BANCA D'ITALIA

ORDINARY GENERAL MEETING OF SHAREHOLDERS

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ABRIDGED REPORT FOR THE YEAR 2005

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THE INTERNATIONAL ECONOMY

In 2005 the world economy continued to expand at a rapid pace of almost 5 per cent. Despite firms' stronger balance sheets and high profits, investment was slack. World trade in goods and services grew substantially, by 7.3 per cent, although this was less than in 2004 (10.4 per cent).

Financial market conditions remained relaxed, with monetary policies progressively resuming a less expansionary stance. These conditions offset the restrictive effects of the rise in oil prices, which was steeper and more protracted than had been expected a year earlier. The higher cost of energy caused a large jump in consumer prices but did not affect global inflation expectations, which credible monetary policies continued to contain. Heightened competition on international goods markets and moderate wage claims in the main industrial countries kept the underlying trend in prices in check. In the United States the Federal Reserve had begun tightening monetary conditions in the middle of 2004. In the euro area the reference rate was raised in December 2005 and again in March of this year; also in March the Bank of Japan abandoned its policy of increasing liquidity. The advanced countries as a whole reduced their budget deficits, mainly thanks to good economic performance.

The rapid expansion in domestic demand in the United States and the transfer of income from countries consuming raw materials to those producing them due to the rise in commodity prices aggravated the payments disequilibria. The deficit on the current account of the US balance of payments exceeded $800 billion, equal to 6.4 per cent of GDP. Until now the oil-producing countries have invested a substantial part of oil revenues in financial assets, for the most part denominated in dollars.

In the United States economic activity increased by 3.5 per cent, still driven by the expansion in consumption, which far outpaced that in disposable income. In Japan output grew by 2.6 per cent as the recovery gained strength from the upturn in domestic demand after two years of stagnation.

In the European Union GDP growth fell to 1.6 per cent, from 2.4 per cent in 2004, with performances among the member countries continuing to diverge. In the euro area it slowed to 1.3 per cent. The United Kingdom also recorded slower growth of 1.8 per cent; in the first half of the year consumption was affected by the stagnation of house prices and the lagged effects of the monetary tightening between the end of 2004 and early 2005.

Economic activity in the emerging economies again expanded strongly, by almost 7 per cent. In the Asian economies growth was driven in the second half of the year by the cyclical upturn in the production of high-tech goods. In China output expanded by almost 10 per cent; a downturn in investment was offset by a larger contribution of net export demand. Raw-material-producing countries, which recorded growth of 6.5 per cent, benefited from the further improvement in the terms of trade.

Despite the widening of the US external deficit in 2005 the dollar strengthened as short-term interest differentials in favour of dollar-denominated assets widened. The Chinese authorities introduced some flexibility into the exchange regime in July, although little advantage has been taken of it yet. In 2005 China was the only country in Asia to accumulate substantial foreign currency reserves; these increased by more than $200 billion, and in the early months of 2006 overtook those of Japan.

Despite small fluctuations, the yields on ten-year government bonds in the main regions of the world remained generally stationary at the levels of 2004. The risk premiums on corporate bonds and on government bonds of emerging economies remained close to their lowest recorded levels. Share prices rose in the advanced countries, albeit to varying degrees, in a context of low volatility. Low interest rates on mortgage loans drove up house prices, which again recorded double-digit increases in the United States and a number of euro-area countries. House prices in the United Kingdom, which had virtually stagnated since the middle of 2004, began to climb once more in the last quarter of 2005.

The International Monetary Fund estimates that world output will increase this year by nearly 5 per cent and trade in goods and services by 8 per cent. The growth in the world economy is likely to be less unbalanced than in recent years as economic activity accelerates in Europe and the expansion in Japan gains strength.

In the United States there are increasingly clear indications that the property market is cooling; the expected slowing of house prices should curb household spending, so that its growth is once again consistent with that in disposable income. The IMF forecasts US economic growth of 3.4 per cent, which is in line with potential.

In Japan the increase in employment and wages should continue to sustain household expenditure. The prospects for investment are also favourable thanks to the strengthening of firms' balance sheets and their high profits. Output is expected to expand by around 3 per cent in 2006.

Economic activity in the EU is forecast to pick up with respect to 2005. International organizations and professional forecasters agree that euro-area GDP should grow by an average of 2 per cent, benefiting from the favourable performance of world trade and investment. Private consumption is expected to remain the least buoyant demand component.

Economic activity continues to expand at a rapid pace in the emerging and developing economies as well, in response to high commodity prices, stable financial conditions and low risk premiums.

The consensus of the international financial community, reiterated at the last meeting of the G7, is that the external current account imbalances between the main regions have now reached proportions that are unlikely to be sustainable in the medium-to-long term. Efficient international capital markets, combined with a higher propensity to save among American households and good growth prospects for the world economy, could allow the imbalances to be gradually reabsorbed. Without suitable economic policy measures, however, it is impossible to rule out a traumatic adjustment, entailing brusque variations in the exchange rate of the dollar and the prices of other financial assets, with serious repercussions for the world economy.

Another threat to the world economy in the short term comes from the price of oil. Since the OPEC countries currently have very limited unused capacity, prices could well rise even further, particularly if temporary supply restrictions are imposed.

Another source of uncertainty is the low level of credit risk premiums on financial instruments issued by the private sector in industrial countries and the authorities of the emerging countries. Their reduction is only partly ascribable to the improvement in the economic fundamentals of borrowers – firms, financial institutions and emerging countries; another possible cause is excessive risk-taking by investors. A sudden upward correction of these premiums, and with them the cost of borrowing, could jeopardize heavily exposed intermediaries and investors.

There is concern about the high level of house prices in the United States, where households are heavily in debt, and in several euro-area countries. Too sharp a deceleration in property prices could have repercussions on consumption.

Although there is considerable uncertainty about the timing, the intensity and the economic impact of a possible bird flu pandemic, the monetary and financial authorities need to assess in advance the possible effects on the operation of the financial systems, preparing procedures to ensure the continuity of key functions in their institutions and verifying the corresponding measures adopted by private financial institutions.

RECENT DEVELOPMENTS AND ECONOMIC POLICIES

The United States

Economic activity expanded by 3.5 per cent in 2005, compared with 4.2 per cent in 2004 (Table 1). In terms of aggregate demand, the increase in real-estate wealth and growth of employment helped to offset the adverse effects of higher energy prices and sustained the 3.5 per cent expansion in household consumption.

Households' saving rate turned negative by 0.5 per cent of disposable income in 2005, falling from 1.8 per cent in 2004. The increase in net saving of general government and the corporate sector contained the decline in the national saving rate, which fell to 0.8 per cent of GDP net of depreciation, compared with 1.2 per cent in 2004.

Notwithstanding the substantial increase in the profits of non-financial corporations as defined by the national accounts, by an average of 22.1 per cent in 2005, the growth in business investment slowed from 9.4 to 8.6 per cent. The robust upswing under way since early 2003 in ICT investment continued, with an increase of 13 per cent in 2005, but investment in traditional capital goods, which accounts for just over 50 per cent of non-residential fixed investment, was slack. In particular, investment in industrial machinery returned to faster growth only in the second half of 2005, while non-residential construction, after declining between 2001 and 2003, has continued to stagnate.

Although gains in labour productivity in the non-farm business sector were lower in 2005 than the average for the previous two years (2.7 as against 3.7 per cent), they were enough to hold the increase in unit labour costs to 2.5 per cent, thus sustaining corporate profit margins. Wage pressures were generally moderate, even though virtually full employment was attained during the year. The share of profits in value added rose by almost 6 percentage points between 2001 and 2005 to its highest level since 1997.

The rate of consumer price inflation rose to 3.4 per cent on average in 2005, compared with 2.7 per cent in 2004, partly owing to the rise in energy prices. This was not passed on to core inflation or expected inflation, however, both of which remained stable and moderate. During 2005 the deflator of personal consumption expenditure, excluding energy and food products – which the Federal Reserve considers to be the most reliable indicator of the underlying trend in inflation – remained close to 2 per cent.

However, the increase in inflation expectations in the first four months of 2006 as indicated by the yields on indexed government securities points to a heightened risk that the continuing rise in energy prices will be passed on to core inflation, in view of the growing tensions on the labour market. And in April the twelve-month rise in the consumer price index, excluding energy and food products, increased to 2.3 per cent.

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)

	2004	2005	2005				2006
			Q1	Q2	Q3	Q4	Q1
United States							
GDP	4.2	3.5	3.8	3.3	4.1	1.7	5.3
Household consumption (1)	3.9	3.5	3.5	3.4	4.1	0.9	5.2
General government expenditure (2)	2.2	1.8	1.9	2.5	2.9	-0.8	4.3
Gross fixed private investment	9.7	8.1	7.0	9.5	8.0	3.9	9.3
Change in stocks (3)	0.4	-0.3	0.3	-2.1	-0.4	1.9	-0.1
Net exports (3)	-0.7	-0.3	-0.4	1.1	-0.1	-1.4	-0.6
Japan							
GDP	2.3	2.6	5.9	5.3	0.6	4.3	1.9
Household consumption (1)	1.9	2.1	5.8	3.1	1.8	2.5	1.6
General government expenditure	2.0	1.7	3.8	0.4	2.0	0.4	0.6
Gross fixed private investment	1.1	3.3	7.9	4.7	4.5	-1.6	1.5
Change in stocks (3)	-0.2	0.1	0.2	1.5	-2.0	0.7	0.5
Net exports (3)	0.8	0.3	-0.1	0.9	0.3	2.4	0.2
Euro area							
GDP	2.0	1.3	1.3	1.7	2.8	1.3	2.4
Household consumption (1)	1.5	1.3	0.4	1.2	2.2	0.5	….
General government expenditure	1.1	1.4	1.0	2.7	3.7	0.1	….
Gross fixed private investment	2.3	2.3	0.9	4.9	4.1	1.1	….
Change in stocks (3) (4)	0.4	..	-0.7	..	..	1.7	….
Net exports (3)	0.1	-0.2	1.4	-0.5	-0.1	-0.9	….
United Kingdom							
GDP	3.1	1.8	0.8	2.1	2.1	2.3	2.3
Household consumption (1)	3.5	1.7	0.1	0.8	2.1	3.2	1.2
General government expenditure	3.1	2.9	1.6	5.1	5.8	4.8	2.6
Gross fixed private investment	5.1	3.2	3.5	-0.1	11.4	-2.1	6.2
Change in stocks (3) (4)	0.1	-0.3	-2.3	..	-0.3	-1.7	1.7
Net exports (3)	-0.8	-0.1	2.0	0.6	-1.9	1.2	-1.8

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.

Throughout 2005 and in the early months of 2006 the Federal Reserve continued the action begun in the middle of 2004 to make monetary policy less expansionary. The target for the federal funds rate was raised by 0.25 percentage points at each Federal Open Market Committee meeting to 5 per cent on 10 May this year, and the Committee has warned that further increases may be needed to counter potential inflationary pressures due to the rise in the prices of energy and other raw materials and to the tight labour market. Futures contracts on federal funds indicate that operators expect a further 0.25 percentage point increase in the reference rate before the end of autumn.

Short-term interest rates, adjusted for the twelve-month change in the core personal consumption expenditure deflator, rose to 2.9 per cent in March of this year, in line with the average for the past thirty years.

The public finances improved in 2005 for the first time in four years, reflecting the partly temporary increase in revenues from taxes on corporate profits. While tax revenues rose by 14.6 per cent, federal expenditure, notably on defence and health, increased by 7.8 per cent, continuing the rapid rise of recent years. In fiscal 2005 ending in September, the gross federal deficit amounted to $318 billion, down from 3.6 to 2.6 per cent of GDP; the deficit for general government as a whole, which includes state and local governments, declined from 4.8 to 4.4 per cent. At the end of fiscal 2005 the total federal debt stood at 64.3 per cent of GDP, compared with 63.7 per cent in 2004, and the amount held by the public had risen from 37.2 to 37.4 per cent. According to the budget proposal presented by the Administration in February of this year the federal deficit should increase to 3.2 per cent of GDP in fiscal 2006.

After slowing towards the end of 2005, economic activity grew at an annualized rate of 5.3 per cent in the first quarter of 2006. Consumption picked up sharply (5.2 per cent) under the impetus of a marked recovery in demand for durables and rising employment. Fixed investment growth picked up to 9.3 per cent and the contribution to growth of the foreign sector improved thanks to the strong performance of exports, up 14.7 per cent. Against a 2.1 per cent rise in real disposable income, households' saving rate fell to –1.3 per cent.

Japan

GDP growth in Japan accelerated to 2.6 per cent in 2005, compared with 2.3 per cent in 2004, thanks to the considerable strengthening of domestic demand. In the spring of 2005 exports began once more to expand rapidly, driven by the worldwide cyclical upturn in demand for high-tech goods and the gains in competitiveness following the depreciation of the yen.

Household expenditure increased by 2.1 per cent, benefiting from the improvement in the labour market. The move to replace full-time with part-time workers ended in 2005 and the improved terms and conditions of contracts fostered a rise of 0.6 per cent in nominal wages, after four years of uninterrupted decline.

The strengthening of demand and rise in energy prices brought the decline in prices to a halt, and in the final months of 2005 the consumer price index finally turned upwards. In March 2006 the Bank of Japan, faced with evidence that the economy had overcome the deflationary phase of recent years, adopted a new operating target for monetary policy. The strategy maintained since 2001 of increasing liquidity on the basis of a reference level for the balance of financial institutions' current accounts with the central bank was abandoned in favour of a target for the overnight interest rate, which was fixed close to zero.

The monetary base grew by slightly less than 1 per cent in 2005, decelerating with respect to the 4.2 per cent recorded in 2004. The rate of growth in the broad monetary aggregate (M2+CDs) was close to 2 per cent throughout 2005. Bank lending to the private sector picked up in the summer of 2005, reaching a twelve-month rate of increase of 1.1 per cent in December and accelerating to 1.5 per cent at the beginning of 2006. No other positive changes in this indicator had been recorded since 1998, when it was first published.

The volume of excess liquidity, which is far more than needed to keep short-term interest rates close to zero, will be absorbed in the months to come. After the new monetary policy strategy was announced, the balance on financial institutions' current accounts with the central bank was almost halved, falling to ¥17,000 billion in May. The central bank's forecasts published at the end of April put the rate of consumer price inflation, excluding fresh food products, at 0.6 per cent for the new fiscal year. The three-month interest rates implicit in futures contracts on Euro-deposits in yen point to market expectations of a rise in reference rates of a total of 50 basis points by the end of 2006.

Budgetary policy in 2005 acquired a slightly less expansionary stance compared with the previous year. According to recent OECD estimates the public sector deficit was reduced from 6.3 per cent of GDP in 2004 to 5.2 per cent, although adjusting for cyclical effects virtually wipes out the improvement. The budget for fiscal 2006 makes provision for a further reduction in expenditure, partly from additional cuts in public investment, and for an increase in revenues as several tax concessions for households and firms expire. The government estimates that in fiscal 2006 the primary deficit will contract to 2.8 per cent of GDP, half a percentage point less than in 2005 but not enough to stabilize the large public debt, which stands at 158.9 per cent of GDP.

After a sharp acceleration in the last quarter of 2005, output slowed to an annualized rate of increase of 1.9 per cent in the first quarter of 2006. According to the Tankan survey in March, firms intend to increase their investment moderately during the current fiscal year, which ends in March 2007. They also believe that the excess labour supply and idle capacity have been virtually reabsorbed.

The EU and the economic convergence of the new members

Economic performances within the European Union continued to diverge. Overall, GDP growth slowed from 2.4 per cent in 2004 to 1.6 per cent last year. In the euro area, the deceleration from 2 to 1.3 per cent was due to the slackening of domestic demand and exports in the first half of the year; consumer price inflation held steady at just over 2 per cent.

In the United Kingdom output growth declined from 3.1 to 1.8 per cent, mainly owing to the slowdown in private consumption caused by the stagnation of house prices and the lagged effects of the monetary tightening in 2004. The Bank of England reduced the base rate by 25 basis points in August 2005 to 4.5 per cent and then kept monetary conditions unchanged. In the fiscal year ending in March 2006 there was only a small contraction in overall public sector net borrowing, to 3.2 per cent of GDP, despite increased revenue from the corporate income tax. The public debt, defined as in the Treaty of Maastricht, amounted to 42.6 per cent of GDP at the end of March, compared with 40.8 per cent a year earlier. GDP growth slowed in Sweden as well, from 3.7 to 2.7 per cent. This was due to the ebbing of the external sector's contribution, which had been particularly large in 2004, while private-sector consumption and investment strengthened in response to the favourable financial conditions. The substantial budget surplus rose from 1.8 to 2.9 per cent of GDP, owing partly to a temporary raising of taxation on corporate profits.

In the ten countries that joined the European Union in May 2004 economic growth remained generally robust in 2005, at 4.6 per cent overall (5.1 per cent in 2004), more than 3 percentage points above the euro-area average.

Over the past two years the convergence of macroeconomic aggregates towards the values necessary for eligibility for the single currency has proceeded unevenly. While some countries have achieved significant progress in curbing inflation, in the Baltic states the rapid reduction of interest rates fostered, among other things, by expectations of entry into the euro area did not allow upward pressures on prices to be satisfactorily contained. In the three largest countries (Poland, the Czech Republic and Hungary) convergence has been slower owing to the presence of large public sector deficits, especially in Hungary.

While consumer prices in the ten countries tended to accelerate in the first half of 2004, owing in part to the increase in regulated prices and energy costs, action to curb inflation was subsequently resumed by all except the Baltic states.

In most of the new EU members short and long-term interest rates have converged rapidly in the past two years towards the levels prevailing in the euro area, a process that has been assisted by expectations of joining the single currency and persistently relaxed world financial conditions. Only Hungary experienced financial market tensions in 2005 caused by the current and prospective deterioration in the public finances.

Between June 2004 and April 2005, six countries (Estonia, Lithuania and Slovenia, followed by Cyprus, Latvia and Malta) signed ERM II, and were joined by Slovakia in November of last year. The currencies of the first six, which were already virtually pegged to the euro, came under upward pressures in 2005, which were countered through the accumulation of foreign exchange reserves. The currencies of the other countries appreciated against the euro, helping to contain inflationary pressures. The only exception was Hungary, whose currency was weakened by the consequences of the large budget and current account deficits.

The main emerging countries

China. – In 2005 economic activity continued to expand at a rapid pace. According to the new national accounts system, GDP increased by 9.9 per cent, which is close to the average of 10.1 per cent recorded in the previous two years and slightly higher than the figure for the period running from 1993 to 2002 (9.8 per cent).

High as this long-term rate of economic growth is, it is not exceptionally so with respect to the past experience of other Asian countries. The rapid increase in labour productivity in China in the past twenty years has been due in almost equal parts to the formation of physical capital and to gains in technical efficiency, resulting to only a small extent from the reallocation of resources from agriculture to industry.

Economic activity drew further impetus from the surge in investment, which increased in 2005 by 25.7 per cent in nominal terms, after growth of 26 per cent in 2004. The deceleration in some branches of industry slowed the growth in imports of raw materials and intermediate goods, particularly in the first half of the year. However, investment began to grow rapidly once more from the summer of 2005 onwards, despite the credit restrictions introduced by the authorities in the spring of the previous year.

The external sector increased its contribution to growth thanks to the persistently strong performance of exports, which rose by 28.5 per cent in nominal terms, and the deceleration in import growth to 17.6 per cent. The merchandise trade surplus exceeded $130 billion in 2005, equal to 6 per cent of GDP, compared with around $60 billion in 2004.

