction of the labour force; the difficult situation has discouraged young people and women from entering the labour market.

Between 1995 and 2004 employment rose by 17.8 per cent in the service sector, compared with 11.4 per cent in the economy as a whole. The increase in private services was 24.9 per cent; employment in industry remained virtually unchanged.

Starting from a lower level, public and private services in Italy are expanding at the same pace as in other advanced economies; the service sector is still not as developed as in France, the United Kingdom or the United States.

Business services continue to be relatively undeveloped in terms of employment, quality and productivity. Efficiency gains are possible in retailing. The fragmentation of supply and regulatory constraints affecting costs and employment weigh on the service sector as well.

In terms of value added, the sector's growth slowed after 2000 compared with the previous decade. The decline in industry's contribution to GDP growth was not offset in Italy by an adequate increase in that of services.

The growth rate of the Italian economy continues to be one of the lowest of all the advanced economies.

The public finances

The modest growth of the economy has weighed on the public finances in recent years.

In the period 1980-1993 primary current expenditure increased by 4.2 per cent per year in real terms; between 1994 and 2000 repeated interventions made it possible to keep the annual growth below 1.2 per cent.

In the last four years primary current expenditure increased by 2.4 per cent per year in real terms.

The growth in this aggregate continued to reflect long-term trends caused by legislation that was enacted in more favourable macroeconomic and demographic conditions.

Support was increased for several categories of citizens in difficult circumstances. Measures were also adopted to boost public investment and increase the role of private capital in infrastructure development. General government investment expenditure rose from 2.5 per cent of GDP in 2000 to 2.9 per cent in 2004.

The combined ratio to GDP of primary current expenditure and investment expenditure rose by 2.2 percentage points, partly in connection with the economic slowdown. The ratio of revenues to GDP fell by 0.6 points; excluding the effect of one-off measures, the fall was almost 2 points; the trend reflects the tax reliefs and concessions granted to firms and households in 2001-2004, for an annual average of €5 billion.

The situation with regard to the public finances remains difficult. The imbalances are of a structural nature and long-standing; they reflect negatively on the economy's potential for growth.

The substantial improvements recorded in the public finances in the 1990s were due to an increase in the taxation of firms and households and to the decline in interest payments associated with disinflation and participation in the monetary union. The containment of expenditure made a significant contribution; however, it also affected public investment.

Net borrowing in 2001, initially estimated at 1.4 per cent of GDP, is now calculated to have been 3.2 per cent.

Since 2002 the stagnation of the economy has aggravated the deterioration in the underlying state of the public finances; in 2004, with the help of one-off measures, net borrowing amounted to 3.2 per cent of GDP.

At the end of 2004 the ratio of debt to GDP was 106.6 per cent.

The premise for all effective action to restore more balanced public finances is a careful assessment of the state of the accounts, of the risks associated with the cost of the debt, of the consequent limits for stabilization policies, and of the difficulty of coping with the burden arising from the aging of the population.

High taxation, the uncertainty connected with the increase in the budget deficit and the insufficiency of infrastructure are a brake on investment and growth.

Corrective action must be based on structural reforms. Expenditure must continue to increase at the rate set in the last Finance Law. There is a need for measures to adjust the level and composition of revenue, progress in managing services, and the creation of a growth-oriented legal framework.

Structural reforms improve expectations, help to create a climate of confidence, increase the economy's potential for growth.

Banking

Last year was a good one for the banking sector in the leading countries.

In the United States bank revenues benefited from the further substantial increase in lending to households, the upturn in lending to firms, and higher commissions on services. Provisions for loan losses diminished. The return on equity was 13.3 per cent.

In the United Kingdom the return on equity of the leading banks was around 20 per cent. As in the United States, their profitability is boosted by large volumes of trading on the financial markets. The large increase in commissions on securities placement and asset management services was accompanied by a smaller rise in interest income.

In Japan the banking system is engaged in strengthening its capital base. The proportion of bad debts decreased, particularly among the large banks.

The euro-area banking sector also achieved good results. Lending grew by 6.3 per cent, one point more than in 2003. Profitability continued to improve among the leading banks as a result of reductions in operating costs and provisions for loan losses. The satisfactory results of the French and Spanish banking systems were accompanied by an improvement in those of the main German banks, which had performed poorly in previous years.

In Italy the return on equity of the banking system rose by 4 percentage points to 10.7 per cent.

The financing of the economy

The new financing provided to all the domestic sectors in Italy, in the form of bank loans, bond and share issues and other instruments, amounted to €163 billion in 2004. The public sector absorbed €51 billion, households €45 billion. The funds raised by firms, including finance companies, totaled €67 billion.

The hesitant growth of investment since 2001 has limited the demand for financing. Bank lending to firms rose by 3.5 per cent in 2004.

Loans to smaller firms continued to grow briskly; lending to production units with fewer than 20 workers, which account for about half the employment in industry and services, increased by 5.7 per cent.

Credit to firms based in the South of Italy expanded by 7.8 per cent.

The economy's growth difficulties were not reflected in a deterioration in loan quality. On average, between 2001 and 2004 new bad debts were equal to 1 per cent of loans outstanding at the beginning of each year. The ratio was about 4 per cent in the recession of the early 1990s and remained above 2 per cent until 1996.

The improvement in loan selection techniques has helped to contain credit risks. Prospectively, however, the quality of bank assets depends on the economy's returning to rapid and sustained growth.

Bank lending to households increased by 15.8 per cent, which was almost 5 percentage points more than in 2003 and twice the increase for the euro area. Demand for home mortgage loans was strong; consumer credit continued to expand at a high rate.

The growth in lending to households in recent years is ascribable to the low level of interest rates, developments on the supply side and fiercer competition. At the end of 2004 the annual percentage rate of charge on new home mortgage loans was 3.8 per cent, in line with the conditions prevailing in the euro area.

Household debt rose from 32 per cent of disposable income at the end of the last decade to 36 per cent in 2003. The ratio remains low by international standards; it is 61 per cent in France, 92 per cent in Spain, 104 per cent in Germany, 107 per cent in the United States and 129 per cent in the United Kingdom.

The expansion of financial assistance to households offers the banking system opportunities for growth. The ample possibility of obtaining credit requires households to be fully aware of the effects of interest rate movements on the obligations they assume.

The Italian banking industry

A stable, efficient, competitive financial system bestows security and value on the savings entrusted to it. It increases the country's growth potential.

The share of total value added attributable to financial intermediation services is equal to 5.5 per cent, in line with the figure for the euro area. The sector gives work to almost 600,000 persons, or 3.2 per cent of all payroll employees; some 340,000 are employed in the banking industry.

The fundamental role of the banking system is to meet the needs of the productive sector, to support it during cyclical downturns and accompany it during phases of expansion and growth.

Since the middle of the 1990s the Italian banking industry has carried out far-reaching consolidation; profitability has increased in connection with the expansion of the range of products and services, the lowering of operating costs, the containment of risks, and entry into fast-growing markets.

Significant productivity gains have been achieved. Between 1995 and 2004 total assets and value added per employee grew respectively by 4.6 and 2.4 per cent per year at constant prices.

At the end of 1994 there were 994 banks. The five largest groups accounted for 33 per cent of total assets.

Encouraged by the Bank of Italy and under the growing pressure of competition, the process of consolidation through mergers and acquisitions has been particularly intense in the last ten years, also by comparison with the other member states of the European Union and all the leading industrial countries. Mergers and acquisitions numbered more than 450 and involved target banks with 42 per cent of the system's total assets. During the decade 231 new intermediaries began to engage in banking.

At the end of last year there were 778 banks. The market share of the top five groups had risen to 51 per cent, in line with the European average.

There are 60 branches and 15 subsidiaries of foreign financial institutions established in Italy, accounting for about 8 per cent of the banking system's total assets. They hold much larger market shares in interbank transactions, securities trading on the wholesale markets, securities portfolio management and corporate financial services. Foreign intermediaries hold approximately one quarter of the consumer credit market.

Between 2000 and 2004 foreign banks handled more than 70 per cent of the value of the 212 Euromarket issues by Italian non-financial corporations.

The Italian banking system has increased its presence beyond the nation's borders. Twenty-five groups are established abroad, with 150 branches and subsidiaries. The expansion is significant in countries that recently joined the European Union and in those that are candidates to become members soon; in some countries, substantial market shares have been acquired in competition with other important European banks.

The reorganization of the system has gone hand in hand with a considerable increase in competition.

Econometric studies by the Bank of Italy indicate that the efficiency gains achieved by banks following concentrations have largely translated into more favourable interest rates for households and firms.

The geographical diffusion of banks has been increasing in both the Centre and North and the South; customers can choose from a wide range of suppliers.

Since the entry into force of the Antitrust Law in 1990, the Bank of Italy has examined about 750 transactions involving reorganization and consolidation; in 23 cases investigations were conducted, many of them ending with the imposition of measures to prevent the creation of positions harmful to competition. In addition, 28 potentially anti-competitive agreements were investigated and 5 cases of abuse of dominant position.

Agreements regarding prices, the division of markets, the exchange of information and uniform model contracts have been examined. A major effort is devoted to analysis of the supply conditions of payment services.

All the decisions have been adopted taking account of the prescribed opinions and in constant, fruitful cooperation with the Antitrust Authority.

The progress made by the Italian banking system in terms of efficiency and capital adequacy has been recognized by the main international organizations. The most recent revisions of the credit ratings assigned by the rating agencies to the leading banking groups have been upgrades.

In the three years 2002-2004 there was an improvement in the supervisory ratings assigned by the Bank of Italy on the basis of banks' financial reports. In the same period full inspections were carried out at 541 banks representing 52 per cent of the system's total assets, a share similar to that of the 518 banks inspected in the previous three years. Unfavourable evaluations declined from 23 to 16 per cent of the total and regarded intermediaries with 1.5 per cent of the system's total assets. In the three years 2002-2004 inspections were also made of specific operational areas in another 16 banks with 10 per cent of total assets. Unfavourable findings were reported in 5 of these cases.

In the first half of the 1980s banks had assisted the shift in the composition of households' financial wealth from deposits to government securities. In recent years, while firms' recourse to direct financing in the markets was growing, banks extended their activity in securities placement and trading, in part to satisfy customers' demand for relatively high-yielding securities.

In several cases banks' procedures for identifying and handling conflicts of interest and their compliance with the disclosure and transparency requirements of the legislation on investment services proved inadequate.

Banks must inform savers correctly and advise them prudently; they must evaluate the suitability of the products offered in the light of investors' declared needs and financial means. It is up to the customer to choose the most appropriate combination of risk and return on investments.

Further determined steps need to be taken by banks to improve the quality of the services they supply and to keep down the costs of retail services and the fees charged.

In cooperation with the Antitrust Authority, the Bank of Italy has initiated an investigation of the costs of closing bank accounts, with the aim of assessing whether the conduct of intermediaries limits customer mobility.

Compliance with the rules on the transparency of banking services is checked at individual bank branches by the Bank of Italy's branches. In the three years 2002-2004 checks were made at 2,536 branches of 224 different banks; 109 banks were ordered to eliminate anomalies and 23 received sanctions.

It is essential that banks attach strategic value to improving customer relations. The strengthening of confidence in intermediaries' correct conduct contributes to the continuity of relationships, prevents disputes and limits reputational risk.

The new legislation on the protection of savings is now being finalized in Parliament after extensive debate.

Bank ownership

The share of total assets attributable to publicly owned credit institutions has fallen from 70 to 9 per cent since 1992.

A distinctive feature of the Italian banking system is its presence on the stock exchange: listed banks account for 77 per cent of the system's total assets; in the other main countries of continental Europe the figure is between 40 and 50 per cent.

The privatization process was completed in just a few years, despite the underdevelopment of institutional investors such as pension funds and, more in general, the shortage of resources available for strategic investments in bank equity. The banking foundations undertook to form stable core groups of shareholders. Compliance with the separation between banking and industry was ensured in placing the equity holdings.

The contribution of foreign financial intermediaries to the formation of controlling ownership arrangements has been considerable and has increased in the course of time. Foreign banks and other foreign investors today hold an average of 16 per cent of the capital of the four largest Italian banking groups. In Germany, France and Spain, the participation of foreign investors in the capital of the four leading national groups is equal to 7, 3 and 2.6 per cent respectively.

Institutional investors and insurance companies, which by their nature have long-term investment horizons, play a prominent role in the ownership structures of the main European banks. In Italy, the share of the capital of the top four banking groups held by Italian and foreign insurance companies is limited, amounting to 4.7 per cent; for the top ten groups it is 4.4 per cent.

The hoped-for growth of pension funds, in connection with the reform of public pension provision, is of great importance for the Italian financial system; it can also increase the resources allocated to strengthening the capital of banks. This will make a greater supply of credit available to the economy.

Control of a company can be acquired in different ways. Economic agents choose the most appropriate, in compliance with the procedures laid down by the legal system to protect the numerous public and private interests involved.

The Italian legal system, like others in Europe, specifies the cases in which exceeding a given threshold in the capital of listed companies triggers the obligation to make a public tender offer.

The decision shareholders take regarding acceptance of the offer may reflect the intention to realize short-term gains or instead the desire to share in formulating and evaluating the company's business strategies.

In view of the special nature of banking, the legal systems of the developed countries contain specific rules for the transfer of the ownership of banks.

In Italy, in conformity with the relevant Community directives, the law is designed to safeguard the sound and prudent management of credit institutions. Persons who intend to acquire control of banks or major holdings in their capital must comply with clearly-defined disclosure requirements and obtain the necessary authorizations.

The criteria and procedures used for supervisory evaluations take account of the proposed methods for making acquisitions. They are neutral with respect to the nationality of the interested parties.

If the entity intending to acquire the equity interest is an EU bank, Community law provides for prior consultation with the supervisory authorities of the country in which it has its registered office. When the applicable conditions are met, the transaction is subject to approval by the European Commission as regards the protection of competition.

The Bank of Italy's analysis of applications for authorization takes account of the situation of the applicant, the purpose of the acquisition and the state of the target company. If the buyer is an Italian bank, consideration is given to the adequacy and feasibility of the plans for obtaining the necessary capital resources, with a view to compliance with the prudential rules. The time required to grant authorizations depends in part on the size of the proposed investment and the availability of information on the applicant's assets and liabilities and financial position.

The Bank of Italy's independence in the performance of its supervisory functions and the transparency with which it discloses the principles and criteria of its controls have regularly been recognized by international institutions.

Information concerning supervisory matters is covered by professional secrecy. This can be waived in the cases which have been explicitly provided for.

The role of banks

The return on equity of the banking system was 10.7 per cent in 2004; profits amounted to €11 billion. Revenues remained basically unchanged compared with the previous year; there was a further reduction in operating costs and loan loss provisions diminished.

Preliminary data indicate that this year's results for the first quarter are in line with those recorded in 2004.

The improvement in profitability has helped to strengthen the banking system's capital base. Supervisory capital has risen to €149 billion; it is equal to 11.6 per cent of the system's risk-weighted assets, compared with 10.1 per cent in 2000. The gap with respect to the average of European banks has narrowed in the last few years and is now about 1 percentage point.

Bank credit continues to be of fundamental importance for Italy's economy, partly owing to the still limited development of the capital market. For small and medium-sized enterprises, which make up the bulk of Italian industry, bank credit accounts for approximately 70 per cent of their total external financing.

Some of the major banking groups have established banks dedicated to the financing of firms, especially small and medium-sized ones. The banks that operate at the provincial and regional levels have strengthened their positions.

In just a few years all the different types of investment funds provided for in the Consolidated Law on Finance have become operational. But demand for innovative corporate finance services is slow in emerging.

The Italian economy is contending with particularly intractable problems of growth. Industry’s loss of competitiveness is essentially of a structural nature. Firms in difficulty risk being shut out of the market. Recourse to the Wage Supplementation Fund is increasing; employment is stagnant.

In this difficult transition of our economy the support of the banking industry is of fundamental importance. It is necessary to nurture new initiatives in high-tech sectors and investment in R&D.

The banking system must encourage the opening of firms’ capital to investors able to increase and redirect productive capacity. It must foster the growth of firms and assist them in the necessary task of expanding abroad in order to defend and regain shares of the international market.

In the United States GDP grew at an annualized rate of 3.5 per cent in the first quarter. Productivity and employment rose further.

Forecasts indicate growth in 2005 and 2006 in line with that of potential output, which is estimated to be of the order of 3.5 per cent per year.

The increase in interest rates that the Federal Reserve has embarked on will slow down the growth in the money stock; intended to curb inflation expectations, the rise has not had an adverse effect on medium and long-term interest rates, which remain at moderate levels in all the main markets, thus encouraging investment and consumption.

The US expansion will have positive effects on the other advanced economies and on the emerging economies.

In Japan GDP is expected to grow by 1.5 per cent in 2005 and faster in 2006. The growth of the newly industrialized Asian countries continues at a rapid pace.

World trade in goods and services is set to expand by about 7 per cent this year.

The growth of the euro-area economy will be slower than in 2004; it will continue to be well below that of potential output, which is estimated to be 2 per cent.

Europe is faced with a slowdown in population growth. Aging affects the ability to innovate, reduces the growth in consumption and investment; it will cause the costs of health care, assistance for the elderly and pensions to rise.

Reforms to lengthen people's working lives and rationalize the organization of health services will have to be enacted.

Tax policies and services aimed at improving the conditions of less well-off households and encouraging births and schooling are indispensable in a medium-term perspective, to prevent a reversal of economic growth and social development. An increase in immigration is inevitable; policies are necessary both to regulate the flows and to promote integration.

Industrial production in Italy has fallen by more than 5 per cent since 2000; in the other euro-area countries it has risen by 4 per cent.

The divergence has been clearly visible since the middle of 2003; whereas industrial output recovered in France and Germany, in Italy it began a fall that became more pronounced in the second half of last year. In the first four months of this year industrial production was 2.7 per cent less than in the first four months of 2004.

Manufacturing industry is suffering from a progressive loss of competitiveness, primarily as a consequence of the lack of productivity growth. The fall in output also has implications for the service sector.

Despite the substantial expansion in world trade, Italy's exports in 2005 will be at the same level as in 2004. In the five years since 2000 they will have recorded no growth in volume terms.

The Bank's annual survey of the spending plans of industrial and service firms with 20 or more workers points to a reduction of 3.6 per cent in investment at constant prices in 2005. In the service sector the fall of 5 per cent in 2004 appears set to be followed by another contraction this year.

Investment in public works in the first few months of this year remained at the level of a year earlier. The expansion in activity expected as a result of legislative changes and the increase in tenders has not yet occurred; in addition to difficulties in the decision-making process, firms report delays in the disbursement of funds.

Consumption is expected to grow by about 1 per cent, in line with the preceding years.

The increase in employment is faltering.

The growth in gross domestic product in 2005 will be virtually nil.

A slight recovery in the second half of the year, fostered by economic policy measures, will permit a return to growth in 2006.

On the basis of current trends, general government net borrowing in 2005 will be of the order of 4 per cent of GDP, compared with the Forecasting and Planning Report figure of 2.7 per cent, based on the hypothesis of 2 per cent growth in GDP.

The Italian economy has weaknesses which, if not overcome, could compromise its growth in the medium term.

Correction of the trend of public current expenditure, reform of the taxation of business and labour, a crackdown on tax evasion, and a significant reduction in public debt in relation to GDP are the prerequisites for raising the potential growth rate of the economy.

Action is required by firms aimed at growth in size, technological innovation and the development of new products.

Business must be encouraged by the prospect of a macroeconomic environment of stability and growth and by specific measures at the sectoral level. An increase in competition within industry and services is necessary.

The participation of the social partners in reviving growth is indispensable.

Thanks in part to its recent strengthening, the banking industry will continue to provide the resources the economy needs.

There has been substantial growth in lending to small businesses, especially those located in the South; support has been provided to large firms in difficulty.

In Italy – as and more than in the United States, France and Germany – the extensive presence of small and medium-sized businesses calls for large banks to be flanked by others focused on the local economy while not neglecting the opportunities offered by globalization.

But finance cannot replace the entrepreneur in pursuing innovation, developing projects and raising productivity.

Italy's endowment of public capital remains small. In many economically advanced regions the basic transport infrastructure is inadequate; in the South the supply of electricity and the distribution of water are also insufficient.

It is necessary to make good the delay in implementing the major initiatives linked to the fast track for public works. With the completion of the legal framework for project financing, large-scale participation of private capital will be possible. The efforts of public entities, including regional and local authorities, can create the conditions for an increase in investment in 2006 and 2007.

Sufficient and modern infrastructure is indispensable for the growth of tourism, a sector in which Italy enjoys a comparative advantage thanks to its exceptional endowment of cultural and environmental assets. In the South the tourist industry is well below its potential.

Further liberalization and modernization in the service sector will contribute to raising productivity and employment. Advanced business services are relatively undeveloped in quantitative terms, partly owing to the lack of demand. It is necessary to proceed with the reorganization of public administration.

Thanks to low interest rates and a large volume of medium and long-term lending, domestic demand has been buoyed in the last four years by investment in construction.

The difficulty of exporting and the decline in productive investment hold back demand in the short run. The growth in gross domestic product remains far below the already modest increase in potential output.

It is necessary for planning and infrastructure investment in large cities to stimulate a rapid revival in demand. The measures to foster competitiveness may provide an incentive for private investment.

Italy has faced and overcome difficult periods in its history, recently as well, thanks to the efforts of governmental and institutional bodies, the initiatives of the business community and the convinced cooperation of society.

The poor performance of the economy has adverse effects on the population's attitude towards institutions, those who govern and their plans.

The recent political developments in important countries of the European Union must strengthen the commitment to achieving faster economic growth in the continent in which we feel integrated by common cultural and civil roots.

It is necessary to give the European institutions a basis of democratic legitimation and representativeness, apply in full the principle of subsidiarity which the founding fathers made a cornerstone of the Treaty of Rome. More than a redoubling of rules, it is necessary to capitalize within a unitary framework on the differences and capabilities of the individual countries and economies.

We must regain confidence. Politics, institutions, forward-looking entrepreneurs and the social partners must react, achieve consensus on realistic goals of general interest, strive to return, in an international economic context that remains basically favourable, to the path of economic growth and civil development.

ANNUAL ACCOUNTS

NOTES TO THE ACCOUNTS [1]

The Bank's results for the year 2004 were affected, like those for 2003, by the depreciation of the US dollar, which fell by about 8 per cent against the euro (from 1.2630 to 1.3621).

The year-end balance sheet total was equal to €159,586 million, up by €14,060 million on the end of 2003 (€145,526 million). On the assets side the increase was due to the creation of an overall credit position vis-à-vis the Eurosystem in connection with TARGET transactions and the growth in refinancing operations and the portfolio of securities denominated in euros, which together offset the fall in the value of foreign currency and gold.

The increase in liabilities reflected the growth in banknotes in circulation and that in the balances on the Treasury's accounts, offset in part by the annulment of the debit position vis-à-vis the Eurosystem.

The net profit for the year amounted to €25 million, compared with €52 million in 2003. The result for the year, which benefited from the increase in net interest income, was influenced by the €1,699 million of foreign exchange writedowns (primarily in relation to dollar-denominated assets) and the Bank of Italy's €248 million share of the loss incurred by the ECB, which was also due to foreign exchange writedowns. A total of €754.5 million was withdrawn from the provision for general risks. Following the elimination of the effects on the accounts of tax legislation pursuant to Legislative Decree 6/2003, last year saw the inclusion in income of the reserve for accelerated depreciation and that consisting of amounts set aside under Legislative Decree 124/1993, on which tax had been paid in the last few years. Taken together, the above-mentioned factors resulted in a tax loss of €758 million.

On 29 April 2005 the exchange rate of the dollar against the euro was 1.2957, a recovery of approximately 5 per cent with respect to the end of 2004.

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[1] This abridged English version of the Bank's annual accounts does not contain all the information required by law in the Italian version. In addition, it does not include the external auditor's report issued by PricewaterhouseCoopers SpA.

1. Legal basis, methods of preparation and layout of the annual accounts

1.1 *Legal basis of the annual accounts.* – In drawing up its annual accounts, the Bank of Italy is subject to special statutory provisions and, if they do not provide any guidance, applies the rules laid down in the Civil Code, taking generally accepted accounting principles into account where necessary.

The main statutory provisions referred to above are:

– Article 8.1 of Legislative Decree 43/1998 ("Adaptation of Italian law to the provisions of the treaty establishing the European Community for matters concerning monetary policy and the European System of Central Banks"). The Decree states that "in drawing up its annual accounts, the Bank of Italy may adapt, *inter alia* by way of derogation from the provisions in force, the methods it uses in recognizing amounts and preparing its annual accounts to comply with the rules laid down by the ECB in accordance with Article 26.4 of the ESCB Statute and the recommendations issued by the ECB in this field. The annual accounts drawn up in accordance with this paragraph, with regard in particular to the methods used in their preparation, are also valid for tax purposes".

  In a guideline approved by the Governing Council of the ECB in 1998, replaced most recently by Guideline ECB/2002/10 of 5 December 2002, the ECB laid down rules for items of central banks' annual accounts with reference mainly to the institutional activities of the ESCB (system items) and non-binding recommendations for the other items of their annual accounts (non-system items). In addition, on 8 April 1999 the Governing Council of the ECB issued Recommendation ECB/1999/NP7 on the accounting treatment of the costs incurred in the production of banknotes.

  On the basis of the authority granted by Article 8 of Legislative Decree 43/1998, the Bank of Italy has applied in full the accounting rules and recommendations issued by the ECB, including those on the layout of the income statement in report form and that of the balance sheet. The latter is the same as that used for the monthly statement approved, pursuant to Article 8.2 of Legislative Decree 43/1998, by the Minister for the Economy and Finance;

– Royal Decree 1067/1936 (the Bank's Statute) as amended, which lays down special rules for the allocation of the net profit for the year, the creation of special reserves and provisions, and the allocation of the income arising from the investment of the reserves.

As regards the matters concerning the preparation of the accounts not covered by the foregoing rules, the following provisions apply:

– Legislative Decree 127/1991 ("Implementation of Directives 78/660/EEC on the annual accounts of certain types of companies and 83/349/EEC on consolidated accounts pursuant to Article 1.1 of Law 69/1990");
– Legislative Decree 6/2003 ("Reform of the rules governing companies and cooperatives in implementation of Law 366/2001");

Pursuant to Legislative Decree 6/2003, it was necessary reverse the effects of transactions carried out in prior years in relation to accelerated depreciation and the setting aside in a special reserve of 3 per cent of staff severance pay allocated to supplementary pensions under Legislative Decree 124/1993.

– Legislative Decree 87/1992, as amended ("Implementation of Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 89/117/EEC on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents");
– Article 65 (transactions involving government bonds) of Law 289/2002.

1.2 *Accounting policies*. – The accounting policies applied in preparing the annual accounts for 2004 are described below. Where provided for by law, they were agreed with the Board of Auditors.

At the start of the Third Stage of EMU the opening book value of gold, of foreign currency assets/liabilities and of the securities used in monetary policy operations were adjusted to the market prices obtaining at that date, with the resulting capital gains assigned to so-called pre-system revaluation accounts.

GOLD

– *in valuing stocks and determining the results of trading, the "average-daily-net-cost" method is applied;*
– *the valuation is effected on the basis of the year-end price communicated by the ECB. Unrealized gains are included in the corresponding revaluation account; unrealized losses in excess of earlier unrealized gains are included in the income statement. Revaluation gains recorded through 1 January 1999 and still existing in special revaluation accounts at 30 December 2002 have been utilized in accordance with Article 65.3 of Law 289/2002;*

- *the cost of gold, for civil law and tax purposes as well, is equal to the amount stated in the accounts net of the pertinent revaluation account.*

FOREIGN CURRENCY ASSETS/LIABILITIES

- *in valuing stocks and determining the results of trading, the "average-daily-net-cost" method is applied for each currency;*
- *the valuation is effected on the basis of the year-end exchange rates communicated by the ECB. Unrealized gains are included in the corresponding revaluation account; those deriving from the adjustment to market value and recorded through 1 January 1999 are included in the income statement on a pro rata basis in the event of redemptions or disposals. Unrealized losses in excess of earlier unrealized gains are included in the income statement, with the simultaneous entry under income of any amount withdrawn from the specific provision existing at the beginning of Stage Three of EMU, if it still exists;*
- *shares denominated in foreign currency held as fixed assets continue to be valued at the historical exchange rate;*
- *the International Monetary Fund quota is translated on the basis of the euro/SDR exchange rate communicated by the IMF on the occasion of the last transaction undertaken for the quota originally subscribed in lire and at the euro/SDR exchange rate communicated by the ECB for the quota in SDRs.*

SECURITIES

- *the cost (clean price) of bonds is adjusted by the amount of the amortization of the premium/discount (the difference between the book value and the par value, to be included in the income statement — on a pro rata basis using a method based on compound capitalization — in relation to the residual life of the security);*
- *the valuation of holdings for the purpose of determining the profit or loss on securities is effected, for each type of security, using the "average-daily-cost" method;*
- *holdings are stated as follows:*
  1) *for securities not held as fixed assets:*
     a) *listed shares and bonds: at the market price available at the end of the year; unrealized gains are included in the corresponding revaluation accounts; unrealized gains deriving from the adjustment to market value and recorded through 1 January 1999 are included in the income statement on a pro rata basis in the event of redemptions or disposals; unrealized losses in excess of earlier unrealized gains are included in the income statement, with the simultaneous entry under income of any amount withdrawn from the specific provision existing at the beginning of Stage Three of EMU, if it still exists;*
     b) *unlisted bonds: at cost with account taken of any diminution in value corresponding to special situations related to the position of the issuer;*
     c) *unlisted shares and equity interests not represented by shares: at cost, reduced where the losses shown in the last approved annual accounts or special situations of the issuing company are such as to cause the security's value to fall below cost;*

2) *for securities held as fixed assets (bonds and shares):*

   a) *at cost, with account taken of special situations related to the position of the issuer that cause the security's value to fall below cost.*

PARTICIPATING INTERESTS

The Bank's participating interests in subsidiary and associated companies classified as fixed assets are stated at cost, with account taken of any losses that reduce the Bank's interest in the shareholders' equity below cost.

The UIC endowment fund and the participating interest in the ECB are stated at cost.

Dividends and profits are recognized on a cash basis.

The Bank's accounts are not consolidated with those of investee companies insofar as the Bank is not among the entities referred to in Article 25 of Legislative Decree 127/1991.

The annual accounts of the UIC are attached to those of the Bank pursuant to Article 4 of Legislative Decree 319/1998.

TANGIBLE FIXED ASSETS

Depreciation begins in the quarter subsequent to that of acquisition both for buildings and for plant and equipment.

Buildings

- *are stated at cost, including improvement expenditure, plus revaluations effected pursuant to specific laws. The depreciation of buildings used in the Bank's institutional activities and those that are "objectively instrumental", in that they cannot be used for other purposes without radical restructuring, included among the investments of the provision for staff severance pay and pensions is on a straight line basis using the annual allowance of 4 per cent established by the ECB.*

Plant and equipment

- *are stated at cost, including improvement expenditure. They are depreciated on a straight line basis using the allowances established by the ECB (plant, furniture and equipment, 10 per cent; computers and related hardware and basic software and motor vehicles, 25 per cent).*

INTANGIBLE FIXED ASSETS

Procedures, studies and designs under way and advances

- *valued at purchase or directly allocable production cost.*

Procedures, studies and designs completed

- *valued at purchase or directly allocable production cost and amortized on the basis of allowances deemed congruent with the assets' remaining useful lives.*

Deferred charges

- *software licences are stated at cost and amortized on a straight line basis over the life of the contract or, where no time limit is established or it is exceptionally long, over the estimated useful life of the software;*
- *costs incurred in constructing and enlarging communication networks and one-off contributions provided for in multi-year contracts are amortized on a straight line basis over the foreseeable life of the network in the first two cases and over the life of the contract in the third case;*
- *costs incurred in improving buildings owned by third parties and rented to the Bank are amortized on a straight line basis over the remaining life of the rental contract.*

Costs of less than 10,000 euros are not capitalized, except for those incurred for software licences.

STOCKS OF THE TECHNICAL DEPARTMENTS

The valuation of stocks, with reference exclusively to the EDP Department, is made using the LIFO method.

ACCRUALS AND DEFERRALS

Include accrued income and prepaid expenses and accrued expenses and deferred income.

BANKNOTES IN CIRCULATION

The ECB and the twelve participating NCBs, which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002 (ECB Decision 2001/15 of 6 December 2001 on the issue of euro banknotes, in OJ L337 of 20 December 2001, pp. 52-54, as amended). The total value of euro banknotes in circulation is allocated on the last working day of each month on the basis of the criteria set out hereinafter.

As of 2002 the ECB has been allocated a share of 8 per cent of the total value of euro banknotes in circulation, whereas the remaining 92 per cent has been allocated to each NCB according to its weighting in the capital key of the ECB. The share of banknotes allocated to each NCB is disclosed under the balance sheet liability item "Banknotes in circulation". The difference between the value of the banknotes allocated to each NCB in accordance with the banknote allocation key and that of the banknotes it actually puts into circulation gives rise to remunerated intra-Eurosystem balances. From 2002 until 2007 the intra-system balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in NCBs' relative income positions as compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the period from July 1999 to June 2001 and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments will be reduced in annual stages until the end of 2007, after which income on banknotes will be allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital (ECB Decision 2001/16 of 6 December 2001 on the allocation of monetary income of the national central banks of participating Member States from the financial year 2002, in OJ L337 of 20 December 2001, pp. 55-61, as amended).

The interest income and expense on these balances is cleared through the accounts of the ECB and is disclosed under "Net interest income".

The Governing Council of the ECB has decided that the seigniorage income of the ECB arising from the 8 per cent share of banknotes allocated to the ECB shall be recognized separately to the NCBs after the end of each quarter in the form of an interim distribution of profit (ECB Decision 2002/9 of 21 November 2002, in OJ L323 of 28 November 2002, pp. 49-50). It shall be so distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation and subject to any decision by the Governing Council to reduce this income in respect of costs incurred by the ECB in connection with the issue and handling of banknotes. The interim distributions by the ECB, corresponding to the share of the ECB's seigniorage income recognized as pertaining to the Bank of Italy, are recorded on an accrual basis in the year to which the income refers, by way of derogation from the cash policy applied in general to dividends and profits from participating interests.

For 2004 the Governing Council decided, in the light of the result recorded by the ECB, that the full amount of the seigniorage income should be retained by the ECB.

INTRA-EUROSYSTEM ASSETS AND LIABILITIES

For each NCB the intra-Eurosystem balance arising from the allocation of euro banknotes within the Eurosystem is included under "Net claim/liability related to the allocation of euro banknotes within the Eurosystem".

TRANSFERS

To the provisions for risks

- *the provisions for risks take account, in compliance with the prudence principle, of the risks associated with the various sectors of the Bank's operations and are based on an evaluation of their adequacy that covers the sum of all the provisions. The riskiness of the Bank's foreign exchange positions and securities portfolio is evaluated on a value-at-risk basis, with consideration also given to the size of the revaluation accounts.*
- *the provision for general risks is also for risks in connection with the Bank's overall activity that cannot be determined individually or allocated objectively.*

Transfers to and withdrawals from the provisions are decided by the Board of Directors.

To the tax provision

- *the provision for taxation is equal to the amount of taxes to be paid (including deferred tax liabilities), determined on the basis of a realistic estimate of the foreseeable liability under the tax rules in force and of amounts arising from possible disputes with the tax authorities.*

To cover the losses of the ECB

- *the allocation is equal to the share borne by the Bank of Italy of the loss incurred by the ECB in 2004, in accordance with Article 32.2 of the Statute of the ESCB.*

To sundry staff-related provisions

- *transfers to the provision for severance pay and pensions of staff hired before 28 April 1993 are included in the annual accounts under Article 3 of the related Rules for an amount that comprises the severance pay accrued at the end of the year, the actuarial reserves for the disbursements to pensioners and those corresponding to the situation of staff having entitlement;*
- *the provision for staff costs includes the estimated amount of costs that had accrued (such as sundry bonuses, holidays not taken, contributions set aside for newly-hired staff) but not been paid at 31 December 2004;*
- *transfers to the provision for grants to BI pensioners and their surviving dependents are made in accordance with Article 24 of the Rules governing staff severance pay and pensions;*
- *transfers to the provision for severance pay of contract staff, who do not participate in pension funds, are determined in accordance with Law 297/1982.*

For staff hired from 28 April 1993 onwards a defined-contribution supplementary pension fund has been created (for more details see below under Other assets and liabilities).

OTHER ASSETS AND LIABILITIES ITEMS

These are stated at their nominal value; in particular:

- *for receivables, the nominal value coincides with the estimated realizable value;*
- *for deferred tax assets and liabilities, including the assets deriving from the application of Article 65.2 of Law 289/2002, the amount stated is determined on the basis of the presumable tax effect in future years.*

The items "Other assets" and "Other liabilities" include the investments and patrimony of the defined-contribution supplementary pension fund created for staff hired from 28 April 1993 onwards. The fund is invested in financial instruments, which are valued at year-end market prices. The resulting revaluation gains (losses) are treated as revenues (expenses) and, in the same way as for other operating revenues (expenses), added to (subtracted from) the fund's patrimony.

The item "Other liabilities" includes the lira banknotes that have not yet been presented for conversion.

INTEREST RATE FUTURES ON THE DOLLAR MARKET

Initial margins are recorded in the balance sheet; positive and negative daily variation margins are communicated by the clearer and taken to the profit and loss account, converted at the exchange rate of the day.

MEMORANDUM ACCOUNTS

Securities held on deposit are stated at their nominal value; shares are stated on a quantity basis; those of other kinds at face value or at conventional value.

Futures contracts are recorded on the trade date at their notional value.

Foreign currency amounts are converted at the year-end exchange rates communicated by the ECB.

2. Comment on the accounts

2.1. *Balance sheet*. – Excluding memorandum items, the balance sheet total at 31 December 2004 was equal to €159,586 million, an increase of €14,060 million compared with the figure of €145,526 million at the end of 2003.

Assets:

The item *gold and gold receivables* fell by €694 million (from €26,042 million to €25,348 million) following their valuation at the year-end market price communicated by the ECB (€321.562 per ounce, compared with €330.364 at the end of 2003). In fact the quantity of gold remained unchanged at 79 million ounces or 2,452 tons.

Claims on non-euro-area residents denominated in foreign currency, valued at market prices and exchange rates, decreased by €3,615 million (from €24,065 million to 20,450 million) as a consequence of the reduced quantity of claims and year-end writedowns.

Within this item:

– *receivables from the IMF* decreased by €578 million (from €4,212 million to €3,634 million). They comprised:
  a) Italy's net position vis-à-vis the IMF, which fell by €590 million (from €3,306 million to €2,716 million);
  b) Italy's share of the loan to support debt-reduction initiatives for the poorest countries (PRGF), which declined from €783 million to €812 million;
  c) the Bank's SDRs, which fell from €123 million to €106 million.
– *securities (other than shares)* fell by €1,282 million (from €14,765 million to €13,483 million) as a result of the price and exchange losses recorded at the end of the year and, to a lesser extent, of net sales. The year-end portfolio consisted of securities denominated in US dollars (€11,786 million) and yen (€1,697 million) and for the most part issued by the US and Japanese Treasuries and international organizations (the BIS and the EIB);
– *current accounts and deposits*, denominated mostly in US dollars and yen, held at the BIS and with residents of the United Kingdom, Japan and the United States, fell by €1,755 million (from €5,086 million to €3,331 million), primarily as a result of the foreign exchange component; in particular, time deposits fell by €1,378 million (from

€2,692 million to €1,314 million) and sight and overnight deposits by €376 million (from €2,393 million to €2,017 million);

– *other claims* consisted almost exclusively of foreign banknotes and remained unchanged at €2 million.

Claims on euro-area residents denominated in foreign currency, valued at market prices and exchange rates, fell by €854 million (from €6,449 million to €5,595 million) as a consequence of year-end writedowns and the reduced quantity of claims.

Within this item, which consists of positions with financial counterparties:

– *securities (other than shares)* increased by €855 million (from € 1,849 million to €2,704 million), as a result of net purchases, offset in part by the exchange losses recorded at the end of the year; they consisted of securities denominated in US dollars issued by financial counterparties resident mainly in France, Germany and the Netherlands;
– *other claims* decreased by €1,709 million (from €4,600 million to €2,891 million) and consisted of deposits with correspondents, mostly in the form of time deposits in US dollars.

Lending to euro-area banks related to monetary policy operations rose by €6,435 million (from €8,197 million to €14,632 million), with a particularly large increase in *main refinancing operations* (from €8,191 million to €14,218 million), which also increased on an annual average basis (from €7,957 million to €14,175 million).

Longer-term refinancing operations rose from zero at the end of 2003 to €412 million at 31 December 2004; the annual average value of this item also rose (from €52 million to €470 million).

Fine-tuning reverse operations were used once during the year; at 31 December 2004 the item was equal to zero.

The balance of the *marginal lending facility* fell from €6 million to zero, while the annual average value of this item rose from €4 million to €7 million.

The year-end balance of *credits related to margin calls* rose from zero to €2 million; the annual average value of this item was €1 million (compared with €0.1 million in 2003).

As in 2003, no use was made of *structural reverse operations* during the year.

The item *other claims on euro-area banks*, which comprises the correspondent accounts in connection with the activity of the Bank's representative offices abroad, remained small, rising from €0.2 million to €0.3 million.

Securities issued by euro-area residents (other than shares) rose by €306 million (from €1,672 million to €1,978 million) as a consequence of net purchases. The annual average value of this item was €1,735 million (compared with €1,326 million in 2003).

General government debt fell by €155 million (from €18,716 million to €18,561 million). In particular:

– the securities received at market price following the bond conversion provided for in Article 65 of Law 289/2002 decreased by the annual accrued amount of the related discounts and declined from €17,621 million to €17,515 million;
– the overall position in respect of the past management of stockpiling bills decreased by €50 million to €1,046 at 31 December 2004.

Intra-Eurosystem claims increased by €7,055 million (from €8,192 million to €15,247) as a result of:

– the €19 million decrease in the *participating interest in the ECB* (from €745 million to €726 million);

Article 29 of the Statute of the ESCB provides for the keys of NCBs for subscription of the ECB's capital to be adjusted every five years. The first five-year change since the establishment of the ECB took effect on 1 January 2004.

On 1 May 2004 a second change was made to the ECB's capital key, pursuant to Article 49.3 of the Statute of the ESCB, in response to the accession of 10 new EU member states. Based on the Decision of the ECB's Governing Council of 15 July 2003 (concerning the statistical data to be used for the determination of the key for subscription of the capital of the European Central Bank), the Bank of Italy's share of the capital decreased from 14.8950 to 14.5726 per cent as of 1 January 2004 and to 13.0516 per cent as of 1 May 2004, thus giving rise to transfers settled within the ESCB. Consequently, with effect from the same dates its participating interest in the ECB diminished to respectively €729 million and €726 million.

If only the Eurosystem countries are considered, as of 1 May 2004 the Bank of Italy's share of the ECB's capital was equal to 18.2563 per cent.

– the €184 million decrease (from €7,447 million to €7,263 million) in *claims deriving from the transfer of foreign reserves to the ECB* in the form of gold, foreign securities and foreign exchange effected by the Bank of Italy at the start of the third stage of EMU;

The reduction in this item compared with end-2003 reflects the adjustments to the Bank of Italy's share of the ECB's capital; on 1 January 2004 the claims declined from €7,447 million to €7,286 million and on 1 May 2004 to €7,263 million.

– the €7,258 million positive balance of the subitem *other claims within the Eurosystem (net)*; at 31 December 2003 there was a negative balance of €2,026 million, included under the corresponding heading on the liabilities side.

Items to be settled fell by €9 million (from €11 million to €2 million).

Other assets rose from €52,181 million to €57,772 million. In particular:

– *euro-area coins*, which includes lira and euro coins, rose from €18 million to €26 million;
– the *UIC endowment fund* remained unchanged at €258 million;
– *investments of reserves and provisions (including shares)* increased by €679 million (from €28,434 million to €29,113 million; the annual average value of this item also rose (from €27,926 million to €28,372 million);
– *intangible fixed assets* (net of amortization) increased slightly (from €24 million to €25 million);
– *deferred charges* remained unchanged at €6 million;
– *tangible fixed assets (net of depreciation)* amounted to €2,452 million. The decrease of €130 million compared with 31 December 2003 was due to €38 million of purchases and capitalized own work, €3 million of disposals and €165 million of depreciation;
– *accrued income and prepaid expenses* increased by €17 million (from €698 million to €715 million);
– *sundry* other assets increased by €5,017 million (from €20,160 million to €25,177 million) and included:
  a) €14,937 million of euro securities held as fixed assets, compared with €10,102 million at 31 December 2003; the increase of €4,835 million was the result of net purchases and transfers from *investments of reserves and provisions (including shares)*. The annual average value of this item was €12,830 million;
  b) €8,333 million of deferred tax assets (€8,075 million at the end of 2003), of which €1 million in respect of the regional tax on productive activities (Irap) and €8,332 million in respect of corporate income tax (Ires), as the algebraic sum of the following:
    – €7,119 million of deferred tax assets deriving from the carry forward of the 2002 tax loss incurred as a consequence of the

bond conversion described above and offsettable up to 2022 under Law 289/2002;

- €973 million of deferred tax assets deriving from the tax loss recorded in 2003, offsettable up to 2008 under Article 84 of the Income Tax Code as amended by Legislative Decree 344/2003;
- €250 million of deferred tax assets deriving from the tax loss recorded in 2004, offsettable up to 2009 under Article 84 of the Income Tax Code;
- €33 million of deferred tax assets deriving from other expense items; in particular the allocation of €24 million to the provision for staff costs and €9 million of prior-year depreciation at rates in excess of those allowed for tax purposes;

The inclusion of deferred tax assets in the balance sheet is based on the reasonable expectation – considering the outlook for the Bank's income – of offsetting, within the time limits established by law, the full amount of the tax losses produced both by the bond conversion and by the exceptional diminution in recent years of the current value of the positions denominated in foreign currency. In this respect there was confirmation of the expected lasting improvement in the profitability of the Bank's ordinary operations, which began in 2003 and continued in 2004, even though it did not appear in the overall results for the two years owing to the exceptional unrealized losses on foreign exchange.

- €43 million of deferred tax liabilities in relation almost exclusively to accelerated depreciation;

The deferred tax assets and liabilities were calculated using the 33 per cent rate of the corporate income tax (Ires) and the Irap rates expected to apply in 2005 and the subsequent years.

c) €55 million, the balance-sheet total of the supplementary pension fund. Up by €11 million, this item is matched on the liabilities side by an equal amount entered under *other liabilities – sundry*.

Liabilities:

Banknotes in circulation increased by €10,384 million (from €73,807 million to €84,191 million). This item is the Bank of Italy's share of the total Eurosystem note issue (see the section on *Banknotes in circulation* under *Accounting policies*).

Liabilities to euro-area banks related to monetary policy operations amounted to €12,972 million (€10,304 million at the end of 2003) and comprised:

– *current accounts (covering the minimum reserve system)*, which consisted almost entirely of banks' deposits under the minimum reserve system, which rose from €10,303 million to €12,970 million; the annual average value also rose, from €14,195 million to €15,095 million);

– *deposit facility*, which rose from €1 million to €2 million, while the annual average value declined from €8 million to €7 million);

– *fixed-term deposits, fine-tuning reverse operations* and *deposits related to margin calls* were all equal to zero, as at the end of 2003.

Liabilities to other euro-area residents denominated in euros increased by €2,597 million (from €13,371 million to €15,968 million). The subitem *general government* (€15,859 million) recorded the following changes:

– the *Treasury payments account* increased from €13,208 million to €15,771 million. The average balance on the account was virtually stable (€28,559 million, compared with €28,400 million);

– the *sinking fund for the redemption of government securities* fell from €24 million to €3 million. By contrast, the annual average value of this item rose (from €665 million to €2,654 million);

– *other liabilities*, comprising other current account deposits, rose from €63 million to €85 million.

The subitem liabilities to *other counterparties* rose from €76 million to €109 million, almost exclusively in connection with the movement in the balance on the UIC's current account; the annual average value also rose, from €32 million to €104 million.

Liabilities to non-euro-area residents denominated in euros rose from €29 million to €31 million and referred mainly to the accounts held by central banks and international organizations, which are included in the subitem *other liabilities*.

Liabilities to non-euro-area residents denominated in foreign currency, denominated exclusively in US dollars and valued at market exchange rates, rose from €374 million to €648 million. In particular, the *other liabilities* consisting of repos rose from €363 million to €638 million. The subitem *deposits and balances* declined from €11 million to €10 million; at end-2003 it had included the daily variation margins for futures contracts (€0.1 million).

The item *Counterpart of SDRs allocated by the IMF* fell by €27 million (from €827 million to €800 million), owing to the valuation at the year-end SDR exchange rate.

Intra-Eurosystem liabilities amounted to €6,077 million and referred entirely to the subitem *Net liabilities related to the allocation of euro banknotes within the Eurosystem*, which at end-2003 had amounted to €5,687 million (see the section on *Banknotes in circulation* under *Accounting policies*).

Items to be settled fell from €34 million to €24 million.

Other liabilities fell by €208 million (from €2,499 million to €2,291 million). Among the subitems, *Accrued expenses and deferred income* rose by €18 million, while *Bank of Italy drafts* fell by €122 million, *Cashier's department services* by €2 million and *Sundry* by €102 million to €1,739 million. The latter included:

– €1,201 million, the amount of lira banknotes not yet presented for conversion (down from €1,337 million at end-2003), excluding the €593 million payment on account that the Bank of Italy has already made to the Treasury for the banknotes that will presumably not be presented within the legal time limit;

– €55 million, the balance-sheet total of the defined-contribution supplementary pension fund for staff hired as of 28 April 1993. This item is matched on the assets side by an equal amount entered under *Other assets-sundry*.

Provisions increased by €244 million (from €6,016 million to €6,260 million). In particular:

– *provisions for specific risks* increased by €220 million to €620 million. The increase was due to:

  a) the creation of a €248.3 million provision to cover the Bank of Italy's share of the loss incurred by the ECB in 2004;

In its meeting on 13 January 2005 the Governing Council of the ECB decided, pursuant to Article 32.2 of the Statute of the ESCB, to retain €1,360 million of the NCB's monetary income pooled in January 2005 to offset part of the loss incurred by the ECB in 2004. Consequently, the Bank of Italy established a provision amounting to €248.3 million, in respect of its allocated monetary income for 2004 to be used to offset the ECB's loss, equivalent to its weighting in the capital key of the ECB, relative to the other NCBs within the Eurosystem. On 11 March 2005 the Governing Council approved the annual accounts for the year ended 31 December 2004, which showed a loss of €1,636 million, of which €1,340 million to be covered by a transfer from monetary income pooled, or €20 million less than the amount originally forecast by the ECB (€1,360 million), in relation to which the Bank had created the above-mentioned provision. The resulting smaller contribution by the Bank (€244.6 million) led to the ECB's returning €3.7 million on 15 March 2005, which will be included as prior-year income in the profit and loss account for 2005 and require minor adjustments to deferred taxes.

b) the reduction of €28 million (from €90 million to €62 million) in the tax provision, of which €22 million was taken to profit and loss account following the reduction in the risk inherent in tax disputes and €6 million to pay prior-year taxes and in relation to the decrease in deferred tax liabilities in respect of Irap.

– *sundry staff-related provisions* rose from €5,616 million to €5,640 million. In particular, the provisions for staff severance pay and pensions rose from €5,521 million to €5,541 million (the provision for severance pay amounted to €1,045 million and that for pensions to €4,496 million). The provision for staff costs rose by €3 million (from €92 million to €95 million), owing to the increase in amounts accrued but not paid at the end of the year. The provision for grants to Bank of Italy pensioners and their surviving dependents and that for severance pay of contract staff under Law 297/1982 together amounted to €4 million.

The *revaluation accounts* rose by €304 million (from €9,246 million to €9,550 million). In more detail, revaluations of securities rose (from €2,614 million to €3,608 million), while revaluations of gold fell (from €6,621 million to €5,927 million); the so-called pre-system revaluation accounts created on 1 January 1999 decreased by €1 million (from €11 million to €10 million) in connection with transfers following redemptions of securities and sales of foreign exchange.

Overall, the valuation at year-end exchange rates of the net foreign exchange positions (in respect of the following items: gold and gold receivables, claims on non-euro-area residents denominated in foreign currency, claims on euro-area residents denominated in foreign currency, liabilities to non-euro-area residents denominated in foreign currency, and counterpart of SDRs allocated by the IMF) led, in addition to the writedowns taken to profit and loss account for a total of €1,699 million (of which €1,484 million in respect of dollars, €145 million in respect of yen, €70 million in respect of SDRs and a negligible amount in respect of other currencies), to:

– unrealized gains amounting to €4 million, almost entirely on Swiss francs, included in the revaluation accounts;
– unrealized losses amounting to €694 million on gold and a negligible amount on foreign currencies that were covered by prior-year unrealized gains included in the corresponding revaluation account.

The *provision for general risks* fell from €7,587 million to €6,832 million following the withdrawal decided by the Board of Directors of €754.5 million in connection with the unrealized losses on foreign currency assets.

The item *capital and reserves* amounted to €13,917 million (€13,666 million at end-2003) and comprised:

– the *ordinary reserve* (€4,989 million) and the *extraordinary reserve* (€4,905 million), which together increased by €398 million;

– *other reserves*, which fell by €147.4 million (from €4,170 million to €4,023 million) as a consequence of the elimination of the effects on the accounts of tax legislation pursuant to Legislative Decree 6/2003, which led to the inclusion in income of the entire reserve for accelerated depreciation (€147.1 million) and of the special reserve of 3 per cent of staff severance pay allocated to supplementary pensions under Legislative Decree 124/1993 (€0.3 million).

2.2. *Income statement*. – The net profit for the year amounted to €25 million (Table 1), down by €27 million from €52 million in 2003.

Among the items included under *net income from institutional operations*, *net interest income* rose by €633 million (from €612 million to €1,245 million), reflecting both an increase in *interest income* and a fall in *interest expense*.

Total *interest income* increased by €404 million (from €2,089 million to €2,493 million).

In particular, there was an increase of:

– €629 million (from €66 million to €695 million) in income from securities denominated in euros (other than the bonds received in the conversion under Law 289/2002 and those in which the reserves and provisions are invested), as a consequence of the increase in the average value of the portfolio (from €1,435 million to €14,565 million). This was primarily due to the Bank of Italy having reacquired securities that had served as collateral for advances under Treasury Ministry Decree 27.9.1974; these advances were extinguished at the end of 2003, year in which they generated €120 million of interest;

– €115 million (from €325 million to €440 million) in income from intra-Eurosystem balances as a consequence of:

  a) the increase of €136 million (from €177 million to €313 million) in income from the Bank's positive TARGET balances;

  b) the fall of €21 million (from €148 million to €127 million) in interest income earned on the claims deriving from the transfer of foreign reserves to the ECB, partly owing to the decrease in the amount outstanding following the adjustment of the Bank of Italy's share in the capital of the ECB (see under *Intra-Eurosystem claims*).