Despite the rapid expansion in credit and the money supply, consumer price inflation remained extremely low – in April the twelve-month rate stood at 1.2 per cent – principally due to the slowing of food prices.

Investment, which represents a large and growing proportion of output (from 36 per cent in 2000 to 43 per cent in 2004), was increasingly financed out of corporate saving, with firms' own funds covering 54 per cent. The International Monetary Fund estimates that in 2005 gross national saving rose to 47 per cent of GDP.

Households account for over a third of national saving and their saving rate is extremely high even compared with countries with a similar level of economic development and a large rural proportion (some 60 per cent of the total in China). With the launch of a series of reforms at the end of the 1970s, private consumption gradually declined from 50 per cent of GDP at the beginning of the 1980s to around 40 per cent in more recent years.

In 2005, although inflows of foreign portfolio investment slackened, inflows of direct investment remained substantial. They amounted to $60 billion, the same as in 2004, and, together with the widening of the current account surplus, brought upward pressure to bear on the renminbi, which the authorities countered by further building up their foreign currency reserves.

Output continued to expand strongly in China in the first quarter of 2006, growing by 10.2 per cent on the same period of 2005, while the merchandise trade surplus widened from $17 billion to $23 billion.

In April of this year the authorities raised the interest rate on twelve-month bank loans by 27 basis points to 5.85 per cent, still not high enough to counter the substantial increase in domestic credit, and announced new measures to liberalize international capital movements for some national operators, such as banks, financial intermediaries and insurance companies. They also increased the maximum permissible amount of residents' foreign currency holdings from $8,000 to $20,000 per head.

India. – Output continued to grow at a rapid pace in 2005, increasing by 8.3 per cent compared with 8.1 per cent in 2004, mainly thanks to the 10 per cent expansion in the service sector, notably the ITC branch, which is highly competitive internationally. The rapid growth in manufacturing output (over 9 per cent) was driven partly by the acceleration in exports of textile products and clothing, following the liberalization of imports by the EU and the United States at the beginning of 2005. After stagnating in 2004 agricultural output increased moderately.

India's productive structure reflects the contrasts that characterize its society. Farming and the rural economy are still very important, with agricultural output constituting 20 per cent of GDP and some 70 per cent of the population residing in rural areas, often in extreme poverty and without basic public services. Although there have been improvements in the past ten years, 25 per cent of India's population, i.e. some 270 million people, live below the poverty line, compared with 36 per cent or around 320 million people in 1994; illiteracy is still very widespread, particularly in the countryside and among adult women, who have one of the lowest schooling rates in the world. By contrast, the availability of large numbers of highly qualified workers, trained in a system based on the British model, has fostered a rapid expansion of some innovative branches of the service sector. The share of services in GDP reached 60 per cent in 2005, a figure comparable with that of the advanced economies. In manufacturing, which accounts for barely 14 per cent of GDP, alongside the traditional branches of food processing and textiles an important role is played by capital-intensive and medium-tech industries, such as petrochemicals and engineering, which continue to be heavily subsidized by the State and sheltered from foreign competition.

The measures to liberalize the economy first introduced in the 1980s and extended in the 1990s spurred labour productivity growth from an average annual rate of 2.3 per cent in 1960-80 to 3.8 per cent between 1980 and 2000, mainly thanks to faster gains in technical efficiency. After slowing briefly in the early years of this decade, from 2003 per capita output grew at a steady rate of 6.2 per cent. The level of prosperity is very low, however: at $2,400 per annum, India's per capita income on a PPP basis is about half that of China.

Over the past decade the government has gradually abolished the barriers to trade and international financial flows that prevented India's integration with the world economy. By comparison with other countries, however, the openness of the Indian economy is still quite limited.

In 2005 exports of goods and services surged to a rate of growth of 24 per cent in volume, driven chiefly by the service sector, whose exports represent about half the total and grew by 48 per cent in volume. Because of the continuing restrictions on the activity of foreign investors and the lack of infrastructure, inflows of foreign direct investment amounted to just $5.6 billion in 2005, equal to barely a tenth of China's. On the other hand, the partial relaxation of controls on capital movements and the favourable financial conditions in the rest of the world boosted inflows of portfolio investment.

THE INTERNATIONAL FOREIGN EXCHANGE AND FINANCIAL MARKETS

Bond markets

In the United States, while official interest rates rose gradually during 2005, yields on ten-year Treasury bonds remained below the values recorded prior to the monetary tightening in June 2004, fluctuating between 4 and 4.5 per cent. From the middle of 2004 to the end of 2005 yields on ten-year index-linked government bonds and those adjusted for long-term inflation expectations based on Consensus Economics data ranged from 1.5 to 2 per cent.

Yields on US government securities began to pick up at the end of 2005, almost in parallel with short-term interest rates, rising overall by 0.7 points to 5.1 per cent. The slope of the yield curve in the United States, measured by the spread between ten-year and three-month spot interest rates, turned slightly negative in December 2005 and then remained close to zero.

The yield spread between ten-year US Treasury notes and the corresponding euro-area securities widened from almost nil in the autumn of 2004 to 1.2 percentage points a year later, before settling at around 1.1 points. On 18 May 2006 long-term interest rates in the euro area stood at 4 per cent. The spread between yields on US and UK securities, which had been –0.8 percentage points in the autumn of 2004, progressively narrowed, turning positive in September 2005 and settling at 0.5 points in April 2006. In Japan the yield on ten-year government securities, which had been less than 1.5 per cent since the end of 2004, began to rise in the summer of 2005 and reached 2 per cent in April of this year; this was the highest level since 1998 and reflected expectations of an imminent shift to a restrictive monetary policy and a rise in long-term interest rates in the United States.

The risk premium for US corporate bonds, after rising briefly in the spring of 2005 with the deepening of the crisis in the motor-vehicle industry, remained moderate throughout the rest of the year. This was partly due to the strengthening of firms' profitability and balance sheets, evidenced also 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 Treasuries settled at about 1.2 percentage points in the summer, while the spread on high-yield bonds was 3.9

points. However, the latter narrowed at the beginning of this year as investors sought higher yields, reaching 3.3 percentage points on 18 May despite the concomitant increase in the interest rates on government securities.

The stock markets

After the small gains recorded in the previous year, in 2005 share prices rose moderately in the United States and more steeply in the euro area, the United Kingdom and Japan. The substantial improvement in corporate profitability following the sweeping reorganizations of recent years, the growth in the world economy and the abundance of international liquidity contributed.

US share prices were virtually stationary in the first ten months of 2005. Since the end of October, the Standard and Poor's 500 index has risen by 5 per cent, while there has been no overall change in the Nasdaq 100 despite wide fluctuations. Firms used the large profits achieved in 2005 to buy back their own shares and to pay out large dividends.

Thanks to the growth in profits in recent years, the average price/earnings ratio, which had been fluctuating downwards since 2002, decreased even further from the beginning of 2005 onwards. Between 10 and 20 May it was around 19, close to the thirty-year average of 18.

Since early 2005 the European stock markets have recorded substantial gains: the Dow Jones Euro Stoxx has risen by 27 per cent and the UK's FTSE All Share index by 20 per cent. In Japan the 40 per cent gain in the Nikkei 225 was driven by the performance of bank shares, which rose 53 per cent in response to the improvement in the balance sheets of the leading banks.

In the financial markets of both the advanced and the emerging countries, share, bond and foreign exchange prices displayed low volatility in 2004 and 2005. Although it is not the first time this has happened in the past five to ten years, what makes this situation unique is the fact that it arose simultaneously on a large number of markets in different geographical areas.

The derivatives markets

The volume of derivatives traded on organized markets continued to expand in 2005 at a pace similar to the previous year's despite less uncertainty about the Federal Reserve's decisions and the low volatility of financial market prices. The notional value of futures contracts and options increased by 24 per cent, compared with 27 per cent in 2004. The amount outstanding of these contracts, nearly all of them relating to interest rates (the others concerned exchange rates and share indices) thus reached $57,800 billion, more than twice the GDP of the leading industrial economies. The increase in notional values mainly reflected the demand for short-term interest rate derivatives, which accounted for almost all of these instruments. Dollar-denominated futures and options, representing close to two-thirds of the market, increased more rapidly than those in euros (nearly a third of the market), with growth of 33 and 10 per cent respectively.

Investors also had significantly more recourse to instruments for transferring credit risk in 2005. Credit derivatives, consisting almost exclusively of credit default swaps, are the contracts that are spreading most rapidly in over-the-counter markets. According to estimates by the International Swaps and Derivatives Association, use of credit default swaps grew substantially last year: the amount outstanding rose to $17,000 billion, up by 103 per cent, compared with 123 per cent in 2004. Although the spread of credit derivatives has helped to strengthen the financial markets in recent years, supervisory authorities are concerned about the lack of infrastructure for trading in these contracts, including incomplete documentation and backlogs of unconfirmed transactions.

The gold and foreign exchange markets

Despite the further increase in the US current account deficit, the dollar appreciated against the other main currencies during 2005, benefiting from the widening of short-term interest rate spreads in favour of dollar-denominated assets; it gained 15.5 per cent against the euro and 14.8 per cent against the yen. The appreciation against the yen was partly due to the increase in flows of bank capital from Japan to America and the continuation of carry trades involving short-term borrowing in yen for reinvestment in public and private-sector securities denominated in dollars, which were encouraged by the still large short and long-term interest rate spreads between the two currencies. The dollar also gained 8 per cent against sterling. In nominal effective terms it appreciated by 3.5 per cent, reflecting its basic stability against the currencies of the emerging Asian economies, which are among the United States' main trade partners.

In the first ten months of 2005 the dollar held steady or rose slightly against the currencies of the main emerging economies of Asia; it later depreciated, even considerably against some currencies. From November

2005 the dollar lost 9 and 7 per cent respectively against the currencies of South Korea and Thailand and 5 and 4 per cent again those of Taiwan and the Philippines. It also depreciated by 4 per cent against the Malayan ringgit, which was pegged to a basket of currencies in July 2005.

On 21 July 2005 the Chinese central bank raised the central exchange rate parity with the dollar by 2.1 per cent to RMB 8.11 and announced the adoption of a more flexible mechanism to calculate the value of the currency. Subsequently the exchange rate vis-à-vis the dollar rose slightly, gaining 1.3 per cent by 20 May.

In order to counter the upward pressure on the renminbi, the Chinese authorities accumulated additional foreign reserves, which increased by a similar amount to the previous year ($207 billion). By the end of February of this year China had the world's largest foreign reserves, amounting to $854 billion. By contrast, the other Asian economies accumulated just over $30 billion, much less than in 2004 ($120 billion). The oil-exporting countries increased their foreign reserves by more than $115 billion, compared with $93 billion in 2004.

This build-up of reserves countered the appreciation of the currencies of the countries with large trade surpluses, thus delaying the re-absorption of international payments imbalances. On 22 April of this year the finance ministers and central bank governors of the G7 countries reaffirmed that exchange rates should reflect economic fundamentals and that excessive volatility and disorderly movements of currencies do not foster economic growth. In addition, they called for greater exchange rate flexibility on the part of the emerging countries with large trade surpluses, such as China.

The dollar, which had stabilized against the other main currencies at the beginning of 2006, depreciated during May and by the 20th of the month had fallen by 4 per cent against the euro to $1.28, and 5 per cent against sterling and the yen, to $1.88 and ¥112.

The price of gold, which had been rising since the beginning of 2001, accelerated sharply in the summer of 2005 to reach $644 per ounce at the end of April 2006, up by 50 per cent on the end-2004 price.

House prices

House prices continued to rise in 2005 in the United States and most of the euro-area countries. Adjusted for consumer price inflation, they rose at a similar rate to that recorded in 2004 in France (13.1 per cent), Spain (10.2

per cent), the United States (9.5 per cent) and Italy (7.4 per cent). In the United Kingdom, property prices remained basically unchanged from the middle of 2004 onwards, only picking up again in the last quarter of 2005.

In Germany house prices continued to stagnate in real terms. In Japan, although falling by 1.5 per cent on average in 2005, they stabilized in the second half of the year, halting the downward trend under way for more than a decade.

In the United States the rise in house prices led to an increase in households' real-estate wealth from 199 per cent of disposable income at the end of 2004 to 219 per cent a year later. In the same period households' debt rose from 112 to 120 per cent of disposable income, while their net wealth, including financial assets, rose by 20 percentage points to 576 per cent.

Mortgage refinancing slowed: in 2005 operations amounted to \$1,290 billion, compared with \$1,460 billion in 2004 and an average of \$2,150 in the previous two years. By contrast, there was a rise in new mortgages, which totalled \$1,486 billion, more than the average of \$1,230 billion recorded between 2002 and 2004. Despite continuously rising short-term interest rates, almost one third of mortgages granted in 2005 carried variable rates. Although they account for only about one fifth of the total outstanding amount (a small proportion compared with other countries), these mortgages are a source of vulnerability for American households as they are usually based on innovative repayment plans that reduce the cost of borrowing in the early years but increase interest payments in the future; they are also granted to households in lower income brackets and with a poor credit-rating.

Financial markets in the emerging economies

Conditions on the financial markets of the emerging countries remained relaxed in 2005. Risk premiums, measured in terms of the yield spread between long-term sovereign securities and US Treasury bonds continued to diminish in the emerging economies as a whole, falling from 3.5 to 2.4 percentage points at the end of the year. All regions were affected: in Latin America risk premiums fell from 4.2 to 2.7 percentage points, in Asia from 2.7 to 2.2 points and in Central and Eastern Europe from 2.2 to 1.5 points.

The narrowing of yield spreads reflected not only the stronger economic performance of these countries' economies but also international investors' search for higher returns in a situation of low interest rates and limited financial market volatility.

In recent years many of these countries have grown rapidly and achieved considerable progress, particularly in combating inflation, improving budget deficits and current account balances, reducing the cost of foreign debt and increasing their ability to generate the currency needed to service it. The result has been less likelihood of insolvency and a higher assessment of their creditworthiness, leading to better ratings by the main agencies. Many sovereign borrowers have restructured their debt and strengthened their balance sheets: Brazil, Colombia, Venezuela and Turkey have announced plans to retire short-term securities denominated in foreign currencies and exchange-rate-linked securities; in 2005 Brazil and Colombia made their first issues of international bonds denominated in domestic currencies.

With the decrease in foreign debt and consequent reduction in the volume of emerging countries' bonds coming onto international markets, investors have extended their search for high yields to these countries' domestic bond markets. According to the Bank for International Settlements, the latter's capitalization amounted to more than $3,000 billion in mid-2005, compared with around $630 billion for the international markets. The Asian markets account for over 60 per cent of all the securities in circulation, while the Latin American markets recorded the fastest rate of growth in the first six months of 2005 (20 per cent).

WORLD TRADE AND THE BALANCE OF PAYMENTS

World trade

World trade in goods and services at constant prices grew by 7.3 per cent in 2005, compared with 10.4 per cent the previous year. The slowdown, which was more pronounced than that in world GDP, was attributable mainly to the performance of the information and communications technology sector, which is highly integrated internationally and where production was weak throughout the first half of the year.

In the United States the rate of growth in imports of goods and services fell by almost half, from 10.7 to 6.3 per cent, and was slower than export growth for the first time in ten years; there was a particularly sharp deceleration in imports of intermediate industrial goods, which include oil products, and in those of capital goods. In Japan and the newly industrialized Asian economies, which are relatively specialized in the manufacture of high-technology products, import growth slowed down to 6.2 and 7.2 per cent respectively (from 8.5 and 16.8 per cent in 2004), owing partly to the need to reduce excessive stocks of electronic products. In the euro area the slowdown in imports, from 6.7 to 4.6 per cent, was in line with that in domestic demand.

The imports of developing countries did not behave uniformly; in energy-exporting countries the rate of growth accelerated from 13.9 to 18.3 per cent, while in the other countries it slowed from 16.2 to 11.1 per cent.

Overall, the growth in world exports was more evenly distributed between countries and areas than it had been in 2004. The exception was China; its exports, which now account for almost 7 per cent of the world total, rose by 23.6 per cent last year, more than three times the rate of growth in world trade. In Japan and the newly industrialized Asian economies the rate of export growth almost halved by comparison with 2004, to 6.9 and 9.3 per cent respectively, owing to the weakness of world demand in the electronics sector.

Driven by the capital goods sector, US exports increased by 7 per cent, in line with the growth in world trade; those of Latin America rose by 8.4 per cent (compared with 10.9 per cent in 2004), thanks to world demand for raw materials.

Exports from the European Union grew by 4.5 per cent, well below the rate of growth in world demand, and there were marked differences between countries: those of the euro area increased by 3.8 per cent, while the United Kingdom and the new member states recorded growth rates of 5.6 and 9.4 per cent respectively.

The continued hiatus in the current Doha Round of multilateral trade negotiations, which was launched more than four years ago, is generating pressure for the adoption of protectionist policies in the leading advanced economies and threatens to undermine the role of the World Trade Organization (WTO), the institution responsible for overseeing international trade and promoting further trade liberalization. For various reasons, not least the difficulty of reaching agreement among 150 member countries differing widely in terms of economic development, product market liberalization and efficiency of production, proposals for the conclusion of bilateral or regional trade agreements have proliferated, at the cost of serious economic inefficiency and the risk of further marginalizing the poorest countries.

Raw materials prices

Tensions in the oil market intensified in 2005. The price of crude oil (expressed by the average of the prices for the three main grades) rose from \$37.80 a barrel in 2004 to an annual average of \$53.40 last year, a rise of 41 per cent; it peaked at a monthly average of more than \$65 in September but fell back below \$60 towards the end of the year. Pressure built up again in the first few months of 2006; spot prices reached a record high of \$72.60 a barrel on 2 May. Futures contracts for WTI grade traded on NYMEX on 18 May indicated that prices are likely to increase from \$69.60 on that date to \$73.40 a barrel in December 2006. However, it should be borne in mind that the six-month forecasts that can be deduced from oil futures prices underestimated spot prices by an average of around \$4 between 1996 and 2004.

Whereas in 2004 the rise in oil prices had been due mainly to the strong and largely unexpected growth of 3.9 per cent in world demand for oil, in 2005 and this year, when the rise in oil demand has been more moderate (1.3 per cent), price pressure has stemmed mainly from the extreme short-term rigidity of supply. This can be attributed to the low investment and rationalization strategies of oil companies during the 1990s, partly in response to low oil prices, which had fallen to \$10 a barrel after the Asian crisis of 1997. Since the beginning of this decade the revival in investment in the oil sector as a whole has been more hesitant than might have been expected, given the large and almost continuous rise in the price of crude.

The rise in the world market prices of other raw materials, which had been very large in 2004 (18.5 per cent), remained substantial in 2005 (10.3 per cent) and in the first few months of 2006, reflecting the sharp increase in metals prices (26.4 per cent on average in 2005).

The increase in raw materials prices led to a marked improvement in the terms of trade of the large producers and exporters of primary products, most of which are developing countries. The ratio of oil prices to the dollar prices of manufactures exported by the G7 countries showed an increase of 38.2 per cent last year, compared with one of 20 per cent in 2004; the rise in the relative price of metals, calculated in the same way, was 23.3 per cent, compared with 25.5 per cent in 2004. By contrast, the prices of non-food farm products declined by 1 per cent and those of food products by 3 per cent relative to those of manufactures.