Table 1

ANALYSIS OF THE INCOME STATEMENT

(euros)

	2004		2003		Changes	
A) NET INCOME FROM INSTITUTIONAL OPERATIONS		**242,970,746**		**-574,885,536**		**817,856,282**
Interest income		2,492,644,809		2,088,545,167		404,099,642
securities and other assets denominated in foreign currency	*384,894,021*		*630,291,710*		*-245,397,689*	
IMF position	*68,263,554*		*70,900,963*		*-2,637,409*	
refinancing operations	*300,213,259*		*188,488,717*		*111,724,542*	
bond conversion securities, Law 289/2002	*929,584,567*		*928,114,565*		*1,470,002*	
other securities denominated in euros	*695,134,729*		*65,762,854*		*629,371,875*	
intra-Eurosystem balances	*439,897,381*		*325,215,993*		*114,681,388*	
advances under Ministerial Decree 1974	–		*119,983,117*		*-119,983,117*	
UIC current account	*2,314*		*59,516*		*-57,202*	
bond premiums and discounts	*-325,345,514*		*-240,272,804*		*-85,072,710*	
other	*498*		*536*		*-38*	
Interest expense		-1,248,021,911		-1,476,836,951		228,815,040
Treasury payments account	*-803,573,713*		*-1,021,368,793*		*217,795,080*	
sinking fund for the redemption of government securities	*-53,941,480*		*-17,783,405*		*-36,158,075*	
current account deposits of required reserves	*-308,235,514*		*-331,742,500*		*23,506,986*	
overnight deposits, term deposits and deposits related to margin calls	*-298,827*		*-95,017*		*-203,810*	
UIC current account	*-1,079,110*		*-390,719*		*-688,391*	
intra-Eurosystem balances	*-57,652,309*		*-73,495,211*		*15,842,902*	
sundry interest denominated in foreign currency	*-22,979,658*		*-31,254,692*		*8,275,034*	
other	*-261,300*		*-706,614*		*445,314*	
Net interest income		**1,244,622,898**		**611,708,216**		**632,914,682**
Profits and losses on financial operations		177,471,731		477,167,233		-299,695,502
profits/losses on securities trading	*25,078,698*		*435,417,524*		*-410,338,826*	
profits/losses on foreign exchange trading	*159,445,705*		*-71,773,381*		*231,219,086*	
profits/losses on derivatives contracts denominated in foreign currency	*-7,052,672*		*449,884*		*-7,502,556*	
profits/losses on forward transactions in securities under Ministerial Decree 1974	–		*113,073,206*		*-113,073,206*	
Writedowns of financial assets and positions		-1,720,953,526		-4,645,447,695		2,924,494,169
foreign securities	*-21,867,323*		*-15,173,420*		*-6,693,903*	
foreign currencies	*-1,698,988,643*		*-4,629,388,356*		*2,930,399,713*	
securities denominated in euros	*-97,560*		*-48,646*		*-48,914*	
foreign currency derivatives	–		*-837,273*		*837,273*	
Transfers to/from provisions for losses on foreign exchange and securities		755,264,050		2,750,754,453		-1,995,490,403
transfers from "pre-system" revaluations reserves	*764,050*		*10,549,730*		*-9,785,680*	
transfers from the provision for general risks	*754,500,000*		*1,202,600,000*		*-448,100,000*	
transfers from the provisions for losses on foreign exchange and securities	–		*1,537,604,723*		*-1,537,604,723*	
Net result of financial operations, writedowns and risk provision transfers		**-788,217,745**		**-1,417,526,009**		**629,308,264**
Fee and commission income		18,240,714		19,822,190		-1,581,476
Fee and commission expense		-19,919,206		-18,968,247		-950,959
Net income from fees and commissions		**-1,678,492**		**853,943**		**-2,532,435**
Income from equity shares and participating interests		27,063,147		215,074,412		-188,011,265
income from participating interest in ECB	*3,958,354*		*112,999,262*		*-109,040,908*	
income from participating interest in UIC endowment fund	*23,104,793*		*102,075,150*		*-78,970,357*	
Net result of the pooling of monetary income		-238,819,062		15,003,902		-253,822,964
monetary income pooled	*1,505,042,547*		*1,427,184,703*		*77,857,844*	
monetary income redistribuited	*-1,495,575,452*		*-1,412,180,801*		*-83,394,651*	
contribution to the coverage of the ECB loss	*-248,286,157*		–		*-248,286,157*	

Table 1 *cont.*

ANALYSIS OF THE INCOME STATEMENT

(euros)

	2004		2003		Changes	
B) OTHER INCOME		**1,572,363,327**		**1,630,133,236**		**-57,769,909**
Income from the investment of reserves and provisions		1,296,057,125		1,431,002,283		-134,945,158
interest income	*868,570,775*		*954,977,626*		*-86,406,851*	
bond premiums and discounts	*-41,632,150*		*-34,251,936*		*-7,380,214*	
dividends on equity shares and participating interests	*263,665,038*		*167,550,705*		*96,114,333*	
trading profits and gains on disposals	*205,453,462*		*342,725,888*		*-137,272,426*	
Prior-year income		181,517,089		83,527,105		97,989,984
Sundry		94,789,113		115,603,848		-20,814,735
rental income from buildings	*20,385,012*		*19,973,686*		*411,326*	
interest on tax credits	*21,093,321*		*22,748,807*		*-1,655,486*	
other interest income	*1,993,675*		*2,125,317*		*-131,642*	
Ministry for the Economy and Finance commissions	*2,153,020*		*299,407*		*1,853,613*	
procedures, studies and designs completed	*10,170,009*		*10,124,950*		*45,059*	
closing stocks	*536,551*		*663,113*		*-126,562*	
other	*38,457,525*		*59,668,568*		*-21,211,043*	
TOTAL NET INCOME (A+B)		**1,815,334,073**		**1,055,247,700**		**760,086,373**
C) SUNDRY EXPENSES AND CHARGES						
Staff wages and salaries and related costs		-612,415,741		-614,612,177		2,196,436
Emoluments paid to head and branch office collegial bodies (1)		-2,697,194		-3,006,845		309,651
Transfers to provisions for accrued expenses and staff severance pay and pensions		-94,568,046		-130,343,405		35,775,359
severance pay and pensions	*-20,230,079*		*-59,677,598*		*39,447,519*	
expenses accrued but not yet paid	*-73,949,611*		*-70,345,172*		*-3,604,439*	
other provisions	*-388,356*		*-320,635*		*-67,721*	
Other staff costs		-41,341,203		-41,266,905		-74,298
Pensions and severance payments		-280,769,310		-242,815,476		-37,953,834
Administrative costs		-374,045,629		-360,659,064		-13,386,565
Depreciation of tangible and intangible fixed assets		-186,390,736		-190,498,010		4,107,274
Other costs:						
losses on investments of reserves and provisions ..		-9,638,221		-42,391,394		32,753,173
losses on trading and disposals	–		..		..	
writedowns	*-9,638,221*		*-42,391,394*		*32,753,173*	
other transfers to provisions		–		-118,554		118,554
prior-year expense		-2,709,017		-1,705,197		-1,003,820
appropriation of investment income to reserves (2) .		-422,324,280		-468,969,171		46,644,891
other taxes and duties		-14,997,525		-15,903,440		905,915
sundry		-6,044,347		-6,664,741		620,394
other interest expense	*-136,642*		*-580,050*		*443,408*	
opening stocks	*-663,113*		*-574,007*		*-89,106*	
miscellaneous payables	*-5,244,592*		*-5,510,684*		*266,092*	
Taxes on income for the year and productive activities (3)		258,061,676		1,116,103,942		-858,042,266
NET PROFIT FOR THE YEAR		**25,454,500**		**52,397,263**		**-26,942,763**

(1) Includes the remuneration of the Board of Directors (€538,873 in 2004 and €648,353 in 2003) and the Board of Auditors (€34,590 in 2004 and €33,210 in 2003). – (2) Pursuant to Article 55 of the Statute. – (3) Under the layout of the income statement adopted, this item includes amounts with a positive sign.

– €112 million (from €188 million to €300 million) in income from refinancing operations, of which:

   a) €103 million in respect of main refinancing operations owing to the growth in the annual average amount from €7,957 million to €14,175 million;

   b) €9 million in respect of longer-term refinancing operations, the annual average amount of which rose from €52 million to €470 million.

Interest income earned on foreign currency assets fell from €701 million to €453 million, owing to the decreases of:

– €245 million in income from securities and other foreign currency assets following the fall in the annual average stock (from €29,683 million to €25,686 million), above all as a result of the fall in assets denominated in dollars;

– €3 million in income from the position with the IMF.

Premiums and discounts on securities denominated in euros and foreign currencies were negative in both years, and increased from €240 million to €325 million.

Interest expense fell by €229 million (from €1,477 million to €1,248 million).

In particular, the reduction in interest expense in respect of positions denominated in euros was due to the decreases of:

– €217 million in interest on the Treasury payment account (from €1,021 million to €804 million), primarily in connection with the reduction from €395 million to €212 million in supplementary interest payable under Law 483/1993, with a consequent fall in the average interest rate (from 3.6 to 2.81 per cent); the annual average balance remained basically unchanged (€28,559 million, against €28,400 million in 2003);

– €24 million in interest on current account deposits of required reserves (from €332 million to €308 million) owing to the fall in the average rate of return (from 2.34 to 2.04 per cent), the effect of which was partly offset by the increase in the annual average amount of required reserves (from €14,195 million to €15,095 million);

– €16 million in interest on intra-Eurosystem balances (from €74 million to €58 million), primarily as a consequence of the reduction (from €21 million to €1 million) in the interest payable on the Bank's TARGET accounts, which was partly offset by the increase in that payable on the balances related to the allocation of euro banknotes within the Eurosystem (from €53 million to €57 million);

– marginal amounts in interest on accounts held with the Bank of Italy by non-euro-area correspondents (from €0.8 million to €0.3 million).

By contrast, the following increases occurred:

– €36 million (from €18 million to €54 million) in interest on the sinking fund for the redemption of government securities owing to the increase in the average amount outstanding (from €665 million to €2,654 million), the effects of which were partly offset by the decrease in the average rate of return (from 2.67 to 2.03 per cent);

– €0.7 million in interest on the current account held by the UIC and €0.2 million in interest on fixed-term deposits.

The interest paid on positions denominated in foreign currency fell by €8 million (from €31 million to €23 million), as a result of the reduction in interest on foreign exchange repos (from €17 million to €8 million), which was offset to a minor extent by the increase in payments in respect of allocations of SDRs (from €14 million to €15 million).

The *net result of financial operations, writedowns and risk provision transfers* was negative and improved from -€1,418 million to -€788 million. The balance was the result of:

– €1,721 million of writedowns of financial assets and positions, of which €1,699 million (€4,629 million at the end of 2003) of foreign exchange writedowns of net foreign currency positions and €22 million of price writedowns in respect of securities in foreign currencies and euros (€16 million in 2003, of which €1 million referred to futures positions);

– €178 million of profits on financial transactions (€477 million in 2003), comprising:

    a) a profit of €160 million on foreign exchange trading, primarily dollars (against a loss of €72 million in 2003) and of €25 million on securities trading (€435 million in 2003);

    b) a loss of €7 million on futures denominated in foreign exchange (against a profit of €0.4 million in 2003);

– provision transfers amounting to €755 million (€2,750 million in 2003), as detailed below:

    a) €754.5 million withdrawn from the provision for general risks (€1,202 million in 2003) in connection with unrealized losses in 2004;

b) €0.8 million of withdrawals from the pre-system revaluation accounts (€10 million in 2003) following redemptions of securities and disposals of foreign currencies.

Net income from fees and commissions swung from +€1 million to -€2 million.

Income from equity shares and participating interests fell by €188 million (from €215 million to €27 million) and comprised:

– €23 million of profits allocated to the Bank in respect of its interest in the UIC's endowment fund (down from €102 million in 2003).
– zero ECB dividends for the year 2003 (down from €113 million for the year 2002 distributed in 2003). Following the reductions in the Bank of Italy's interest in the capital of the ECB (see under *Intra-Eurosystem claims*) and the corresponding reduction in the proportion of shareholders' equity pertaining to the Bank of Italy, an amount equal to €4 million was recognized with reference to the profits and revaluation accounts accumulated by the ECB up to 30 April 2004.

The Governing Council of the ECB decided, as in 2003, not to pay the NCB shareholders the full amount of the ECB's seigniorage income, equal to €733 million, of which the Bank of Italy's share was €134 million (€128 million in 2003) in view of the loss incurred for 2004 (see the item Banknotes in circulation in the section Legal basis, methods of preparation and layout of the annual accounts*). The loss of €1,636 million that nonetheless remained for 2004 was covered in full by withdrawing the entire amount from the general reserve fund (about €296 million) and, subsequently, by transferring about €1,340 million from the NCBs' monetary income pooled pursuant to Article 33.2 of the Statute of the ESCB.*

The *net result of the pooling of monetary income*, swung from plus €15 million to minus €239 million, the sum of the Bank of Italy's €9 million share of monetary income actually redistributed among the NCBs and its €248.3 million contribution to cover the loss forecast for the ECB in 2004 (see transfers under liabilities).

The above-mentioned balance of €9 million was the difference between the monetary income pooled, €1,496 million, and that redistributed, €1,505 million. The monetary income pooled of each NCB is determined by measuring the actual annual income that derives from the earmarkable assets held against its liability base.

The liability base of each NCB consists of: banknotes in circulation; liabilities to credit institutions related to monetary policy operations denominated in euros; net intra-Eurosystem liabilities resulting from TARGET transactions; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is deducted from the monetary income to be pooled.

The earmarkable assets of each NCB consist of: lending to euro-area credit institutions related to monetary policy operations denominated in euros; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; and a limited amount of each NCB's gold holdings in proportion to each NCB's capital key. Gold is considered to generate no income. Where the value of an NCB's earmarkable assets exceeds or falls short of the value of its liability base, the difference is offset by applying the average rate of return on the earmarkable assets of all NCBs taken together to the value of the difference.

The monetary income pooled by the Eurosystem is allocated to each NCB according to its subscribed capital key.

Other income decreased by €58 million (from €1,630 million to €1,572 million). In particular:

– *income from the investment of reserves and provisions* fell by €135 million (from €1,431 million to €1,296 million) as a result of the decrease in profits on disposals of equity securities (from €343 million to €205 million), which was partially offset by the rise in income from securities (from €1,088 million to €1,091 million);

– *prior-year income* rose by €98 million (from €84 million to €182 million) and mainly comprised:

  a) €147.4 million, the elimination of the effects on the accounts of tax legislation pursuant to Legislative Decree 6/2003 (see under *capital and reserves*);

  b) €22 million, the reduction in the tax provision following the reduction in the risk inherent in tax disputes;

– *sundry* income fell by €21 million (from €115 million to €94 million).

Among the *Sundry expenses and charges*:

– *Staff wages and salaries and related costs* declined by €2 million (from €615 million to €613 million);

– *Transfers to provisions for accrued expenses and staff severance pay and pensions* amounted overall to €94 million (€130 million in 2003). In particular, €20 million referred to the provision for staff severance pay and pensions (€60 million in 2003), reflecting an increase of €21 million for staff severance pay and a decrease of €1 million for pensions, and €74 million to the provision for staff costs accrued that had not been paid at the end of the year (€70 million in 2003);

– *Other staff costs* and *Emoluments paid to head and branch office collegial bodies* remained unchanged at respectively €41 million and €3 million;

– *Pensions and severance payments* rose by €38 million (from €243 million to €281 million), exclusively as a result of the increase in severance payments.

The breakdown of the Bank's staff by type of employment is shown in Table 2.

Administrative costs rose by €13 million (from €361 million to €374 million).

Depreciation of tangible and intangible fixed assets decreased by €4 million (from €190 million to €186 million).

Table 2

THE BANK'S STAFF

	Average number of persons in service			Percentage composition		
	1994	2003	2004	1994	2003	2004
Managerial	1,825	2,011	1,994	19.6	24.1	24.5
Clerical	5,591	4,910	4,874	60.1	58.8	60.0
General services and security	1,202	880	750	12.9	10.5	9.2
Blue-collar	692	550	514	7.4	6.6	6.3
TOTAL PAYROLL WORKERS	**9,310**	**8,351**	**8,132**	**100.0**	**100.0**	**100.0**
Contract workers	27	34	34			

Other costs fell by €80 million (from €536 million to €456 million) and comprised:

– *losses on investments of reserves and provisions*, which amounted to €10 million (€42 million in 2003) and referred almost exclusively to writedowns of equity investments denominated in euros;
– *prior-year expense*, which rose from €2 million to €3 million;
– *appropriation of investment income to reserves*, which amounted to €422 million, down from €469 million in 2003, primarily owing to the smaller profits on share disposals;
– *other taxes and duties* (i.e. excluding income tax for the year and the regional tax on productive activities), which declined from €16 million to €15 million and consisted primarily of the municipal tax on buildings (€11 million in both years);
– *sundry* other costs, which fell from €7 million to €6 million.

Taxes for the year show a positive net result equal to €258 million (€1,116 million in 2003), of which €250 million referred to the deferred corporate income tax (Ires) asset in connection with the carry forward of the tax loss for 2004 (€758 million) and €8 million to the net change in the remaining components of deferred tax. The liability in respect of the regional tax on productive activities (Irap) amounted to €0.2 million (no liability in 2003).

3. Proposals of the Board of Directors

Pursuant to Articles 54 and 57 of the Statute and after hearing the favourable opinion of the Board of Auditors, the Board of Directors proposes the following allocation of the net profit for 2004 of €25,454,500:

	euros
– 20 per cent to the ordinary reserve	5,090,900
– an amount equal to 6 per cent of the share capital to shareholders	9,360
– 20 per cent to the extraordinary reserve	5,090,900
– an additional amount equal to 4 per cent of the share capital to shareholders	6,240
– the remaining amount to the State	15,257,100
TOTAL	25,454,500

Pursuant to Article 56 of the Statute, the Board of Directors has also proposed the distribution to shareholders – drawing on the income earned on the ordinary and extraordinary reserves – of an additional €47,478,000, equal to 0.50 per cent (as in 2002) of the total reserves at 31 December 2003.

If these proposals are approved, the total dividend will be equal to €47,493,600 corresponding to €158,312 per share.

THE GOVERNOR
Antonio Fazio

BALANCE SHEET
AND INCOME STATEMENT
for the year ended 31 December 2004

ASSETS	amounts in euros 2004	2003
1 GOLD AND GOLD RECEIVABLES	**25,348,345,047**	**26,042,196,103**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**20,449,732,089**	**24,064,856,474**
2.1 Receivables from the IMF	3,633,965,360	4,211,994,537
2.2 Securities (other than shares)	13,482,833,103	14,764,931,919
2.3 Current accounts and deposits	3,330,872,380	5,085,717,614
2.4 Reverse operations	–	–
2.5 Other claims	2,061,246	2,212,404
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**5,595,383,242**	**6,449,175,541**
3.1 Financial counterparties	5,595,383,242	6,449,175,541
3.1.1 Securities (other than shares)	*2,704,043,645*	*1,848,796,804*
3.1.2 Reverse operations	–	–
3.1.3 Other claims	*2,891,339,597*	*4,600,378,737*
3.2 General government	–	–
3.3 Other counterparties	–	–
4 CLAIMS ON NON-EURO-AREA RESIDENTS	**–**	**–**
4.1 Claims on non-euro-area EU central banks	–	–
4.2 Securities (other than shares)	–	–
4.3 Other claims	–	–
5 LENDING TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS	**14,632,036,365**	**8,196,818,477**
5.1 Main refinancing operations	14,218,340,951	8,190,917,667
5.2 Longer-term refinancing operations	411,676,704	–
5.3 Fine-tuning reverse operations	–	–
5.4 Structural reverse operations	–	–
5.5 Marginal lending facility	–	5,900,810
5.6 Credits related to margin calls	2,018,710	–
6 OTHER CLAIMS ON EURO-AREA BANKS	**308,848**	**227,195**
7 SECURITIES ISSUED BY EURO-AREA RESIDENTS (other than shares)	**1,978,377,877**	**1,672,191,348**
8 GENERAL GOVERNMENT DEBT	**18,560,774,548**	**18,716,265,228**
9 INTRA-EUROSYSTEM CLAIMS	**15,246,998,970**	**8,192,250,000**
9.1 Participating interest in the ECB	726,278,371	744,750,000
9.2 Claims deriving from the transfer of foreign reserves to the ECB	7,262,783,715	7,447,500,000
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem	–	–
9.4 Other claims within the Eurosystem (net)	7,257,936,884	–
10 ITEMS TO BE SETTLED	**1,916,202**	**10,974,891**
11 OTHER ASSETS	**57,771,627,737**	**52,180,741,403**
11.1 Euro-area coins	26,161,148	18,374,486
11.2 UIC endowment fund	258,228,450	258,228,450
11.3 Investments of reserves and provisions (including shares)	29,112,651,560	28,433,560,388
11.4 Intangible fixed assets	25,170,761	24,293,642
11.5 Deferred charges	5,729,126	6,378,808
11.6 Tangible fixed assets (net of depreciation)	2,452,221,341	2,582,288,268
11.7 Accrued income and prepaid expenses	714,539,423	697,771,469
11.8 Sundry	25,176,925,928	20,159,845,892
TOTAL	**159,585,500,925**	**145,525,696,660**
13 MEMORANDUM ACCOUNTS	**254,009,182,041**	**418,246,089,603**

Audited and found correct - 28 April 2005

THE AUDITORS: Giuseppe Bruni, Enrico Nuzzo, Angelo Provasoli, Massimo Stipo, Gianfranco Zanda

SHEET

LIABILITIES	amounts in euros	
	2004	2003
1 BANKNOTES IN CIRCULATION	**84,191,125,720**	**73,807,445,600**
2 LIABILITIES TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS	**12,971,530,076**	**10,303,853,566**
2.1 Current accounts (covering the minimum reserve system)	12,970,082,463	10,302,910,669
2.2 Deposit facility	1,447,613	942,897
2.3 Fixed-term deposits	–	–
2.4 Fine-tuning reverse operations	–	–
2.5 Deposits related to margin calls	–	–
3 OTHER LIABILITIES TO EURO-AREA BANKS	**–**	**–**
4 LIABILITIES TO OTHER EURO-AREA RESIDENTS DENOMINATED IN EUROS	**15,968,221,526**	**13,371,028,021**
4.1 General government	15,859,340,512	13,294,608,579
4.1.1 Treasury payments account	*15,770,902,538*	*13,208,116,796*
4.1.2 Sinking fund for the redemption of government securities	*3,585,994*	*23,509,723*
4.1.3 Other liabilities	*84,851,980*	*62,982,060*
4.2 Other counterparties	108,881,014	76,419,442
5 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN EUROS	**30,501,268**	**28,970,683**
5.1 Liabilities to non-euro-area EU central banks	150,659	858
5.2 Other liabilities	30,350,609	28,969,825
6 LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**–**	**–**
6.1 Financial sector counterparties	–	–
6.2 General government	–	–
6.3 Other liabilities	–	–
7 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**648,188,775**	**373,752,751**
7.1 Deposits and balances	9,609,089	10,445,935
7.2 Other liabilities	638,579,686	363,306,816
8 COUNTERPART OF SDRs ALLOCATED BY THE IMF	**800,455,040**	**827,427,200**
9 INTRA-EUROSYSTEM LIABILITIES	**6,077,311,530**	**7,713,040,731**
9.1 Promissory notes covering debt certificates issued by the ECB	–	–
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	6,077,311,530	5,687,329,465
9.3 Other liabilities within the Eurosystem (net)	–	2,025,711,266
10 ITEMS TO BE SETTLED	**23,640,110**	**33,905,286**
11 OTHER LIABILITIES	**2,290,976,932**	**2,499,260,409**
11.1 Bank of Italy drafts	524,323,203	646,587,178
11.2 Cashier's department services	2,382	2,312,894
11.3 Accrued expenses and deferred income	27,161,553	8,934,436
11.4 Sundry	1,739,489,794	1,841,425,901
12 PROVISIONS	**6,259,616,599**	**6,015,636,567**
12.1 Provisions for specific risks	619,813,508	399,766,823
12.2 Sundry staff-related provisions	5,639,803,091	5,615,869,744
13 REVALUATION ACCOUNTS	**9,549,667,970**	**9,246,350,725**
14 PROVISION FOR GENERAL RISKS	**6,832,281,998**	**7,586,781,997**
15 CAPITAL AND RESERVES	**13,916,528,881**	**13,665,845,861**
15.1 Capital	156,000	156,000
15.2 Ordinary and extraordinary reserves	9,893,879,958	9,495,815,772
15.3 Other reserves	4,022,492,923	4,169,874,089
16 NET PROFITS FOR DISTRIBUTION	**25,454,500**	**52,397,263**
TOTAL	**159,585,500,925**	**145,525,696,660**
18 MEMORANDUM ACCOUNTS	**254,009,182,041**	**418,246,089,603**

THE ACCOUNTANT GENERAL
Antonio Pasquale Soda

THE GOVERNOR
Antonio Fazio

INCOME STATEMENT

	amounts in euros	
	2004	2003
a) Net income from institutional operations		
Interest income	*2,492,644,809*	*2,088,545,167*
Interest expense	*-1,248,021,911*	*-1,476,836,951*
Net interest income	**1,244,622,898**	**611,708,216**
Profits and losses on financial operations	*177,471,731*	*477,167,233*
Writedowns of financial assets and positions	*-1,720,953,526*	*-4,645,447,695*
Transfers to/from provisions for losses on foreign exchange and securities	*755,264,050*	*2,750,754,453*
Net result of financial operations, writedowns and risk provision transfers	**-788,217,745**	**-1,417,526,009**
Fee and commission income	*18,240,714*	*19,822,190*
Fee and commission expense	*-19,919,206*	*-18,968,247*
Net income from fees and commissions	**-1,678,492**	**853,943**
Income from equity shares and participating interests	27,063,147	215,074,412
Net result of the pooling of monetary income	-238,819,062	15,003,902
b) Other income		
– income from the investment of reserves and provisions	1,296,057,125	1,431,002,283
– prior-year income	181,517,089	83,527,105
– sundry	94,789,113	115,603,848
Total net income (a+b)	**1,815,334,073**	**1,055,247,700**
Sundry expenses and charges		
Staff wages and salaries and related costs (1)	-612,415,741	-614,612,177
Emoluments paid to head and branch office collegial bodies	-2,697,194	-3,006,845
Transfers to provisions for accrued expenses and staff severance pay and pensions	-94,568,046	-130,343,405
Other staff costs	-41,341,203	-41,266,905
Pensions and severance payments	-280,769,310	-242,815,476
Administrative costs	-374,045,629	-360,659,064
Depreciation of tangible and intangible fixed assets	-186,390,736	-190,498,010
Banknote production services	–	–
Other costs:		
– losses on investments of reserves and provisions	-9,638,221	-42,391,394
– other transfers to provisions	–	-118,554
– prior-year expense	-2,709,017	-1,705,197
– appropriation of investment income to reserves (2)	-422,324,280	-468,969,171
– other taxes and duties	-14,997,525	-15,903,440
– sundry	-6,044,347	-6,664,741
Taxes on income for the year and productive activities (3)	258,061,676	1,116,103,942
Net profit for the year	**25,454,500**	**52,397,263**

(1) The Bank's staff averaged 8,166 in 2004, against 8,385 in 2003. – (2) Pursuant to Article 55 of the Statute. – (3) Under the layout of the income statement adopted, this item includes amounts with a positive sign.

ALLOCATION OF THE NET PROFIT FOR THE YEAR	amounts in euros
TO THE ORDINARY RESERVE	**5,090,900**
TO THE EXTRAORDINARY RESERVE	**5,090,900**
TO SHAREHOLDERS: 6% OF THE CAPITAL	**9,360**
AN ADDITIONAL 4% OF THE CAPITAL	**6,240**
TO THE STATE	**15,257,100**
TOTAL	**25,454,500**

Audited and found correct
28 April 2005.

THE AUDITORS

GIUSEPPE BRUNI
ENRICO NUZZO
ANGELO PROVASOLI
MASSIMO STIPO
GIANFRANCO ZANDA

THE ACCOUNTANT GENERAL

ANTONIO PASQUALE SODA

THE GOVERNOR

ANTONIO FAZIO

REPORT OF THE BOARD OF AUDITORS ON THE 111th FINANCIAL YEAR OF THE BANK OF ITALY AND THE ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2004

To the shareholders,

The accounts for the year ended 31 December 2004 submitted for your approval show the following results (in euros):

Assets	159,585,500,925
Liabilities	145,643,517,544
Capital and reserves	13,916,528,881
Net profit for the year (as shown in the vertical income statement)	25,454,500

The memorandum accounts, shown on both sides of the balance sheet for an amount of €254,009,182,041, refer to deposits of securities and sundry valuables and commitments and contingent liabilities (for purchases and sales of securities and sundry valuables), in foreign currencies and euros.

The accounts were kept properly in conformity with the standards and rules laid down by the law in force. The individual items of the accounts, which were also checked by the independent auditors, were compared with the accounting records and found to conform with them.

The methods used in preparing the annual accounts and valuing assets and liabilities have been amended and supplemented compared with the previous year in relation to:

– the accounting treatment of dollar interest rate futures, in accordance with the indications of the Eurosystem. Under the new treatment, which did not produce material effects on the accounts, positive and negative variation margins are included in income on a daily basis instead of at the time the transaction is closed;

– the creation of a provision to cover the Bank of Italy's share of the ECB's expected loss for 2004 pursuant to Article 33.2 of the Statute of the ESCB;

– the provisions of Legislative Decree 6/2003 (reform of company law) that required amounts to be included in income to reverse the effects of transactions carried out in prior years for tax purposes in relation to accelerated depreciation and the setting aside in a special reserve of 3 per cent of staff severance pay allocated to supplementary pensions under Legislative Decree 124/1993.

The criteria for preparing the annual accounts for 2004 and the valuation methods used, with whose adoption we agree, were found to conform with those approved by the Board of Directors and with the law in force. They are described in detail in the notes to the accounts and comply with the harmonized accounting rules laid down by the Governing Council of the ECB and transposed for the purposes of the annual accounts by Article 8 of Legislative Decree 43/1998. The notes to the accounts contain all the other information required by current legislation.

We inform you that in drawing up the annual accounts it was not necessary to invoke the waiver provided for in the fourth paragraph of Article 2423 of the Civil Code.

The results for the year, which closed with a net profit of €25,454,500, were affected by the unrealized losses on positions denominated in foreign currency, above all owing to the depreciation of the US dollar, and the Bank of Italy’s share of the ECB’s loss for 2004, which was also the consequence of unrealized foreign exchange losses. The above-mentioned factors contributed to the Bank incurring a loss of €758 million for corporate income tax purposes.

The Board of Directors resolved to withdraw €754.5 million from the provision for general risks; the profit and loss account includes €147.4 million deriving from the reversal of the effects of transactions carried out in prior years for tax purposes referred to above.

The above-mentioned tax loss allowed the Bank to carry forward deferred tax assets amounting to €250 million that can be offset, under Article 84 of the Income Tax Code, against taxable income in the next five financial years. This amount, in addition to the €8 million of other net changes in deferred tax, led to the inclusion of a positive result of €258 million under taxes for the year. The above-mentioned amount of €250 million supplements the deferred tax assets already entered in the accounts for a total of €8,092 million, of which €7,119 million in respect of the tax loss caused by the bond conversion under Law 289/2002, which is recoverable up to 2022, and €973 million in respect of the tax loss for 2003, which is recoverable up to 2008.

The inclusion in the balance sheet of deferred tax assets is based on a careful assessment of the prospects for the Bank’s ordinary income, which makes it possible to affirm that there is a reasonable expectation of offsetting, within the legal time limits, the entire amount of the tax losses deriving from the bond conversion and the unrealized losses on foreign exchange assets, which, exceptionally, were recorded in the last two years.

In relation to the above-mentioned transfer from the provision for general risks, we declare that the total amount of the Bank's general and specific risk provisions stand at a prudent level in our opinion. In particular, the provision for severance pay and pensions comprises both the actuarial reserves corresponding to the situation of staff having entitlement and that of pensioners and the severance pay accrued by all the members of the staff in service at the end of the year having entitlement.

Pursuant to Article 54 of the Statute, the Board of Directors proposes the following allocation of the net profit for 2004 of €25,454,500:

– 20 per cent to the ordinary reserve	€	5,090,900
– an amount equal to 6 per cent of the share capital to shareholders	”	9,360
– 20 per cent to the extraordinary reserve.........................	”	5,090,900
– an additional amount equal to 4 per cent of the share capital to shareholders	”	6,240
– the remaining amount to the State	”	15,257,100
Total	€	25,454,500

Pursuant to Article 56 of the Statute, the Board of Directors also proposes the distribution to shareholders – drawing on the income earned on the ordinary and extraordinary reserves – of an additional €47,478,000, equal to 0.50 per cent of such reserves at 31 December 2003 and within the limit laid down in the above-mentioned article.

During the year we attended all the meetings of the Board of Directors and the Board Committee and made the tests and controls within the scope of our authority, in particular as regards the quantities of cash and valuables belonging to the Bank and third parties, verifying at all times compliance with the law and the Bank's Statute and General Regulations.

We monitored the activity of the Bank's peripheral units in close contact, in accordance with Articles 23 and 24 of the Bank's Statute, with the examiners at the main branches and the branches, whom we thank warmly.

We recommend that you approve the accounts for 2004 that have been submitted to you (the balance sheet, the income statement and the notes to the accounts) and the proposed allocation of the net profit for the year and distribution to shareholders of an additional amount pursuant to Article 56 of the Statute.

THE AUDITORS
Giuseppe Bruni
Enrico Nuzzo
Angelo Provasoli
Massimo Stipo
Gianfranco Zanda

STATISTICAL APPENDIX

LIST OF TABLES

Page

Table a1

SOURCES AND USES OF INCOME IN FRANCE (1)
(at 1995 prices; billions of euros)

	Sources			Uses								
				Domestic demand								Exports of good and services
	Gross domestic product	Imports of goods and services	Total	Gross fixed investment			National consumption		Change in stocks and valuables	Total		
				Construction	Other (2)	Total	Households (3)	General government				
2000	1348.8	368.2	1717.0	116.8	160.2	276.9	729.1	307.1	12.8	1325.7	391.3	
2001	1377.1	373.0	1750.1	118.4	163.8	282.3	749.2	316.2	4.9	1352.4	397.7	
2002	1393.4	383.8	1777.2	116.6	160.2	276.8	760.7	330.8	3.4	1372.0	405.2	
2003	1399.9	383.5	1783.4	116.9	159.4	276.3	771.9	338.7	0.4	1388.3	395.1	
2004	....	....	....	....	....	....	....	....	....	....	....	
2001 – I	346.0	95.5	441.4	30.0	41.9	71.9	187.3	77.9	1.6	338.7	102.8	
II	345.8	94.4	440.3	29.4	41.9	71.3	188.1	78.4	2.4	340.2	100.0	
III	348.0	93.6	441.6	29.6	41.9	71.5	189.8	79.9	-0.1	341.2	100.4	
IV	345.4	92.9	438.2	29.4	41.1	70.5	190.0	80.1	-0.3	340.2	98.0	
2002 – I	348.6	95.8	444.4	29.3	41.4	70.7	190.9	81.5	1.1	344.2	100.3	
II	350.2	97.4	447.7	29.4	40.6	70.0	191.6	82.6	0.5	344.8	102.9	
III	351.3	98.2	449.5	29.1	40.8	69.9	193.0	83.1	0.5	346.6	102.8	
IV	350.3	97.3	447.5	28.9	40.5	69.4	193.5	83.8	-1.0	345.6	101.9	
2003 – I	350.7	97.2	447.9	29.0	40.5	69.4	194.6	84.0	0.2	348.3	99.7	
II	349.2	96.7	445.9	29.1	40.5	69.6	194.2	84.4	-0.5	347.7	98.3	
III	353.1	96.7	449.8	29.3	41.1	70.4	196.1	85.2	-1.1	350.7	99.1	
IV	355.0	99.1	454.1	29.6	41.9	71.5	196.7	86.0	-0.7	353.5	100.6	
2004 – I	357.8	100.4	458.3	29.7	42.1	71.8	198.8	86.4	-0.1	357.0	101.3	
II	360.3	104.2	464.5	30.2	42.7	72.9	199.6	87.1	2.5	362.2	102.4	
III	360.3	106.8	467.1	30.1	42.4	72.5	199.2	87.3	4.9	364.1	103.0	
IV	363.4	107.5	470.9	30.3	43.2	73.5	201.6	87.7	3.6	366.6	104.3	

Source: National statistics.
(1) The national accounts do not incorporate the update released on 20 May 2005; the quarterly data are adjusted for seasonal factor and the number of working days. – (2) Machinery, equipment, transport equipment and intangible assets. – (3) Consumption by resident households and non-profit institutions serving households.

Table a2

SOURCES AND USES OF INCOME IN GERMANY (1)
(at 1995 prices; billions of euros)

	Sources			Uses								
				Domestic demand								Exports of good and services
	Gross domestic product	Imports of goods and services	Total	Gross fixed investment			National consumption		Change in stocks and valuables	Total		
				Construction	Other (2)	Total	Households (3)	General government				
2000	2,041.6	636.6	2,678.2	243.8	212.6	456.4	1,166.1	387.4	-1.5	1,997.0		681.2
2001	2,066.0	644.1	2,710.1	232.6	207.1	439.8	1,187.0	390.7	2.8	1,985.8		724.3
2002	2,069.2	637.9	2,707.0	219.0	194.0	413.0	1,181.8	397.3	6.7	1,949.5		757.6
2003	2,069.2	664.9	2,734.1	211.7	194.4	406.1	1,185.2	395.6	-0.2	1,963.0		771.1
2004	2,101.6	709.8	2,811.4	206.2	197.9	404.1	1,184.1	393.0	0.9	1,971.1		840.2
2001 – I	517.2	162.9	680.1	58.9	54.2	113.1	295.1	97.8	-5.9	499.2		180.9
II	517.4	162.9	680.3	58.6	52.8	111.4	297.8	97.7	-5.1	499.8		180.4
III	516.7	161.5	678.2	58.2	50.9	109.1	298.9	97.3	-7.7	498.0		180.2
IV	517.2	158.6	675.8	57.2	50.1	107.2	295.9	97.9	-8.5	490.8		185.0
2002 – I	516.4	155.1	671.6	57.2	48.9	106.1	294.2	99.2	-11.4	486.8		184.8
II	517.0	159.0	676.0	54.5	48.9	103.4	294.8	99.5	-6.9	487.9		188.1
III	519.9	161.7	681.6	54.3	48.3	102.6	297.1	99.6	-8.3	489.6		192.0
IV	519.2	164.0	683.2	53.8	48.7	102.5	296.6	99.1	-9.3	487.9		195.2
2003 – I	517.2	167.6	684.8	53.1	49.2	102.3	296.4	98.0	-4.7	492.1		192.6
II	516.8	164.6	681.4	53.2	48.3	101.5	297.4	98.6	-4.2	493.9		187.5
III	517.6	164.8	682.4	52.9	48.2	101.2	296.6	99.1	-7.1	486.8		195.5
IV	520.7	169.6	690.4	53.5	49.3	102.9	295.8	99.9	-2.2	493.1		197.2
2004 – I	522.9	171.0	693.9	52.0	47.7	99.7	295.2	97.9	-3.0	489.9		204.1
II	524.0	174.9	698.9	51.1	48.7	99.8	294.4	97.9	-3.1	488.1		210.8
III	523.8	179.7	703.5	50.2	50.1	100.3	295.3	98.6	3.7	494.8		208.6
IV	523.1	179.9	703.0	50.7	49.8	100.6	296.1	98.7	-0.1	492.0		211.0

Source: National statistics.
(1) The national accounts incorporate the update released on 28 April; the quarterly data are adjusted for seasonal factor and the number of working days. – (2) Machinery, equipment, transport equipment and intangible assets. – (3) Consumption by resident households and non-profit institutions serving households.

SOURCES AND USES OF INCOME IN SPAIN (1)
(at 1995 prices; billions of euros)

	Sources			Uses								
				Domestic demand								Exports of good and services
	Gross domestic product	Imports of goods and services	Total	Gross fixed investment			National consumption		Change in stocks and valuables	Total		
				Construction	Other (2)	Total	Households (3)	General government				
2000	529.7	172.0	701.7	69.0	61.6	130.5	313.7	93.9	2.0	540.1	161.6	
2001	544.5	178.7	723.2	72.6	61.8	134.4	322.5	97.3	1.7	555.8	167.4	
2002	556.7	184.3	740.9	76.4	60.2	136.6	331.7	101.2	1.8	571.4	169.5	
2003	570.6	193.1	763.6	79.7	61.2	141.0	341.2	105.2	2.3	589.6	174.0	
2004	….	….	….	….	….	….	….	….	….	….	….	
2001 – I	135.2	45.2	180.4	17.8	15.6	33.5	80.5	24.0	..	138.0	42.4	
II	135.5	45.2	180.8	18.1	15.7	33.8	80.5	24.2	0.8	139.3	41.4	
III	136.5	44.6	181.1	18.1	15.5	33.6	80.5	24.4	0.4	138.8	42.2	
IV	137.3	43.8	181.0	18.6	15.0	33.6	80.9	24.7	0.4	139.6	41.4	
2002 – I	138.5	45.2	183.7	18.8	15.0	33.8	82.0	25.0	2.3	143.1	40.7	
II	138.6	45.4	184.0	19.0	14.7	33.6	82.8	25.2	0.4	142.0	42.0	
III	139.4	45.8	185.2	19.2	15.0	34.2	83.0	25.4	-0.9	141.7	43.5	
IV	140.1	47.8	187.9	19.5	15.5	35.0	83.9	25.7	..	144.6	43.4	
2003 – I	141.3	46.5	187.9	19.6	15.4	35.0	84.4	25.9	1.2	146.4	41.4	
II	142.1	47.6	189.7	19.9	15.0	34.9	85.0	26.1	0.1	146.1	43.7	
III	143.0	49.4	192.4	20.0	15.2	35.2	85.5	26.4	0.4	147.5	44.9	
IV	144.1	49.6	193.7	20.3	15.6	35.9	86.3	26.7	0.6	149.6	44.1	
2004 – I	145.2	50.2	195.4	20.4	15.5	35.9	87.2	27.1	1.5	151.8	43.7	
II	145.9	51.5	197.4	20.7	15.6	36.2	88.1	27.3	0.6	152.3	45.1	
III	146.8	54.1	200.9	20.9	16.4	37.3	88.5	27.6	0.7	154.1	46.7	
IV	148.0	54.7	202.6	21.3	16.8	38.0	89.4	28.2	0.7	156.3	46.3	

Source: National statistics.
(1) The national accounts do not incorporate the updates released on 19 and 25 May 2005; the quarterly data are adjusted for seasonal factor and the number of working days. – (2) Machinery, equipment, transport equipment and intangible assets. – (3) Consumption by resident households and non-profit institutions serving households.

ITALY: VALUE ADDED PER STANDARD LABOUR UNIT AND UNIT LABOUR COSTS, BY BRANCH

	2000	2001	2002	2003	2004
	Value added at factor cost per standard labour unit (1) *(euros at 1995 prices)*				
Agriculture, forestry and fishing	**23,184**	**23,088**	**22,627**	**22,270**	**24,580**
Industry excluding construction	**43,478**	**43,604**	**43,255**	**42,967**	**43,277**
of which: manufacturing	*40,260*	*40,254*	*39,523*	*39,062*	*39,159*
Construction	**30,076**	**29,624**	**29,623**	**29,460**	**29,253**
Services (2)	**36,792**	**37,075**	**36,852**	**36,891**	**36,975**
Wholesale and retail trade, repair of household goods	*36,523*	*36,636*	*36,197*	*35,856*	*36,611*
Hotels and restaurants	*26,292*	*26,182*	*25,871*	*25,546*	*24,727*
Transport, storage and communication	*51,305*	*53,289*	*53,469*	*53,153*	*54,323*
Financial intermediation	*97,561*	*96,590*	*95,021*	*93,990*	*92,443*
Sundry business and household services (2) (3)	*37,670*	*38,586*	*38,229*	*38,199*	*36,548*
Public administration (4)	*35,316*	*35,344*	*35,432*	*36,877*	*37,921*
Education	*26,847*	*26,319*	*26,297*	*26,678*	*27,051*
Health and social work services	*31,871*	*33,387*	*34,558*	*35,283*	*36,096*
Other public, social and personal services	*33,988*	*33,268*	*32,378*	*31,822*	*32,839*
Private households with employed persons	*9,553*	*9,541*	*9,552*	*9,560*	*9,567*
Total (2)	**37,057**	**37,201**	**36,961**	**36,903**	**37,104**
	Unit labour costs (1) (5) *(current euros per euro at 1995 prices)*				
Agriculture, forestry and fishing	**0.577**	**0.584**	**0.604**	**0.638**	**0.583**
Industry excluding construction	**0.691**	**0.710**	**0.732**	**0.758**	**0.777**
of which: manufacturing	*0.731*	*0.754*	*0.786*	*0.819*	*0.846*
Construction	**0.784**	**0.812**	**0.832**	**0.862**	**0.900**
Services (2)	**0.805**	**0.826**	**0.854**	**0.888**	**0.910**
Wholesale and retail trade, repair of household goods	*0.683*	*0.702*	*0.734*	*0.765*	*0.771*
Hotels and restaurants	*0.907*	*0.946*	*1.001*	*1.062*	*1.132*
Transport, storage and communication	*0.606*	*0.594*	*0.594*	*0.612*	*0.616*
Financial intermediation	*0.537*	*0.553*	*0.578*	*0.594*	*0.615*
Sundry business and household services (2) (3)	*0.788*	*0.814*	*0.835*	*0.850*	*0.905*
Public administration (4)	*0.958*	*1.001*	*1.064*	*1.137*	*1.160*
Education	*1.217*	*1.272*	*1.292*	*1.350*	*1.316*
Health and social work services	*1.063*	*1.075*	*1.069*	*1.063*	*1.121*
Other public, social and personal services	*0.754*	*0.792*	*0.829*	*0.865*	*0.865*
Private households with employed persons	*1.159*	*1.177*	*1.216*	*1.268*	*1.285*
Total (2)	**0.779**	**0.801**	**0.827**	**0.859**	**0.879**

Source: Istat, national accounts.

(1) Includes indirectly measured financial intermediation services. – (2) Excludes renting of buildings. – (3) Renting real estate services, renting services, computer and related services, research and other business services. – (4) Includes defence and compulsory social security services. – (5) Compensation of employees at current prices per standard labour unit divided by value added at factor cost at 1995 prices per standard labour unit.

SOURCES AND USES OF INCOME AND HOUSEHOLD CONSUMPTION IN ITALY
(millions of euros at 1995 prices)

	SOURCES AND USES								
	Uses								TOTAL SOURCES/ USES
	Agriculture, forestry and fishing (1)	Industry (1)	Services (1) (2)	Financial intermediation services indirectly measured (–)	Other services (1) (3)	VAT and indirect taxes of import	Gross domestic product	Imports of goods and services (*fob*) (4)	
1999	29,051	307,882	455,143	42,815	176,681	59,311	985,253	267,349	1,252,602
2000	28,219	314,182	480,512	47,726	178,453	61,437	1,015,077	286,418	1,301,495
2001	28,093	315,304	495,860	51,119	182,123	62,724	1,032,985	287,798	1,320,783
2002	26,969	314,014	500,981	52,064	184,243	62,803	1,036,945	286,466	1,323,410
2003	25,572	314,802	505,464	53,806	185,943	61,606	1,039,581	290,187	1,329,768
2004	28,338	316,620	508,560	54,485	191,168	62,107	1,052,308	297,470	1,349,779
2002 – I	6,822	78,251	124,406	12,994	45,922	15,674	258,082	69,995	328,077
II	6,801	78,155	125,294	12,908	45,900	15,688	258,930	71,159	330,088
III	6,715	78,725	125,293	13,030	46,131	15,747	259,581	71,204	330,785
IV	6,631	78,856	126,017	13,133	46,300	15,693	260,364	74,108	334,472
2003 – I	6,633	78,921	126,145	13,639	46,450	15,438	259,948	72,509	332,457
II	6,216	78,142	126,846	13,534	46,557	15,345	259,572	71,561	331,132
III	6,169	79,106	126,821	13,388	46,429	15,458	260,595	72,698	333,293
IV	6,553	79,237	126,027	13,246	46,584	15,365	260,521	73,420	333,941
2004 – I	6,990	79,137	126,440	13,716	47,481	15,398	261,732	72,524	334,255
II	7,223	79,003	127,049	13,972	47,818	15,540	262,661	74,424	337,085
III	7,018	79,021	127,575	13,295	47,823	15,570	263,711	75,235	338,946
IV	7,107	78,415	126,909	13,502	48,056	15,599	262,584	75,287	337,871

Sources: Istat, national accounts.
(1) Value added at market prices. – (2) Wholesale and retail trade, repair services, hotel and restaurant services, transport and communication services; monetary and financial institution; real estate expenditure abroad. – (5) Expenditure of general government and non-profit institutions serving households. – (6) Includes non-residents' expenditure in Italy.

Table a5

OF INCOME						HOUSEHOLD DOMESTIC CONSUMPTION				
Uses						By type of consumption			By type of good	
Investment in building and public works	Investment in machinery, equipment, transport equipment and intangible assets	Domestic consumption		Change in stocks and valuables	Export of goods and services (*fob*) (6)	Non-durable goods	Durable goods	Services	Food products, beverages and tobacco products	Non-food products
		Domestic household expenditure	Public expenditure (5)							
80,106	115,517	595,251	174,188	10,958	276,584	268,576	71,593	263,589	107,373	496,385
84,849	124,368	611,570	177,227	171	303,311	272,867	75,744	274,071	109,918	512,765
87,369	125,752	616,427	184,011	-906	308,131	273,143	75,215	278,569	110,300	516,627
90,180	125,522	618,920	187,468	3,173	298,147	272,832	73,937	280,262	111,040	515,991
91,712	120,195	627,722	191,702	5,959	292,478	275,127	74,921	283,888	111,698	522,238
94,550	121,717	633,815	193,075	4,872	301,750	272,988	80,886	287,526	110,719	530,681
22,341	30,659	153,328	46,569	1,076	74,103	68,090	18,075	69,414	27,562	128,017
21,949	30,609	154,307	46,796	1,912	74,515	68,166	18,130	70,120	27,807	128,610
22,664	31,287	155,225	46,987	-246	74,868	68,301	18,597	70,306	27,863	129,341
23,256	33,072	156,174	47,115	192	74,662	68,363	19,116	70,466	27,897	130,049
23,044	30,321	156,131	47,494	2,487	72,980	68,217	18,820	70,910	27,921	130,026
22,989	29,916	156,794	47,718	2,790	70,926	68,851	18,298	70,850	27,979	130,020
22,806	29,942	157,776	48,224	-144	74,689	69,368	18,899	71,048	28,028	131,286
22,900	29,982	156,971	48,266	1,938	73,883	68,581	18,922	71,123	27,658	130,967
23,340	30,758	158,756	48,131	717	72,554	68,421	19,715	72,320	27,857	132,598
23,682	31,037	158,064	48,216	868	75,218	68,408	20,270	71,618	27,759	132,537
23,852	30,207	158,310	48,317	-589	78,850	67,872	20,628	71,695	27,516	132,679
23,638	29,505	158,701	48,411	2,487	75,129	68,314	20,237	71,918	27,617	132,852

services and business activities. – (3) Public administration and defence services; compulsory social security services; other community, social and personal service activities. – (4) Includes residents'

ITALY: INDUSTRIAL PRODUCTION BY MAIN INDUSTRIAL GROUPINGS
(indices, 2000=100; raw annual data; quarterly data adjusted for seasonal factors and the number of working days)

	Consumer goods			Investment goods	Intermediate goods	Energy	Manufacturing	Aggregate index
	Durable	Non-durable	Total					
1995	84.2	94.8	92.6	92.6	94.7	89.0	93.5	92.8
1996	83.8	94.2	92.1	94.3	91.4	89.6	92.4	92.0
1997	85.0	97.2	94.7	96.8	95.0	93.0	95.4	95.1
1998	89.6	98.8	96.9	97.0	97.2	95.6	97.0	96.8
1999	93.6	100.0	98.7	97.3	95.1	97.3	96.9	97.0
2000	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2001	99.2	100.7	100.4	99.8	98.2	99.6	99.3	99.4
2002	96.1	99.1	98.5	97.3	95.6	103.8	97.0	97.8
2003	91.9	99.1	97.6	93.7	94.4	108.2	95.3	96.8
2004	92.7	99.3	97.9	93.4	95.2	110.2	95.6	97.3
1998 – I	87.4	96.9	95.1	97.6	98.9	94.7	97.3	97.0
II	90.0	98.8	97.0	97.7	98.4	94.7	97.7	97.2
III	90.0	98.9	96.9	97.1	95.9	95.5	96.7	96.5
IV	88.7	98.7	96.6	93.2	94.0	97.2	95.1	95.4
1999 – I	88.8	98.8	97.0	96.0	93.2	97.9	94.8	95.2
II	90.4	97.5	96.1	95.6	93.4	95.2	94.9	94.9
III	94.3	101.2	99.5	96.6	94.4	97.4	96.7	96.9
IV	97.9	99.7	99.3	98.1	97.0	98.3	98.1	98.2
2000 – I	98.4	97.4	97.7	99.2	98.4	99.6	98.4	98.6
II	101.1	100.5	100.7	101.1	100.3	100.6	100.6	100.4
III	99.8	100.9	100.3	100.7	100.2	100.3	100.4	100.4
IV	103.5	103.5	103.5	101.1	102.8	99.4	102.5	102.1
2001 – I	102.9	103.8	104.0	103.2	100.9	97.8	102.5	101.9
II	100.1	101.0	100.8	100.7	99.5	98.5	100.3	100.2
III	96.6	100.3	99.2	98.6	97.9	98.9	98.7	98.7
IV	96.9	98.2	98.0	96.5	94.9	103.3	96.3	97.1
2002 – I	96.6	99.4	99.1	96.8	95.1	103.3	96.7	97.3
II	96.6	99.5	98.8	97.1	95.6	104.3	97.2	98.1
III	95.4	98.8	97.9	97.6	96.4	105.0	97.3	98.2
IV	95.2	99.2	98.4	97.7	95.5	103.0	97.1	97.8
2003 – I	90.5	99.4	97.8	94.5	96.4	108.2	96.2	97.5
II	89.7	99.4	97.3	92.9	94.3	107.7	94.9	96.4
III	94.0	100.2	98.8	94.7	94.8	109.1	96.1	97.6
IV	95.3	99.7	98.9	95.3	94.2	109.1	96.1	97.6
2004 – I	96.0	100.0	99.2	94.0	93.8	108.8	95.7	97.1
II	93.4	99.6	98.2	94.0	94.9	108.8	95.7	97.2
III	91.1	98.3	96.7	92.4	94.9	111.3	94.9	96.9
IV	88.3	96.4	94.7	90.1	94.5	110.6	93.5	95.6

Source: Based on Istat data.

ITALY: CAPACITY UTILIZATION RATES, BY MAIN INDUSTRIAL GROUPINGS
(data adjusted for seasonal factors and the number of working days; percentages)

	Consumer goods			Investment goods	Intermediate goods	Energy	Manufacturing	Aggregate index
	Durable	Non-durable	Total					
1995	99.6	99.1	98.9	95.3	97.9	98.5	98.7	98.8
1996	95.4	96.4	95.8	95.1	92.8	96.0	95.7	95.9
1997	93.6	98.6	97.3	97.3	96.0	97.9	98.1	98.0
1998	94.4	98.1	97.0	95.6	96.5	98.1	97.8	97.8
1999	95.1	97.8	96.9	94.9	93.3	97.5	95.7	96.2
2000	99.3	97.7	97.7	97.9	98.1	98.1	98.5	98.8
2001	96.3	97.2	96.6	96.6	95.6	95.5	97.0	97.4
2002	93.3	95.6	94.7	94.3	93.1	97.5	94.7	95.8
2003	89.8	96.1	94.4	91.4	92.4	99.8	93.5	95.3
2004	89.6	95.0	93.5	89.7	92.0	99.8	92.6	94.7
1998 – I	93.9	97.2	96.3	97.1	99.0	98.1	99.0	98.9
II	95.8	98.7	97.8	97.0	98.3	97.5	99.0	98.7
III	95.0	98.5	97.3	96.2	95.5	97.8	97.6	97.7
IV	92.8	98.0	96.6	92.1	93.4	98.9	95.6	96.2
1999 – I	92.2	97.8	96.5	94.7	92.3	99.0	94.9	95.6
II	93.0	96.2	95.2	94.1	92.3	95.8	94.7	94.9
III	96.3	99.5	98.2	94.8	93.0	97.5	96.1	96.6
IV	99.1	97.7	97.5	96.1	95.4	97.8	97.1	97.5
2000 – I	98.7	95.1	95.6	97.0	96.5	98.5	97.1	97.6
II	100.0	97.8	98.0	98.5	98.1	98.9	98.8	99.0
III	98.6	97.8	97.2	98.0	97.8	98.1	98.3	98.7
IV	100.0	100.0	99.9	98.1	100.0	96.7	100.0	100.0
2001 – I	100.0	100.0	100.0	100.0	98.2	94.6	100.0	99.7
II	97.3	97.3	97.0	97.5	96.8	94.7	97.9	98.1
III	93.9	96.7	95.3	95.5	95.3	94.6	96.3	96.6
IV	94.2	94.7	94.2	93.5	92.4	98.2	94.0	95.1
2002 – I	93.9	95.8	95.3	93.8	92.5	97.7	94.3	95.3
II	93.9	95.9	95.0	94.1	93.0	98.2	94.8	96.0
III	92.8	95.2	94.1	94.5	93.8	98.3	94.9	96.2
IV	92.5	95.6	94.6	94.7	92.9	95.9	94.8	95.8
2003 – I	88.0	95.8	94.0	91.6	93.8	100.0	93.9	95.5
II	87.1	95.8	93.5	90.0	91.8	99.2	92.5	94.4
III	91.4	96.6	95.0	91.8	92.3	100.0	93.7	95.6
IV	92.6	96.1	95.1	92.4	91.7	100.0	93.7	95.5
2004 – I	93.3	96.4	95.4	91.1	91.3	99.7	93.3	95.1
II	90.8	96.0	94.4	91.0	92.4	99.7	93.3	95.2
III	88.6	94.7	93.0	89.5	92.4	100.0	92.6	94.9
IV	85.8	92.9	91.1	87.3	92.0	100.0	91.2	93.6

Source: Based on Istat data.

Table a8

ITALY: CONSUMER PRICE INDICES

(percentage changes on corresponding period)

	CPI (1)													WEH (2)
	Goods and services with unregulated prices (4)							Goods and services with regulated prices (4)			Rents	Overall index	Total net of food and energy products and those with regulated prices	Overall index
	Non-food and non-energy products	Ser-vices	Food products			Energy products	Total	Energy products	Non-energy products (5)	Total				
			Processed	Un-processed	Total									
Weights (3)	*30.0*	*31.9*	*10.0*	*6.6*	*16.6*	*3.3*	*81.8*	*2.8*	*12.3*	*15.2*	*3.0*	*100.0*	*61.9*	*100.0*
2000	1.5	2.8	1.2	2.0	1.6	13.2	2.5	9.8	1.2	3.0	2.5	2.5	2.1	2.6
2001	2.0	3.2	2.4	6.4	4.0	-2.0	2.7	5.8	3.1	3.7	2.3	2.7	2.6	2.7
2002	2.2	3.9	2.4	5.3	3.6	-1.9	2.9	-3.4	1.3	0.3	2.3	2.5	3.0	2.4
2003	1.9	3.5	2.4	4.2	3.2	2.3	2.8	4.1	1.6	2.1	2.8	2.7	2.7	2.5
2004	0.8	3.4	2.3	2.0	2.2	5.8	2.3	-1.2	2.4	1.7	2.8	2.2	2.1	2.0
2002 – Jan.	2.0	3.7	2.8	7.7	4.8	-6.5	2.8	-4.0	1.8	0.6	2.1	2.4	2.8	2.3
Feb.	2.2	3.8	2.6	6.5	4.2	-5.4	2.9	-4.3	1.6	0.4	2.1	2.3	3.0	2.3
Mar.	2.2	3.8	2.6	6.2	4.1	-4.5	2.9	-5.4	1.8	0.3	2.1	2.5	3.0	2.4
Apr.	2.1	3.7	2.4	6.8	4.2	-1.6	2.9	-6.4	1.3	-0.4	2.4	2.3	2.8	2.4
May	2.1	3.8	2.4	6.1	3.9	-3.5	2.8	-4.3	0.5	-0.5	2.4	2.3	2.9	2.3
June	2.1	3.9	2.4	4.5	3.3	-5.1	2.6	-4.3	0.8	-0.2	2.4	2.2	2.9	2.3
July	2.2	4.0	2.3	3.7	2.9	-3.4	2.7	-1.9	0.9	0.4	2.1	2.2	3.0	2.3
Aug.	2.2	4.2	2.3	3.8	2.9	-1.4	2.9	-1.8	1.2	0.6	2.1	2.4	3.1	2.5
Sep.	2.3	4.1	2.3	4.4	3.2	-0.5	3.0	-1.5	1.3	0.8	2.1	2.6	3.1	2.6
Oct.	2.2	4.0	2.3	4.6	3.2	2.3	3.1	-1.4	1.3	0.8	2.5	2.7	3.1	2.6
Nov.	2.3	4.2	2.2	4.8	3.3	3.5	3.2	-2.8	1.2	0.4	2.5	2.8	3.2	2.7
Dec.	2.2	4.0	2.2	4.8	3.3	4.3	3.2	-2.9	1.9	0.9	2.5	2.8	3.1	2.7
2003 – Jan.	2.2	3.8	2.1	3.1	2.5	7.2	3.0	1.5	1.3	1.3	2.7	2.8	3.0	2.7
Feb.	2.0	3.6	2.2	2.6	2.4	8.4	2.9	2.0	0.5	0.8	2.7	2.6	2.8	2.5
Mar.	2.0	3.7	2.3	2.8	2.5	9.5	3.0	3.2	0.5	1.0	2.7	2.7	2.8	2.6
Apr.	2.1	3.7	2.3	2.1	2.2	3.2	2.7	6.0	1.7	2.5	2.8	2.7	2.8	2.5
May	2.0	3.6	2.3	2.4	2.4	-0.4	2.6	6.3	2.6	3.3	2.8	2.7	2.8	2.4
June	2.0	3.6	2.4	3.9	3.0	-1.3	2.7	6.4	2.1	2.9	2.8	2.7	2.8	2.3
July	1.9	3.6	2.4	4.6	3.3	-0.2	2.7	4.5	1.9	2.4	2.9	2.7	2.7	2.5
Aug.	1.9	3.7	2.4	5.2	3.6	1.3	2.9	4.5	1.8	2.3	2.9	2.8	2.7	2.5
Sep.	1.8	3.4	2.4	6.0	3.9	1.8	2.8	4.4	1.8	2.3	2.9	2.8	2.6	2.5
Oct.	1.6	3.4	2.6	6.3	4.2	-1.1	2.7	3.7	1.7	2.1	2.7	2.6	2.5	2.4
Nov.	1.4	3.3	2.7	6.1	4.1	-0.3	2.6	3.7	1.9	2.2	2.7	2.5	2.3	2.4
Dec.	1.4	3.2	2.8	5.4	3.9	0.3	2.5	3.7	1.9	2.3	2.7	2.5	2.3	2.3
2004 – Jan.	1.3	3.2	2.8	5.5	3.9	-1.7	2.4	1.6	1.6	1.6	2.7	2.2	2.2	2.0
Feb.	1.2	3.1	2.8	5.7	4.0	-2.4	2.4	0.6	2.6	2.2	2.7	2.3	2.2	2.2
Mar.	0.9	3.2	2.7	5.1	3.7	-3.2	2.2	0.2	3.6	2.9	2.7	2.3	2.1	1.9
Apr.	0.8	3.5	2.6	4.5	3.4	0.7	2.3	-2.4	2.4	1.5	3.0	2.3	2.1	2.0
May	0.7	3.3	2.6	3.8	3.1	6.4	2.4	-2.8	2.4	1.4	3.0	2.3	2.0	2.1
June	0.6	3.6	2.4	3.2	2.8	9.6	2.5	-2.9	2.7	1.6	3.0	2.4	2.1	2.2
July	0.6	3.6	2.4	2.2	2.3	9.0	2.4	-2.3	2.7	1.8	2.8	2.3	2.1	2.1
Aug.	0.6	3.7	2.3	1.4	1.9	9.0	2.4	-2.3	2.7	1.8	2.8	2.3	2.2	2.1
Sep.	0.6	3.8	2.1	-0.2	1.1	7.9	2.2	-2.3	2.5	1.6	2.8	2.1	2.2	1.8
Oct.	0.8	3.3	1.8	-1.6	0.4	12.1	2.1	-0.9	1.9	1.4	2.7	2.0	2.1	1.7
Nov.	0.8	3.4	1.5	-2.3	..	12.2	2.0	-0.5	1.3	0.9	2.7	1.9	2.1	1.7
Dec.	0.8	3.6	1.3	-2.3	-0.2	11.1	2.1	-0.3	2.1	1.7	2.7	2.0	2.2	1.7
2005 – Jan.	0.8	3.5	1.2	-2.6	-0.4	8.3	1.9	1.7	1.5	1.6	2.5	1.9	2.2	1.6
Feb.	0.8	3.3	1.0	-2.2	-0.3	9.2	1.8	2.4	1.5	1.7	2.5	1.9	2.1	1.6
Mar.	0.9	3.4	0.9	-1.4	-0.1	10.7	2.0	2.7	0.4	0.8	2.5	1.9	2.2	1.6

Source: Based on Istat data.