Global imbalances

The balance-of-payments disequilibria of the major countries and areas have increased significantly since the beginning of this decade, both in absolute terms and in relation to world output; they constitute one of the greatest threats to the future development of the world economy. This situation is the result of a number of factors, among which the following are worth mentioning: the strong growth in domestic demand in the United States, accompanied by a steady fall in households' propensity to save, which turned negative in 2005; the high saving rates in China and other emerging Asian countries, especially by comparison with the relatively low level of investment in the latter countries; and the rise in oil prices, which from 2003 onwards caused a massive transfer of resources from consumer to producer countries.

The present pattern of balance-of-payments disequilibria differs from that of the mid-1990s mainly on account of the exceptional increase in the current account deficit of the United States, equivalent to 1.8 per cent of world GDP in 2005, and the corresponding steady increase in the number of countries with substantial surpluses.

The current account surplus of the Asian economies as a whole increased from $356 billion in 2004 to $405 billion in 2005 (Table 2) owing to a rise in China's surplus, which more than doubled to $161 billion; those of Japan and the other Asian countries remained large ($166 billion and $80 billion respectively). Improvements in their terms of trade caused the surpluses of countries in Latin America and the Middle East to rise; the current account surplus of the oil-exporting countries as a whole, which invested a large proportion of their higher oil revenues in financial assets in international markets, rose from $189 billion to $347 billion.

Table 2

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

	Billions of dollars				As a percentage of GDP			
	2002	2003	2004	2005	2002	2003	2004	2005
Advanced countries								
United States	-475.2	-519.7	-668.1	-804.9	-4.5	-4.7	-5.7	-6.4
Japan	112.8	136.4	172.1	165.8	2.9	3.2	3.8	3.6
European Union	0.5	-8.0	-23.0	-109.5	..	-0.1	-0.2	-0.8
of which: euro area	*51.7*	*37.5*	*63.0*	*-28.0*	*0.7*	*0.4*	*0.6*	*-0.3*
United Kingdom	*-24.6*	*-26.2*	*-43.0*	*-57.6*	*-1.6*	*-1.4*	*-2.0*	*-2.6*
Newly industrialized Asian economies (NIEs) (1)	55.3	80.0	88.8	85.5	5.1	6.9	7.0	6.0
of which: South Korea	*5.4*	*11.9*	*28.2*	*16.6*	*1.0*	*2.0*	*4.1*	*2.1*
Developing and emerging countries								
Latin America	-16.0	7.1	17.7	29.6	-0.9	0.4	0.9	1.2
of which: Argentina	*8.6*	*7.7*	*3.3*	*5.4*	*8.9*	*6.3*	*2.2*	*1.8*
Brazil	*-7.6*	*4.2*	*11.7*	*14.2*	*-1.7*	*0.8*	*1.9*	*1.8*
Mexico	*-13.5*	*-8.6*	*-7.2*	*-5.7*	*-2.1*	*-1.3*	*-1.1*	*-0.7*
Venezuela	*7.6*	*11.4*	*13.8*	*25.4*	*8.2*	*13.7*	*12.5*	*19.1*
Asia	72.2	86.3	94.7	155.4	2.7	2.9	2.7	3.9
of which: ASEAN-4 (2)	*27.2*	*30.7*	*27.1*	*22.5*	*5.5*	*5.4*	*4.4*	*3.3*
China	*35.4*	*45.9*	*68.7*	*160.8*	*2.4*	*2.8*	*3.6*	*7.2*
India	*7.1*	*8.8*	*1.4*	*-12.9*	*1.4*	*1.5*	*0.2*	*-1.7*
Middle East	29.5	59.0	103.4	196.0	4.6	8.1	12.4	19.1
Russia	**29.1**	**35.4**	**58.6**	**84.2**	**8.4**	**8.2**	**9.9**	**11.0**
Memorandum items:								
Oil-exporting emerging and developing countries	**63.8**	**109.2**	**188.8**	**347.4**	**5.5**	**8.1**	**11.1**	**16.1**
Japan, NIEs and Asian developing countries	**240.3**	**302.7**	**355.6**	**404.8**	**3.1**	**3.6**	**3.8**	**4.1**

Sources: IMF, ECB, European Commission and national statistics.
(1) Hong Kong, Singapore, South Korea and Taiwan. – (2) Indonesia, Malaysia, the Philippines and Thailand.

As regards current account deficits, that of the EU rose from 0.2 to 0.8 per cent of GDP, but it is the expansion in the US deficit to $800 billion (6.4 per cent of GDP) that stands out. In 2005 the current account of the euro area swung into a deficit of $28 billion, thereby contributing to a reduction in global imbalances.

Since the beginning of this decade the underlying causes of the current account imbalance of the United States have been different from those that prevailed in the 1990s. As a counterpart to slower growth in investment, the national saving rate declined sharply; first, budgetary policy was made distinctly expansionary in order to counter the risk of recession after the bursting of the stock market bubble and the attacks of 11 September, and secondly the large increases in property values boosted household consumption, which rose by more than disposable income.

In the last three years the rise in the cost of imported oil products, which in 2005 accounted for over 10 per cent of total merchandise imports, caused the deficit to increase by the equivalent of more than one percentage point of GDP; despite having substantial domestic resources, the United States is highly dependent on imported energy, partly because over the last thirty years the US economy has made smaller gains in the efficient use of energy than the other leading industrial countries: the oil requirement per unit of output remains the highest, despite having halved since 1973.

In 2005 net inflows of private capital rose to $1,072 billion, compared with $1,045 billion in 2004, while according to data collected by the Bureau of Economic Analysis net inflows from foreign official bodies declined from $395 billion to $221 billion; only China continued to accumulate official reserves at the same pace as in 2004. Foreign financial investment was concentrated in bonds.

The net debtor position of the United States is likely to have increased to nearly 30 per cent of GDP in 2005, compared with 21.7 per cent at the end of 2004; the increase reflects not only the rise in the current account deficit but also the appreciation of the dollar, which reduces the dollar value of assets held abroad by residents.

Despite the rapid accumulation of net foreign debt, net investment income remained positive over the last ten years, albeit steadily declining to 0.1 per cent of GDP in 2005. This reflects the yield differential between the United States' foreign assets and liabilities, which can be put at about 1.5 percentage points in 2004. The differential is ascribable mainly to direct investment, as the ex post yield on US direct investment abroad, often in the more dynamic emerging economies, was four percentage points higher than that on non-residents' investments in the United States.

Net capital flows to emerging countries

Net inflows of private capital to emerging countries increased further, from $231 billion in 2004 to $254 billion last year, thus exceeding the levels reached before the Asian crisis in the second half of the 1990s (Table 3). The greatest beneficiaries were the countries of Central and Eastern Europe, which saw net inflows increase from $71 billion to $108 billion.

Table 3

NET CAPITAL FLOWS TO EMERGING COUNTRIES (1)

(billions of dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
	ALL EMERGING COUNTRIES (2)							
Net private flows	66.2	80.8	74.3	75.6	97.3	160.4	230.6	254.0
Direct investment	*159.0*	*177.6*	*167.5*	*180.3*	*149.5*	*157.5*	*184.3*	*212.3*
Portfolio investment	*42.9*	*72.7*	*17.6*	*-70.6*	*-78.6*	*-3.7*	*34.5*	*38.5*
Other investment	*-135.7*	*-169.5*	*-110.8*	*-34.1*	*26.5*	*6.6*	*11.8*	*3.2*
Net official flows	52.3	26.4	-46.0	-0.1	9.0	-61.5	-81.5	-138.6
	Asia (2)							
Net private flows	-53.8	3.1	6.5	19.6	20.8	63.5	120.3	53.8
Direct investment	*56.8*	*71.6*	*59.0*	*51.6*	*50.7*	*67.9*	*60.0*	*71.8*
Portfolio investment	*8.8*	*56.9*	*20.2*	*-51.2*	*-59.9*	*4.4*	*3.8*	*-31.1*
Other investment	*-119.4*	*-125.4*	*-72.8*	*19.1*	*30.0*	*-8.8*	*56.4*	*13.1*
Net official flows	19.6	1.8	-11.7	-11.7	4.6	-17.6	1.8	5.0
	Latin America							
Net private flows	71.2	44.7	49.9	23.1	-2.1	15.5	6.0	25.2
Direct investment	*61.5*	*65.9*	*69.6*	*66.8*	*45.0*	*35.1*	*48.1*	*51.2*
Portfolio investment	*25.6*	*1.3*	*2.6*	*-7.6*	*-14.9*	*-8.4*	*-13.9*	*27.6*
Other investment	*-15.9*	*-22.5*	*-22.3*	*-36.1*	*-32.2*	*-11.2*	*-28.1*	*-53.6*
Net official flows	14.2	6.4	-5.2	26.3	18.5	6.1	-7.1	-25.2
	Africa							
Net private flows	7.6	9.0	..	5.7	4.9	4.6	13.0	30.4
Direct investment	*6.3*	*8.6*	*7.6*	*23.0*	*13.3*	*14.9*	*15.1*	*23.2*
Portfolio investment	*4.3*	*9.1*	*-1.8*	*-7.6*	*-0.9*	*0.1*	*5.5*	*4.5*
Other investment	*-3.0*	*-8.7*	*-5.8*	*-9.6*	*-7.5*	*-10.4*	*-7.7*	*2.7*
Net official flows	5.3	3.8	2.7	-0.5	4.3	3.7	1.8	-6.6
	Middle East (3)							
Net private flows	15.6	0.2	5.5	9.2	4.1	7.9	12.2	11.4
Direct investment	*9.5*	*4.1*	*4.7*	*9.6*	*9.8*	*17.6*	*13.3*	*19.6*
Portfolio investment	*-2.3*	*0.7*	*3.3*	*-3.5*	*-5.1*	*-5.4*	*6.0*	*7.6*
Other investment	*8.4*	*-4.6*	*-2.6*	*3.1*	*-0.6*	*-4.3*	*-7.1*	*-15.8*
Net official flows	10.5	19.0	-27.4	-14.9	..	-39.7	-63.6	-87.9
	Central and Eastern Europe (4)							
Net private flows	27.2	37.0	39.7	11.6	53.5	52.3	71.0	108.2
Direct investment	*19.3*	*22.8*	*24.2*	*24.2*	*25.6*	*16.6*	*34.0*	*41.3*
Portfolio investment	*-1.3*	*5.7*	*3.2*	*0.5*	*1.8*	*6.1*	*27.4*	*28.8*
Other investment	*9.1*	*8.6*	*12.3*	*-13.1*	*26.1*	*29.5*	*9.7*	*38.1*
Net official flows	1.0	-2.6	1.8	5.9	-7.7	-5.3	-6.8	-8.5
	Countries of the former Soviet Union (5)							
Net private flows	-1.5	-13.1	-27.3	6.3	16.1	16.7	8.0	24.9
Direct investment	*5.6*	*4.7*	*2.3*	*5.0*	*5.2*	*5.4*	*13.7*	*5.2*
Portfolio investment	*7.8*	*-0.9*	*-10.0*	*-1.2*	*0.4*	*-0.5*	*5.7*	*1.0*
Other investment	*-14.9*	*-16.9*	*-19.7*	*2.4*	*10.6*	*11.8*	*-11.4*	*18.7*
Net official flows	1.7	-2.1	-6.3	-5.2	-10.7	-8.6	-7.7	-15.5
Memorandum item:								
Change in reserves (6)								
All emerging countries	-29.5	-101.3	-128.3	-127.1	-194.7	-351.6	-515.4	-580.2
of which: Asia	*-53.1*	*-88.2*	*-53.7*	*-90.2*	*-148.8*	*-226.5*	*-340.1*	*-281.9*

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.

Net flows of direct investment increased substantially, from $184 billion to $212 billion, reflecting increased confidence in the economic policies and growth prospects of emerging economies and the high level of corporate profits in the industrialized countries.

There were net inflows of portfolio investment for the second year in succession ($38 billion, compared with $34 billion in 2004). Gross bond issues amounted to $182 billion, compared with $135 billion in 2004, and were equally divided between sovereign and private issues. They increased significantly in all regions, particularly in Latin America (78 per cent) as a result of Argentina's return to the international markets following the debt restructuring carried out at the beginning of 2005. By the end of January 2006 the emerging countries as a whole had already made sovereign issues amounting to half the volume planned for the entire year. New issues of shares increased from $45 billion in 2004 to $78 billion.

In Asian countries net inflows of private capital decreased from $120 billion to $54 billion in 2005. Net inflows of direct investment rose from $60 billion to $72 billion, but there were net outflows of portfolio investment, owing mainly to diminished expectations that currencies in the area would appreciate following the revaluation of the renminbi in the summer.

The improved ratio of risk to return on emerging countries' bonds and the low correlation with yields on other classes of financial assets made such investments attractive. It is estimated that pension funds and insurance companies in industrialized countries purchased around $14 billion of foreign debt securities of emerging countries, 40 per cent more than in 2004; investment funds contributed a further $10.2 billion, compared with $3.2 billion in 2004.

INTERNATIONAL COOPERATION

International Monetary Fund financial assistance

In 2005 the International Monetary Fund approved fourteen financial assistance programmes for a total of 8.9 billion SDRs, or $13.1 billion, of which the main recipients were Turkey and Uruguay, which obtained 6.6 billion SDRs and 0.8 billion SDRs respectively. The IMF also granted 0.1 billion SDRs for emergency measures connected with natural disasters in the Maldives and Sri Lanka and for post-war reconstruction in Haiti.

The stock of IMF loans declined considerably with respect to the peak of 2002-03 and fell to the lowest level of the last twenty years. At the end of April 2006 the stock amounted to 23.1 billion SDRs, 39 billion SDRs less than at the end of 2004. The reduction was partly due to the early repayment of loans by some major borrowers, such as Brazil and Argentina, which paid off 10.8 billion SDRs and 6.7 billion SDRs respectively. More generally, it reflected the extremely favourable economic conditions in emerging market economies in the past two years, which reduced the demand for loans while making the IMF's terms appear less advantageous.

The geographical distribution of IMF financing remained highly concentrated. At the end of March 2006 the five largest borrowers (in order, Turkey, Indonesia, Uruguay, Ukraine and Serbia and Montenegro) accounted for 86.8 per cent of outstanding loans.

The IMF's revenues. – Under the present system, the IMF's revenues are strictly related to the amount of loans granted to member countries, which fell sharply in 2005, and to the level of interest rates on SDRs. In fact, the rate of charge on loans is set as a margin above the SDR interest rate; the margin, which is set on a yearly basis, is intended to cover the Fund's operating expenses and ensure a profit for allocation to loan loss provisions. The decline in the stock of loans made it necessary for the Fund to raise its rate of interest, which stood at 4.85 per cent in the first quarter of 2006, 1.7 points higher than in 2004. Nonetheless, the IMF estimates that its net revenue for the 2006 financial year, which it computes by deducting operating costs from gross income, will be well below target and that losses will be incurred in the years to come.

Faced with the decline in revenue, the Executive Board called on the Fund's departments to submit proposals for the 2007 budget hinging mainly on a suspension of allocations to reserves and, to a smaller extent, on an increase in the lending rate – even though this might encourage members to repay more loans early – while temporarily reducing the interest paid on members' reserve positions. In the medium term, if the decline in the stock of loans turns out to be structural, solving the IMF's revenue problems will require more drastic measures to reduce operating expenses. The Board has not yet drawn up a strategy for the medium term, given its implications not only for the present distribution of membership quotas, but also for the amount of funds destined to the low-income countries. These questions will be discussed at the Singapore meetings in September.

Structure and functions of the IMF

There has been a growing international debate in recent years concerning the need for a reform of the institutions created at Bretton Woods, particularly the IMF, to adapt them to the newly globalized economy and financial markets and to ensure better representation of the developing countries whose growth and transformation have been most rapid. At the meetings in Washington in September 2005 the Fund initiated a review of its strategic priorities, intending to submit, by September of this year, a set of reform proposals regarding its role in the international monetary system, changes in the assistance mechanisms, financial and otherwise, member countries' quotas and voting rights.

The IMF and the international monetary system. – The basic task of the Fund is to monitor the monetary, fiscal, financial and exchange rate policies of its members and the international financial system as a whole. At the meetings in April this year agreement was reached on the need for a thorough review of its surveillance activity. The objective should be to accord greater importance to multilateral and regional aspects and focus on exchange rate regimes, policies and performance, while basing surveillance of individual countries on principles of greater selectivity and simplification with emphasis on major issues, such as better coverage of financial sector problems and simplified procedures for countries whose economies are more stable and not of systemic importance.

New mechanisms of assistance for member countries. – In response to calls from several emerging countries the IMF has suggested introducing a new insurance-type instrument with which to prevent capital account crises and encourage suitable economic reforms. The instrument would provide a credit line, possibly for a substantial amount, to be drawn on in the event of a crisis by emerging countries with sound institutions and underlying economic conditions but vulnerable to sudden changes in expectations and thus in the direction of financial flows.

The International Monetary and Financial Committee has asked the Fund to examine the proposal in greater depth, not least in view of the difficulties encountered in the past by a similar instrument, the Contingent Credit Line, which was introduced in 1999 and abolished in 2003 for lack of use.

Urgent measures are also needed to adapt the Fund's role in sovereign debt restructuring by making the granting of loans conditional upon the definition of a clear medium-term macroeconomic framework and reviewing the Fund's policy of lending into arrears.

In October 2005 the Policy Support Instrument was introduced for low-income countries not in need of financial assistance but wishing to continue to collaborate with the Fund on a regular basis. This instrument involves a procedure similar to that of a normal financial assistance programme, but without disbursement of a loan. Its purpose is to signal the Fund's positive assessment of the economic policies pursued by the country concerned to donor countries, multilateral development banks and international financial markets.

In November 2005 the Exogenous Shocks Facility was introduced, aimed at low-income countries affected by events outside the authorities' control that impact negatively on the economy, such as a decline in the prices of exported raw materials, natural disasters, or war in neighbouring countries with serious repercussions for trade. The loan has a maximum duration of two years and preferential conditions. The ESF places less emphasis on programmes of broad structural reform, focusing instead on specific actions to tackle the effects of the shock.

Reform of governance. – This issue was the subject of broad international debate in 2005, it being widely recognized that if the Fund is to retain legitimacy its governance structure must reflect the changes that have occurred in the international context and ensure that all member countries have proper representation. At the meetings in Washington in April 2006 agreement was reached to increase the quotas of the countries most under-represented in relation to their positions in the world economy (China, Mexico, South Korea and Turkey). The Fund was asked to submit proposals before the meetings in Singapore in September 2006. As regards the Fund's governing bodies, there is consensus on the need to extend the Executive Board's powers of strategic direction and oversight, and to delegate certain non-essential operational functions to the management.

Poverty reduction initiatives and development finance

Poverty reduction. – The poor countries are still a considerable way from achieving the Millennium Development Goals. According to recent estimates the only goal that can realistically be achieved within the allotted time is the reduction of poverty measured in terms of income.

The prospects of achieving the human development goals are not encouraging, however. All the regions are behind with initiatives to reduce infant mortality and with at least one other goal. Two regions, southern Asia and, in particular, sub-Saharan Africa, are behind schedule on all the Millennium Development Goals.

In view of the unsatisfactory results to date the international community has reasserted its commitment to development. First, the advanced countries confirmed their intent to increase the current volume of official aid so that the target of 0.7 per cent of GNI can be reached by the end of 2015. The developing countries, for their part, are called upon to take advantage of the favourable cyclical phase to pursue economic policies more specifically aimed at reducing poverty and to improve the quality of their institutions and step up investment in infrastructure.

Close attention has been focused recently on governance in developing countries, which is crucial for achievement of the Millennium Development Goals. The additional financial commitments entered into by the donor countries over the next years must go hand in hand with the adoption by the beneficiary countries of principles of good governance and rigorous administration.

Increased aid and debt cancellation. – In purely quantitative terms and only insofar as the loans are current, debt cancellation constitutes a transfer of resources to a poor country, similar to aid as an instrument of development finance. The difference between debt cancellation and other forms of aid resides in the implications in terms of incentives for the beneficiaries.

Excessive borrowing can jeopardize a country's prospects of growth; the burden of the debt can swallow all the expected benefits of investment projects, discouraging them even when they do produce returns. At the same time, one should not underestimate the attendant moral hazard, which eventually could encourage excessive borrowing to the detriment of countries whose debtor position is more balanced as a result of their pursuing virtuous policies.

The international community has decreed that efforts should be intensified on both fronts, taking steps to ensure the efficiency of both aid and debt cancellation.

Official aid granted by the OECD members to developing countries amounted to $80 billion in 2004, equal to 0.26 per cent of the donor countries' GNI. This represented an increase on 2001 of 18 per cent in real terms, while in relation to GNI the amount remained basically the same. Early estimates for 2005 set aid at $106 billion, or 0.33 per cent of donors' GNI. Most of this increase was due to the cancellation of Iraq's and Nigeria's debt, amounting respectively to $14 billion and $5 billion.

On the basis of the donor countries' commitments, the OECD estimates that the annual flow of aid in 2010 will amount to $130 billion. This represents a $50 billion increase with respect to 2004, at least half of which will go to Africa. The ultimate goal of each donor country is to raise its aid to 0.7 per cent of GNI by 2015. All will need to make an exceptional effort to keep faith with their commitments, especially countries with very tight budget constraints or where official aid still represents a small proportion of GNI. Italy is one such country, having disbursed $2.5 billion of aid in 2004, equal to 0.15 per cent of its GNI. Estimates for 2005 point to a doubling of development finance, to $5 billion and 0.29 per cent of GNI. Italy has undertaken to raise this to 0.33 per cent in 2006.

In the area of debt cancellation the Heavily Indebted Poor Countries initiative has been flanked by the Multilateral Debt Relief Initiative. The latter involves the cancellation of some $50 billion of debt maturing over the next 40 years that the poorest and most heavily indebted countries owe to the International Development Association ($37 billion), the African Development Fund ($9 billion) and the IMF ($3.4 billion).

The initiative hinges on two elements: first, the donor countries undertake to repay the IDA and the ADF as the cancelled debts reach maturity in order to preserve those institutions' financing capacity; second, the donor countries must guarantee that the resources are genuinely additional, not funds raised to the detriment of amounts allocated during the IDA's and ADF's periodical replenishments.

INCOME, PRICES AND THE BALANCE OF PAYMENTS

The gross domestic product of the euro area grew by 1.3 per cent in 2005, compared with 2 per cent in 2004. The growth gap with the other main economies widened. The expansion in national demand was slower than in 2004 (1.6 per cent as against 2 per cent). Curbed by the appreciation of the euro in the first half of the year, export expansion also slowed, from 6.5 to 3.8 per cent; which was again well below the rate of increase in world trade (7.3 per cent).

Output growth was higher than the area average in Spain (3.4 per cent), about the same in France (1.2 per cent), lower in Germany (0.9 per cent) and nil in Italy. The differences depended on trends in national demand, which was lively in the first two countries, stagnant in the other two.

Given broad wage moderation, the expansion of economic activity sustained employment, which rose by 0.7 per cent on average despite a contraction of 0.2 per cent in Germany. In France and Italy employment increased by 0.4 and 0.2 per cent respectively. The area-wide unemployment rate came down to 8.6 per cent, reversing the upward trend that had started in 2001. The employment rate for the population of working age rose to 63.4 per cent, still far below the target of 70 per cent that the Lisbon Agenda set for the entire EU.

Consumer price inflation remained virtually unchanged in 2005 at 2.2 per cent. Excluding the most volatile items, it declined by 0.6 points to 1.5 per cent. The rise in energy prices was offset by slowdowns in administered prices and in the prices of services.

After slowing in late 2005, euro-area GDP accelerated again in the first three months of 2006, to grow by 0.6 per cent according to Eurostat's preliminary estimate. Qualitative indicators suggest that the pace will be maintained in the second quarter. The leading international institutions have revised their growth forecasts for the year upwards to about 2 per cent. There is still uncertainty about the transmission of the external cyclical impulse to national demand, especially household consumption. The absence of domestic cost pressures is the basis for forecasts of stable inflation, despite the risks connected with possible further rises in oil prices and the appreciation of the euro.

The Italian economy stagnated in 2005, falling further behind the rest of the euro area and the world economy. In the five years from 2001 to 2005 the average rate of GDP growth was 0.6 per cent, nearly one point a year below the area average. In per capita terms growth was practically nil, as a result of a statistical increase in population in connection with the regularization of immigrants.

The only sector in which value added grew in 2005 was services; in industry it contracted again. The index of industrial production fell by 1.7 per cent. Between 2000 and 2005 it fell by more than 4 per cent overall and by 8 per cent for industries that generate at least 40 per cent of their sales abroad.

In terms of aggregate demand, as in the preceding years the stagnation of economic activity was the result of weak domestic demand and persistent difficulty in increasing export sales.

Household consumption was almost unchanged. The share of disposable income saved, which is high by international standards, again increased slightly, to 14 per cent.

Investment in houses increased by 6.2 per cent. As a ratio to GDP, it was near the peak of the previous real-estate cycle. Contributory factors included rising house prices and the protracted expansion of demand, sustained by advantageous mortgage terms. Net of housing investment, gross fixed investment diminished by 2.3 per cent. The low degree of capacity utilization and the uncertainty about the course of demand worked to counter the impulse imparted by favourable financial conditions, in terms of both interest rates and self-financing.

Firms' caution reflects the difficulties they faced in domestic and export markets. Imports increased by 1.4 per cent in real terms in 2005 while exports stagnated, remaining more than three per cent below their level in 2001. Measured at constant prices, Italy's share of world trade continued to decline, falling to 2.7 per cent, compared with 3.5 per cent at the beginning of the decade. At current prices it remained essentially unchanged at just under 4 per cent.

The difference in export performance by volume and by value may signal a gradual shift in the composition of exports towards higher quality and higher unit prices and the abandonment of standard products for which the competition of the emerging economies is sharper. In some cases it presumably reflects a renunciation of the defence of market shares in order to widen short-term profit margins.

Between the end of 2000 and the end of 2005, Italy's cumulative loss of competitiveness came to 9 per cent on the basis of producer prices of manufactures and to 30 per cent on the basis of unit labour costs, which were affected above all by stagnant productivity. In 2005 value added per full-time equivalent worker increased by 0.4 per cent but remained lower than in 2001. In the last five years labour productivity was curbed by a fall in total factor productivity of about half a percentage point a year that reflected the structural weakening of the economy: small firm size, insufficient use of information and communication technology and inadequate improvement in human capital. There remain substantial obstacles to competition that decrease the opportunities for the growth of employment and productivity and increase the costs of the firms most exposed to competition.

With the common European currency, the Italian productive system's difficulties in coping with the intense competitive pressures on domestic and export markets translate more quickly into a worsening of the balance of payments. In 2005 Italy's trade surplus was eliminated, and the balance on current account, which has been negative since 2000, worsened to 1.6 per cent of GDP. In 1996 there had been a surplus of more than three points.

Consumer price inflation measured by the harmonized index eased marginally to 2.2 per cent. The differential with the other euro-area countries was eliminated, thanks in part to the decreased impact of rising oil prices. Core inflation fell by 0.3 points, which was less than the area average, to 2 per cent. The gap widened owing to more unfavourable trends in domestic costs.

At the beginning of 2006 the Italian cyclical rebound appeared to be in line with European trends. GDP growth accelerated in Italy as well in the first quarter (to 0.6 per cent according to Istat's preliminary estimate). The modest rise in the index of industrial production estimated for April and May suggests that the pace will be slower in the second quarter. The latest assessments of international organizations and the leading private forecasters put Italian growth in 2006 at almost 1.5 per cent, even after discounting the restrictive effects of the expected budget adjustment measures.

The latest indicators point to a modest recovery in consumption. There appears to be only a slight improvement in the outlook for investment according to ISAE's cyclical surveys and the annual survey performed in February by the branches of the Bank of Italy of industrial and service firms' investment plans for the year.

ECONOMIC CONDITIONS

The euro area

In the first five years of this decade average annual GDP growth in the euro area was 1.3 per cent per year, less than half the rate recorded in the second half of the 1990s, while in the rest of the world it remained above 4 per cent. The gap reveals the euro-area countries' delay in taking advantage of the rapid progress of technologies and international integration, with adverse effects on the growth of productivity. In 2005 GDP growth slowed to 1.3 per cent, from 2 per cent in 2004, primarily because of less stimulus from foreign demand. The shortfall with respect to estimated potential output widened.

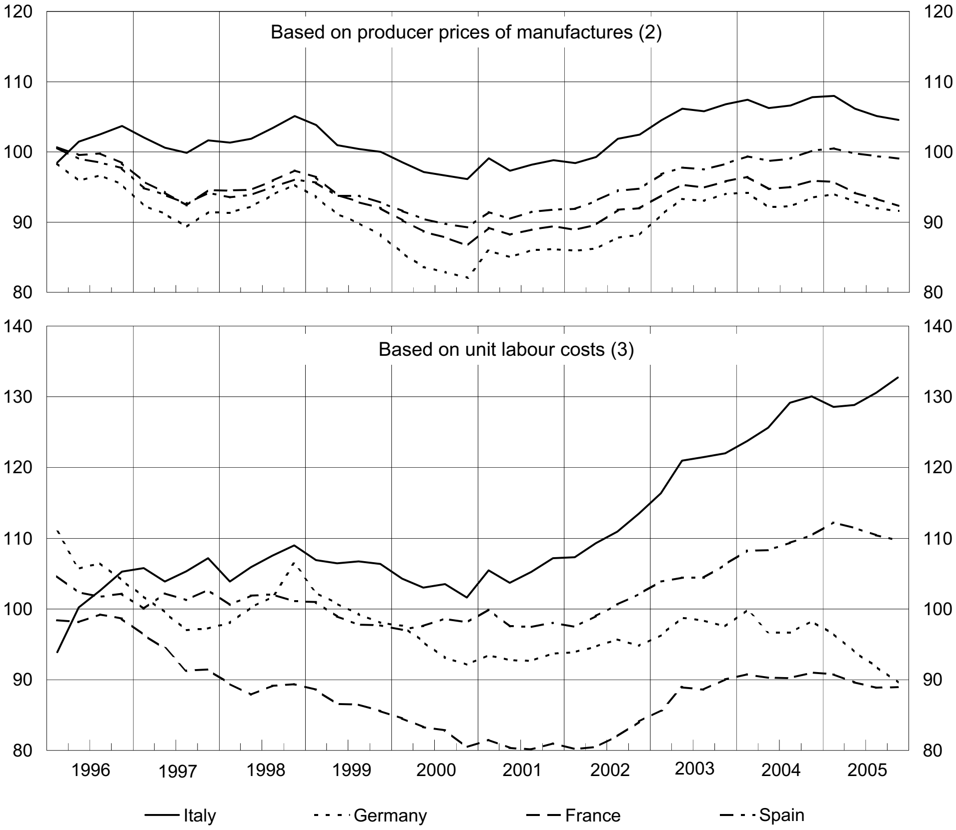
The annual increase in euro-area exports of goods and services, including intra-area flows, declined from 6.5 to 3.8 per cent in 2005. The deceleration was pronounced in all the main countries, though somewhat less so in France, and was due in part to the slight slowdown in world trade and the lagged effects of the loss of competitiveness suffered in 2004 (Figure 1). The area's overall share of world exports at constant prices continued to diminish, falling to 17.6 per cent, compared with 20 per cent in 2001.

Euro-area imports of goods and services, including flows between member countries, slowed from growth of 6.7 per cent in 2004 to 4.6 per cent in 2005. There was a sharp acceleration in the second and third quarters, coinciding with the recovery in the demand components, such as exports and investment, that involve a higher proportion of imported inputs. In France the marked expansion in imports caused net exports again to have a strong negative impact on GDP growth. As in Italy, in the euro area as a whole the negative effect was more limited; in Germany, by contrast, net exports helped to sustain growth, although their contribution was smaller than in 2004.

Euro-area household consumption increased by 1.3 per cent, breaking off the gradual acceleration that had begun two years earlier. The average annual increase in the first five years of this decade (1.3 per cent) was less than half the rate recorded in the second half of the 1990s; in the previous cyclical downturn, between 1988 and 1993, it was one percentage point higher. The differences between the leading countries widened last year, reflecting markedly disparate trends in disposable income.

Figure 1

INDICATORS OF COMPETITIVENESS OF THE MAIN EURO-AREA COUNTRIES



Source: Bank of Italy.

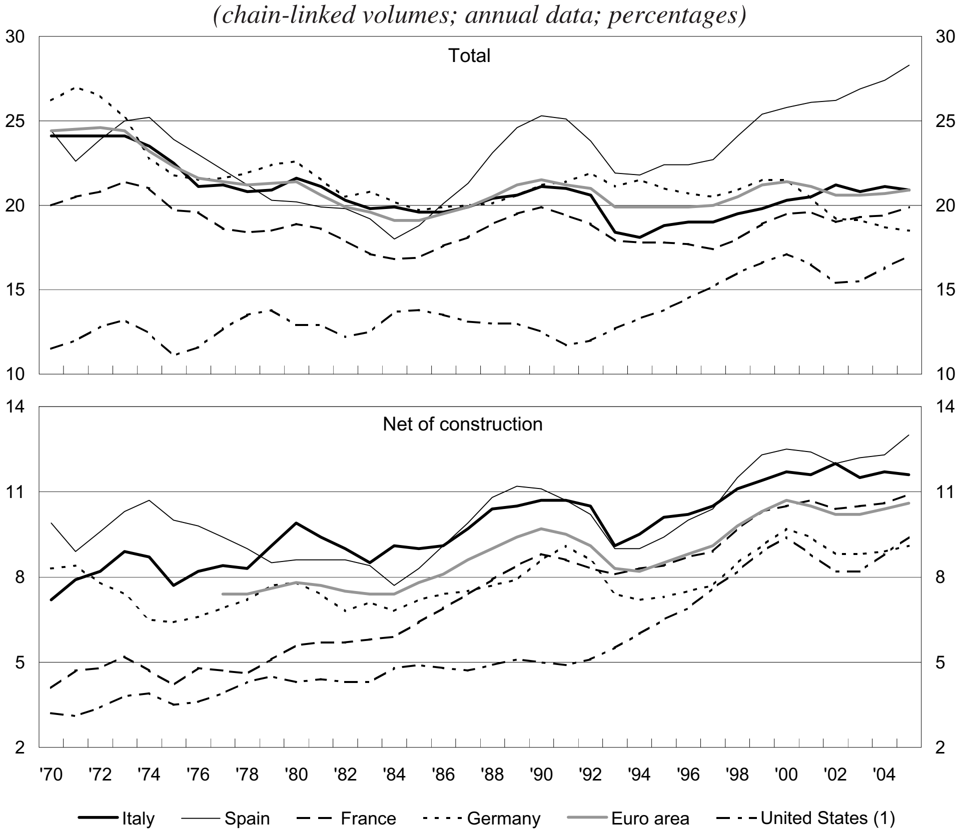
(1) Real effective exchange rate; an increase indicates a loss of competitiveness. – (2) Vis-à-vis 61 competitor countries. – (3) Vis-à-vis 24 competitor countries.

After accelerating in the second half of the year, euro-area gross fixed investment grew again at an average annual rate of just over 2 per cent in 2005. The increase was again larger for investment in machinery, equipment and transport equipment (3.2 per cent); the recovery of investment in construction was dampened by a new, acute contraction in Germany. The propensity to invest, measured by the ratio of total gross fixed investment to GDP, rose slightly in the area as a whole, reaching 21 per cent for the first time since 2001 (Figure 2). Together with the persistence of favourable financing conditions and profitability, there was a sharp improvement in the outlook for demand during the year. The ebbing of confidence that began in the autumn of 2004, largely because of uncertainty about the intensity of world economic growth, was overcome last summer as industrial firms offered increasingly positive assessments of the short-term performance of demand, especially foreign demand. The indicators of confidence continued to improve in the first few months of 2006, reaching the highest levels of the last five years.

Figure 2

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

(chain-linked volumes; annual data; percentages)



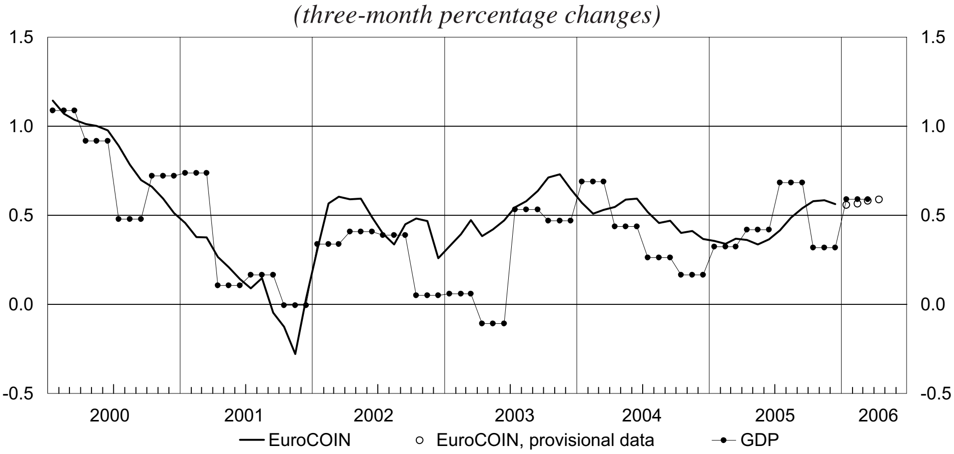
Sources: Based on OECD and Eurostat data.
(1) Private sector.

GDP growth in the euro area gradually strengthened during 2005, reaching an annualized rate of 2.8 per cent in the third quarter, higher than the estimated potential rate. It slackened once more towards the end of the year as a result of the stagnation in Germany and Italy and the slowdown in France.

More recent data point to a strengthening of cyclical conditions. According to preliminary estimates, in the first quarter of 2006 GDP grew by 0.6 per cent compared with the previous quarter both in the euro area as a whole and in Italy, with a more moderate increase in France and Germany. The recovery in the confidence of firms and, to a lesser extent, households has intensified everywhere since the start of the year. In the first four months the EuroCOIN coincident indicator of the euro-area business cycle, which provides an estimate of GDP growth adjusted for short-term fluctuations, remained broadly in line with long-term levels (Figure 3).

Figure 3

EUROCOIN INDICATORS
OF THE EURO-AREA BUSINESS CYCLE AND GDP
(three-month percentage changes)



Source: Center of Economic Policy Research.