(1) Consumer price index (entire resident population); 1995=100. – (2) Consumer price index for worker and employee households, excluding tobacco products; 1995=100. – (3) As of January 1999 Istat changes the weights every year on the basis of estimates of households' final consumption in the previous year. The weights shown in the table are those for January 2005. – (4) The sub-indices are based on the 207-product classification. – (5) Includes medicines, for which the reference is to the aggregate calculated by Istat; around one third of this consists of products in the so-called "C band", the prices of which are unregulated.

ITALY: HARMONIZED INDEX OF CONSUMER PRICES (1)
(percentage changes on corresponding period) (2)

	Non-food and non-energy products	Services	Total net of food and energy products	Food products			Energy products	Total net of unprocessed food and energy products	Overall index
				Processed	Unprocessed				
Weights	*34.0*	*40.0*	*74.0*	*11.6*	*7.9*	*19.5*	*6,4*	*85.6*	*100.0*
2000	1.7	2.3	2.0	1.3	1.8	1.5	11.6	1.9	2.6
2001	1.8	2.9	2.4	2.5	5.8	3.9	1.6	2.4	2.7
2002	2.4	3.4	2.9	2.2	4.9	3.4	-2.6	2.8	2.6
2003	1.9	3.1	2.5	3.4	3.9	3.6	3.1	2.6	2.8
2004	1.6	2.6	2.1	3.6	1.9	2.9	2.4	2.3	2.3
2002 – Jan.	1.6	3.3	2.5	2.9	7.1	4.7	-5.3	2.5	2.3
Feb.	2.7	3.3	3.0	2.8	5.9	4.1	-4.9	2.9	2.7
Mar.	2.5	3.3	2.9	2.7	5.6	4.0	-4.9	2.9	2.5
Apr.	2.5	3.1	2.8	1.8	6.2	3.7	-4.0	2.7	2.5
May	2.3	3.3	2.8	1.8	5.7	3.4	-3.9	2.7	2.4
June	2.3	3.4	2.8	2.0	4.3	3.0	-4.7	2.7	2.2
July	2.2	3.4	2.8	2.0	3.6	2.7	-2.7	2.7	2.4
Aug.	2.3	3.6	2.9	2.2	3.6	2.8	-1.6	2.8	2.6
Sep.	2.7	3.6	3.1	2.2	4.1	3.0	-1.0	3.0	2.8
Oct.	2.4	3.5	3.0	2.2	4.3	3.1	0.5	2.9	2.8
Nov.	2.6	3.6	3.1	2.1	4.4	3.1	0.4	3.0	2.9
Dec.	2.7	3.5	3.1	2.3	4.3	3.1	0.7	3.0	3.0
2003 – Jan.	1.8	3.5	2.7	2.3	2.8	2.5	4.4	2.7	2.9
Feb.	1.1	3.4	2.4	2.3	2.5	2.4	5.3	2.4	2.6
Mar.	2.0	3.4	2.7	2.4	2.6	2.5	6.4	2.7	2.9
Apr.	2.0	3.4	2.7	3.8	1.9	3.0	4.4	2.9	3.0
May	2.2	3.3	2.7	3.8	2.3	3.2	2.7	2.9	2.9
June	2.2	3.2	2.7	3.6	3.6	3.5	2.3	2.9	2.9
July	1.8	3.2	2.6	3.6	4.3	3.9	2.0	2.7	2.9
Aug.	1.4	3.2	2.4	3.4	4.8	4.0	2.8	2.5	2.7
Sep.	1.6	3.1	2.4	3.5	5.6	4.4	2.9	2.5	3.0
Oct.	2.0	2.8	2.4	3.6	5.8	4.6	1.1	2.5	2.8
Nov.	1.9	2.7	2.3	3.9	5.7	4.6	1.6	2.5	2.8
Dec.	1.8	2.5	2.2	4.0	5.0	4.4	1.9	2.4	2.5
2004 – Jan.	1.0	2.4	1.7	3.9	5.1	4.4	-0.1	2.0	2.2
Feb.	2.0	2.3	2.3	3.9	5.2	4.5	-1.1	2.4	2.4
Mar.	1.5	2.4	2.0	5.1	4.7	5.0	-1.5	2.4	2.3
Apr.	1.8	2.5	2.2	3.6	4.2	3.9	-0.8	2.3	2.3
May	1.7	2.4	2.0	3.7	3.6	3.6	1.9	2.3	2.3
June	1.6	2.6	2.2	3.5	2.9	3.4	3.5	2.3	2.4
July	1.3	2.6	2.0	3.7	2.2	2.9	3.4	2.2	2.2
Aug.	1.4	2.7	2.1	3.4	1.4	2.6	3.5	2.4	2.4
Sep.	1.6	2.8	2.3	3.2	-0.2	1.8	3.1	2.4	2.1
Oct.	1.7	2.6	2.2	3.0	-1.5	1.0	5.8	2.3	2.1
Nov.	1.7	2.6	2.2	2.6	-2.1	0.6	6.1	2.2	2.0
Dec.	1.7	2.8	2.4	3.5	-1.9	1.2	5.5	2.5	2.4
2005 – Jan.	1.3	2.6	2.0	3.4	-2.3	1.0	5.1	2.2	2.0
Feb.	1.1	2.5	1.8	3.2	-1.9	1.0	5.8	2.0	2.0
Mar.	1.3	2.7	2.1	1.9	-1.3	0.5	6.9	2.0	2.1

Source: Eurostat.

(1) Chain indices, 1996=100. Istat updates the weights every year on the basis of estimates of households' final consumption in the previous year. The weights shown in the table are those for January 2005. – (2) From January 2002, calculated with reference to the indices compiled using the new treatment of price reductions introduced in that month by Istat in accordance with Commission Regulation (EC) no. 2602/2000.

EURO AREA: HARMONIZED INDEX OF CONSUMER PRICES (1)
(percentage changes on corresponding period) (2)

	Non-food and non-energy products	Services	Total net of food and energy products	Food products			Energy products	Total net of unprocessed food and energy products	Overall index
				Processed	Unprocessed				
Weights	*30.8*	*41.0*	*71.8*	*12.0*	*7.6*	*19.6*	*8.5*	*83.8*	*100.0*
2001	0.9	2.5	1.8	2.9	7.0	4.5	2.2	1.9	2.3
2002	1.5	3.1	2.4	3.1	3.1	3.1	-0.6	2.5	2.3
2003	0.7	2.5	1.7	3.3	2.1	2.8	3.0	1.9	2.1
2004	0.8	2.6	1.8	3.4	0.6	2.3	4.5	2.1	2.1
2002 – Jan.	1.6	3.0	2.4	3.8	8.4	5.6	-1.9	2.6	2.6
Feb.	1.8	3.0	2.5	3.4	7.1	4.9	-2.9	2.6	2.5
Mar.	1.7	3.2	2.6	3.3	5.6	4.2	-1.5	2.7	2.5
Apr.	1.7	2.9	2.4	3.3	4.2	3.6	-0.5	2.5	2.3
May	1.6	3.3	2.5	3.2	2.1	2.7	-2.8	2.6	2.0
June	1.5	3.2	2.5	3.1	1.2	2.3	-3.6	2.5	1.9
July	1.3	3.2	2.4	3.0	0.9	2.2	-1.6	2.5	2.0
Aug.	1.3	3.3	2.4	3.0	1.4	2.3	-0.3	2.5	2.1
Sept.	1.3	3.2	2.4	2.8	1.7	2.4	-0.2	2.4	2.1
Oct.	1.2	3.1	2.3	2.6	1.7	2.2	2.6	2.3	2.3
Nov.	1.3	3.1	2.3	2.6	1.9	2.3	2.4	2.3	2.3
Dec.	1.2	3.0	2.2	2.7	1.3	2.1	3.8	2.2	2.3
2003 – Jan.	0.6	2.8	1.9	2.8	-0.7	1.4	6.0	2.0	2.1
Feb.	0.7	2.7	1.9	3.2	0.3	2.0	7.7	2.0	2.4
Mar.	0.8	2.6	1.8	3.2	0.7	2.2	7.4	1.9	2.4
Apr.	0.8	2.8	1.9	3.3	0.9	2.3	2.2	2.1	2.1
May	0.9	2.4	1.8	3.2	1.1	2.3	0.6	1.9	1.8
June	0.8	2.5	1.7	3.2	2.5	2.9	1.5	2.0	1.9
July	0.7	2.3	1.5	3.1	2.7	2.9	2.0	1.8	1.9
Aug.	0.5	2.5	1.6	3.0	3.2	3.1	2.6	1.8	2.1
Sept.	0.7	2.5	1.8	3.1	4.2	3.5	1.6	1.9	2.2
Oct.	0.8	2.4	1.7	3.5	3.7	3.6	0.6	1.9	2.0
Nov.	0.7	2.3	1.6	3.9	3.7	3.8	2.2	1.9	2.2
Dec.	0.6	2.2	1.5	3.8	3.2	3.6	1.7	1.9	2.0
2004 – Jan.	0.6	2.5	1.7	3.3	2.8	3.1	-0.4	1.9	1.9
Feb.	0.8	2.6	1.8	3.2	1.9	2.7	-2.2	2.0	1.6
Mar.	0.8	2.6	1.8	4.0	1.7	3.1	-2.0	2.2	1.7
Apr.	0.9	2.5	1.8	3.8	1.5	2.9	2.0	2.1	2.0
May	0.8	2.6	1.8	3.9	1.7	3.1	6.6	2.1	2.5
June	0.9	2.7	1.9	3.8	1.3	2.8	6.0	2.1	2.4
July	0.8	2.6	1.9	3.7	0.8	2.6	5.9	2.1	2.3
Aug.	1.0	2.6	1.9	3.6	-0.2	2.1	6.5	2.1	2.3
Sept.	0.8	2.6	1.8	3.4	-1.6	1.4	6.4	2.0	2.1
Oct.	0.8	2.6	1.9	2.8	-1.2	1.3	9.9	2.0	2.4
Nov.	0.8	2.7	1.9	2.2	-1.0	1.0	8.7	2.0	2.2
Dec.	0.8	2.7	1.9	3.3	..	2.0	6.9	2.0	2.4
2005 – Jan.	0.5	2.5	1.5	2.8	-0.6	1.5	6.3	1.8	1.9
Feb.	0.2	2.4	1.4	2.6	0.7	1.9	7.7	1.6	2.1
Mar.	0.4	2.4	1.5	1.6	1.3	1.4	8.8	1.6	2.1

Source: Eurostat.
(1) Weighted average of the indices of the euro-area countries. The weights shown in the table are those for January 2005. – (2) From January 2002, calculated with reference to the indices compiled using the new treatment of price reductions introduced in that month by Istat in accordance with Commission Regulation (EC) no. 2602/2000.

Table a11

ITALY: INDEX OF THE PRODUCER PRICES OF MANUFACTURES SOLD IN THE DOMESTIC MARKET (1)
(percentage changes on corresponding period)

	Consumer goods (2)		Investment goods	Intermediate goods		Overall index net of food and energy products	Overall index
	Non-food products	Food products		Non-energy products	Energy products		
Weights	*17.2*	*13.1*	*17.9*	*34.3*	*17.5*	*69.4*	*100*
2001	2.2	2.8	1.2	1.3	2.7	1.6	1.9
2002	2.5	1.0	1.0	0.4	-4.0	1.1	0.2
2003	1.1	2.7	0.7	1.5	2.5	1.2	1.6
2004	0.6	1.4	1.7	4.9	2.4	3.0	2.7
2002 – Jan.	2.8	1.9	1.1	-1.4	-8.6	0.3	-1.2
Feb.	2.8	0.9	1.0	-1.0	-8.2	0.5	-1.1
Mar.	2.8	0.9	1.2	-0.8	-7.3	0.6	-0.8
Apr.	2.3	0.1	1.2	-0.5	-7.1	0.6	-0.8
May	2.1	0.4	1.1	..	-6.2	0.8	-0.5
June	2.6	0.2	1.0	0.3	-6.8	1.1	-0.5
July	2.3	0.6	1.0	0.7	-3.2	1.2	0.4
Aug.	2.6	0.7	1.0	0.9	-2.4	1.3	0.6
Sept.	2.5	1.0	1.0	1.1	-1.5	1.4	0.9
Oct.	2.6	1.5	1.1	1.5	1.2	1.7	1.6
Nov.	2.4	2.0	1.1	1.8	0.6	1.8	1.6
Dec.	2.5	2.1	0.9	1.9	2.8	1.8	2.0
2003 – Jan.	1.7	2.2	0.7	2.3	5.7	1.7	2.5
Feb.	1.5	2.3	0.6	2.6	7.2	1.8	2.8
Mar.	1.5	2.0	0.6	2.5	8.1	1.7	2.8
Apr.	1.6	2.6	0.5	2.4	3.1	1.7	2.0
May	1.5	2.4	0.7	2.0	0.8	1.5	1.6
June	1.2	2.7	0.7	1.3	2.2	1.1	1.5
July	1.1	2.6	0.9	0.8	2.0	0.9	1.3
Aug.	0.8	2.9	0.9	0.4	2.9	0.6	1.4
Sept.	0.8	3.6	0.9	0.6	0.1	0.7	1.0
Oct.	0.4	3.4	0.8	0.8	-1.4	0.7	0.7
Nov.	0.5	3.3	0.8	1.0	1.0	0.8	1.2
Dec.	0.3	2.8	0.9	1.0	-1.4	0.8	0.8
2004 – Jan.	0.2	2.7	1.1	1.2	-3.6	0.9	0.4
Feb.	0.1	2.6	1.2	1.5	-5.9	1.1	0.1
Mar.	..	3.1	1.3	2.8	-5.6	1.7	0.7
Apr.	..	2.6	1.6	3.9	-1.2	2.3	1.7
May	-0.2	2.8	1.7	4.5	4.3	2.6	2.9
June	-0.1	2.9	2.0	5.2	3.8	3.1	3.2
July	0.3	2.1	1.7	5.9	3.8	3.4	3.3
Aug.	0.8	1.1	1.9	6.6	4.2	3.9	3.5
Sept.	1.0	-0.3	1.9	6.7	5.8	4.1	3.8
Oct.	1.4	-0.7	2.0	6.9	9.2	4.3	4.4
Nov.	1.7	-1.1	2.1	7.0	8.0	4.4	4.3
Dec.	1.8	-0.7	2.0	7.0	7.6	4.4	4.2
2005 – Jan.	1.8	-1.3	2.2	6.9	9.9	4.4	4.5
Feb.	2.0	-0.8	2.2	6.2	11.9	4.1	4.7
Mar.	2.1	-1.0	2.1	4.7	14.2	3.4	4.6

Source: Istat.

(1) Classification of goods by main industrial groupings, 2000=100; Istat data. – (2) The item does not include energy products or motor vehicles; the latter are included under investment goods.

MAJOR EURO-AREA COUNTRIES: INDEX OF THE PRODUCER PRICES OF MANUFACTURES SOLD IN THE DOMESTIC MARKET
(percentage changes on corresponding period)

	GERMANY					FRANCE				
	Consumer goods net of food products (2)	Intermediate goods		Overall index net of food and energy products	Overall index	Consumer goods net of food products (2)	Intermediate goods		Overall index net of food and energy products	Overall index
		Non-energy products	Energy products				Non-energy products	Energy products		
Weights (1)	*13.5*	*31.2*	*18.1*	*68.0*	*100.0*	*13.5*	*34.3*	*17.5*	*65.2*	*100.0*
2002	0.3	-0.7	-3.7	0.1	-0.6	-0.2	-0.6	-0.7	-0.2	-0.2
2003	-0.2	0.4	7.1	0.2	1.7	0.4	0.4	2.6	0.3	0.9
2004	-0.6	2.8	2.5	1.2	1.6	-0.7	2.7	5.1	1.1	2.0
2003 – June	-0.1	0.3	5.8	0.1	1.4	0.7	0.6	1.8	0.6	0.9
July	0.3	-0.1	8.6	..	1.9	0.6	-0.3	1.7	0.1	0.6
Aug.	-0.1	-0.4	9.8	-0.2	2.0	0.3	-0.6	1.6	-0.1	0.5
Sept.	..	-0.3	9.0	-0.1	2.0	0.2	-0.3	-0.8	0.1	0.1
Oct.	..	-0.4	7.9	-0.2	1.7	..	-0.1	-0.6	0.1	0.3
Nov.	..	-0.1	8.5	..	2.0	-0.2	0.2	1.0	0.2	0.8
Dec.	-0.3	-0.1	8.0	-0.1	1.8	-0.6	0.3	-1.0	..	0.3
2004 – Jan.	-0.3	-0.2	0.7	-0.1	0.2	-1.0	0.4	-1.7	0.1	0.3
Feb.	-0.5	0.1	-0.7	..	-0.1	-1.0	0.9	-4.3	0.3	..
Mar.	-0.7	0.6	-1.1	0.1	0.3	-1.3	1.3	-3.1	0.3	0.3
Apr.	-1.0	1.5	0.7	0.5	0.9	-1.3	1.6	2.5	0.4	1.3
May	-1.3	2.0	3.9	0.7	1.6	-1.4	1.9	7.4	0.5	2.2
June	-0.9	2.2	2.9	0.8	1.5	-1.6	2.3	6.3	0.7	2.2
July	-0.9	3.3	2.7	1.4	1.9	-1.1	3.3	6.7	1.4	2.6
Aug.	-0.6	4.0	3.1	1.8	2.2	-0.8	3.8	7.3	1.7	2.8
Sept.	-0.6	4.2	3.4	1.9	2.3	-0.4	4.0	9.0	1.8	3.0
Oct.	-0.4	5.2	6.4	2.4	3.3	..	4.3	12.0	2.0	3.5
Nov.	-0.1	5.2	4.5	2.5	2.8	0.4	4.3	10.7	2.2	3.2
Dec.	0.4	5.1	3.3	2.6	2.9	0.5	4.1	9.2	2.3	3.0
2005 – Jan.	0.5	5.5	7.3	3.0	3.9	1.3	4.1	8.4	2.5	2.9
Feb.	0.5	5.6	8.2	3.0	4.2	1.6	3.8	10.2	2.5	3.1
Mar.	1.3	5.0	10.0	3.0	4.2	1.2	3.5	11.2	2.4	3.1

	SPAIN					EURO (3)				
Weights (1)	*16.8*	*31.6*	*18.0*	*66.7*	*100.0*	*14.0*	*31.7*	*16.8*	*66.8*	*100.0*
2002	1.8	0.2	-1.3	1.1	0.7	0.8	-0.3	-2.3	0.3	-0.1
2003	2.3	0.8	1.3	1.3	1.4	0.4	0.8	3.8	0.5	1.4
2004	1.3	4.5	5.3	2.9	3.4	-0.6	3.5	3.9	1.7	2.3
2003 – June	2.6	0.4	-0.9	1.2	0.9	0.7	0.7	3.1	0.6	1.3
July	2.4	0.1	0.2	1.0	1.1	0.6	0.1	3.3	0.3	1.1
Aug.	2.4	..	0.1	0.9	1.1	0.3	-0.2	4.1	0.1	1.2
Sept.	2.5	0.3	-2.4	1.1	0.8	0.4	..	1.8	0.2	0.9
Oct.	2.2	0.7	-3.6	1.2	0.6	..	0.2	1.1	0.2	0.8
Nov.	2.1	0.9	-0.4	1.3	1.3	-0.3	0.4	3.2	0.2	1.3
Dec.	1.6	1.0	-1.2	1.2	1.1	-0.7	0.4	1.7	0.1	0.9
2004 – Jan.	1.3	1.4	-3.6	1.3	0.7	-0.9	0.5	-1.5	0.2	0.2
Feb.	1.1	2.0	-5.4	1.6	0.7	-0.9	0.9	-3.5	0.3	..
Mar.	1.0	2.6	-5.6	1.9	0.8	-1.1	1.5	-2.8	0.6	0.4
Apr.	1.0	3.7	1.3	2.4	2.6	-1.2	2.3	1.2	1.0	1.4
May	1.1	4.4	7.2	2.6	3.8	-1.3	2.8	5.5	1.2	2.4
June	1.0	4.8	7.1	2.9	4.0	-1.2	3.3	4.5	1.5	2.4
July	1.0	5.3	7.2	3.2	4.1	-0.9	4.2	5.3	2.1	2.9
Aug.	1.0	5.7	9.0	3.4	4.4	-0.7	4.8	5.6	2.4	3.1
Sept.	1.2	5.9	11.0	3.5	4.6	-0.5	5.0	7.3	2.5	3.3
Oct.	1.8	6.2	14.2	3.8	5.4	0.1	5.5	10.1	2.9	4.1
Nov.	1.9	6.3	12.6	3.9	5.2	0.7	5.5	8.3	3.1	3.7
Dec.	2.6	6.2	10.7	4.0	5.0	1.0	5.4	7.0	3.1	3.6
2005 – Jan.	3.1	6.2	8.8	4.2	4.8	1.5	5.5	8.4	3.4	3.9
Feb.	3.5	5.5	11.0	4.0	4.9	1.6	5.1	10.0	3.3	4.2
Mar.	3.4	4.9	13.1	3.7	5.1	1.7	4.4	11.5	3.0	4.2

Source: Based on Eurostat data.
(1) 1995=100 for Germany; 2000=100 for France, Spain and euro area. – (2) The item does not include energy products. – (3) GDP-weighted average for the 12 euro-area countries.

Table a13

ITALY: BALANCE OF PAYMENTS
(millions of euros)

	1999	2000	2001	2002	2003	2004
Current account	**7,692**	**-6,305**	**-740**	**-10,014**	**-17,351**	**-12,035**
Goods	22,044	10,368	17,405	14,049	9,922	8,838
Credits	221,484	260,906	273,596	267,582	263,599	283,331
Debits	199,440	250,538	256,191	253,533	253,677	274,493
Services	1,125	1,167	18	-3,043	-2,362	1,528
Credits	55,307	61,479	64,614	63,760	63,420	67,529
Debits	54,182	60,312	64,596	66,803	65,781	66,001
Income	-10,392	-13,099	-11,635	-15,396	-17,811	-14,711
Credits	43,483	41,894	43,111	45,782	43,097	42,833
Debits	53,875	54,993	54,746	61,178	60,908	57,544
Transfers	-5,085	-4,742	-6,527	-5,624	-7,101	-7,690
Credits	15,608	16,996	17,962	22,183	18,418	17,565
EU institutions	*5,756*	*6,275*	*6,121*	*6,183*	*6,531*	*6,917*
Debits	20,693	21,738	24,489	27,807	25,519	25,255
EU institutions	*10,441*	*11,180*	*11,755*	*11,910*	*12,820*	*13,454*
Capital account	**2,789**	**3,195**	**936**	**-67**	**2,494**	**2,081**
Intangible assets	-3	-72	-312	-206	-86	-38
Transfers	2,792	3,267	1,248	139	2,580	2,118
EU institutions	*3,201*	*3,624*	*1,748*	*1,625*	*3,635*	*2,814*
Financial account	**-8,867**	**4,287**	**-3,294**	**8,532**	**17,319**	**8,884**
Direct investment	178	1,149	-7,377	-2,739	6,507	-1,971
Abroad	-6,309	-13,368	-23,995	-18,194	-8,037	-15,513
In Italy	6,487	14,517	16,618	15,455	14,544	13,542
Portfolio investment	-23,635	-26,255	-7,640	16,107	3,369	26,447
Assets	-121,493	-86,340	-40,070	-16,968	-51,068	-21,065
Shares	-60,122	-82,894	-11,153	-6,039	-13,806	-12,863
Debt securities	-61,371	-3,446	-28,917	-10,929	-37,262	-8,202
bonds	*-60,908*	*-1,698*	*-27,017*	*-10,301*	*-40,133*	*-8,903*
Liabilities	97,858	60,085	32,430	33,075	54,437	47,512
Shares	-4,336	-1,714	-354	-7,155	-2,191	13,381
Debt securities	102,194	61,799	32,784	40,230	56,628	34,131
bonds	*65,800*	*75,160*	*43,171*	*32,064*	*48,276*	*47,979*
Financial derivatives	1,766	2,501	-477	-2,710	-4,827	1,833
Other investment	5,725	29,950	11,716	985	13,676	-19,687
Assets	-31,471	987	3,007	8,296	-19,390	-37,619
Liabilities	37,196	28,963	8,709	-7,311	33,066	17,932
Change in official reserves	7,099	-3,058	484	-3,111	-1,406	2,262
Errors and omissions	**-1,614**	**-1,177**	**3,098**	**1,549**	**-2,462**	**1,071**

Table a14

ITALY: NET INTERNATIONAL INVESTMENT POSITION

(millions of euros)

	2000	2001	2002	2003	2004
ASSETS	**1,220,570**	**1,223,523**	**1,147,737**	**1,241,481**	**1,319,849**
Non-bank sectors	**955,517**	**958,264**	**851,961**	**911,935**	**952,932**
Direct investment	178,948	191,630	170,155	174,767	191,478
Real estate	6,682	7,490	7,609	8,067	9,148
Other	172,266	184,140	162,546	166,700	182,330
Portfolio investment	597,869	588,912	526,659	563,108	586,944
Other investment	176,296	174,347	146,977	162,912	163,367
Financial derivatives	2,404	3,375	8,170	11,148	11,143
Banks	**203,420**	**188,498**	**229,356**	**265,380**	**300,389**
Direct investment	14,791	15,305	15,306	14,371	14,435
Portfolio investment	36,298	36,553	38,920	64,964	73,099
Other investment	150,938	135,106	172,762	179,216	203,082
Financial derivatives	1,393	1,534	2,368	6,829	9,773
Central bank	**61,633**	**76,761**	**66,420**	**64,166**	**66,528**
Direct investment	4	5	5	5	5
Portfolio investment	715	912	2,673	2,436	3,313
Other investment	10,548	23,407	10,702	11,637	17,409
Financial derivatives	50,366	52,437	53,040	50,088	45,801
Gold	*23,098*	*24,732*	*25,764*	*26,042*	*25,348*
LIABILITIES	**1,178,412**	**1,197,590**	**1,216,343**	**1,310,705**	**1,418,410**
Non-bank sectors	**845,666**	**869,566**	**901,365**	**964,514**	**1,044,841**
Direct investment	120,967	121,701	119,706	136,522	154,496
Real estate	2,961	3,249	3,566	4,835	5,013
Other	118,006	118,452	116,140	131,687	149,483
Portfolio investment	599,693	621,083	656,944	707,165	760,566
Government securities (1)	*470,349*	*485,224*	*515,343*	*568,043*	*590,940*
BOTs	*61,369*	*55,799*	*43,533*	*57,582*	*42,842*
BTPs	*257,994*	*283,700*	*326,404*	*371,266*	*407,624*
Other	*82,749*	*65,333*	*62,596*	*54,045*	*64,047*
Republic of Italy	*68,237*	*80,392*	*82,810*	*85,150*	*76,427*
Other investment	123,108	123,191	119,185	113,289	117,744
Financial derivatives	1,898	3,591	5,530	7,538	12,035
Banks	**314,728**	**325,531**	**309,870**	**343,747**	**372,802**
Direct investment	9,253	7,012	5,038	6,701	7,548
Portfolio investment	19,697	21,005	18,957	25,601	33,317
Other investment	284,838	295,942	282,900	306,396	324,631
Financial derivatives	940	1,572	2,975	5,048	7,307
Central bank	**18,018**	**2,493**	**5,108**	**2,444**	**767**
Direct investment	....	....	....	....	....
Portfolio investment	....	....	....	....	....
Other investment	18,018	2,493	5,108	2,444	767
OVERALL NET POSITION	**42,158**	**25,933**	**-68,606**	**-69,224**	**-98,561**

(1) The breakdown by instrument is estimated and subject to revision.