Italy

Economic activity

Output stagnated in 2005, as in 2003 (in 2004 GDP had grown by 1.1 per cent; Table 4). In the five years 2001-2005 average annual GDP growth fell to 0.6 per cent (0.1 per cent in per capita terms), just over one third of the rate in the rest of the area and scarcely half the rate during the previous cyclical downturn between the peak of 1988 and the trough of 1993. Growth is impaired by the fact that Italian exporters find it increasingly difficult to benefit from the rapid expansion in world trade, owing to structural factors that hinder both the reorientation of supply towards technologically more advanced sectors and the improvement of the productive system's organizational and innovative capacities. The uncertain outlook made households and firms more cautious about increasing their spending plans, which were flat as a whole in 2005. As in the rest of the area, cyclical conditions improved during the year; GDP growth, which had been negative in the first half, turned positive in the second (1.2 per cent on an annualized basis) as exports and domestic final demand picked up.

After faltering again in the final months of 2005, industrial production rose by 1.5 per cent in the first quarter with respect to the previous quarter, coming into line with the trend in the rest of the area; this stimulated GDP

Table 4

ITALY: RESOURCES AND USES OF INCOME

	As a percentage of GDP in 2005 (volumes at previous-year prices)	2004			2005		
		Percentage changes		Contibution to GDP growth (chain-linked volumes)	Percentage changes		Contibution to GDP growth (chain-linked volumes)
		Chain-linked volumes	Deflators		Chain-linked volumes	Deflators	
Resources							
GDP	–	1.1	2.9	–	..	2.1	–
Imports of goods *fob* and services (1)	25.0	2.5	4.2	-0.6	1.4	7.7	-0.3
of which: goods	*19.9*	*3.3*	*5.0*	*-0.6*	*-0.1*	*8.7*	..
Uses							
National demand	99.6	0.9	2.9	0.9	0.2	2.6	0.2
Consumption of resident households	58.3	0.6	2.6	0.3	0.1	2.3	..
Consumption of general government and non-profit institutions serving households	20.4	0.6	4.2	0.1	1.2	3.2	0.2
Gross fixed capital formation	20.5	2.2	3.2	0.4	-0.6	2.5	-0.1
machinery, equipment and transport equipment	*10.1*	*3.5*	*2.2*	*0.4*	*-1.5*	*1.1*	*-0.2*
intangible assets	*0.9*	*0.9*	*0.1*	..	*-2.5*	*2.7*	..
construction	*9.6*	*0.9*	*4.6*	*0.1*	*0.5*	*3.9*	*0.1*
Change in stocks and valuables (2)	0.3	....	....	0.1	....	....	0.1
Exports of goods *fob* and services (3)	25.4	3.0	4.2	0.7	0.3	5.7	0.1
of which: goods	*20.3*	*2.8*	*4.5*	*0.6*	*-0.8*	*6.6*	*-0.2*
Net exports	0.4	....	....	0.1	....	....	-0.3

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

growth, which, according to preliminary data released by Istat, rose to 0.6 per cent after stalling in the fourth quarter of 2005. Industrial activity has continued to strengthen in the most recent months, albeit moderately by comparison with the sharp recovery in confidence displayed by firms (Figure 4).

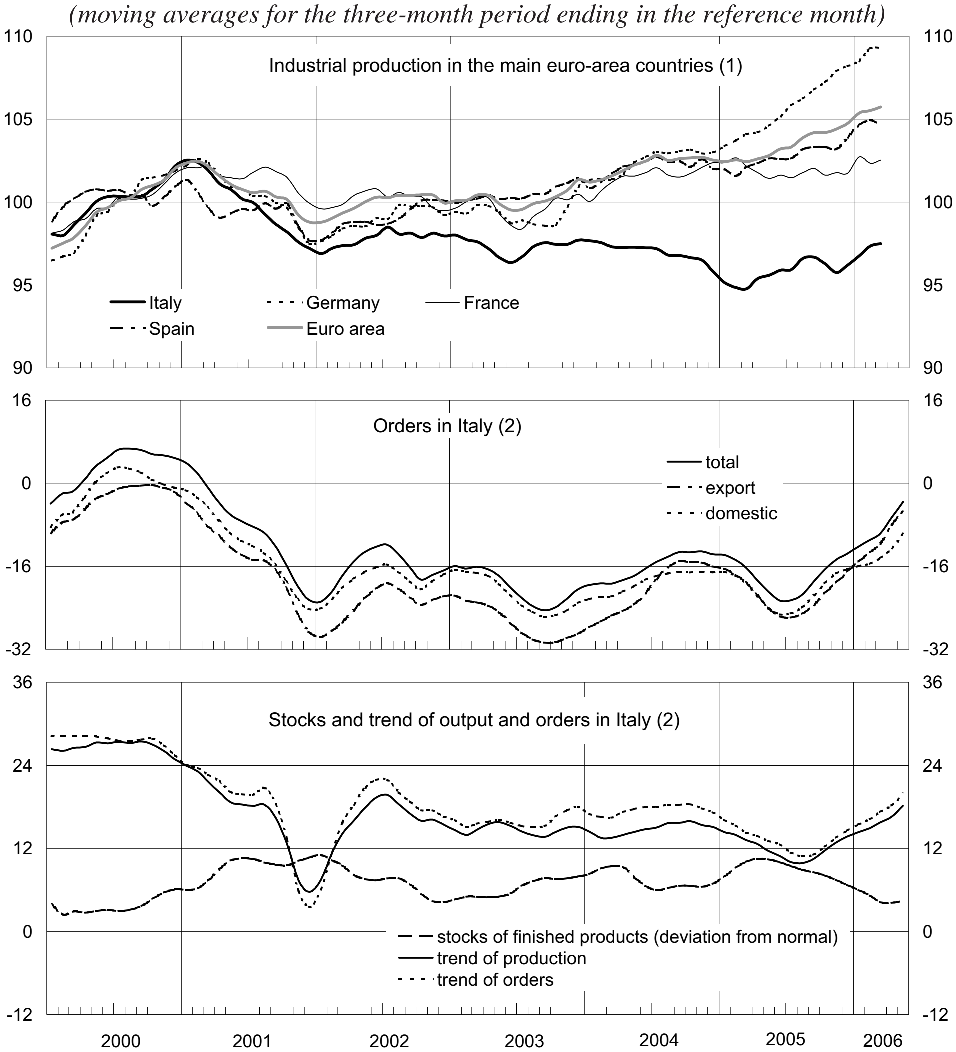
Household consumption

After slowing in 2004, the growth in household consumption basically ceased in 2005 (Table 5). Its average annual growth from the start of the decade was 0.5 per cent, nearly one percentage point lower than in the previous cyclical downturn.

Figure 4

INDUSTRIAL PRODUCTION, DEMAND AND STOCKS

(moving averages for the three-month period 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.

The fresh deceleration in consumer households' disposable income played a part. Istat has not yet released accounts of the institutional sectors consistent with the new national accounts. According to Bank of Italy estimates, in 2005 the growth in disposable income declined from 0.9 to 0.2 per cent in real terms and from 3.5 to 2.5 per cent at current prices. Taking into account the monetary erosion of net financial assets caused by expected inflation, households' purchasing power diminished by 0.2 per cent; in the last five years it expanded by 0.8 per cent per year, in line with its markedly low rate during the previous cyclical downturn.

Table 5

ITALIAN HOUSEHOLD CONSUMPTION

(chain-linked volumes, except as indicated; percentage changes)

	% share in 2000 (volumes at previous-year prices)	% share in 2005 (volumes at previous-year prices)	2002	2003	2004	2005
Non-durable goods	31.0	30.6	0.6	1.6	-0.5	0.7
of which: food and beverages	*15.3*	*15.1*	*-0.1*	*1.0*	*-0.5*	*1.8*
Semi-durable goods	12.4	11.0	-1.1	-1.5	-1.5	-3.7
of which: clothing and footwear	*9.0*	*7.8*	*-1.3*	*-1.5*	*-2.2*	*-4.9*
Durable goods	11.3	10.2	-0.9	0.1	5.2	0.6
of which: furniture and furnishings	*3.4*	*3.0*	*-1.0*	*-2.0*	*0.8*	*-3.0*
electrical household appliances and repairs	*1.2*	*1.1*	*-2.1*	*3.9*	*3.4*	*-1.9*
audio-visual, photographic, computer and telephony equipment	*1.9*	*1.8*	*1.4*	*5.9*	*19.1*	*10.3*
transport equipment	*4.3*	*3.9*	*-1.4*	*-0.2*	*4.1*	*-0.7*
Services	45.2	48.2	-0.1	0.6	1.0	0.2
of which: hotel and restaurant	*9.4*	*9.7*	*-1.7*	*-0.8*	*-0.2*	*0.5*
communication	*2.1*	*2.2*	*7.3*	*5.4*	*3.3*	*2.6*
recreational and cultural	*2.6*	*2.6*	*0.3*	*-0.4*	*9.3*	*-1.3*
healthcare	*1.8*	*1.6*	*-0.4*	*-1.2*	*-0.4*	*-1.7*
Total domestic consumption	**100.0**	**100.0**	**-0.1**	**0.6**	**0.7**	**-0.1**
Residents' consumption abroad	(1)	(1)	5.5	10.3	-6.0	6.8
Non-residents' consumption in Italy	(1)	(1)	-4.5	-4.7	1.2	-0.8
Total national consumption	**–**	**–**	**0.2**	**1.0**	**0.5**	**0.1**
Memorandum item:						
Deflator of national consumption	–	–	2.9	2.8	2.6	2.3

Source: Istat, national accounts.

(1) Residents' consumption abroad and non-residents' consumption in Italy amounted in 2000 to 1.6 and 4.2 per cent, respectively, of total domestic consumption; in 2005 the corresponding figures were 1.7 and 3.5 per cent.

Households' propensity to save rose for the fifth successive year, from 13.9 to 14 per cent (it had been 12.5 per cent in 2000). Measured on the basis of income adjusted for the expected monetary erosion of net financial assets, the propensity to save declined slightly to 11.6 per cent (compared with 10 per cent in 2000). Net new saving of €134 billion, together with the revaluation of financial assets and, to a greater extent, real estate, buoyed household wealth. On the basis of the revisions to the national accounts, at the end of last year household wealth was nine times the gross disposable income of consumer households.

In 2005 private-sector gross disposable income slowed from 3.5 to 1.9 per cent growth at current prices and contracted by 0.4 per cent in real terms. The growth at current prices for the household sector alone was smaller, reflecting the decrease in undistributed profits of enterprises, above all sole proprietorships. The propensity to save of the private sector as a whole declined slightly for the first time since the end of the 1990s. The national saving rate fell by 0.6 percentage points, returning to its 2003 level (Table 6).

Table 6

GROSS SAVING AND INVESTMENT IN ITALY

(as a percentage of gross national disposable income)

	Average 1981-1990	Average 1991-2000	Average 1996-2005	2002	2003	2004	2005
General government saving	-6.2	-3.3	-0.1	0.3	-0.9	-0.4	-0.5
Private sector saving	28.3	24.5	21.2	20.8	21.0	21.0	20.5
of which: consumer households	*21.8*	*14.4*	*10.3*	*9.1*	*9.4*	*9.5*	*9.6*
Gross national saving	22.1	21.2	21.1	21.1	20.1	20.6	20.0
Gross investment	23.0	20.3	20.5	21.4	21.0	21.1	21.1
Memorandum item:							
Balance of current account transactions with the rest of the world	-0.9	0.9	0.6	-0.3	-0.9	-0.5	-1.1

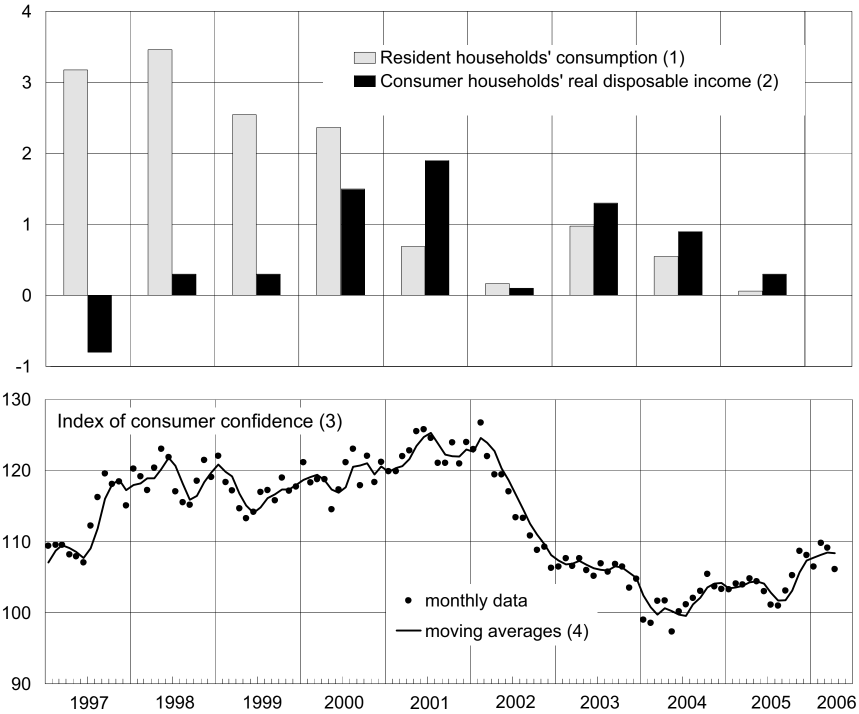
Sources: Based on Istat and Bank of Italy data.

The persistence of consumer caution also emerges from households' opinions regarding their personal prospects and the national outlook. According to the ISAE surveys, the climate of confidence fluctuated during 2005: a steady weakening in the first part of the year was followed by a rapid recovery until the autumn, when a fresh deterioration ensued. The signs of uncertainty continued into the first few months of 2006, with the index fluctuating upwards but remaining well below the values recorded in previous cyclical expansions (Figure 5).

Demand for semi-durable goods declined more sharply than in 2004, falling by 3.7 per cent. The contraction was especially large in the clothing and footwear sectors, which continue to account for a significant share of domestic supply. In five years semi-durable goods fell from 12.4 to 11 per cent of total household consumption, the largest decrease among the main expenditure items. The stimulus deriving from durable goods, which had been particularly strong in 2004, faded abruptly: the further increase in the high-tech-goods component was countered by a drop in spending on furniture and transport equipment. Consumption of services, whose share of the total in the new national accounts was revised up by 4 percentage points to 48.2 per cent, also slowed, growing by 0.2 per cent, compared with 1 per cent in 2004. It was curbed by the modest size of the increase in the transport and communications sector and the fall in spending on recreation and culture. In contrast with the trend, there was a moderate recovery in consumption of non-durable goods, especially food products; their contribution to total household consumption was positive by 0.2 percentage points.

Figure 5

CONSUMPTION, REAL INCOME AND CONSUMER CONFIDENCE IN ITALY



Sources: Based on Istat and ISAE data.

(1) Chain-linked volumes; 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.

Investment

After turning upwards in 2004, gross fixed investment declined by 0.6 per cent in 2005 (Table 7). Excluding residential building, it fell by 2.3 per cent. The contraction in investment was especially sharp for the machinery, equipment and transport equipment component, which fell by 1.6 per cent after showing an increase of 3.3 per cent in 2004.

Despite the persistence of low financing costs in the credit market, investment plans were held in check by the deterioration in profitability and, above all, by the existence of substantial spare capacity. The average capacity utilization rate was the lowest in the last six years (Figure 6), marking a new historic low in industries in which exports account for a substantial share of turnover. Net of depreciation, fixed investment fell by 7.2 per cent, after the slight increase of the previous year, but still remained close to the level recorded at the peak of the previous cyclical expansion.

Table 7

FIXED INVESTMENT IN ITALY

(chain-linked volumes, except as indicated; percentage changes and percentages)

	% composition in 2005 (volumes at previous-year prices)	Percentage change			As a percentage of GDP (1) (volumes at previous-year prices)		
		2003	2004	2005	2000	2003	2005
Construction	46.6	1.4	0.9	0.5	8.5	9.3	9.6
residential	*20.8*	*2.2*	*2.8*	*6.2*	*3.7*	*3.9*	*4.3*
other	*25.8*	*0.8*	*-0.4*	*-3.6*	*4.8*	*5.4*	*5.3*
Machinery and equipment	40.2	-2.3	4.4	-0.8	8.6	8.3	8.2
Transport equipment	9.0	-11.4	-0.3	-4.6	2.1	2.0	1.9
Intangible assets	4.2	-3.0	0.9	-2.5	0.9	0.9	0.9
Total gross fixed investment	**100.0**	**-1.7**	**2.2**	**-0.6**	**20.2**	**20.6**	**20.5**
Total excluding residential buildings	–	-2.5	2.0	-2.3	16.4	16.7	16.2
Total excluding construction	–	-4.1	3.3	-1.6	11.6	11.2	11.0
Total net fixed investment (2)	**–**	**-10.4**	**1.2**	**-7.2**	**6.6**	**6.2**	**5.8**

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

The steep decline in investment between mid-2004 and the start of 2005 was followed by a recovery in the middle months of the year and then a fresh decline in the last quarter –1.7 per cent compared with the third quarter). According to the ISAE surveys, after deteriorating sharply during the winter the climate of confidence among firms stabilized and then showed a marked improvement. However, businesses' assessments of demand were more cautious, reflecting a new onset of uncertainty towards the end of 2005. In the spring of this year both the current and the expected level of orders became more favourable.

In the first half of the decade non-construction investment grew at a very modest rate (0.4 per cent per year). The abrupt slowdown by comparison with the second half of the 1990s (4.9 per cent) was consistent with the weakening of demand. In 2005, however, the ratio to GDP of such investment remained unchanged with respect to five years earlier (11.6 per cent), while that of total investment rose slightly (20.9 per cent; Figure 2).

Investment in construction slowed again, from annual growth of 1 per cent to 0.6 per cent, owing entirely to the large drop in non-residential construction. This was due in part to the sharp reduction in civil engineering projects (primarily public works), after two years of expansion. According to the semi-annual survey of about 480 construction firms conducted by Bank of Italy branches in February and March of this year, in 2005 output of public works fell by an average of nearly 2 per cent in real terms, after growing by 3.5 per cent per year between 2002 and 2004.

Figure 6

CAPACITY UTILIZATION RATE, TREND OF INDUSTRIAL PRODUCTION AND ECONOMY-WIDE INVESTMENT IN ITALY

Sources: Based on Istat and ISAE data.

(1) Chain-linked volumes. Indices, 2000=100. – (2) Average of seasonally adjusted differences between the percentage of positive replies ("increasing") and negative replies ("decreasing") to ISAE business opinion surveys regarding the 3-month trend of production. Indices, 2000=100. – (3) Average of Bank of Italy's indicators (Wharton) and ISAE indicators for industrial sectors. Indices, 2000=100. Right-hand scale.

Investment in residential building expanded by 6.2 per cent, almost twice as fast as in 2004, and rose to 4.2 per cent of GDP, just below its level at the peak of the previous real-estate cycle in the early 1990s. This was partly a consequence of the rapid growth in demand, which has persisted for a decade, although there are recent signs of its easing. With mortgage loan conditions remaining advantageous, in 2005 the number of housing units sold reached a six-year high, growing by 3.6 per cent, compared with 5.5 per cent in 2004. Property prices increased by 7.6 per cent in real terms, compared with 6.3 per cent in 2004.

Exports and imports

Exports. – After recouping some ground in 2004, last year exports of goods and services grew by a mere 0.3 per cent, by far the smallest increase among the main European countries (Table 8). From 2000 Italian exports have fallen by an average of 0.6 per cent per year, compared with an average annual increase of 5.3 per cent in world trade and of 3.7 per cent in the exports of the other euro-area countries. During 2005 the performance of Italian exports fluctuated: the rise in April-June, the first in three quarters, was followed by a fall in the third quarter and a recovery in the fourth. According to the latest indicators, the recovery appears to have strengthened in the early part of this year.