CONSOLIDATED ACCOUNTS OF GENERAL GOVERNMENT (1)
(millions of euros)

	1999	2000	2001	2002	2003	2004
Revenue						
Direct taxes	166,435	170,547	182,690	178,964	178,098	184,175
Indirect taxes	167,500	175,171	176,492	185,116	187,345	195,207
Actual social security contributions	137,322	144,199	149,841	157,504	165,101	171,198
Imputed social security contributions	3,809	3,884	3,978	3,737	3,798	3,558
Income from capital	7,115	5,617	7,686	7,673	7,704	8,319
Other	29,215	29,872	32,404	32,940	32,913	35,736
Total current revenue	**511,396**	**529,290**	**553,091**	**565,934**	**574,959**	**598,193**
Capital taxes	1,252	1,117	1,065	2,986	19,235	9,572
Other	4,332	3,993	2,337	2,600	4,246	3,435
Total capital revenue	**5,584**	**5,110**	**3,402**	**5,586**	**23,481**	**13,007**
Total revenue	**516,980**	**534,400**	**556,493**	**571,520**	**598,440**	**611,200**
as a % of GDP	*46.7*	*45.8*	*45.7*	*45.3*	*46.0*	*45.2*
Expenditure						
Compensation of employees	117,955	123,480	131,084	136,423	143,870	148,248
Intermediate consumption	54,549	58,214	62,338	63,411	66,978	66,755
Social assistance benefits in kind (market purchases)	23,610	27,512	31,299	33,084	33,909	36,302
Social assistance benefits in cash	189,990	195,460	202,291	214,035	224,445	234,181
Subsidies to firms	13,681	13,903	14,670	13,641	14,194	14,471
Interest payments	74,738	75,333	79,570	72,547	69,275	68,434
Other	17,494	18,756	20,542	24,191	29,104	30,899
Total current expenditure	**492,017**	**512,658**	**541,794**	**557,332**	**581,775**	**599,290**
Gross investment (2)	26,773	27,807	30,196	23,768	34,133	34,875
Investment grants	13,297	14,143	17,662	19,031	19,043	17,638
Other (3)	4,018	-11,408	5,582	5,852	5,244	3,049
Total capital account expenditure (2) (3)	**44,088**	**30,542**	**53,440**	**48,651**	**58,420**	**55,562**
Total expenditure (2) (3)	**536,105**	**543,200**	**595,234**	**605,983**	**640,195**	**654,852**
as a % of GDP	*48.4*	*46.6*	*48.8*	*48.1*	*49.2*	*48.5*
Deficit on current account (surplus –)	**-19,379**	**-16,632**	**-11,297**	**-8,602**	**6,816**	**1,097**
Net borrowing (4)	**19,125**	**8,800**	**38,741**	**34,463**	**41,755**	**43,652**
as a % of GDP	*1.7*	*0.8*	*3.2*	*2.7*	*3.2*	*3.2*

Source: Based on Istat data.

(1) Rounding may cause discrepancies. – (2) This item includes (with a negative sign) the proceeds of disposals of public buildings. – (3) The figures for 2000 include the proceeds of the sale of UMTS licences with a negative sign (1.2 per cent of GDP). – (4) The figures for 2000 include the proceeds of the sale of UMTS licences.

FINANCING OF THE GENERAL GOVERNMENT BORROWING REQUIREMENT (1)
(millions of euros)

	1999	2000	2001	2002	2003	2004
Currency and deposits	**12,721**	**5,090**	**17,912**	**14,497**	**-38,727**	**17,265**
of which: PO funds	12,162	4,753	16,410	11,496	-64,806	-1,688
savings certificates	*3,507*	*2,375*	*4,132*	*3,863*	*-19,725*	*-4,430*
savings books	*5,529*	*2,285*	*6,788*	*3,424*	*-48,917*	*–*
current accounts	*3,126*	*92*	*5,491*	*4,208*	*3,835*	*2,743*
Short-terms securities	**-17,680**	**-17,830**	**11,775**	**-372**	**6,057**	**-997**
of which: issued abroad	368	-237	202	-333	–	–
Medium and long-term securities	**21,260**	**35,639**	**23,201**	**31,705**	**23,065**	**41,181**
of which: variable rate	-26,805	-7,610	-9,810	-13,470	-13,978	860
issued abroad	-2,750	16,006	10,205	8,960	7,997	4,902
Other liabilities	**5,344**	**-6,462**	**1,045**	**-4,246**	**41,278**	**-5,557**
of which: MFI loans (2)	1,091	-6,363	-3,790	-2,417	-5,256	-1,318
resident banks	*1,977*	*-2,799*	*-2,442*	*-1,406*	*-4,066*	*-1,214*
non-resident banks	*-886*	*-3,564*	*-1,349*	*-1,011*	*-1,189*	*-104*
towards the central bank	*-422*	*-1,403*	*-52*	*39*	*127*	*-88*
Treasury assets held with the Bank of Italy	**-6,831**	**9,590**	**-2,024**	**284**	**8,022**	**-2,578**
TOTAL BORROWING REQUIREMENT	**14,815**	**26,027**	**51,910**	**41,867**	**39,694**	**49,313**
as a % of GDP	*1.3*	*2.2*	*4.3*	*3.3*	*3.1*	*3.6*
Settlements of past debts (3)	**6,259**	**4,601**	**9,310**	**5,328**	**8,537**	**533**
Privatization receipts (3)	**-22,641**	**-15,450**	**-4,603**	**-1,929**	**-16,855**	**-7,673**
Borrowing requirement net of debt settlements and privatization receipts	**31,198**	**36,876**	**47,203**	**38,469**	**48,013**	**56,453**
Memorandum items:						
change in bank deposits	2,971	737	-42	1,836	552	660
debts of other entities serviced by the government	-1,108	-2,317	-4,117	-1,873	-1,307	-1,610
Central government borrowing requirement	**9,026**	**19,808**	**50,117**	**36,895**	**14,935**	**44,429**
securities	1,557	15,196	33,116	26,654	25,947	35,812
MFI loans (2)	-2,674	-9,969	-3,723	-2,561	-4,420	-1,969
other	10,143	14,581	20,724	12,802	-6,592	10,586
Local government borrowing requirement	**5,856**	**6,218**	**1,753**	**5,008**	**24,837**	**4,906**
securities	2,024	2,613	1,860	4,678	3,174	4,371
MFI loans (2)	3,832	3,605	-108	179	-758	673
other	–	–	–	151	22,420	-139
Borrowing requirement of social security institutions (4)	**-67**	**1**	**40**	**-35**	**-78**	**-22**

(1) Rounding may cause discrepancies. – (2) Excluding the central bank, which is prohibited from providing any form of credit facility to general government (Article 101 of the Treaty Establishing the European Community). – (3) Central government transactions. Includes other extraordinary receipts (e.g. in 2000 the part of the proceeds of the sale of UMTS licences used to reduce debt). – (4) Exclusively MFI loans.

GENERAL GOVERNMENT DEBT BY INSTRUMENT AND SUBSECTOR (1)
(millions of euros)

	1999	2000	2001	2002	2003	2004
Currency and deposits	**108,346**	**113,436**	**131,349**	**145,845**	**107,118**	**124,383**
of which: PO funds	106,466	111,218	127,629	139,124	74,318	72,630
savings certificates	*66,880*	*69,255*	*73,387*	*77,250*	*57,525*	*53,094*
memorandum item: redemption value (2)	113,085	120,108	129,644	138,367	127,301	126,037
savings books	*36,420*	*38,705*	*45,493*	*48,917*	–	–
current accounts	*3,166*	*3,258*	*8,749*	*12,958*	*16,793*	*19,536*
Short-term securities	**119,753**	**101,923**	**113,699**	**113,325**	**119,382**	**118,384**
of which: in foreign currencies	–	–	–	–	–	–
issued abroad	368	132	335	–	–	–
Medium and long-term securities	**971,453**	**1,008,669**	**1,029,908**	**1,034,022**	**1,050,184**	**1,090,758**
of which: in foreign currencies	38,347	43,954	36,904	37,046	24,929	24,909
variable rate	240,913	233,190	223,166	209,262	194,784	195,214
issued abroad	59,897	77,147	87,558	93,179	98,144	102,357
Other liabilities	**81,003**	**74,641**	**75,992**	**71,687**	**112,891**	**107,330**
of which: MFI loans (3)	73,832	67,569	64,084	61,608	56,278	54,956
in foreign currencies	*2,273*	*1,891*	*1,408*	*1,064*	*569*	*267*
resident MFIs	*62,663*	*59,863*	*57,422*	*56,016*	*51,949*	*50,736*
non-resident MFIs	*11,169*	*7,706*	*6,662*	*5,592*	*4,329*	*4,221*
towards the central bank	1,498	95	42	82	209	120
GENERAL GOVERNMENT DEBT (4)	**1,280,554**	**1,298,670**	**1,350,948**	**1,364,880**	**1,389,575**	**1,440,855**
as a % of GDP	*115.6*	*111.3*	*110.9*	*108.3*	*106.8*	*106.6*
Central government debt	**1,247,714**	**1,259,607**	**1,310,093**	**1,319,090**	**1,319,039**	**1,365,163**
securities	1,086,842	1,103,611	1,134,774	1,133,873	1,152,930	1,187,863
MFI loans (3)	45,473	35,605	32,180	29,561	25,066	23,094
other	115,399	120,391	143,138	155,656	141,042	154,206
Local government debt	**32,705**	**38,927**	**40,678**	**45,649**	**70,473**	**75,650**
securities	4,364	6,981	8,833	13,474	16,636	21,279
MFI loans (3)	28,223	31,828	31,728	31,906	31,148	31,821
other	118	118	118	268	22,689	22,550
Debt of social security institutions (5)	**135**	**136**	**176**	**141**	**63**	**41**
Treasury assets held with the Bank of Italy	**29,125**	**19,535**	**21,559**	**21,275**	**13,253**	**15,831**
DEBT NET OF THE TREASURY ASSETS HELD WITH THE BANK OF ITALY	**1,251,429**	**1,279,135**	**1,329,389**	**1,343,605**	**1,376,322**	**1,425,023**
of which: in foreign currencies	40,620	45,845	38,312	38,110	25,497	25,176
Memorandum items:						
bank deposits	21,316	22,053	22,012	23,847	24,399	25,059
debts of other entities serviced by the government	13,180	10,964	6,926	4,885	3,391	1,723

(1) Rounding may cause discrepancies. – (2) Calculated including accrued interest. – (3) Excluding the central bank, which is prohibited from providing any form of credit facility to general government (Article 101 of the Treaty Establishing the European Community). – (4) Calculated according to the criteria laid down in Council Regulation (EC) No. 3605/93. – (5) Exclusively MFI loans.

GENERAL GOVERNMENT DEBT BY HOLDING SECTOR (1)
(millions of euros)

Voci	1999	2000	2001	2002	2003	2004
Currency and deposits	**108,346**	**113,436**	**131,349**	**145,845**	**107,118**	**124,383**
Short-term securities	**119,753**	**101,923**	**113,699**	**113,325**	**119,382**	**118,384**
held by:						
Bank of Italy	–	78	–	180	–	–
MFIs	19,127	9,312	21,172	26,930	44,647	46,564
other financial institutions	5,150	3,097	5,271	6,197	6,037	6,311
other residents	29,424	26,847	30,489	36,090	10,692	19,644
non-residents	66,052	62,590	56,767	43,928	58,006	45,865
Medium and long-term securities	**971,453**	**1,008,669**	**1,029,908**	**1,034,022**	**1,050,184**	**1,090,758**
held by:						
Bank of Italy	57,902	62,320	64,283	40,920	49,072	53,937
MFIs	148,204	126,709	117,426	100,774	116,258	111,080
other financial institutions	140,287	142,554	173,566	158,476	135,744	148,736
other residents	270,043	274,228	255,190	284,777	259,897	263,271
non-residents	355,017	402,858	419,443	449,076	489,213	513,734
Other liabilities	**81,003**	**74,641**	**75,992**	**71,687**	**112,891**	**107,330**
of which: MFI loans (2)	73,832	67,569	64,084	61,608	56,278	54,956
resident MFIs	*62,663*	*59,863*	*57,422*	*56,016*	*51,949*	*50,736*
non-resident MFIs	*11,169*	*7,706*	*6,662*	*5,592*	*4,329*	*4,221*
towards the central bank	1,498	95	42	82	209	120
GENERAL GOVERNMENT DEBT (3)	**1,280,554**	**1,298,670**	**1,350,948**	**1,364,880**	**1,389,575**	**1,440,855**
as a % of GDP	*115.6*	*111.3*	*110.9*	*108.3*	*106.8*	*106.6*
held by:						
Bank of Italy	59,400	62,493	64,326	41,181	49,281	54,058
MFIs	229,994	195,885	196,020	183,720	212,854	208,380
other financial institutions	145,437	145,650	178,836	165,760	209,757	240,966
other residents	413,485	421,489	428,892	475,623	366,135	373,632
non-residents	432,238	473,154	482,873	498,597	551,548	563,820
Memorandum item:						
Debt issued abroad	71,434	84,984	94,555	98,771	102,472	106,578

(1) Rounding may cause discrepancies. – (2) Excluding the central bank, which is prohibited from providing any form of credit facility to general government (Article 101 of the Treaty Establishing the European Community). – (3) Calculated according to the criteria laid down in Council Regulation (EC) No. 3605/93.

LOCAL GOVERNMENT DEBT BY INSTRUMENT AND SUBSECTOR (1)
(billions of lire and millions of euros)

	1999	2000	2001	2002	2003	2004
Securities	**4,364**	**6,981**	**8,833**	**13,474**	**16,636**	**21,279**
issued in Italy	1,556	1,965	2,463	3,096	3,834	6,052
issued abroad	2,808	5,016	6,370	10,378	12,803	15,227
MFI loans (2)	**28,223**	**31,828**	**31,728**	**31,906**	**31,148**	**31,821**
resident MFIs	27,188	30,822	30,716	30,764	29,773	30,439
non-resident MFIs	1,035	1,006	1,012	1,142	1,376	1,383
Other (3)	**118**	**118**	**118**	**268**	**22,689**	**22,550**
LOCAL GOVERNMENT DEBT	**32,705**	**38,927**	**40,678**	**45,649**	**70,473**	**75,650**
as a % of GDP	*3.0*	*3.3*	*3.3*	*3.6*	*5.4*	*5.6*
Debt of the regions	**14,766**	**17,576**	**18,564**	**21,535**	**26,799**	**29,134**
Securities	2,562	4,761	6,070	9,832	11,612	13,494
issued in Italy	*97*	*85*	*100*	*316*	*444*	*828*
issued abroad	*2,465*	*4,676*	*5,971*	*9,516*	*11,167*	*12,666*
MFI and Cassa Depositi e Prestiti S.p.A. loans (2)	12,204	12,815	12,493	11,703	13,273	13,725
resident	*11,204*	*11,908*	*11,687*	*10,991*	*12,475*	*12,943*
non-resident	*1,000*	*906*	*807*	*713*	*798*	*782*
Debt of provinces and municipalities (4)	**14,796**	**16,767**	**17,197**	**18,628**	**38,039**	**40,897**
Securities	1,802	2,220	2,763	3,643	5,025	7,785
issued in Italy	*1,460*	*1,881*	*2,363*	*2,780*	*3,390*	*5,224*
issued abroad	*343*	*340*	*399*	*862*	*1,635*	*2,561*
MFI and loans (2)	12,993	14,546	14,434	14,985	32,483	32,581
resident	*12,958*	*14,447*	*14,229*	*14,556*	*31,905*	*31,980*
non-resident	*35*	*100*	*205*	*429*	*578*	*601*
Debt of other entities (5)	**3,143**	**4,585**	**4,918**	**5,486**	**5,635**	**5,619**

(1) Rounding may cause discrepancies. – (2) Excluding the central bank, which is prohibited from providing any form of credit facility to general government (Article 101 of the Treaty Establishing the European Community). – (3) Excluding loans from Cassa Depositi e Prestiti S.p.A., for which data classified by subsector are not available. – (4) Including metropolitan areas and municipal unions. – (5) Exclusively loans granted by MFIs and Cassa Depositi e Prestiti S.p.A.

BANKS AND MONEY MARKET FUNDS RESIDENT IN ITALY: SUMMARY BALANCE SHEET DATA (1)

(end-of-period stocks; millions of euros)

ASSETS

	Cash	Loans							Holdings of securities other than		
		Residents of Italy			Residents of other euro-area countries			Rest of the world	Residents of Italy		
		MFIs	General government	Other sectors	MFIs	General government	Other sectors		MFIs	General government	Other sectors
2001 – Dec.	8,687	205,076	58,003	922,575	49,945	124	13,771	65,094	42,488	149,149	13,509
2002 – ”	9,566	285,834	56,763	979,517	72,827	110	13,544	71,406	48,040	145,094	13,127
2003 – ”	9,488	325,056	52,867	1,048,297	74,876	110	16,016	69,670	56,184	167,108	19,075
2004 – Jan.	6,779	326,878	54,292	1,037,837	71,392	110	14,914	79,970	57,145	167,962	19,384
Feb.	6,506	325,946	54,575	1,032,680	67,110	95	14,627	72,558	57,166	169,467	21,975
Mar.	7,013	333,278	54,949	1,035,338	72,987	97	15,083	76,092	60,697	172,857	21,306
Apr.	6,859	324,790	55,538	1,042,660	72,678	89	12,898	74,366	61,014	173,178	21,076
May	7,453	321,881	56,693	1,045,578	70,113	93	12,678	72,392	63,567	169,944	22,222
June	7,066	314,827	55,427	1,062,547	67,725	89	12,306	71,878	63,438	176,642	23,388
July	7,271	328,100	54,827	1,067,267	74,668	89	12,019	72,980	62,845	173,260	23,393
Aug.	7,289	330,127	54,622	1,061,609	77,220	89	11,814	71,584	62,244	173,171	23,210
Sept.	7,476	323,748	55,391	1,069,506	75,978	89	12,110	73,071	62,980	179,400	23,735
Oct.	7,044	325,013	54,493	1,071,433	85,969	95	12,072	69,579	64,405	176,277	24,331
Nov.	7,981	317,237	54,193	1,091,995	89,807	92	11,723	72,762	63,620	174,363	27,230
Dec.	9,083	338,471	51,936	1,109,687	93,689	89	13,439	65,037	61,157	162,813	25,090
2005 – Jan. (2) ..	7,508	327,202	52,897	1,125,371	86,065	89	12,836	60,824	60,931	164,729	24,687
Feb. (2)...	7,465	322,797	53,694	1,120,832	88,373	89	13,791	58,058	62,133	170,139	24,418
Mar. (2)...	8,045	331,775	52,809	1,128,719	89,422	89	12,622	61,964	62,533	169,638	25,430

(1) ESCB harmonized statistics. Rounding may cause discrepancies in totals. – (2) Provisional.

Table a20

ASSETS

shares, at market value				Shares and other equity								
Residents of other euro-area countries			Rest of the world	Residents of Italy		Residents of other euro-area countries		Rest of the world	Fixed assets	Remaining assets	Total assets	
MFIs	General government	Other sectors		MFIs	Other sectors	MFIs	Other sectors					
4,039	4,671	6,279	13,286	42,957	30,513	6,481	10,393	6,454	48,397	176,266	1,878,155	...... Dec. –2001
4,456	5,692	8,333	11,354	42,179	38,105	6,692	11,073	6,818	49,992	185,600	2,066,122	.... ” – 2002
6,943	17,475	9,492	15,730	51,004	43,420	5,232	12,052	7,631	46,545	190,587	2,246,094	.... ” – 2003
7,434	20,500	10,297	16,166	52,026	43,588	5,358	12,287	7,797	45,920	209,216	2,268,602	.... Jan. – 2004
7,490	23,133	10,497	15,596	52,446	46,213	5,103	12,352	9,498	46,648	202,189	2,255,199	.... Feb.
7,994	22,229	10,696	17,760	53,268	50,725	5,182	12,426	9,513	46,568	211,628	2,299,062	.... Mar.
8,541	23,115	10,275	17,725	53,699	54,524	5,155	12,793	9,497	46,593	199,396	2,287,859	.... Apr.
9,003	24,249	10,619	17,856	55,497	58,342	5,380	12,590	9,447	46,655	198,455	2,292,089	.... May
8,671	23,068	9,843	18,362	52,543	54,121	5,403	12,577	8,106	46,776	203,104	2,299,363	.... June
8,114	25,102	9,058	18,573	51,827	49,581	5,394	12,314	9,563	46,955	188,639	2,303,328	.... July
8,234	25,951	8,701	18,281	51,660	48,576	5,380	12,547	9,998	46,979	182,946	2,293,760	.... Aug.
8,650	24,731	8,675	18,675	51,345	44,317	5,617	12,327	10,295	47,071	195,227	2,312,053	.... Sept.
9,285	24,346	8,969	19,794	51,899	45,569	5,322	12,817	10,705	47,128	199,962	2,328,299	.... Oct.
9,163	26,949	8,685	18,780	52,796	47,501	5,335	13,010	10,633	46,835	214,884	2,367,398	.... Nov.
8,970	25,996	8,762	16,333	52,578	46,074	5,455	12,426	8,368	47,079	214,689	2,379,092	.... Dec.
9,599	26,741	8,838	20,086	52,955	48,482	5,236	12,222	10,009	46,544	227,233	2,392,794	...(2) Jan. – 2005
10,644	27,179	8,711	19,855	53,083	49,947	5,272	12,830	10,111	46,985	225,835	2,394,118	...(2) Feb.
11,759	25,878	9,204	20,982	55,456	52,587	5,086	12,881	10,273	46,990	234,183	2,430,135	...(2) Mar.

BANKS AND MONEY MARKET FUNDS RESIDENT IN ITALY: SUMMARY BALANCE SHEET DATA (1)
(end-of-period stocks; millions of euros)

LIABILITIES

	Deposits					
	Residents of Italy			Residents of other euro-area countries		
	MFIs	Central government	Other general government – other sectors	MFIs	Central government	Other general government – other sectors
2001 – Dec.	192,934	7,214	636,656	109,572	291	5,525
2002 – ”	285,275	7,109	689,068	111,654	8	9,279
2003 – ”	313,742	7,730	691,960	118,928	17	9,268
2004 – Jan.	322,317	7,670	680,193	124,308	2,220	11,779
Feb.	320,193	7,639	674,498	131,632	2,013	10,806
Mar.	328,314	7,767	682,047	129,437	1,012	12,482
Apr.	326,442	7,707	689,251	126,338	339	10,646
May	328,459	7,449	688,681	130,820	1,263	11,200
June	316,665	8,002	696,693	128,988	503	10,398
July	335,645	7,396	696,822	128,835	302	10,486
Aug.	336,390	7,296	683,829	133,739	24	11,028
Sept.	335,403	7,570	693,510	122,448	12	12,128
Oct.	341,393	7,834	704,524	125,938	18	11,004
Nov.	334,641	7,079	694,671	134,442	14	10,810
Dec.	342,576	7,222	725,756	126,294	13	13,214
2005 – Jan. (2)	335,004	7,588	716,222	137,623	19	10,978
Feb. (2)	332,067	7,293	711,992	147,243	99	11,364
Mar. (2)	344,466	7,437	717,084	143,892	94	11,551

(1) ESCB harmonized statistics. Rounding may cause discrepancies in totals. – (2) Provisional.

Table a20 *cont.*

LIABILITIES

Rest of the world	Money market fund shares/units	Debt securities issued	Capital and reserves	Remaining liabilities	Total liabilities	
171,121	26,164	334,672	133,633	260,372	1,878,155	.... Dec. – 2001
146,026	41,966	367,969	146,172	261,595	2,066,123	.... ” – 2002
159,227	107,031	399,958	156,726	281,508	2,246,095	.... ” – 2003
159,117	106,102	399,519	158,496	296,881	2,268,603	.... Jan. – 2004
153,448	105,666	402,231	158,980	288,091	2,255,199	.... Feb.
162,022	103,597	411,171	160,934	300,279	2,299,062	.... Mar.
159,241	102,921	413,978	161,438	289,557	2,287,858	.... Apr.
156,256	103,021	419,994	161,518	283,428	2,292,089	.... May
158,388	106,295	419,267	161,630	292,534	2,299,364	.... June
160,558	105,967	421,826	161,469	274,021	2,303,327	.... July
159,880	107,269	423,527	161,463	269,315	2,293,760	.... Aug.
155,914	105,970	431,001	161,669	286,428	2,312,053	.... Sept.
148,806	104,229	437,177	161,854	285,521	2,328,299	.... Oct.
157,486	102,010	438,181	162,394	325,669	2,367,398	.... Nov.
157,033	101,079	442,994	163,183	299,727	2,379,092	.... Dec.
163,627	99,645	442,682	165,154	314,254	2,392,794	.... (2) Jan. – 2005
157,396	99,086	451,423	165,142	311,013	2,394,118	.... (2) Feb.
161,484	98,125	458,092	166,903	321,007	2,430,135	.... (2) Mar.

BANK INTEREST RATES ON EURO LOANS: OUTSTANDING AMOUNTS (1)
(percentages)

	Households							
		Loans for house purchases			Consumer credit and other loans			Overdrafts
			of which:		up to 1 year (2)	from 1 to 5 years	more than 5 years	
			from 1 to 5 years	*more than 5 years*				
2003 – Dec.	5.90	4.68	4.76	4.67	8.05	7.87	5.42	8.44
2004 – Jan.	5.89	4.66	4.76	4.65	8.19	7.84	5.40	8.57
Feb.	5.85	4.62	4.72	4.62	8.21	7.79	5.37	8.60
Mar.	5.80	4.57	4.69	4.57	8.14	7.75	5.33	8.52
Apr.	5.74	4.52	4.65	4.51	8.13	7.72	5.30	8.56
May	5.71	4.49	4.62	4.49	8.08	7.72	5.30	8.49
June	5.70	4.48	4.71	4.47	8.11	7.70	5.29	8.51
July	5.69	4.44	4.58	4.44	8.19	7.76	5.29	8.60
Aug.	5.68	4.44	4.56	4.44	8.23	7.75	5.28	8.64
Sept.	5.66	4.43	4.54	4.42	8.21	7.73	5.27	8.60
Oct.	5.64	4.41	4.53	4.41	8.23	7.72	5.25	8.62
Nov.	5.62	4.40	4.53	4.39	8.17	7.68	5.25	8.55
Dec.	5.57	4.37	4.49	4.37	8.04	7.65	5.22	8.39
2005 – Jan. (3)	5.56	4.35	4.47	4.35	8.19	7.62	5.20	8.60
Feb. (3)	5.54	4.34	4.45	4.33	8.15	7.62	5.20	8.56
Mar. (3)	5.51	4.31	4.48	4.30	8.07	7.58	5.19	8.47

(1) ESCB harmonized statistics. – (2) Includes overdrafts. – (3) Provisional.

	Non-financial corporations				Households and non-financial corporations	
	Loans with original maturity			Overdrafts	up to 1 year	*of which: overdrafts*
		from 1 to 5 years	more than 5 years			
4.44	4.98	3.92	4.05	5.62	5.45	6.12
4.48	5.10	3.92	4.03	5.77	5.57	6.26
4.47	5.11	3.92	4.01	5.79	5.59	6.29
4.41	5.03	3.84	4.00	5.67	5.51	6.18
4.39	5.04	3.82	3.94	5.67	5.52	6.18
4.37	5.02	3.81	3.93	5.61	5.49	6.11
4.33	4.91	3.81	3.92	5.54	5.39	6.06
4.40	5.04	3.86	3.92	5.71	5.51	6.22
4.40	5.07	3.84	3.92	5.75	5.55	6.26
4.39	5.06	3.84	3.90	5.72	5.54	6.23
4.38	5.05	3.85	3.90	5.70	5.54	6.23
4.36	5.00	3.84	3.90	5.62	5.48	6.14
4.31	4.91	3.83	3.89	5.49	5.38	6.00
4.36	5.08	3.74	3.88	5.73	5.55	6.23
4.33	4.99	3.77	3.88	5.62	5.47	6.13
4.29	4.91	3.80	3.87	5.51	5.38	6.03

Table a22

BANK INTEREST RATES ON EURO DEPOSITS: OUTSTANDING AMOUNTS AND NEW BUSINESS (1)
(percentages)

	Outstanding amounts							New business		
		of which:						Deposits of households with agreed maturity		Repos
		Overnight deposits		Deposits of households with agreed maturity		Deposits of households redeemable at notice up to 3 months	Repos		*of which: up to 1 year*	
			of which:	up to 2 years	more than					
2003 – Dec.	0.88	0.71	0.61	1.62	3.67	0.89	1.95	1.49	1.47	1.96
2004 – Jan.	0.87	0.68	0.59	1.59	3.66	0.91	1.94	1.52	1.50	1.91
Feb.	0.87	0.68	0.59	1.58	3.62	0.94	1.92	1.53	1.51	1.89
Mar.	0.88	0.68	0.59	1.56	3.72	1.02	1.89	1.50	1.48	1.87
Apr.	0.85	0.67	0.58	1.54	3.70	0.96	1.88	1.47	1.46	1.85
May	0.86	0.67	0.58	1.54	3.69	0.97	1.88	1.48	1.47	1.88
June	0.86	0.68	0.58	1.51	3.65	0.98	1.90	1.49	1.48	1.91
July	0.84	0.66	0.57	1.50	3.62	0.91	1.92	1.49	1.48	1.92
Aug.	0.86	0.67	0.58	1.49	3.62	0.93	1.92	1.51	1.50	1.90
Sept.	0.87	0.69	0.59	1.48	3.59	0.94	1.93	1.50	1.49	1.92
Oct.	0.87	0.69	0.58	1.47	3.58	0.95	1.94	1.51	1.49	1.93
Nov.	0.88	0.70	0.59	1.47	3.56	0.96	1.96	1.50	1.49	1.93
Dec.	0.89	0.71	0.59	1.47	3.54	1.01	1.97	1.50	1.49	1.97
2005 – Jan. (2).........	0.87	0.70	0.59	1.47	3.52	0.96	1.97	1.51	1.50	1.95
Feb. (2).........	0.87	0.68	0.58	1.46	3.51	0.98	1.97	1.52	1.51	1.93
Mar. (2).........	0.89	0.70	0.59	1.46	3.49	1.05	1.96	1.51	1.50	1.93

(1) ESCB harmonized statistics. – (2) Provisional.

EURO-AREA BANKING SYSTEM’S LIQUIDITY POSITION: ITALIAN CONTRIBUTION

(maintenance period average amounts in millions of euros)

Maintenance period ending in:		Liquidity-providing factors					
				Monetary policy operations			
month	day	Net assets in gold and foreign currency	Net claims on the Eurosystem	Main refinancing operations	Longer-term refinancing operations	Marginal lending facility	Other liquidity-providing operations
2002 – Dec.	23	51,533	7,493	7,315	15	..	128
2003 – Dec.	23	53,520	12,524	10,895	,,	1	..
2004 – Jan.	23	50,405	5,638	7,910	,,	8	..
Feb.	–	–	–	–	–	–	–
Mar.	9	49,735	14,388	8,380	42	16	2
Apr.	6	49,240	14,638	10,848	176	8	5
May	11	51,582	8,671	12,036	327	..	..
June	8	51,935	12,206	12,475	447	1	..
July	6	51,521	24,131	13,112	456	5	..
Aug.	10	49,327	21,705	15,505	329	..	1
Sept.	7	47,684	18,542	16,026	217	6	1
Oct.	11	47,669	16,849	18,551	544	6	1
Nov.	8	47,796	8,953	20,189	1,239	..	46
Dec.	7	48,076	16,942	19,574	1,255	15	1
2005 – Jan.	18	46,552	15,188	17,455	686	5	2
Feb.	7	45,237	28,446	17,572	634	..	33
Mar.	8	45,058	30,400	18,944	908	..	1
Apr.	12	45,308	30,043	18,434	1,143	..	1
May	10	45,968	32,180	15,094	1,227	1	1

Maintenance period ending in:		Liquidity-absorbing factors					Credit institutions’ current accounts with the central bank (c)	Italian contribution to base money (a+b+c)
		Monetary policy operations						
month	day	Other liquidity-absorbing operations	Deposit facility (a)	Currency in circulation (b)	Central government deposits	Other factor (net)		
2002 – Dec.	23	..	11	68,420	31,866	-47,272	13,458	81,889
2003 – Dec.	23	..	2	80,669	33,368	-51,706	14,606	95,277
2004 – Jan.	23	..	6	81,503	17,086	-49,186	14,551	96,060
Feb.	–	–	–	–	–	–	–	–
Mar.	9	..	11	78,998	28,563	-50,092	15,083	94,093
Apr.	6	..	3	80,533	30,441	-51,008	14,947	95,483
May	11	38	1	82,287	25,185	-49,453	14,559	96,847
June	8	..	4	83,437	28,809	-50,086	14,901	98,341
July	6	..	3	84,791	40,679	-51,214	14,967	99,761
Aug.	10	..	2	86,924	38,492	-53,532	14,981	101,907
Sept.	7	..	32	87,101	34,078	-53,970	15,236	102,369
Oct.	11	..	1	87,774	35,285	-54,715	15,274	103,050
Nov.	8	..	9	88,463	29,803	-54,950	14,898	103,371
Dec.	7	91	12	89,930	35,735	-55,036	15,131	105,073
2005 – Jan.	18	..	2	94,716	25,200	-55,149	15,119	109,838
Feb.	7	..	7	91,154	41,914	-56,159	15,006	106,167
Mar.	8	56	5	92,247	44,762	-57,480	15,721	107,973
Apr.	12	..	4	94,049	42,906	-57,696	15,666	109,719
May	10	..	3	95,138	41,187	-57,268	15,412	110,553

ITALIAN COMPONENTS OF THE MONETARY AGGREGATES OF THE EURO AREA: RESIDENTS OF THE AREA (1)

(end-of-period amounts in millions of euros)

	Currency held by the public and overnight deposits (2)	Deposits with agreed maturity up to 2 years	Deposits redeemable at notice up to 3 months	Total	Repurchase agreements
2002	572,306	50,669	151,025	774,000	89,310
2003	616,242	43,956	165,919	826,117	68,469
2004 – Jan.	608,388	46,847	167,713	822,948	63,554
Feb.	603,204	45,704	168,759	817,667	64,516
Mar.	612,016	46,435	170,351	828,802	63,989
Apr.	621,291	45,624	171,980	838,895	63,585
May	623,595	46,078	172,871	842,544	62,436
June	629,492	45,929	173,877	849,298	61,587
July	636,823	45,217	175,053	857,093	63,309
Aug.	619,657	45,933	177,992	843,582	65,725
Sept.	633,411	45,787	179,092	858,290	63,249
Oct.	643,469	43,591	179,916	866,976	66,597
Nov.	636,102	42,857	181,269	860,228	67,725
Dec.	663,072	45,665	184,357	893,095	72,226
2005 – Jan.	658,927	44,257	186,053	889,237	65,852
Feb.	656,190	43,028	188,267	887,485	67,383
Mar.	659,103	45,497	189,757	894,357	67,136

(1) Liabilities of Italian MFIs and the Post Office to the “money-holding sector”, except for the items specified in footnote (3), for the whole euro area. – (2) Includes Bank of Italy banknotes and Treasury by the MFIs of the rest of the area or that held by central government, it is not possible to determine exactly the amount held by the “money-holding sector”.

Money-market fund shares/units (3)	Debt securities up to 2 years and money-market paper (3)	Total monetary liabilities	Contribution to euro-area monetary aggregates (excluding currency held by the public)			
			M1	M2	M3	
41,690	9,814	914,814	510,801	712,495	853,309	 2002
105,462	7,195	1,007,242	542,936	752,811	933,937	 2003
104,418	6,816	997,736	536,533	751,093	925,881	.... Jan. – 2004
103,993	6,976	993,152	530,457	744,920	920,405	.... Feb.
101,870	6,432	1,001,093	538,546	755,332	927,623	.... Mar.
101,142	5,790	1,009,412	545,788	763,392	933,909	.... Apr.
101,240	6,138	1,012,358	547,217	766,166	935,980	.... May
104,438	5,374	1,020,697	551,683	771,489	942,888	.... June
104,084	5,065	1,029,551	556,716	776,986	949,444	.... July
105,339	4,183	1,018,829	540,131	764,056	939,303	.... Aug.
103,932	3,885	1,029,356	553,165	778,044	949,110	.... Sept.
102,033	3,522	1,039,128	561,648	785,155	957,307	.... Oct.
99,788	3,550	1,031,291	554,302	778,428	949,491	.... Nov.
98,789	3,479	1,067,589	577,764	807,786	982,281	.... Dec.
97,521	3,063	1,055,673	574,734	805,044	971,480	.... Jan. – 2005
96,794	3,080	1,054,741	571,459	802,754	970,011	.... Feb.
95,940	3,092	1,060,525	572,852	808,106	974,273	.... Mar.

coins. – (3) Calculated by subtracting from the total of such liabilities of Italian MFIs the amount held by Italian MFIs themselves. Since the returns to the ECB do not contain the amounts held

ITALIAN COUNTERPARTS OF MONEY OF THE EURO AREA: RESIDENTS OF THE AREA

(end-of-period amounts in millions of euros)

	Total monetary liabilities	OTHER LIABILITIES OF MFIs								
		Deposits of central gevernment	Medium and long-term liabilities to the money-holding sector					Liabilities to non-residents of the euro area	Finance
			Deposits with agreed maturity over 2 years	Deposits redeemable at notice over 3 months	Debt securities over 2 years' agreed maturity (1)	Capital and reserves (1)	Total		Loans
2002	914,814	28,433	4,067	..	302,928	120,907	427,902	149,678	56,907
2003	1,007,242	21,041	4,321	49	327,524	123,939	455,833	160,065	53,011
2004 – Jan.	997,736	44,884	4,312	51	325,786	125,013	455,162	160,342	54,436
Feb.	993,152	50,015	4,230	53	328,124	125,340	457,747	154,467	54,704
Mar.	1,001,093	41,950	3,915	55	333,212	129,386	466,568	163,479	55,080
Apr.	1,009,412	43,590	3,887	58	335,529	127,654	467,128	160,722	55,661
May	1,012,358	44,322	3,636	59	338,839	125,126	467,660	157,572	56,820
June	1,020,697	63,894	3,680	62	339,364	128,328	471,434	159,914	55,550
July	1,029,551	55,421	3,617	64	343,009	129,529	476,219	161,888	54,950
Aug.	1,018,829	55,143	3,487	66	345,477	131,376	480,406	161,281	54,745
Sept.	1,029,356	54,719	3,466	70	352,154	131,017	486,707	157,340	55,514
Oct.	1,039,128	49,330	3,439	71	356,574	131,199	491,283	149,963	54,622
Nov.	1,031,291	47,522	3,662	74	358,875	131,516	494,127	158,564	54,319
Dec.	1,067,589	23,095	3,713	78	366,323	131,071	501,185	158,370	52,059
2005 – Jan.	1,055,673	54,705	3,715	81	365,645	135,513	504,954	165,475	53,020
Feb.	1,054,741	67,872	3,709	82	371,857	135,164	510,811	158,744	53,817
Mar.	1,060,525	57,680	3,453	87	376,896	135,232	515,668	162,901	52,932

(1) Calculated by subtracting from the total of such liabilities of Italian MFIs the amount held by Italian MFIs themselves. Since the returns to the ECB do not contain the amounts held by the

ASSETS OF MFIs									
Claims on residents of Italy and the rest of the euro area							Claims on non-residents of the euro area	Other counterparts	
to general government		Finance to the other residents				Total			
Bonds	Total	Loans	Bonds	Holdings of	Total				
195,237	252,144	993,061	21,522	54,397	1,068,980	1,321,124	112,723	86,980	 2002
238,272	291,284	1,064,314	28,631	61,161	1,154,105	1,445,389	113,458	85,334	 2003
242,585	297,021	1,052,801	29,733	61,745	1,144,279	1,441,300	125,000	91,824	.... Jan. – 2004
247,809	302,513	1,047,347	32,527	64,574	1,144,448	1,446,961	118,641	89,779	.... Feb.
250,645	305,725	1,050,517	32,056	69,157	1,151,730	1,457,455	124,004	91,631	.... Mar.
251,730	307,391	1,055,558	31,407	73,500	1,160,465	1,467,856	123,157	89,839	.... Apr.
249,950	306,770	1,058,256	32,895	76,914	1,168,065	1,474,835	121,389	85,688	.... May
255,648	311,198	1,074,853	33,285	72,827	1,180,965	1,492,163	120,900	102,876	.... June
255,090	310,040	1,079,286	32,504	67,953	1,179,743	1,489,783	121,853	111,443	.... July
256,962	311,707	1,073,423	31,964	67,126	1,172,513	1,484,220	119,305	112,134	.... Aug.
262,376	317,890	1,081,617	32,463	62,898	1,176,978	1,494,868	121,038	112,216	.... Sept.
259,561	314,183	1,083,505	33,354	64,929	1,181,788	1,495,971	118,554	115,179	.... Oct.
261,370	315,689	1,103,718	35,974	67,222	1,206,914	1,522,603	120,337	88,564	.... Nov.
249,300	301,359	1,123,127	33,947	65,341	1,222,415	1,523,774	107,117	119,347	.... Dec.
253,526	306,546	1,138,207	33,661	67,092	1,238,960	1,545,506	109,224	126,077	.... Jan. – 2005
259,527	313,344	1,134,624	33,225	69,219	1,237,067	1,550,411	105,722	136,035	.... Feb.
257,932	310,864	1,141,342	34,729	71,962	1,248,033	1,558,897	111,368	126,508	.... Mar.

MFIs of the rest of the area or that held by central government, it is not possible to determine exactly the amount held by the “money-holding sector”.

PROFIT AND LOSS ACCOUNTS OF RESIDENT ITALIAN BANKS BY CATEGORY OF BANK (1)
(millions of euros)

	INTEREST RECEIVABLE					INTEREST PAYABLE					Balance of derivative hedging contracts	Net interest income (a)
	Deposits with BI-UIC & Treasury	Loans	Securities	Interbank accounts	Claims on non-residents	Deposits	BI-UIC financing	Interbank accounts	Bonds and subordinated liabilities	Liabilities to non-residents		
						Limited company banks (2)						
2001	674	48,680	6,008	7,156	5,344	10,571	436	7,055	12,866	9,121	-607	27,207
2002	620	47,457	5,504	6,467	4,162	8,881	183	6,231	12,093	5,910	-1,032	29,881
2003	471	44,529	4,646	6,440	3,513	6,310	126	6,261	10,789	4,554	-1,415	30,145
2004 (3)	397	43,954	4,096	6,162	4,514	5,309	254	6,097	11,219	4,534	-1,089	30,623
						Cooperative banks *(banche popolari)*						
2001	114	9,002	1,206	729	769	2,221	49	736	1,805	989	-183	5,836
2002	88	6,555	892	573	509	1,375	18	645	1,489	427	-132	4,531
2003	48	5,814	779	580	525	906	13	685	1,543	310	-196	4,094
2004 (3)	44	5,281	645	647	489	728	10	792	1,338	281	-142	3,816
						Mutual banks *(banche di credito cooperativo)*						
2001	51	3,469	928	227	41	1,082	..	52	714	3	..	2,865
2002	45	3,503	848	223	36	937	..	31	778	3	24	2,931
2003	38	3,722	678	163	45	747	..	22	773	2	57	3,157
2004 (3)	34	3,970	604	146	38	681	..	21	794	2	84	3,380
						Branches of foreign banks						
2001	133	1,807	999	577	862	325	44	1,082	2	2,177	-246	502
2002	121	1,975	467	467	594	402	60	529	..	1,713	-157	765
2003	114	2,140	229	301	681	478	148	481	..	1,233	-101	1,025
2004 (3)	86	2,425	174	399	727	459	162	831	2	1,007	-175	1,174
						Total banks						
2001	972	62,958	9,141	8,689	7,015	14,198	529	8,925	15,387	12,290	-1,036	36,411
2002	874	59,491	7,712	7,731	5,301	11,595	261	7,434	14,361	8,053	-1,296	38,108
2003	672	56,204	6,332	7,484	4,764	8,440	287	7,450	13,105	6,099	-1,654	38,420
2004 (3)	562	55,630	5,518	7,355	5,769	7,178	427	7,740	13,352	5,824	-1,322	38,992

(1) Rounding may cause descrepancies in totals. – (2) Includes central credit institutions. – (3) Provisional.

Table a26

Non-interest income (b)	of which: trading	of which: services	Gross income (c)=(a)+(b)	Operating expenses (d)	of which: banking staff costs	Operating profit (e)=(c)-(d)	Value adjustments and re-adjustments and allocations to provisions (f)	of which: for loan losses	Tax (g)	Net profit (e)-(f)-(g)	Total assets	Capital and reserves	Number of banking staff (average)
Limited company banks (2)													
27,592	2,134	9,985	54,799	29,333	16,073	25,466	10,476	5,572	6,079	8,912	1,467,458	101,233	261,702
24,720	1,183	9,721	54,601	32,086	17,646	22,515	9,610	6,451	4,944	7,961	1,605,476	111,392	273,369
25,844	2,367	9,965	55,989	33,888	18,743	22,100	9,273	7,604	3,757	9,071	1,774,397	121,131	274,799
25,622	1,235	10,708	56,245	33,592	18,356	22,654	5,314	5,979	4,762	12,578	1,880,159	126,935	269,218
Cooperative banks *(banche popolari)*													
4,102	300	1,844	9,938	5,713	3,188	4,225	1,768	1,057	1,026	1,431	249,669	18,714	53,857
3,203	134	1,439	7,734	4,716	2,573	3,018	1,086	651	762	1,170	213,991	17,134	39,717
3,513	279	1,248	7,607	4,647	2,562	2,960	1,061	759	625	1,274	195,664	17,219	35,057
3,520	166	1,211	7,335	4,590	2,513	2,745	709	675	489	1,547	223,195	20,684	38,125
Mutual banks *(banche di credito cooperativo)*													
802	84	347	3,667	2,443	1,279	1,224	433	229	150	641	86,388	9,931	23,147
803	52	347	3,734	2,584	1,363	1,150	356	269	164	630	96,274	10,480	23,637
917	93	379	4,075	2,737	1,447	1,338	427	326	183	729	109,637	11,209	24,794
968	79	400	4,348	2,910	1,540	1,438	294	290	245	898	121,078	11,970	25,730
Branches of foreign banks													
663	-75	558	1,165	958	426	207	-204	128	162	249	86,209	1,117	3,572
553	30	321	1,319	917	428	401	115	138	153	133	82,883	1,273	3,837
648	-6	337	1,673	1,004	414	669	474	402	173	21	90,785	1,351	3,638
600	109	370	1,774	1,130	449	644	301	320	209	134	103,557	1,565	3,906
Total banks													
33,158	2,443	12,734	69,570	38,447	20,966	31,123	12,473	6,985	7,416	11,233	1,889,724	130,994	342,279
29,279	1,399	11,827	67,388	40,304	22,012	27,084	11,167	7,509	6,022	9,895	1,998,624	140,279	340,560
30,922	2,733	11,928	69,343	42,275	23,166	27,067	11,235	9,091	4,737	11,095	2,170,483	150,909	338,288
30,710	1,589	12,690	69,702	42,221	22,859	27,481	6,618	7,264	5,706	15,158	2,327,988	161,154	336,979

ITALY'S FINANCIAL ASSETS AND LIABILITIES IN 2004 (1)

(stocks in millions of euros)

Institutional sectors / Financial instruments	Non-financial corporations		Financial corporations							
			Monetary financial institutions		Other financial intermediaries		Financial auxiliaries		Insurance corporations and pension funds	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Monetary gold and SDRs	**–**	**–**	**25,454**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Currency and transferable deposits, with	**141,776**	**–**	**117,079**	**819,902**	**16,128**	**–**	**20,716**	**–**	**26,875**	**–**
MFIs	134,063	–	92,471	819,902	16,032	–	13,285	–	9,683	–
other residents	991	–	342	–	95	–	–	–	100	–
rest of the world	6,723	–	24,266	–	..	–	7,431	–	17,092	–
Other deposits, with	**11,597**	**–**	**309,304**	**538,072**	**11,507**	**99,798**	**8,558**	**–**	**2,952**	**–**
MFIs	10,580	–	262,589	538,072	11,507	–	8,558	–	2,885	–
other residents	1,017	–	1,201	–	–	99,798	–	–	–	–
rest of the world	..	–	45,514	–	..	–	,,	–	67	–
Short-term securities, issued by	**1,495**	**9,359**	**66,283**	**5**	**7,301**	**53**	**199**	**–**	**6,486**	**–**
general government	255	–	46,260	–	5,791	–	199	–	5,494	–
other residents	3	9,359	9,160	5	77	53	–	–	–	–
rest of the world	1,237	–	10,863	–	1,433	–	–	–	992	–
Bonds, issued by	**54,670**	**49,684**	**273,677**	**452,072**	**230,975**	**122,637**	**9,787**	**–**	**232,350**	**4,321**
MFIs	12,586	–	52,544	452,072	12,310	–	401	–	31,263	–
central government: CCTs	1,956	–	69,886	–	15,749	–	852	–	43,139	–
central government: other	6,432	–	90,327	–	53,994	–	5,286	–	100,920	–
local government	2,609	–	6,302	–	2,677	–	1,306	–	1,394	–
other residents	14,552	49,684	13,767	–	15,251	122,637	1,941	–	10,658	4,321
rest of the world	16,535	–	40,851	–	130,993	–	–	–	44,976	–
Derivatives	**4,072**	**6,818**	**102,468**	**94,838**	**1,556**	**1,802**	**–**	**–**	**1,018**	**1,705**
Short-term loans, of	**48,339**	**368,667**	**583,076**	**89,871**	**32,652**	**122,495**	**..**	**8,832**	**6,551**	**1,842**
MFIs	–	280,870	583,076	20,431	–	99,557	–	8,832	–	1,842
other financial corporations	–	30,398	–	643	32,652	–	,,	–	6,551	..
general government	–	–	–	–	–	–	–	–	–	–
other residents	48,339	–	–	–	–	–	–	–	–	–
rest of the world	–	57,399	–	68,798	–	22,938	–	–	–	–
Medium and long-term loans, of	**–**	**404,077**	**728,576**	**60,623**	**165,590**	**36,375**	**25**	**3,104**	**2,211**	**11,887**
MFIs	–	328,700	728,576	5,023	–	28,642	–	1,697	–	8,196
other financial corporations	–	37,766	–	745	165,590	–	25	–	2,211	17
general government	–	31,679	–	3,327	–	–	–	1,406	–	1,734
other residents	–	–	–	–	–	–	–	–	–	–
rest of the world	–	5,933	–	51,528	–	7,732	–	–	–	1,941
Shares and other equity, issued by	**542,956**	**1,160,042**	**155,790**	**303,155**	**181,811**	**31,131**	**..**	**2,262**	**86,237**	**137,275**
residents	405,265	1,160,042	135,988	303,155	48,572	31,131	..	2,262	57,371	137,275
of which: listed shares	*209,014*	*369,228*	*29,125*	*144,360*	*39,498*	*1,256*	–	–	*22,842*	*66,038*
rest of the world	137,691	–	19,802	–	133,239	–	–	–	28,867	–
Mutual fund shares, issued by	**13,387**	**–**	**11,630**	**101,079**	**25,728**	**257,213**	**379**	**–**	**44,057**	**–**
residents	4,214	–	6,034	101,079	–	257,213	379	–	39,640	–
rest of the world	9,173	–	5,596	–	25,728	–	–	–	4,417	–
Insurance technical reserves	**19,932**	**97,091**	**1,125**	**17,397**	**–**	**–**	**–**	**–**	**–**	**416,960**
net equity of households	–	97,091	–	17,397	–	–	–	–	–	350,701
prepayments and other claims	19,932	–	1,125	–	–	–	–	–	–	66,260
Other accounts receivable/payable	**340,591**	**307,625**	**232**	**354**	**6,963**	**..**	**–**	**–**	**56**	**3,274**
Trade credits	318,783	291,635	–	–	–	–	–	–	–	–
Other	21,808	15,991	232	354	6,963	,,	–	–	56	3,274
Total	**1,178,816**	**2,403,363**	**2,374,693**	**2,477,367**	**680,209**	**671,503**	**39,664**	**14,198**	**408,792**	**577,264**

(1) Provisional. Rounding may cause discrepancies in totals.

General governmet						Households and non-profit institutions serving households		Rest of the world		Total		Institutional sectors
Central government		Local government		Social security funds								
Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Financial instruments
–	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**25,454**	**25,454**	**25,454**	**Monetary gold and SDRs**
18,980	**31,094**	**24,335**	**–**	**14,143**	**–**	**515,094**	**–**	**21,970**	**66,100**	**917,097**	**917,097**	**Currency and transferable deposits,** with
13,080	–	12,373	–	13,667	–	493,363	–	21,884	–	819,902	819,902	MFIs
–	31,094	8,882	–	..	–	20,598	–	86	–	31,094	31,094	other residents
5,901	–	3,080	–	475	–	1,133	–	–	66,100	66,100	66,100	rest of the world
798	**127,054**	**903**	**–**	**1,017**	**–**	**308,391**	**–**	**155,825**	**45,928**	**810,852**	**810,852**	**Other deposits,** with
795	–	787	–	1,016	–	83,530	–	155,825	–	538,072	538,072	MFIs
–	127,054	–	–	–	–	224,634	–	–	–	226,852	226,852	other residents
3	–	116	–	1	–	227	–	–	45,928	45,928	45,928	rest of the world
21	**117,860**	**14**	**..**	**223**	**–**	**13,693**	**–**	**46,421**	**14,858**	**142,136**	**142,136**	**Short-term securities,** issued by
21	117,860	14	..	223	–	13,182	–	46,421	–	117,860	117,860	general government
–	–	–	–	–	–	176	–	–	–	9,417	9,417	other residents
–	–	–	–	–	–	335	–	–	14,858	14,858	14,858	rest of the world
873	**1,161,084**	**4,679**	**21,432**	**6,105**	**–**	**685,297**	**–**	**637,828**	**325,009**	**2,136,240**	**2,136,240**	**Bonds,** issued by
247	–	855	–	816	–	337,734	–	3,316	–	452,072	452,072	MFIs
46	201,125	51	–	916	–	18,950	–	49,580	–	201,125	201,125	central government: CCTs
325	959,959	418	–	2,352	–	189,127	–	510,780	–	959,959	959,959	central government: other
50	–	1,306	21,432	..	–	2,614	–	3,174	–	21,432	21,432	local government
206	–	433	–	87	–	48,769	–	70,978	–	176,642	176,642	other residents
–	–	1,617	–	1,934	–	88,103	–	–	325,009	325,009	325,009	rest of the world
–	**6,585**	**–**	**–**	**–**	**–**	**–**	**–**	**62,468**	**59,834**	**171,582**	**171,582**	**Derivatives**
15,974	**1,654**	**–**	**4,325**	**–**	**956**	**..**	**52,490**	**149,135**	**184,594**	**835,727**	**835,727**	**Short-term loans,** of
–	1,654	–	4,193	–	29	–	51,528	–	114,139	583,076	583,076	MFIs
–	–	–	132	–	–	–	962	–	7,068	39,203	39,203	other financial corporations
15,974	–	–	–	–	926	–	–	–	15,047	15,974	15,974	general government
–	–	–	–	–	–	..	–	–	48,339	48,339	48,339	other residents
–	–	–	–	–	–	–	–	149,135	–	149,135	149,135	rest of the world
77,136	**104,029**	**638**	**69,298**	**..**	**584**	**–**	**327,294**	**74,524**	**31,428**	**1,048,699**	**1,048,699**	**Medium and long-term loans,** of
–	18,697	–	26,245	–	12	–	299,545	–	11,818	728,576	728,576	MFIs
–	72,692	–	22,875	–	573	–	27,725	–	5,435	167,826	167,826	other financial corporations
77,136	6,634	638	18,795	..	–	–	24	–	14,176	77,774	77,774	general government
–	–	–	–	–	–	–	–	–	–	–	–	other residents
–	6,006	–	1,383	–	–	–	–	74,524	–	74,524	74,524	rest of the world
85,008	**–**	**7,771**	**121**	**529**	**–**	**763,506**	**–**	**214,747**	**404,369**	**2,038,355**	**2,038,355**	**Shares and other equity,** issued by
77,973	–	6,870	121	421	–	686,779	–	214,747	–	1,633,985	1,633,985	residents
31,323	–	*3,076*	–	*248*	–	*156,275*	–	*89,481*	–	*580,881*	*580,881*	*of which: listed shares*
7,035	–	901	–	108	–	76,727	–	–	404,369	404,369	404,369	rest of the world
159	**–**	**5,212**	**–**	**1,337**	**–**	**343,266**	**–**	**4,114**	**90,977**	**449,269**	**449,269**	**Mutual fund shares,** issued by
43	–	40	–	814	–	303,012	–	4,114	–	358,292	358,292	residents
115	–	5,172	–	522	–	40,254	–	–	90,977	90,977	90,977	rest of the world
141	**–**	**1,317**	**–**	**32**	**–**	**522,256**	**30,012**	**16,657**	**–**	**561,460**	**561,460**	**Insurance technical reserves**
–	–	–	–	–	–	488,388	30,012	6,813	–	495,201	495,201	net equity of households
141	–	1,317	–	32	–	33,868	–	9,844	–	66,260	66,260	prepayments and other claims
45,212	**14,076**	**25,610**	**25,363**	**30,279**	**1,882**	**15,831**	**79,729**	**25,499**	**57,970**	**490,273**	**490,273**	**Other accounts receivable/payable**
–	–	–	–	–	–	5,323	–	25,499	57,970	349,605	349,605	Trade credits
45,212	14,076	25,610	25,363	30,279	1,882	10,509	79,729	–	–	140,668	140,668	Other
244,303	**1,563,437**	**70,479**	**120,540**	**53,664**	**3,422**	**3,167,334**	**489,525**	**1,409,188**	**1,306,522**	**9,627,142**	**9,627,142**	**Total**