Table 8

ITALY'S EXPORTS AND IMPORTS OF GOODS AND SERVICES

(percentage changes on previous year, except as indicated)

	2003			2004			2005		
	Goods	Services	Total	Goods	Services	Total	Goods	Services	Total
Exports (1)									
At current prices	-1.6	-1.4	-1.6	7.4	6.9	7.3	5.7	7.1	6.0
Chain-linked volumes	-2.3	-2.9	-2.4	2.8	3.9	3.0	-0.8	4.6	0.3
Deflators	0.7	1.5	0.9	4.5	2.8	4.2	6.6	2.4	5.7
Imports (2)									
At current prices	0.1	-0.9	-0.1	8.4	0.5	6.8	8.6	11.7	9.2
Chain-linked volumes	0.5	1.9	0.8	3.3	-0.4	2.5	-0.1	7.5	1.4
Deflators	-0.4	-2.8	-0.9	5.0	0.9	4.2	8.7	3.8	7.7
Exports/imports									
At current prices (% ratio)	103.7	96.8	102.3	102.8	102.9	102.8	100.1	98.7	99.8
Chain-linked volumes (% ratio)	98.8	91.6	97.3	98.4	95.6	97.8	97.7	93.0	96.7
Term of trade (indices, 2000=100)	105.0	105.6	105.1	104.5	107.7	105.1	102.4	106.2	103.2
Contribution of net exports to real GDP growth (3)	*-0.6*	*-0.2*	*-0.8*	*-0.1*	*0.2*	*0.1*	*-0.1*	*-0.1*	*-0.3*

Source: Istat, national accounts.
(1) Includes non-residents' consumption in Italy. – (2) Includes residents' consumption abroad. – (3) Percentage points.

The weakness of Italian exports reflects the structural factors underlying the unsatisfactory trend in productivity and the model of product specialization, which is still tilted towards low-tech sectors where the competition of emerging countries is greatest and the growth in world demand slowest. As a consequence, Italian exporters are finding it increasingly difficult to satisfy the robust demand originating from Italy's main outlet markets (Table 9).

Between the end of 2000 and the end of 2005 the price competitiveness of Italian goods, measured on the basis of the unit labour costs of manufactures, declined by 30 per cent, of which less than a third is attributable to the nominal effective appreciation of the euro. In the same period the competitiveness of French goods worsened by only 10 per cent and that of German goods actually improved by almost 3 per cent (Figure 1). The more unfavourable trend for Italy prevalently reflects the long-term deterioration in Italian industry's efficiency and ability to adapt to new technologies. A symptom of this is the structural decline in total factor productivity in nearly all sectors of Italian industry since the mid-1990s.

The widening gap in costs was not offset by Italian firms' export pricing policies. Prices applied in foreign markets increased more than

Table 9

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

(chain-linked volumes; percentage changes on previous year)

	2001	2002	2003	2004	2005
Germany					
Imports of goods and services	1.2	-1.4	5.1	7.0	5.3
Exports of goods and services	6.4	4.2	2.4	9.3	6.3
Outlet markets (1)	1.0	1.9	2.9	7.5	5.3
Indicators of competitiveness (2)					
overall	2.7	1.5	6.7	0.2	-0.4
export	2.7	1.9	7.1	0.3	-0.7
import	2.6	1.1	6.2	..	-0.2
France					
Imports of goods and services	2.2	1.7	1.1	6.6	6.1
Exports of goods and services	2.5	1.5	-1.2	3.9	3.1
Outlet markets (1)	1.0	1.4	3.5	7.5	5.2
Indicators of competitiveness (2)					
overall	0.7	1.8	4.9	0.6	-1.7
export	0.8	2.2	5.6	0.7	-2.0
import	0.6	1.4	4.2	0.4	-1.4
Italy					
Imports of goods and services	-0.2	-0.5	0.8	2.5	1.4
Exports of goods and services	0.5	-4.0	-2.4	3.0	0.3
Outlet markets (1)	1.1	1.5	3.5	7.9	5.6
Indicators of competitiveness (2)					
overall	1.3	2.2	5.3	1.2	-1.0
export	1.3	2.7	6.3	1.4	-1.3
import	1.2	1.7	4.3	0.9	-0.8
Spain					
Imports of goods and services	4.2	3.9	6.0	9.3	7.1
Exports of goods and services	4.0	1.8	3.6	3.3	1.0
Outlet markets (1)	1.1	1.0	2.6	7.0	4.9
Indicators of competitiveness (2)					
overall	1.2	2.4	4.3	1.8	0.4
export	1.1	2.8	4.9	1.9	..
import	1.2	2.1	3.8	1.7	0.7

Source: Based on national statistics.

(1) 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. – (2) Based on the producer prices of manufactures. A positive value indicates a loss of competitiveness.

those of goods sold on the domestic market, indicating that firms sought to defend profit margins in connection with improved demand conditions but also made greater efforts to ameliorate product quality, especially in non-traditional sectors.

Italy's share of world merchandise exports at constant prices has fallen from 4.6 to 2.7 per cent since 1995. The export performance is less negative when measured at current prices, the share having fallen from 4.6 per cent in 1995 to 3.7 per cent in 2005.

In 2005 the volume of exports of machinery and equipment declined and there was a further contraction, as in the four previous years, in that of both textile products and clothing and leather products and footwear. Foreign sales of furniture also decreased. By contrast, positive contributions to exports in volume terms came from refined petroleum products, chemicals, and basic metals and metal products.

Table 10

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					
	2004			2005			2004			2005		
	% composition of values in 2004	% change in AUV	% change in volumes	% composition of values in 2005	% change in AUV	% change in volumes (2)	% composition of values in 2004	% change in AUV	% change in volumes	% composition of values in 2005	% change in AUV	% change in volumes (2)
EU countries	**60.0**	**4.5**	**1.7**	**59.2**	**5.5**	**-1.2**	**60.4**	**4.0**	**2.4**	**57.8**	**5.2**	**-1.3**
EU-15 countries ...	54.2	4.4	2.3	53.4	5.2	-1.1	56.5	4.1	1.8	53.5	5.3	-2.5
France	*12.4*	*4.7*	*2.1*	*12.4*	*5.7*	*-0.3*	*11.0*	*4.7*	*0.2*	*10.0*	*4.8*	*-5.2*
Germany	*13.6*	*3.6*	*0.7*	*13.3*	*3.2*	*-0.5*	*18.0*	*3.6*	*4.3*	*17.3*	*3.7*	*0.9*
United Kingdom .	*7.1*	*5.3*	*2.9*	*6.5*	*4.0*	*-6.9*	*4.3*	*0.7*	*-4.1*	*4.0*	*5.8*	*-4.8*
Spain	*7.3*	*5.7*	*3.7*	*7.5*	*6.4*	*2.1*	*4.7*	*4.1*	*0.1*	*4.2*	*6.9*	*-8.3*
New EU countries .	5.8	5.2	-4.0	5.8	8.3	-2.3	3.9	2.6	13.0	4.4	5.6	14.2
Non-EU countries	**40.0**	**3.9**	**4.9**	**40.8**	**8.3**	**-0.8**	**39.6**	**6.1**	**5.3**	**42.2**	**14.6**	**0.9**
China	*1.6*	*2.5*	*12.5*	*1.5*	*10.2*	*-5.8*	*4.1*	*1.4*	*22.0*	*4.6*	*1.9*	*17.5*
Japan	*1.5*	*6.2*	*-5.7*	*1.5*	*7.9*	*-3.0*	*1.9*	*0.5*	*4.2*	*1.6*	*1.1*	*-10.8*
DAEs (3)	*3.2*	*1.6*	*2.5*	*3.0*	*7.5*	*-6.0*	*2.6*	*4.4*	*11.2*	*2.7*	*4.0*	*6.5*
Russia	*1.7*	*3.1*	*24.8*	*2.0*	*5.9*	*15.3*	*3.4*	*6.8*	*11.2*	*3.8*	*29.7*	*-6.2*
United States	*7.9*	*-0.7*	*2.9*	*8.0*	*10.1*	*-3.3*	*3.5*	*2.5*	*-5.0*	*3.5*	*9.0*	*-1.7*
Total	**100.0**	**4.2**	**3.0**	**100.0**	**6.6**	**-1.0**	**100.0**	**4.8**	**3.6**	**100.0**	**9.0**	**-0.5**

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 tax declarations. – (2) For EU countries, changes in volumes for 2005 are calculated on the basis of deflated AUV data. – (3) Dynamic Asian economies: Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand.

Italian exports to other EU countries fell more steeply than those to the rest of the world (Table 10). They declined in Germany and France by 0.5 and 0.3 per cent respectively, and more sharply still in the United Kingdom (–6.9 per cent). The volume of sales also diminished in the ten new members of the EU (–2.3 per cent), owing to a fall both in electrical equipment and precision instruments and in transport equipment. Exports to non-EU countries contracted in 2005 in all the main markets except Russia, where they grew by 15.3 per cent.

Imports. – The annual increase in imports of goods and services eased from 2.5 to 1.4 per cent in 2005, primarily reflecting the smaller stimulus deriving from domestic demand and from exports. The contribution of net exports to the change in GDP was negative by 0.3 percentage points in 2005; in the first half of the decade it was negative by an average of 0.4 points each year.

While Italian imports from the rest of the EU declined, those from non-EU countries rose slightly, mainly as a consequence of purchases from China, which increased by 17.5 per cent, and, to a lesser extent, from the other emerging economies of Asia. Imports from China rose from 4.1 per cent of the total value of Italian imports in 2004 to 4.6 per cent in 2005. China confirmed its place as Italy's leading supplier of manufactures outside the EU, while for Germany and France the leading non-EU supplier remains the United States.

THE STRUCTURE OF ITALIAN DOMESTIC SUPPLY

Economic sectors and value added

Total value added at factor cost was held down by the 2.3 per cent reduction in that of industry excluding construction, recording zero growth in real terms in 2005 (Table 11). During the long period of economic weakness beginning in 2001, industrial value added declined by 1 per cent per year. In manufacturing the fall was sharper, 1.3 per cent per year (2.2 per cent in 2005). The very poor performance of traditional manufacturing industries was confirmed with contractions of 8.9 per cent in textiles and clothing and 11.7 per cent in hides and leather products. Value added growth in construction slowed significantly to 0.7 per cent, compared with 2.8 per cent in 2003 and 2004.

In the service sector value added rose by 0.8 per cent, as in 2004. In transport and communications it increased by 3.7 per cent, confirming the positive trend of previous years. In monetary and financial intermediation it increased by 2 per cent, which was slightly more than in the past. In wholesale and retail trade it grew at the modest pace of the previous year; in business services it declined for the third consecutive year.

The gross primary energy requirement increased by 1 per cent, down from 1.5 per cent in 2004. Domestic energy production contracted by 4.2 per cent while net imports rose by 0.7 per cent. The energy intensity of GDP rose by 1 percentage point, continuing the upward trend that began in 2003.

The balance between new entries and deletions in the Chamber of Commerce register of non-farm companies was positive by nearly 90,000, about the same as in 2004. By the end of the year the number of businesses registered had risen by 1.3 per cent. Net new business creation was positive in all geographical areas. As in recent years, it was faster in the South (1.6 per cent). About one quarter of businesses are owned by women, slightly less than in 2000.

Table 11

VALUE ADDED AT FACTOR COST IN ITALY

	2004		2005		Percentage changes			
	Current prices (millions of euros)	Share of value added (%)	Current prices (millions of euros)	Share of value added (%)	Chain-linked volumes		Deflators	
					2004	2005	2004	2005
Industry	**329,316**	**27.3**	**328,654**	**26.7**	**1.6**	**-1.7**	**3.2**	**1.5**
Industry excluding construction	**258,197**	**21.4**	**254,162**	**20.7**	**1.3**	**-2.3**	**2.5**	**0.8**
Mining and quarrying	4,814	0.4	4,877	0.4	1.4	-1.7	3.2	3.0
Manufacturing	229,112	19.0	224,687	18.3	0.8	-2.2	3.0	0.2
Production and distribution of electricity, gas, steam and water	24,271	2.0	24,598	2.0	6.5	-4.1	-1.4	5.7
Construction	**71,119**	**5.9**	**74,492**	**6.0**	**2.8**	**0.7**	**5.3**	**4.1**
Services	**847,525**	**70.0**	**870,635**	**70.8**	**0.8**	**0.8**	**2.8**	**1.9**
Wholesale and retail trade, repairs	141,805	11.7	141,997	11.5	0.4	0.3	0.5	-0.2
Hotels and restaurants	45,794	3.8	47,832	3.9	1.6	2.8	4.1	1.6
Transport, storage and communication services	93,346	7.7	96,957	7.9	1.8	3.7	2.5	0.1
Financial intermediation services (1)	55,386	4.6	55,200	4.5	1.7	2.0	-0.4	-2.3
Services to businesses and households (2)	264,164	21.8	273,375	22.2	-0.6	-0.3	5.4	3.7
Public administration (3)	76,722	6.4	78,758	6.4	-0.3	-0.3	6.4	3.0
Education	58,191	4.8	61,120	5.0	-1.1	1.7	-0.7	3.3
Health and other social services	66,334	5.5	69,138	5.6	2.4	1.9	4.6	2.3
Other community, social and personal services	34,377	2.8	34,337	2.8	8.6	-3.1	-6.5	3.1
Private households with employed persons	11,406	0.9	11,921	1.0	4.5	2.0	2.0	2.5
Agriculture (4)	**32,504**	**2.7**	**30,995**	**2.5**	**13.6**	**-2.3**	**-9.5**	**-2.4**
Total	**1,209,345**	**100.0**	**1,230,284**	**100.0**	**1.3**	**0.0**	**2.5**	**1.7**

Source: Istat.

(1) Includes insurance and pension funds. – (2) Real estate, rentals, computers, research and other professional and business services. – (3) Includes defence and compulsory social security services. – (4) Includes forestry and fishing.

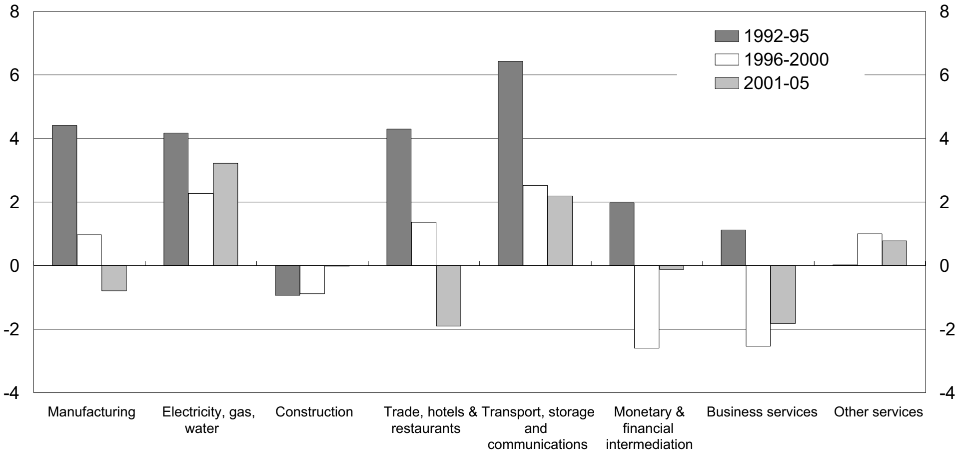
The productivity decline

The growth in Italian labour productivity, which had averaged more than one per cent a year in the second half of the 1990s, came to a halt in the first five years of the new decade, compared with gains of 1.1 per cent in France and 1.2 per cent in Germany. The decline affected most branches of the Italian economy (Figure 7). Productivity fell by 0.8 per cent per year in manufacturing industry, 1.8 per cent in business services, 1.9 per cent in distribution and hotels and 0.1 per cent in monetary and financial intermediation. In France and Germany, meanwhile, it rose by 2.4 per cent and 3.7 per cent respectively in industry excluding construction and by 0.9 and 0.3 per cent in the service sector.

Figure 7

GROWTH OF LABOUR PRODUCTIVITY BY ECONOMIC SECTOR

(annual averages, percentages)



Source: Istat, *Contabilità nazionale.*

Innovation is decisive for the growth of productivity. Italian spending on R&D was 1.1 per cent of GDP in 2003, slightly less than in 2002 and significantly less than in France (2.2 per cent), Germany (2.5 per cent) and the European average (1.8 per cent). The gap is especially wide in business R&D spending.

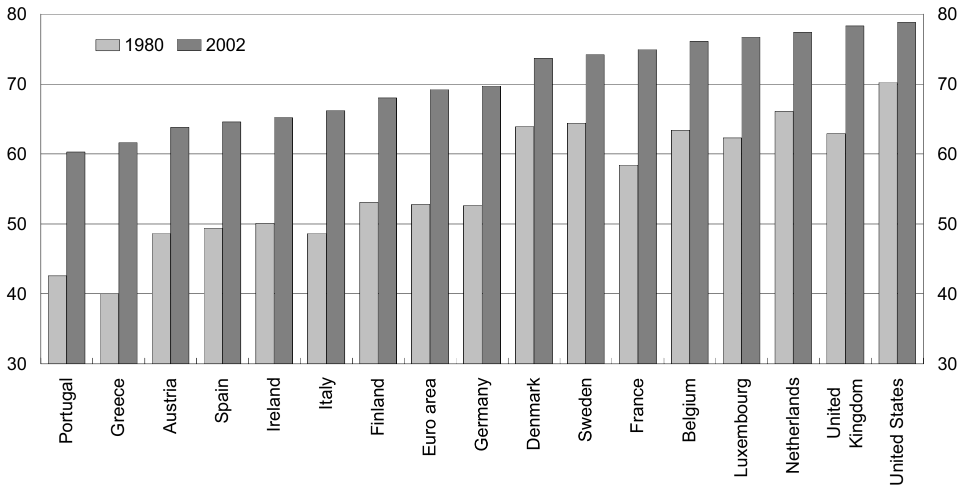
The lack of innovative capacity does not depend chiefly on product specialization but on the small size of Italian firms. Small firms have less propensity to innovate, and this is reflected in lower productivity growth. According to Istat's company accounts system, between 1998 and 2003 productivity growth in firms with fewer than 20 workers was considerably less, in all branches, than in larger firms. In manufacturing, moreover, there was an increase in the share of total employment accounted for by those smaller firms, where productivity is structurally lower. In the private non-financial service sector, larger firms succeeded in increasing both the total number of man-hours worked and, albeit marginally, their level of productivity, but not enough to offset the decline among small firms.

Productivity and competition in the service sector

Substantial barriers to competition keep the European economies from making the most of the opportunities that the service sector offers for employment and productivity growth. According to the OECD, the share of persons employed in services rose appreciably in all European countries between 1980 and 2002, when it reached 66.2 per cent in Italy, 74.9 per cent in France, 69.7 per cent in Germany, and 69.2 per cent in the euro area. The share is nonetheless still significantly lower than in the United States (78.8 per cent; Figure 8). The gap is especially wide in public and personal services (27.5 per cent in Italy, 29.4 per cent in the euro area, 32.3 per cent in the United States) and in financial intermediation (2.7 per cent in Italy, 3 per cent in the euro area and 4.4 per cent in the United States).

Figure 8

SHARE OF EMPLOYMENT IN THE SERVICE SECTOR, 1980-2002 (1)



Sources: OECD, *Stan database*; ECB, *Competition, productivity and prices in the euro area service sector*, 2006.
(1) For the United States, data are for 1980 and 2001.