ITALY'S FINANCIAL ASSETS AND LIABILITIES IN 2004 (1)
(flows in millions of euros)

Institutional sectors / Financial instruments	Non-financial corporations		Financial corporations							
			Monetary financial institutions		Other financial intermediaries		Financial auxiliaries		Insurance corporations and pension funds	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Monetary gold and SDRs	**–**	**–**	**-16**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Currency and transferable deposits, with	**15,264**	**–**	**-17,270**	**21,694**	**-794**	**–**	**-16,245**	**–**	**-362**	**–**
MFIs	15,051	–	-19,918	21,694	-793	–	-207	–	632	–
other residents	31	–	-11	–	-1	–	–	–	15	–
rest of the world	183	–	2,659	–	..	–	-16,037	–	-1,010	–
Other deposits, with	**1,927**	**–**	**52,723**	**47,664**	**-8,955**	**19,948**	**5,369**	**–**	**1,270**	**–**
MFIs	2,080	–	51,484	47,664	-8,955	–	5,369	–	1,270	–
other residents	-153	–	283	–	–	19,948	–	–	–	–
rest of the world	..	–	957	–	..	–	..	–	..	–
Short-term securities, issued by	**-576**	**3,639**	**7,885**	**1**	**3,032**	**-26**	**-147**	**–**	**-1,077**	**–**
general government	-508	–	1,413	–	2,954	–	-147	–	121	–
other residents	2	3,639	3,615	1	-33	-26	–	–	–	–
rest of the world	-70	–	2,856	–	112	–	–	–	-1,198	–
Bonds, issued by	**10,478**	**10,083**	**1,656**	**42,734**	**-7,548**	**14,792**	**2,571**	**–**	**24,673**	**11**
MFIs	1,291	–	3,824	42,734	-117	–	-155	–	2,709	–
central government: CCTs	2	–	946	–	-1,974	–	249	–	4,645	–
central government: other	141	–	-6,562	–	-3,334	–	-78	–	6,241	–
local government	458	–	2,510	–	461	–	212	–	241	–
other residents	9,418	10,083	3,394	–	1,206	14,792	2,343	–	3,338	11
rest of the world	-833	–	-2,456	–	-3,789	–	–	–	7,498	–
Derivatives	**–**	**-1,350**	**3,720**	**–**	**–**	**6,538**	**–**	**–**	**–**	**248**
Short-term loans, of	**23,824**	**-3,882**	**-10,820**	**-6,122**	**-8,436**	**-16,573**	**..**	**3,397**	**2,356**	**1,130**
MFIs	–	-2,844	-10,820	-4,844	–	-19,498	–	3,397	–	1,130
other financial corporations	–	43	–	31	-8,436	–	..	–	2,356	..
general government	–	–	–	–	–	–	–	–	–	–
other residents	23,824	–	–	–	–	–	–	–	–	–
rest of the world	–	-1,081	–	-1,309	–	2,926	–	–	–	–
Medium and long-term loans, of	**–**	**38,986**	**80,308**	**-3,072**	**9,186**	**-1,943**	**8**	**955**	**-116**	**2,962**
MFIs	–	35,896	80,308	-87	–	302	–	955	–	2,793
other financial corporations	–	-5,684	–	-29	9,186	–	8	–	-116	-6
general government	–	7,032	–	280	–	–	–	..	–	176
other residents	–	–	–	–	–	–	–	–	–	–
rest of the world	–	1,742	–	-3,236	–	-2,245	–	–	–	-2
Shares and other equity, issued by	**6,473**	**13,081**	**-589**	**3,625**	**-1,285**	**837**	**-957**	**-40**	**5,822**	**..**
residents	3,266	13,081	-1,165	3,625	5,903	837	-957	-40	4,204	..
of which: listed shares	....	....	....	....	....	....	–	–	....	....
rest of the world	3,206	–	576	–	-7,188	–	–	–	1,618	–
Mutual fund shares, issued by	**133**	**–**	**184**	**-8,721**	**2,585**	**-9,236**	**-19**	**–**	**-792**	**–**
residents	-215	–	-245	-8,721	–	-9,236	-19	–	-1,944	–
rest of the world	349	–	429	–	2,585	–	–	–	1,152	–
Insurance technical reserves	**1,972**	**6,175**	**111**	**-206**	**–**	**–**	**–**	**–**	**–**	**51,414**
net equity of households	–	6,175	–	-206	–	–	–	–	–	45,046
prepayments and other claims	1,972	–	111	–	–	–	–	–	–	6,370
Other accounts receivable/payable	**579**	**838**	**4**	**128**	**6,557**	**..**	**–**	**–**	**6**	**534**
Trade credits	1,981	802	–	–	–	–	–	–	–	–
Other	-1,401	35	4	128	6,557	..	–	–	6	534
Total	**60,074**	**67,569**	**117,896**	**97,726**	**-5,657**	**14,337**	**-9,419**	**4,312**	**31,780**	**56,299**

(1) Provisional. Rounding may cause discrepancies in totals.

Table a28

General governmet						Households and non-profit institutions serving households		Rest of the world		Total		Institutional sectors
Central government		Local government		Social security funds								
Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Financial instruments
–	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**-16**	**-16**	**-16**	**Monetary gold and SDRs**
2,467	**3,253**	**1,430**	**–**	**473**	**–**	**27,146**	**–**	**-6,180**	**-19,017**	**5,930**	**5,930**	**Currency and transferable deposits,** with
2,315	–	774	–	478	–	29,542	–	-6,180	–	21,694	21,694	MFIs
–	3,253	286	–	..	–	2,933	–	..	–	3,253	3,253	other residents
153	–	371	–	-4	–	-5,329	–	–	-19,017	-19,017	-19,017	rest of the world
-260	**-2,945**	**-222**	**–**	**135**	**–**	**14,913**	**–**	**-1,277**	**957**	**65,626**	**65,626**	**Other deposits,** with
-260	–	-222	–	135	–	-1,960	–	-1,277	–	47,664	47,664	MFIs
–	-2,945	–	–	–	–	16,873	–	–	–	17,004	17,004	other residents
..	–	..	–	..	–	..	–	–	957	957	957	rest of the world
16	**-888**	**1**	**..**	**114**	**–**	**6,083**	**–**	**-10,853**	**1,750**	**4,476**	**4,476**	**Short-term securities,** issued by
16	-888	1	..	114	–	6,003	–	-10,853	–	-888	-888	general government
–	–	–	–	–	–	30	–	–	–	3,613	3,613	other residents
–	–	–	–	–	–	50	–	–	1,750	1,750	1,750	rest of the world
-61	**33,457**	**268**	**4,534**	**-590**	**–**	**38,139**	**–**	**34,536**	**-1,490**	**104,121**	**104,121**	**Bonds,** issued by
16	–	5	–	-73	–	35,313	–	-79	–	42,734	42,734	MFIs
-43	-122	-77	–	-444	–	-13,888	–	10,462	–	-122	-122	central government: CCTs
-21	33,579	86	–	-152	–	24,611	–	12,647	–	33,579	33,579	central government: other
..	–	231	4,534	..	–	449	–	-27	–	4,534	4,534	local government
-13	–	-2	–	-30	–	-6,302	–	11,533	–	24,886	24,886	other residents
–	–	25	–	109	–	-2,044	–	–	-1,490	-1,490	-1,490	rest of the world
–	**..**	**–**	**–**	**–**	**–**	**–**	**–**	**1,716**	**–**	**5,436**	**5,436**	**Derivatives**
-109	**140**	**–**	**90**	**–**	**13**	**..**	**-1,124**	**535**	**30,281**	**7,351**	**7,351**	**Short-term loans,** of
–	140	–	122	–	13	–	-1,015	–	12,580	-10,820	-10,820	MFIs
–	–	–	-32	–	–	–	-109	–	-6,013	-6,080	-6,080	other financial corporations
-109	–	–	–	–	..	–	–	–	-109	-109	-109	general government
–	–	–	–	–	–	..	–	–	23,824	23,824	23,824	other residents
–	–	–	–	–	–	–	–	535	–	535	535	rest of the world
10,405	**11,368**	**58**	**3,476**	**..**	**-1,297**	**–**	**45,831**	**-3,726**	**-1,141**	**96,124**	**96,124**	**Medium and long-term loans,** of
–	-2,091	–	539	–	-35	–	43,466	–	-1,431	80,308	80,308	MFIs
–	13,802	–	-396	–	-1,262	–	2,363	–	291	9,079	9,079	other financial corporations
10,405	-350	58	3,325	..	–	–	2	–	..	10,463	10,463	general government
–	–	–	–	–	–	–	–	–	–	–	–	other residents
–	7	–	7	–	–	–	–	-3,726	–	-3,726	-3,726	rest of the world
-4,489	**–**	**907**	**5**	**-198**	**–**	**-9,175**	**–**	**19,444**	**-1,555**	**15,952**	**15,952**	**Shares and other equity,** issued by
-4,489	–	907	5	103	–	-9,709	–	19,444	–	17,507	17,507	residents
....	–	....	–	....	–	....	–	....	–	....	....	*of which: listed shares*
..	–	..	–	-300	–	534	–	–	-1,555	-1,555	-1,555	rest of the world
18	**–**	**-8**	**–**	**10**	**–**	**-7,509**	**–**	**6**	**12,565**	**-5,392**	**-5,392**	**Mutual fund shares,** issued by
-2	–	-2	–	-42	–	-15,494	–	6	–	-17,957	-17,957	residents
20	–	-6	–	52	–	7,984	–	–	12,565	12,565	12,565	rest of the world
14	**–**	**130**	**–**	**3**	**–**	**54,814**	**2,205**	**2,544**	**–**	**59,589**	**59,589**	**Insurance technical reserves**
–	–	–	–	–	–	51,650	2,205	1,570	–	53,220	53,220	net equity of households
14	–	130	–	3	–	3,164	–	974	–	6,370	6,370	prepayments and other claims
-4,140	**-1,678**	**496**	**653**	**1,826**	**-120**	**-135**	**3,647**	**166**	**1,358**	**5,358**	**5,358**	**Other accounts receivable/payable**
–	–	–	–	–	–	13	–	166	1,358	2,159	2,159	Trade credits
-4,140	-1,678	496	653	1,826	-120	-148	3,647	–	–	3,200	3,200	Other
3,860	**42,707**	**3,061**	**8,757**	**1,773**	**-1,404**	**124,275**	**50,559**	**36,909**	**23,693**	**364,555**	**364,555**	**Total**

FINANCIAL MARKET: GROSS AND NET ISSUES OF SECURITIES BY ITALIAN RESIDENTS
(millions of euros)

	BONDS AND PUBLIC							
	Public sector							
	Government securities							
	BOTs	CTZs	CCTs (1)	BTPs (1)	CTEs	Republic of Italy issues	Other (2)	Total
				Gross issues				
2000	164,650	33,317	19,866	106,737	–	19,727	1,167	345,465
2001	188,677	35,528	28,330	119,929	–	22,379	54	394,897
2002	208,761	32,556	44,535	133,646	–	16,135	–	435,633
2003	214,093	31,185	38,313	144,882	–	21,998	..	450,471
2004	221,300	27,128	34,527	134,803	–	13,980	–	431,739
				Redemptions				
2000	182,200	53,401	27,912	57,916	1,744	5,922	..	329,094
2001	176,960	49,367	38,357	83,562	1,500	14,037	48	363,830
2002	208,831	21,940	57,279	93,797	–	11,522	39,407	432,775
2003	208,188	37,742	55,111	114,843	–	15,782	1,180	432,846
2004	222,195	34,161	34,632	100,745	–	10,808	50	402,591
				Issue discounts				
2000	–	2,378	-114	1,195	–	15	–	3,474
2001	–	2,637	-215	-1,639	–	22	–	805
2002	–	2,281	-454	-2,515	–	71	-21,836	-22,453
2003	–	1,350	-483	-1,672	–	51	–	-755
2004	–	1,165	-430	502	–	35	–	1,271
				Net issues (6)				
2000	-17,550	-22,462	-7,932	47,626	-1,744	13,804	1,167	12,909
2001	11,717	-16,476	-9,812	38,006	-1,500	9,049	6	30,990
2002	-70	8,335	-12,290	42,364	–	4,388	-17,571	25,157
2003	5,905	-7,907	-16,315	31,711	–	5,582	-1,180	17,796
2004	-895	-8,198	325	33,556	–	2,468	-50	27,206
				Coupons (7)				
2000	4,854	3,293	10,161	37,484	236	3,381	394	59,802
2001	4,817	3,111	12,681	38,031	95	4,107	394	63,235
2002	4,256	1,906	9,209	37,324	–	4,643	394	57,731
2003	2,990	2,855	7,094	37,921	–	4,279	–	55,139
2004	2,921	2,383	4,836	37,410	–	4,006	–	51,556

(1) The 1993 issues include 10,000 billion lire of CCTs and 21,000 billion of BTPs placed with the Bank of Italy in December to finance the new treasury payments account. – (3) Includes the securities issued in 2004 by Infrastrutture S.p.A. to finance the construction of high-speed railway infrastructure. – (4) The total for the public sector differs from the sum Share cancellations following mergers are not included. – (6) The net issues of Republic of Italy loans include accounting lags. – (7) The figures refer only to fixed rate securities, except for CCTs.

SECTOR SECURITIES								
			Other sectors			Total bonds and public sector securities	Listed shares of Italian companies (5)	
Autonomous government agencies, State Railways et al. (3)	Local governments	Total (4)	Banks	Firms	Total			
			Gross issues					
–	3,114	348,579	86,915	20,398	107,313	455,891	9,148	 2000
–	2,408	397,304	95,777	52,917	148,694	545,998	6,171	 2001
–	5,995	441,628	92,346	44,487	136,833	578,461	3,894	 2002
–	4,033	454,505	116,815	42,677	159,492	613,997	8,710	 2003
6,500	5,867	444,106	120,462	50,705	171,167	615,272	3,197	 2004
			Redemptions					
1,420	328	330,843	55,987	5,279	61,266	392,109	384	 2000
1,937	392	366,159	63,586	6,086	69,672	435,831	767	 2001
1,653	481	434,908	59,049	11,783	70,832	505,740	40	 2002
–	582	433,428	84,826	18,167	102,992	536,421	983	 2003
516	756	403,863	77,426	25,548	102,974	506,836	17	 2004
			Issue discounts					
–	..	3,474	1,152	672	1,824	5,298	–	 2000
–	..	805	2,134	693	2,827	3,632	–	 2001
–	-8	-22,461	1,247	121	1,368	-21,093	–	 2002
–	..	-755	799	30	829	75	–	 2003
41	-2	1,310	358	82	440	1,750	–	 2004
			Net issues (6)					
-1,420	2,786	14,275	30,585	14,447	45,032	59,307	9,148	 2000
-1,937	2,015	31,069	31,834	46,137	77,972	109,041	6,171	 2001
-1,653	5,523	29,027	32,941	32,583	65,524	94,550	3,894	 2002
–	3,452	21,248	31,560	24,479	56,039	77,287	8,710	 2003
5,943	5,114	38,263	42,575	25,075	67,650	105,913	3,197	 2004
			Coupons (7)					
192	248	60,242	12,485	....	12,485	72,727	15,711	 2000
144	436	63,815	13,274	....	13,274	77,089	15,889	 2001
83	604	58,418	12,178	....	12,178	70,597	18,650	 2002
83	712	55,934	11,020	....	11,020	66,954	17,030	 2003
83	861	52,500	11,226	....	11,226	63,726	22,517	 2004

(2) Includes the 76,206 billion lire of securities issued in November 1994 to consolidate the Treasury's overdraft on its current account with the Bank of Italy and redeemed earlier in December 2002. – of the individual components by the amount of the bonds issued by Crediop on behalf of the Treasury. – (5) Issues for cash. Redemptions refer to the market value of shares bought back and cancelled.

Table a30

INTEREST RATES ON SECURITIES LISTED ON THE ITALIAN STOCK EXCHANGE
(average values before tax)

	CCTs	CTEs	CTOs	BTPs	CTZs	Fixed-rate bank bonds
1995	11.60	8.82	11.64	11.94	11.40	11.58
1996	9.01	6.33	8.77	9.06	8.49	9.20
1997	6.81	5.42	7.17	6.76	6.45	7.41
1998	4.89	4.87	7.01	4.92	4.58	5.45
1999	3.13	4.35	–	4.71	3.21	4.80
2000	4.58	5.94	–	5.59	4.70	5.80
2001	4.34	6.02	–	5.17	4.04	5.13
2002	3.37	–	–	4.95	3.49	4.90
2003	2.30	–	–	4.28	2.30	3.87
2004	2.14	–	–	4.28	2.25	3.59
2003 – Jan.	2.77	–	–	4.35	2.59	4.13
Feb.	2.63	–	–	4.18	2.40	3.88
Mar.	2.41	–	–	4.21	2.34	3.95
Apr.	2.44	–	–	4.30	2.39	4.00
May	2.45	–	–	4.05	2.18	3.68
June	2.16	–	–	3.89	1.95	3.40
July	2.01	–	–	4.16	2.06	3.63
Aug.	2.10	–	–	4.34	2.30	3.94
Sept.	2.18	–	–	4.36	2.27	3.90
Oct.	2.14	–	–	4.43	2.32	3.91
Nov.	2.19	–	–	4.53	2.42	4.02
Dec.	2.18	–	–	4.50	2.35	4.04
2004 – Jan.	2.13	–	–	4.38	2.18	3.80
Feb.	2.08	–	–	4.34	2.11	3.69
Mar.	2.04	–	–	4.18	1.99	3.48
Apr.	1.93	–	–	4.35	2.15	3.65
May	2.10	–	–	4.49	2.32	3.73
June	2.19	–	–	4.54	2.43	3.90
July	2.22	–	–	4.45	2.37	3.74
Aug.	2.23	–	–	4.31	2.30	3.60
Sept.	2.18	–	–	4.27	2.38	3.53
Oct.	2.22	–	–	4.16	2.29	3.45
Nov.	2.19	–	–	4.05	2.27	3.33
Dec.	2.20	–	–	3.87	2.21	3.16
2005 – Jan.	2.22	–	–	3.80	2.23	–
Feb.	2.20	–	–	3.74	2.23	–
Mar.	2.22	–	–	3.90	2.26	–
Apr.	2.24	–	–	3.76	2.20	–

Table a31

CREDIT RISK INDICATORS (1)

(end-of-period data; amounts in millions of euros and percentages)

	Loans (2)	As a ratio to loans (2)				Adjusted bad debts / Accounting bad debts
		Non-performing loans	*of which: bad debts*	Adjusted bad debts	New bad debts (3)	
		Banking system				
2002	1,028,608	6.5	4.5	4.8	1.0	106.5
2003	1,090,940	6.7	4.7	5.1	1.2	108.5
2004	1,151,170	6.6	4.7	5.0	0.9	106.9
		Limited company banks (*società per azioni*)				
2002	883,961	6.5	4.1	4.9	1.0	106.5
2003	922,551	6.8	4.9	5.4	1.2	108.4
2004	962,679	6.8	5.0	5.4	0.9	106.6
		Cooperative banks *(banche popolari)*				
2002	87,746	6.1	4.1	4.4	1.0	106.2
2003	101,673	5.4	3.7	4.0	1.2	109.0
2004	112,326	4.9	3.3	3.6	0.7	109.0
		Mutual banks *(banche di credito cooperativo)*				
2002	56,901	6.8	3.2	3.5	0.9	107.5
2003	66,716	6.5	2.9	3.2	0.9	109.9
2004	76,165	6.3	2.9	3.1	0.9	109.5
		Major, large and medium-sized banks *(banche maggiori, grandi e medie)*				
2002	744,803	6.2	4.2	4.5	1.0	106.3
2003	761,023	6.7	4.7	5.1	1.3	107.9
2004	783,844	6.7	4.9	5.2	0.9	106.0
		Other banks				
2002	283,805	7.4	5.3	5.6	0.9	106.9
2003	329,917	6.7	4.7	5.1	1.1	109.7
2004	367,335	6.3	4.3	4.7	0.8	109.1
		Banks based in the Centre or North				
2002	965,529	6.1	4.2	4.5	1.0	107.3
2003	1,030,414	6.3	4.4	4.8	1.2	109.1
2004	1,085,258	6.2	4.4	4.7	0.8	107.5
		Banks based in the South				
2002	63,079	12.3	9.7	9.9	1.0	101.6
2003	60,526	13.1	10.2	10.6	1.3	103.8
2004	65,912	12.1	9.7	10.0	1.1	102.6

(1) Based on the classifications in force at the end of 2004. For the sake of homogeneousness, merged banks have been assigned to the category of the assorbing banks – (2) Gross of bad debts and unpaid and protested bills. The figures refer to business with resident customers of units operating in Italy and abroad – (3) Percentage ratio of loans newly classed as bad debts to performing loans in the previous year net of repo assets, net interest to be debited to customers and adjusted bad debts.

Table a32

CONSOLIDATED INCOME STATEMENT:
CONTRIBUTION OF OPERATIONS TO SUPERVISORY CAPITAL (1)
(percentages of total assets)

	Banking system					
	of which:				Classification by geographical area	
	limited company banks	*cooperative banks*	*mutual banks*		Centre and North	South
Net interest income						
2002	2.13	2.51	3.31	2.22	2.21	3.13
2003	2.07	2.45	3.18	2.19	2.17	3.05
2004	2.03	2.42	3.06	2.15	2.13	3.07
Non-interest income						
2002	1.31	1.36	0.89	1.29	1.29	1.00
2003	1.45	1.33	0.91	1.41	1.42	1.08
2004	1.38	1.43	0.86	1.37	1.38	1.14
Gross income						
2002	3.44	3.87	4.20	3.51	3.50	4.13
2003	3.53	3.78	4.08	3.60	3.59	4.13
2004	3.42	3.85	3.92	3.52	3.51	4.21
Operating expenses						
2002	2.05	2.35	2.92	2.13	2.12	2.90
2003	2.04	2.26	2.74	2.12	2.11	2.82
2004	1.97	2.21	2.62	2.05	2.04	2.83
Operating profit						
2002	1.39	1.51	1.29	1.38	1.38	1.23
2003	1.49	1.52	1.34	1.48	1.48	1.31
2004	1.45	1.64	1.30	1.47	1.47	1.38
Non-recurring items (net) and allocations to provisions						
2002	0.24	0.31	0.07	0.23	0.23	0.14
2003	0.28	0.31	0.05	0.27	0.27	0.14
2004	0.06	0.23	-0.01	0.09	0.09	0.09
Loan losses						
2002	0.55	0.40	0.22	0.50	0.50	0.33
2003	0.56	0.51	0.23	0.52	0.53	0.39
2004	0.44	0.40	0.30	0.41	0.42	0.32
Tax						
2002	0.25	0.39	0.19	0.27	0.27	0.29
2003	0.28	0.32	0.19	0.29	0.29	0.26
2004	0.33	0.39	0.24	0.34	0.33	0.34
Dividends						
2002	0.19	0.20	0.04	0.18	0.18	0.08
2003	0.23	0.27	0.04	0.22	0.22	0.06
2004	0.27	0.23	0.04	0.24	0.25	0.07
Allocations to supervisory capital						
2002	0.16	0.21	0.77	0.20	0.20	0.39
2003	0.14	0.11	0.83	0.18	0.17	0.46
2004	0.36	0.39	0.73	0.39	0.38	0.56
Share of non-interest income in gross income *(percentages)*						
2002	38.0	35.1	21.2	36.7	35.3	24.1
2003	41.2	35.2	22.3	39.1	39.4	26.2
2004	40.5	37.1	22.0	38.9	39.2	27.2
Cost-income ratio *(percentages)* (2)						
2002	59.6	60.8	69.4	60.7	60.4	70.2
2003	57.9	59.9	67.1	59.0	58.8	68.2
2004	57.6	57.5	66.9	58.4	58.2	67.3
ROE *(percentages)*						
2002	6.2	7.4	6.0	6.4	6.5	4.5
2003	6.8	5.8	6.7	6.7	6.7	5.1
2004	11.4	9.6	7.5	10.7	10.8	6.5
Memorandum item: **Total assets** *(average values in millions of euros)* (3)						
2002	1,391,875	286,437	88,651	1,819,937	1,787,061	32,875
2003	1,381,519	303,623	99,111	1,826,795	1,793,132	33,663
2004	1,404,039	317,041	110,110	1,875,705	1,840,489	35,216

(1) Consolidated data for banking groups and data on a solo basis for banks not belonging to a group. – (2) The cost-income ratio is the ratio of operating expenses to gross income. – (3) Refers only to the banks that submitted reports with income statement data.

SUPERVISORY CAPITAL AND SOLVENCY RATIO (1)
(end-of-period data; amounts in millions of euros)

	Primary capital	Supplementary capital		Supervisory capital	Solvency ratio (percentages)	Excess capital	Capital shortfalls	
			of which: subordinated liabilities (2)				Number of banks	Amount
				Banking system				
2002	98,828	40,272	36,084	134,385	11.2	39,605	7	198
2003	104,356	41,558	37,151	139,829	11.4	42,482	–	–
2004	112,887	42,380	38,506	149,157	11.6	47,457	2	5
				Main banking groups (3)				
2002	48,655	26,614	24,871	72,474	10.6	18,567	–	–
2003	50,894	25,779	24,338	72,825	10.8	19,876	–	–
2004	55,495	26,402	25,157	78,198	11.4	23,781	–	–
				Banks and banking groups based in the Centre or North				
2002	95,802	40,004	35,920	131,093	11.1	37,769	6	196
2003	101,211	41,217	36,916	136,344	11.3	40,541	–	–
2004	109,404	42,028	38,227	145,403	11.6	45,428	2	5
				Banks and banking groups based in the South				
2002	3,026	268	164	3,292	18.1	1,836	1	2
2003	3,145	342	235	3,485	18.1	1,941	–	–
2004	3,403	352	279	3,754	17.4	2,029	–	–
				Limited company banks *(società per azioni)*				
2002	71,299	33,019	29,744	100,605	10.9	27,998	1	133
2003	75,075	33,303	30,002	103,638	11.2	30,707	–	–
2004	80,465	34,417	31,372	110,246	11.6	34,833	2	5
				Cooperative banks *(banche popolari)*				
2002	16,156	6,662	6,229	21,849	10.1	4,728	2	43
2003	17,133	7,476	6,965	23,298	10.0	4,679	–	–
2004	19,403	7,212	6,907	25,192	10.2	5,429	–	–
				Mutual banks *(banche di credito cooperativo)*				
2002	11,220	582	111	11,767	18.8	6,780	4	22
2003	11,984	768	184	12,718	17.8	6,986	–	–
2004	12,862	740	226	13,559	16.9	7,124	–	–

(1) Consolidated data for banking groups and data on a solo basis for banks not belonging to a group. Excludes the Italian branches of foreign banks. – (2) Includes innovative and hybrid capital instruments. – (3) Six largest banking groups in terms of total assets.

LIST OF ABBREVIATIONS

ABI – *Associazione bancaria italiana*
Italian Bankers' Association

BI–COMP – *Banca d'Italia Compensazione*
Bank of Italy Clearing System

BI–REL – *Banca d'Italia Regolamento Lordo*
Bank of Italy real-time gross settlement system

BOT – *Buoni ordinari del Tesoro*
Treasury bill

BTP – *Buoni del Tesoro poliennali*
Treasury bond

CCT – *Certificati di credito del Tesoro*
Treasury credit certificate

CIPA – *Convenzione interbancaria per i problemi dell'automazione*
Interbank Convention on Automation

Confindustria – *Confederazione generale dell'industria italiana*
Confederation of Italian Industry

Consob – *Commissione nazionale per le società e la borsa*
Companies and Stock Exchange Commission

CTO – *Certificati del Tesoro con opzione*
Treasury option certificates

CTZ – *Certificati del Tesoro zero-coupon*
Zero-coupon Treasury certificates

EFPD – Economic and Financial Planning Document

FPR – Forecasting and Planning Report

HICP – Harmonized index of consumer prices

ICI – *Imposta comunale sugli immobili*
Municipal real estate tax

Iciap – *Imposta comunale per l'esercizio di imprese e di arti e professioni*
Municipal tax on businesses and the self-employed

Ilor – *Imposta locale sui redditi*
Local income tax

INAIL – *Istituto nazionale per l'assicurazione contro gli infortuni sul lavoro*
National Industrial Accidents Insurance Institute

INPS – *Istituto nazionale per la previdenza sociale*
National Social Security Institute

Irap – *Imposta regionale sulle attività produttive*
Regional tax on productive activities

Irpef	–	*Imposta sul reddito delle persone fisiche* Personal income tax
Ires	–	*Imposta sul reddito delle società* Corporate income tax
ISAE	–	*Istituto di studi e analisi economica* Institute for Economic Research and Analysis
Istat	–	*Istituto nazionale di statistica* National Institute of Statistics
Isvap	–	*Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo* Supervisory authority for the insurance industry
MTS	–	*Mercato telematico dei titoli di Stato* Screen-based secondary market in government securities
QRBR	–	Quarterly Report on the Borrowing Requirement
SACE	–	*Istituto per i servizi assicurativi per il commercio estero* Foreign Trade Insurance Services Agency
SIM	–	*Società di intermediazione mobiliare* Securities investment firm
TARGET	–	Trans-European Automated Real-Time Gross Settlement Express Transfer System
UIC	–	*Ufficio italiano dei cambi* Italian Foreign Exchange Office

ADMINISTRATION OF THE BANK OF ITALY

AT 31 DECEMBER 2004

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Pierluigi CIOCCA - Deputy director general
Antonio FINOCCHIARO - Deputy director general and Secretary to the Board

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