The smaller incidence of the service sector is accompanied by a productivity growth gap. Since the mid-1990s the gains in productivity in services have been especially rapid in the United States and modest in Europe (Table 12). The difference is greatest in the sectors where information and communications technology has radically changed production processes, such as retail and wholesale trade and financial intermediation. The gap is particularly wide for Italy, where the growth in productivity since the mid-1990s has been practically nil.

Sharper competition in Europe would help to improve efficiency in the service sector, speeding up the introduction of new technologies, the resulting reorganization of production and the entry of more efficient competitors. Despite the progress made in the 1990s, there is still ample scope for increasing competition in many service industries.

Resistance to liberalization was manifest during the drafting of the EU directive on services, whose innovative content was progressively diluted in the course of its legislative passage. Liberalization policies remain primarily under the discretionary powers of national governments.

Table 12

GROWTH OF LABOUR PRODUCTIVITY IN THE SERVICE SECTOR (1996-2003) (1)

(annual averages, percentages)

	Germany	Spain	France	Italy	United Kingdom	Euro area (2)	United States (3)
Market services	**1.24**	**-0.17**	**0.70**	**0.00**	**0.67**	**0.68**	**3.23**
Wholesale and retail trade, hotels and restaurants	-0.28	-0.37	0.80	-0.50	2.19	0.21	5.18
Transport and storage	1.51	0.83	0.96	0.05	-0.84	….	0.72
Post and telecommunications	14.75	5.00	7.67	10.95	-4.96	….	4.17
Monetary and financial intermediation	3.53	1.56	1.81	0.76	-1.54	2.50	5.16
Real estate, rentals, other professional and business activities	-2.01	-2.90	-0.89	-2.26	0.39	-2.06	-0.13
Other service activities	**-0.02**	**0.50**	**0.23**	**0.71**	**2.70**	**-0.01**	**-0.02**
Total services	**0.94**	**0.14**	**0.66**	**0.38**	**1.38**	**0.59**	**2.33**

Sources: OECD, *Stan database*; ECB, *Competition, productivity and prices in the euro area service sector*, 2006; the figures for Italy are calculated on the basis of the national accounts data released in 2006.

(1) Productivity is defined as sectoral value added divided by the total number of persons employed in the sector. – (2) Includes Ireland only from 2002 onwards. – (3) For the period 1996-2001.

The effects of retail trade reform in Italy. – Legislative Decree 114/1998 (the Bersani law) reformed the regulation of retailing, delegating to the regions the power to authorize the opening of large retail outlets. The regions have used this power in highly disparate fashion. The empirical evidence shows that where regions have enacted stricter entry barriers for new outlets, this has worked to the advantage of existing enterprises at the expense of efficiency, the spread of new technology, consumers and employment.

Privatization and public utilities

Privatizations. – The privatization of publicly controlled companies resumed in 2005. The total proceeds of the sale of shares held directly or indirectly by the Ministry for the Economy and Finance and by local authorities, including purchases by Cassa Depositi e Prestiti S.p.A., amounted to more than €18 billion, an increase of €5 billion on 2004.

The main privatizations involved Enel and its subsidiaries. In July the fourth tranche of Enel equity was auctioned and the Ministry sold 9.3 per cent of the company’s shares for €4.07 billion (Table 13). Enel, in turn, made a public offering of 13.9 per cent of the equity of Terna, the owner of the Italian electricity grid, which raised €568 million, and sold another 30 per cent to Cassa Depositi e Prestiti. Enel also sold 62.8 per cent of the equity of its Wind mobile telephone subsidiary to Weather Investment for €12.1 billion, including €2.9 billion in cash (Table 14). The remainder was sold in February 2006.

Table 13

MAIN PRIVATIZATIONS IN ITALY IN 2005

Company	Sector	Number of employees in 2004	Seller	Method of sale	% of share capital sold	Date of completion of sale	Gross proceeds (millions of euros)
Terna	Energy	2,929	Enel	Public offering	13.9	March 2005	568.0
Terna	Energy	2,929	Enel	Direct sale to an institutional investor	30.0	May 2005	1,315.0
Enel	Energy	61,898	Ministry for the Economy and Finance	Public offering	9.3	July 2005	4,070.5
Wind	Telecommunications	8,188	Enel	Direct sale to an institutional investor	62.8	August 2005	12,100.0

Sources: Mediobanca, *R&S*, 2005; Fondazione ENI Enrico Mattei and Fondazione IRI, *Privatization Barometer,* www.privatizationbarometer.net; company financial reports; financial press.

Following Alitalia's capital increase, the Ministry for the Economy and Finance reduced its holding to under 50 per cent (49.9 per cent) as the European Commission had requested in order to authorize the carrier's refinancing in the course of 2005. The Ministry currently holds 21.8 per cent of Enel, 20.3 per cent of ENI and 34 per cent of Finmeccanica (Table 14). Other significant equity holdings are in the portfolio of Cassa Depositi e Prestiti S.p.A., which is 70 per cent owned by the Ministry but is not within the general government sector. The company holds 30 per cent of Terna, 10.2 per cent of Enel, 10 per cent of ENI, 35 per cent of Poste Italiane and 10.1 per cent of STMicroelectronics.

Table 14

MAIN PUBLIC SHAREHOLDINGS AT 31 DECEMBER 2005

Company	Sector	Turnover (millions of euros)	Number of employees	Residual % interest held by the Ministry for the Economy and Finance
ENI	Energy	58,382	71,497	20.3
Enel	Energy	34,312	61,898	21.8
Finmeccanica	Defence and aerospace	8,975	51,026	34.0
Poste Italiane	Postal services	8,970	154,113	65.0
Ferrovie dello Stato	Transport	5,151	99,305	100.0
Alitalia	Transport	4,071	20,575	49.9
RAI	Television and multimedia	2,965	11,480	99.6

Sources: Mediobanca, *R&S* 2005; company financial reports; Ministry for the Economy and Finance.

Utilities regulation. – At the end of the 1990s, partly in response to Community directives, Italy initiated a process of liberalization in the utility sector, accompanied by the introduction of mechanisms for regulating natural monopolies in some product chains. Liberalization did not come until after the partial privatization of the vertically integrated former public monopolies, and this delay did not help to produce fully competitive markets.

In the energy sector, liberalization is still incomplete. Supply remains quite concentrated and vertical integration between regulated and competitive phases remains substantial. In the electrical power industry, following the prime minister's decree of 11 May 2004, in 2005 Terna purchased the national grid operator's dispatching and network planning and development division. Putting the ownership and the operation of the national power grid in the same hands, which corresponds to the prevalent European model, is intended to make investment in the grid more attractive. To guarantee equal access to all operators, the decree also provides for the reduction of Enel's stake in Terna to below 20 per cent by 1 July 2007. At the end of 2005 the ex-monopolist held about 5 per cent.

There remain numerous obstacles to completion of the transition to fully competitive arrangements in the electricity market. The configuration continues to be that of an oligopoly in which the former monopolist is dominant, as the anti-trust authority and the electricity and gas authority noted in a joint inquiry completed in 2005. There are also significant entry barriers both to electricity imports and to the construction of new generating stations and the modernization and conversion of existing ones. The import barriers depend in part on the congestion of the cross-border power transmission lines, while entry barriers are posed by the complexity of the authorization procedures, despite the simplifications introduced by Law 55/2002 (the so-called "power plant unblocking law"), and by widespread local opposition.

The data available from Eurostat indicate that in January 2006 the final pre-tax price of electricity for household use in Italy was 46.2 per cent higher than the European average, and for industrial users 33 per cent (compared with a differential of 4.4 per cent nine years earlier). There are significant disparities even with respect to countries that, like Italy, have no nuclear power plants.

The structure of the natural gas market is still less conducive to competition. Here a vertically integrated incumbent retains great market power in all stages of the product chain, in part because it has not been required to dispose of capacity. The conditions for access to essential infrastructure are still relatively opaque. Moreover, substantial import dependency and the concentration of the sources of supply expose Italy to possible exogenous supply shocks.

Regional economic developments and regional policy

Svimez (the Association for Industrial Development in Southern Italy) estimates that GDP growth in the Centre and North was nil, compared with 1.4 per cent in 2004, and that in the South there was a contraction of 0.3 per cent, following modest growth of 0.7 per cent in 2004. Final consumption expanded slightly in both parts of the country (0.2 and 0.1 per cent respectively), thanks to general government spending. Household consumption fell by 0.3 per cent in the South while holding stable in the rest of the country. Gross fixed investment contracted in both areas, but more sharply in the South, by 0.8 per cent, as against 0.6 per cent in the Centre and North.

The value of merchandise exports rose in all parts of the country except the Centre, where it remained unchanged (Table 15). The sharpest rise was recorded in the South (11.3 per cent) and its share of national exports increased by nearly one percentage point.

Table 15

EXPORTS BY GEOGRAPHICAL AREA

(at current prices)

	Percentage shares 2005 (1)	Percentage changes on previous year			
		2002	2003	2004	2005
North-West	40.9	-3.5	0.6	4.0	5.6
North-East	31.0	0.8	-2.6	7.8	2.3
Centre	15.1	0.6	-4.7	5.0	0.0
South	11.4	-3.0	-2.6	7.8	11.3
Italy	**100.0**	**-1.4**	**-1.6**	**7.5**	**4.0**

Source: Istat, *Le esportazioni delle regioni italiane.*
(1) The total for Italy includes the share of exports (1.6 per cent) not attributed to any region.

Regional policy. – Regional development policy, whose objective is to lessen territorial disparities, draws on the European structural funds for social cohesion, with national co-financing, and on national resources appropriated in the budget over a four-year time frame drawing on the Fund for Underutilized Areas and distributed by the Interministerial Committee for Economic Planning. According to the annual report for 2005 of the Department for Development Policy, a division of the Ministry for the Economy and Finance, the total resources assigned to the regions of the South for regional policy between 2000 and 2008, which corresponds to the current Community planning cycle, exceeds €100 billion, or 20 per cent of Italy's total public expenditure on capital account.

The resources available for European structural fund programmes for the period 2000-06, through which Community funds and national co-financing are allocated, amount to more than €64 billion, 71 per cent of which is to go to the South (Community Support Frameworks, Objective 1). According to the State Accounting Office, through December 2005 payments amounting to €33 billion had been made, equal to 51 per cent of the funds allocated. Spending in the South came to €22.7 billion (49.2 per cent of allocations), which was slightly short of the target for that date.

For 2005, the Interministerial Committee assigned nearly €12 billion in national funds to the underutilized areas, equally divided between support to firms and infrastructure projects. Actual spending during the year was less than planned. Preliminary estimates indicate that disbursements fell from €5.4 billion in 2004 to €4.8 billion last year, including €4 billion for the South (down from €4.6 billion). Factors in the decline were the cyclical weakness of the economy, which reduced utilization of incentives even when they had been applied for, the slowdown in infrastructure investment and difficulties due to the recent legislative reform of some of the main incentive programmes.

Regional policy instruments have been extensively revised. The reform of the main spending item for the Fund for Underutilized Areas, namely the investment tax credit, which was begun in 2002, has resulted in a sharp drop in disbursements. The resources utilized came to less than €2.7 billion in the three years from 2003 to 2005, or 45.8 per cent of the amount available, compared with €1.8 billion in 2002 alone.

Protracted negotiations following the enlargement of the EU were concluded in December 2005, when the twenty-five member states agreed on the budget guidelines for the Union from 2007 to 2013, which will be the basis for negotiations between the Council, the Commission and the Parliament. The agreement calls for expenditure commitments over the planning period for a total of €860 billion, or just over 1 per cent of the EU's gross national income. Italy is the third-largest contributor, behind Germany and France, with net contributions equal to 0.35 per cent of national income.

The legal framework for business

The benefits of an adequate legal framework for the economy are widely recognized. Last year Italy enacted significant reforms of bankruptcy and company law. However, there remain legislative and regulatory shortcomings that impose costs on firms and adversely affect growth.

Bankruptcy law. – In January 2006 a legislative decree completed the reform of Italy's bankruptcy law. The new rules and procedures are designed to encourage companies to signal impending crises in advance, thereby increasing the chances for the recovery and rapid restructuring of firms; they provide for less costly reallocation of resources. This should produce beneficial effects in terms of incentives to take entrepreneurial risk.

The new rules give greater scope for the restructuring of firms in temporary difficulty by offering them a series of options. They also streamline and modernize the proceedings for liquidation of firms that cannot remain in business. Finally, the old punitive concept of bankruptcy has been abandoned. All in all, the reform brings Italian rules closer to international standards. To make the new procedures more effective, further adjustments may be needed to modify criminal provisions (not affected by the reform), create instruments for early detection of critical situations, and broaden the scope of the legislation.

Company law. – Company law reform over nearly a decade has radically revised the safeguards for minority shareholders and small investors generally, bringing Italian rules progressively up to international standards. The shortcomings in investor protection in Italy now seem to consist not so much in inadequate rules as in ineffective enforcement. The problem lies partly with the slowness and inefficiency of the civil justice system, but it also reflects the lack of specific mechanisms of corporate law enforcement that enhance investor protection in other countries. Unlisted companies in Italy tend to have a highly concentrated ownership and little aptitude for change. Stock exchange listing continues to be very infrequent, especially for non-financial companies, and the total capitalization of listed firms is equal to no more than 47.7 per cent of GDP.

Thus the degree of separation between ownership and control is still limited, which is an impediment to the growth of firms. By international standards, Italian law lacks instruments permitting entrepreneurs to exercise control with limited, if not nil, ownership stakes. The concentration and inertia of ownership structures make transposition of the EU directive on takeover bids (Directive 2004/25/EC) problematical. Enactment of additional rules to impose contestability might simply reinforce the tendency of firms to keep ownership concentrated. On the other hand, too onerous a law on takeovers could further impede Italy's already scant dynamism in corporate ownership.

A number of options are available to Italian legislators. As to contestability, the directive allows for stricter measures than those currently envisaged by Italian law. Their transposition by member states is optional, however. As to mandatory takeover bids, Community legislation leaves member states narrower scope for choice. By comparison with Italian law, the European regulation is more onerous, on the whole, for those seeking to acquire control. But it does not set a threshold at which the bid becomes mandatory and the consequent costs to the purchaser set in. The main European countries do not intend to enact the more stringent measures on contestability, while their positions on the threshold differ considerably.

Bureaucratic simplification and regulatory quality. – Of the OECD countries, Italy has among the most restrictive and costly regulations on economic activity. In the 1990s legislation laying the basis for regulatory reform was enacted and the first steps in its implementation were taken (such as the one-stop office for business start-ups and regulatory impact analysis). After a lull in the reform process in the first few years of the new decade, major legislation was enacted last year, reordering administrative law and providing for greater application of tacit consent. There is still a great deal of room for progress in the rapid and effective implementation of these measures, as well as in stepped-up use of ICT (so-called e-government).

The civil justice system. – The inefficiencies of Italian civil justice by comparison with other countries are well known. Economic growth and competitiveness are both adversely affected. An intensive process of reform over the past fifteen years has sought to shorten the duration of proceedings. However, the reforms have not sufficed to streamline trials, owing to their unsystematic nature and to the persistence of possible distortions on the demand side for justice and low productivity of resources on the supply side. The latter depend on the technologically obsolete organization of courts, the lack of incentives for those involved (judges and administrative staff) to pursue efficiency, and an excessive jurisdictional dispersion that hinders the exploitation of economies of scale and scope.

THE LABOUR MARKET

Italy

The composition of employment

The number of persons employed in Italy was 24,281,000 in 2005, including unreported and non-resident workers, an increase of 49,000 or 0.2 per cent compared with 2004 (Figure 9). The total labour input of the economy, in standard labour units, diminished by 0.4 per cent, or by the equivalent of 102,000 full-time workers. Though insignificant for purposes of tracking the economic cycle, the growth differential between these two gauges of employment has marked the last decade and is due mainly to the spread of part-time work and the reduction in the number of second jobs. Another factor last year was increased recourse to Wage Supplementation.

Figure 9

MEASURES OF EMPLOYMENT IN ITALY

(thousands)

Source: Istat, national accounts and labour force survey and quarterly labour force survey.
(1) Full-time equivalent workers, resident and non-resident, official and unreported. – (2) Number of persons employed – residents and non-residents, official and unreported – in resident firms (Source: Istat, national accounts). – (3) Source: Istat, national accounts. – (4) The household is defined as cohabiting persons with ties of marriage, relation, adoption, guardianship or affection (Source: Istat, labour force survey).

The growth in the demand for labour has slackened steadily over the past three years, reflecting the sluggishness of economic activity and an increase in private-sector labour costs that outstripped the value added deflator, partly because of the termination of employment incentives.

The component consisting of resident workers, which had remained more or less constant until 2001, has risen perceptibly since 2002 as a result of the Bossi-Fini law on immigration (Law 189/2002), which regularized some 650,000 immigrants already present in the country, increasing the observed number of legally resident persons employed by about the same amount. This led to a statistical increase in the number of residents employed between 2002 and 2005 that was 430,000 greater than the increase in total employment. The estimate of unreported employment included in the latter already allows for irregular immigrants; the number of unreported non-resident workers fell by 400,000 between 2002 and 2004.

As estimated by the labour force survey, which counts labour market participation by all members of the respondent household, employment averaged 22,563,000 in 2005, an increase of 159,000 (0.7 per cent) on the previous year (Table 16). The employment rate for persons of working age (15-64) rose marginally to 57.5 per cent.

The labour force survey excludes persons living in barracks, hospitals, prisons, convents and institutions in general. Its estimates too were affected by the immigrant regularization of 2002. The number of persons aged 15-64 in work increased by 675,000 between the fourth quarter of 2002 and the fourth quarter of 2005; of this figure, 387,000 represented the increase in the resident population due to regularizations and 288,000 the rise in the employment rate, which in turn was affected by the immigrants' greater propensity to work (see the box "The impact of regularizing immigrant workers on employment growth in the labour force survey", *Economic Bulletin* No. 41, November 2005). In this survey the effect of the regularization provision was nearly 270,000 less than in the national accounts estimate of resident workers, because some of the regularized immigrants have taken up residence in the household where they are in service and are thus not covered by the labour force survey, which counts labour market participation only by members of the respondent household (defined as cohabiting persons with ties of marriage, relation, adoption, guardianship or affection). The survey put the average number of employed foreigners at 1,170,000 in 2005, or 5.2 per cent of total employment. Most of these foreigners are men (63.1 per cent, compared with 60.9 per cent overall), work in the Centre and North (88.7 per cent), and by comparison with Italians are more often employed in industry, particularly construction.

Regional disparities widened further in 2005. Since 2003 the number of persons employed in the South has been declining (by a total of 69,000 or 0.4 per cent per year), while in the rest of the country it has increased (by 719,000, or 1.5 per cent per year). The geographical divergence has been accompanied by falling employment rates in the South, especially for

Table 16

STRUCTURE OF EMPLOYMENT IN ITALY, 2005

(thousands of persons and percentages)

	Centre and North		South		Italy	
	Thousands of persons (1)	Percentage change 2005-04 (2)	Thousands of persons (1)	Percentage change 2005-04 (2)	Thousands of persons (1)	Percentage change 2005-04 (2)
Employees	11,828	3.1	4,706	1.2	16,534	2.6
Permanent	10,602	2.7	3,906	0.5	14,508	2.1
full-time	*9,223*	*1.7*	*3,561*	*0.2*	*12,784*	*1.3*
part-time	*1,379*	*9.7*	*345*	*3.7*	*1,724*	*8.4*
Fixed-term and temporary	1,226	7.1	800	4.8	2,026	6.1
full-time	*962*	*7.1*	*636*	*7.3*	*1,598*	*7.2*
part-time	*264*	*7.1*	*164*	*-4.1*	*428*	*2.4*
Self-employed	4,324	-4.0	1,706	-4.3	6,029	-4.1
Entrepreneurs, professional, self-employed workers	3,612	-1.0	1,496	-1.3	5,108	-1.1
Family workers	313	-23.5	109	-31.3	421	-25.7
Cooperative members	33	-26.2	10	-34.0	43	-28.3
Regular collaborators	305	-5.8	72	6.8	377	-3.6
Occasional workers	61	-22.9	19	-28.3	80	-24.3
full-time	3,778	-3.2	1,507	-2.9	5,285	-3.1
part-time	546	-9.4	199	-13.8	744	-10.7
Total employment	16,152	1.1	6,411	-0.3	22,563	0.7
women	6,712	1.2	2,113	-1.9	8,825	0.5
men	9,440	1.0	4,298	0.5	13,738	0.9
Unemployed	821	-0.5	1,067	-6.0	1,889	-3.7
women	471	-1.9	515	-7.2	986	-4.8
men	350	1.6	552	-4.8	902	-2.4
Labour force	16,973	1.0	7,479	-1.2	24,451	0.4
women	7,183	1.0	2,628	-3.0	9,811	-0.1
men	9,790	1.1	4,850	-0.2	14,640	0.6
Participation rate (ages 15-64)	67.3	0.2	53.6	-0.7	62.4	-0.1
women	57.6	0.2	37.5	-1.2	50.4	-0.2
men	76.8	..	69.9	-0.4	74.4	-0.1
Employment rate (ages 15-64)	64.0	0.2	45.8	-0.3	57.5	0.1
women	53.8	0.3	30.1	-0.6	45.3	0.1
men	74.0	-0.1	61.9	0.1	69.7	..
Unemployment rate	4.8	-0.1	14.3	-0.7	7.7	-0.3
women	6.6	-0.2	19.6	-0.9	10.1	-0.4
men	3.6	..	11.4	-0.5	6.2	-0.2
Youth unemployment rate (ages 15-24)	15.3	0.3	38.6	1.0	24.0	0.5
women	18.5	0.8	44.6	..	27.4	0.2
men	12.8	0.1	34.8	2.0	21.5	0.9

Source: Based on data from Istat, labour force survey.

(1) Participation, employment and unemployment rates are percentages. The unemployment rate is the number of persons unemployed aged 15-74 as a percentage of the population aged 15 and over. The youth unemployment rate is for the labour force in the 15-24 age-group. Rounding may cause discrepancies in the totals. – (2) For participation, employment and unemployment rates, change in percentage points.

women, reflecting slower output growth and the resumption of emigration by the better educated and more employable southerners.

For Italy as a whole, only payroll employment grew in 2005, gaining 2.6 per cent. Self-employment contracted sharply, by 4.1 per cent or 258,000 persons, to 26.7 per cent of the total. The fall in self-employment was the largest in the past thirty years. It came almost entirely among family workers (whose number fell by 25.7 per cent), members of cooperatives (28.3 per cent), regular collaborators (3.6 per cent) and occasional workers (24.3 per cent), positions generally held by young women. Between 2004 and 2005 a fifth of these workers left the labour force, 14.9 per cent found permanent payroll jobs and another 4.3 per cent took fixed-term jobs. The rest did not change their occupational status. These shifts towards payroll employment may be due in part to firms' utilization of the new contractual forms instituted by Law 30/2003, but they also reflect the full phasing in of the revised labour force survey, which has refined its capability for accurately determining workers' occupational positions. For 2005 as a whole, self-employed workers on regular collaboration or occasional employment contracts numbered 457,000 or 2 per cent of total employment.

Among payroll employees, there was an increase in those with open-ended, full-time jobs (1.3 per cent), but above all in those with flexible employment relationships. The number of part-time employees rose by 7.2 per cent to 2,152,000 or 13 per cent of total payroll employment (still significantly lower than the euro-area average). Four fifths of them (82.9 per cent) are women; and one quarter of women employees work part-time. Fixed-term contracts increased by 6.1 per cent and now account for 12.3 per cent of payroll jobs, half a percentage point more than in 2004. Here too the incidence among women was greater (14.7 per cent).

The spread of fixed-term contracts, which is one of the main modes of taking on new staff (see *Economic Bulletin* No. 42, March 2006), furthers the segmentation of the labour market. Based on the labour force survey, it is estimated that of all the workers on fixed-term contracts in 2004 (1,909,000), after 12 months 51.4 per cent had not changed type of contract, 25.4 per cent had found open-ended jobs, 3.5 per cent were self-employed and the remaining 19.7 per cent had left the labour market (Table 17). Getting permanent jobs was easier for men than for women, for workers aged 15-34 than for older workers and for those in the Centre and North than those in the South. The type of fixed-term contract had a very strong impact on the likelihood of conversion into a stable job. Those who had had mixed contracts (trainee or apprenticeship, which in 2004 had an average duration of 26 months) had a 35.5 per cent probability of having a permanent job a year later and a 12.9 per cent probability of having lost their job. For seasonal workers and workers with other types of fixed-term

Table 17

OCCUPATIONAL STATUS IN 2005 OF PERSONS WITH FIXED-TERM PAYROLL JOBS IN 2004

(percentages)

Type of contract in 2004	Occupational status in 2005				*Memorandum item:* percentage of fixed-term contracts in total payroll employment	
	Permanent employee	Fixed-term employee	Self-employed	Not employed	2004	2005
Italy	**25.4**	**51.4**	**3.5**	**19.7**	**11.8**	**12.3**
Mixed-purpose contracts	35.5	48.9	2.7	12.9	1.9	2.0
Trial	40.6	40.1	2.5	16.8	0.9	0.9
Seasonal	15.0	54.1	2.7	28.2	2.4	2.7
Other fixed-term and temporary	24.1	52.7	4.3	18.9	6.6	6.7
Men	**29.2**	**48.9**	**4.4**	**17.4**	**9.9**	**10.5**
Mixed-purpose contracts	36.0	49.3	2.7	11.9	1.9	1.9
Trial	44.2	36.5	3.1	16.2	0.9	0.9
Seasonal	15.8	57.2	3.8	23.2	2.0	2.4
Other fixed-term and temporary	29.2	47.6	5.5	17.7	5.1	5.3
Women	**21.8**	**53.7**	**2.7**	**21.8**	**14.5**	**14.7**
Mixed-purpose contracts	34.7	48.1	2.6	14.5	1.9	2.0
Trial	36.3	44.5	1.7	17.5	0.9	0.9
Seasonal	14.3	51.2	1.7	32.9	2.9	3.1
Other fixed-term and temporary	20.0	56.9	3.2	19.9	8.7	8.7
Aged 15-24	**26.2**	**49.7**	**3.0**	**21.1**	**34.6**	**37.0**
Mixed-purpose contracts	31.8	54.0	1.9	12.2	14.2	17.3
Trial	25.2	54.1	1.5	19.2	3.8	3.5
Seasonal	18.7	45.6	4.0	31.7	4.3	4.6
Other fixed-term and temporary	22.1	44.4	4.5	28.9	12.3	11.5
Aged 25-34	**28.7**	**47.2**	**4.5**	**19.6**	**14.2**	**15.0**
Mixed-purpose contracts	42.2	38.2	4.5	15.1	2.2	1.8
Trial	50.9	30.4	3.3	15.4	1.3	1.4
Seasonal	15.3	54.5	2.5	27.7	2.4	2.8
Other fixed-term and temporary	25.7	50.0	5.2	19.0	8.4	9.1
North	**31.5**	**49.5**	**3.2**	**15.8**	**9.4**	**9.8**
Mixed-purpose contracts	39.9	48.1	1.5	10.6	2.1	2.2
Trial	45.7	40.2	3.0	11.1	1.1	1.1
Seasonal	19.5	55.5	2.1	23.0	1.3	1.3
Other fixed-term and temporary	27.5	50.7	4.4	17.5	4.9	5.2
Centre	**25.1**	**52.5**	**4.7**	**17.8**	**11.6**	**11.9**
Mixed-purpose contracts	30.1	51.7	5.5	12.7	2.2	2.3
Trial	42.7	38.8	0.6	17.8	0.9	0.9
Seasonal	19.2	55.5	3.6	21.8	1.7	2.0
Other fixed-term and temporary	22.5	53.8	5.1	18.6	6.7	6.8
South	**19.6**	**52.7**	**3.3**	**24.4**	**16.4**	**17.0**
Mixed-purpose contracts	30.0	47.5	2.7	19.8	1.4	1.4
Trial	23.1	40.9	2.5	33.6	0.6	0.7
Seasonal	12.1	53.2	2.7	32.0	4.9	5.6
Other fixed-term and temporary	21.8	54.0	3.7	20.4	9.5	9.3

Source: Based on data from Istat, labour force survey.

employment, the outlook was much more precarious, partly because their contracts were so short.

Unemployment and the labour supply

The average unemployment rate in Italy fell from 8.0 per cent in 2004 to 7.7 per cent in 2005. Both men and women and all age groups except those under 25 were involved. The unemployment rate in the South fell by 0.7 points to 14.3 per cent; since 1999, when the reduction began, it has fallen by more than five percentage points, or 430,000 persons. From 2000 to 2002 the decline in the number of unemployed workers in the South corresponded to a rise in employment; in the last three years, both aggregates have contracted.

The supply of labour expanded again in 2005 at about the same pace as the previous year (0.4 per cent). The rise can be attributed entirely to the increase in the resident population of working age, while the participation rate (for ages 15-64) declined for the second year (by 0.1 points to 62.4 per cent) after a steady expansion from 1996 to 2003.

The increase in the number of residents was the effect of the Bossi-Fini law. On 1 January 2005 resident foreigners numbered 2,402,000 (an increase of 412,000 or 20.7 per cent in twelve months) and accounted for 4.1 per cent of the total population. About half these new residents were between 18 and 39 years old. The rise in the number of foreign citizens legally present in Italy, which includes those not entered in the civic registers, was much less pronounced (6.6 per cent, or 170,000 persons). The increase in the resident foreign population was concentrated in the Centre and North (367,000 persons) and this also helped produce a marginal rise in the participation rate. In the South the increase (45,000 persons) was less substantial, not enough to offset the fall in the participation rate; the labour supply declined for the third consecutive year (by 1.2 per cent).

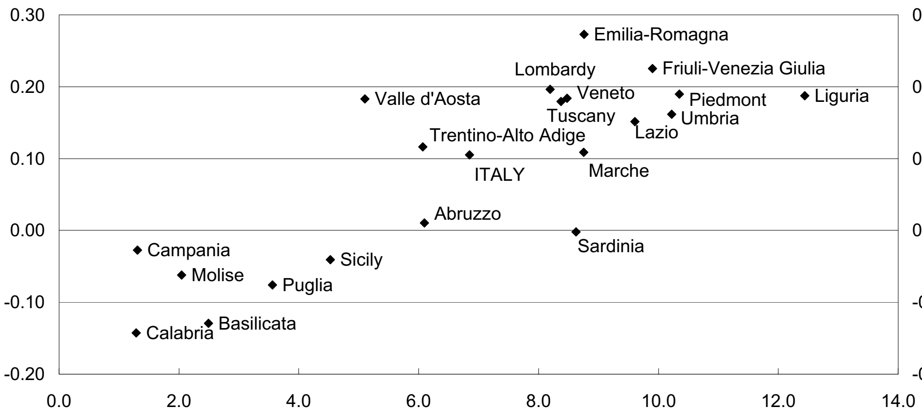
In the long run this low participation rate, 7.4 points below that of the euro area, is not sustainable in a rapidly ageing society such as Italy's. Greater use must be made of the human resources available, which requires that full access to the labour market be guaranteed for groups that are relatively less involved at present, such as women, young people and those over 55. The female participation rate fell for the second year, by 0.2 points to 50.4 per cent, after rising 6.7 points between 1995 and 2003. As this was not offset by an expansion of the population, it resulted in the first decline in the female labour supply since 1994 (0.1 per cent).

The period of expansion in the female labour supply coincided with the first signs of progress in gradually righting a number of disequilibria in the economy, such as the low fertility rate and the earnings differential between men and women. The correlation between the inter-regional variation in the fertility rate (average number of children per woman aged 15-49) and that in the female employment rate is positive and significant (Figure 10). Both rose more in the regions of the Centre and North, where the endowment of day-care facilities in proportion to the number of children is greater. For Italy as a whole, between 1995 and 2003 the average number of children per woman (aged 15-49) rose from 1.18 to 1.29 and the employment rate for women aged 15-44 rose from 40.4 to 47.2 per cent. The difference in actual earnings between men and women also appears to have narrowed in the past decade. According to the Bank of Italy's survey of household income and wealth, the earnings of female employees rose from 78.1 per cent of those of their male colleagues in 1995 to 81.0 per cent in 2004. The indications are similar also considering only full-time workers or adjusting for age and education. Even so, the differentials remain substantial, if less than in some other European countries; in part, they depend on women's more frequent absence for reasons exclusively involving care of children and the elderly.

Figure 10

NUMBER OF CHILDREN PER WOMAN AND UNEMPLOYMENT RATES BY REGION (1)

(absolute change, 1995-2003)



Source: Istat.

(1) The change in the average number of children for women aged 15-49, vertical axis. Absolute change in the unemployment rate, in percentage points, for women aged 15-44, horizontal axis.

The labour supply constituted by young people under 25 diminished again, by 6.4 per cent: not only did the population decrease but the participation rate also declined, by 2.1 percentage points overall and by 3 points among young women. In part this decline is normal, reflecting not only the smaller size of the new cohorts but also increasing education. The upper secondary school attendance rate for the 15-18 age-group rose from

76.7 per cent in the 1999-2000 school year to 82.5 per cent in 2003-04. Over the same period the proportion of 19-year-olds holding secondary-school diplomas rose from 70 to 76 per cent, and university attendance rose equally rapidly, favoured by the introduction of first-level, three-year degree courses. The proportion of 19-year-olds registering for university instruction rose from 43 to 56 per cent; in 1996-97 it had been 40 per cent.

The supply of labour from persons aged 55 to 64 increased by 2.9 per cent, reflecting a 0.6 per cent increase in that population group and a 0.7 per cent rise in their participation rate to 32.6 per cent. Over the next few years the rate will continue to benefit from the effects of the succession of pension rule changes enacted since 1995.

Wages and the cost of labour

Actual earnings per standard employee labour unit for the entire economy, as measured in the national accounts, rose by 3.1 per cent in 2005 (3.3 per cent in 2004). The rise was sharper in the public than in the private sector (4.3 and 2.5 per cent respectively; Table 18). In real terms the increase came to 1.1 per cent, which was faster than the rise in labour productivity. Between 2000 and 2005 real earnings for the entire economy gained 3.5 per cent: 0.9 per cent in the private sector and more than 9 per cent in the public sector, where they recouped the reduction registered in the first half of the 1990s.

Contractual earnings rose at the same rate as actual earnings in 2005 (3.1 per cent). The new contracts signed during the year mostly involved the private service sector and some parts of the public sector, where there still remain many expired contracts. In the first part of 2006 contract renewals for construction, energy, clothing and textiles and metal workers, the last signed more than thirteen months late, introduced a number of innovations in industrial relations. In determining wage increases these contracts, like most of the others renewed since the end of 2002, take as reference parameter the inflation forecasts of experts rather than the Government's inflation target.

The new contracts also introduce significant rules changes. The metalworkers' contract calls for a one-off payment to workers not covered by company-level wage agreements, as an implicit share in productivity gains. Like that for the energy sector, this agreement increases the flexibility of working hours, reducing overtime during demand peaks and underutilization of manpower in slack periods. The duration of the economic clauses was lengthened to 30 months for metalworkers and 27 for clothing

Table 18

LABOUR COSTS AND PRODUCTIVITY IN ITALY

(annual percentage changes, except as indicated)

	Value added base prices, chain-linked volumes (1)	Total standard labour units	Output per standard labour unit (2)	Compensation per standard employee labour unit	Labour costs per standard employee labour unit (3)	Unit labour costs (3) (4)	Labour's share of value added at base prices (3) (5)	Real cost of labour per standard employee labour unit (6)	Real earnings per standard employee labour unit (7)
				Industry excluding construction					
1992-1995	2.7	-1.5	4.3	4.2	4.6	0.3	66.3	1.1	-0.4
1996-2000	0.6	-0.3	0.8	3.5	2.5	1.7	62.6	-0.1	1.0
2001-2005	-1.0	-0.6	-0.4	2.8	3.0	3.4	62.9	0.8	0.4
2001	-0.7	-0.6	-0.1	3.1	3.2	3.4	60.8	-0.4	0.3
2002	-0.8	0.7	-1.4	2.7	2.5	4.0	61.7	0.1	0.2
2003	-2.3	..	-2.2	2.6	2.8	5.2	64.1	1.5	-0.1
2004	1.3	-1.2	2.5	3.5	4.0	1.5	63.5	1.6	1.2
2005	-2.3	-1.6	-0.7	2.5	2.4	3.2	64.6	1.0	0.5
				Construction					
1992-1995	-3.4	-2.5	-0.9	3.3	3.3	4.2	71.4	-0.2	-1.3
1996-2000	0.9	1.0	-0.2	3.3	2.1	2.3	71.8	-0.2	0.9
2001-2005	3.2	3.0	0.2	2.7	3.1	2.9	67.8	-1.1	0.3
2001	7.6	6.2	1.3	2.7	1.8	0.5	69.4	-1.3	-0.1
2002	2.4	2.1	0.3	2.0	3.0	2.7	68.4	-1.2	-0.5
2003	2.8	2.7	..	2.5	3.9	3.8	67.9	-0.7	-0.2
2004	2.8	1.6	1.2	3.7	4.4	3.2	66.7	-0.5	1.5
2005	0.6	2.3	-1.6	2.8	2.7	4.4	66.8	-1.5	0.8
				Private services (8) (9)					
1992-1995	2.7	-1.3	4.0	4.5	4.4	0.4	73.4	1.2	-0.1
1996-2000	3.2	2.2	1.0	3.2	2.1	1.1	69.7	..	0.7
2001-2005	1.0	1.6	-0.6	2.4	2.5	3.1	68.3	-0.1	..
2001	3.1	2.4	0.6	3.0	2.7	2.0	67.0	-0.5	0.2
2002	0.5	2.6	-2.0	1.7	1.8	3.9	67.7	-0.9	-0.8
2003	-0.3	1.8	-2.1	2.0	2.3	4.5	68.1	-1.5	-0.7
2004	0.6	0.3	0.3	2.9	3.3	3.0	69.1	1.7	0.7
2005	1.0	0.9	0.1	2.3	2.2	2.1	69.7	1.0	0.3
				Private sector (9)					
1992-1995	2.1	-1.8	4.0	4.4	4.6	0.5	73.2	1.2	-0.2
1996-2000	2.1	0.9	1.2	3.4	2.4	1.2	69.5	0.2	0.9
2001-2005	0.5	0.7	-0.3	2.6	2.7	3.0	68.4	0.3	0.2
2001	1.9	1.8	0.1	2.9	2.7	2.6	67.2	-0.7	0.1
2002	0.1	1.5	-1.4	2.1	2.2	3.6	67.7	-0.5	-0.3
2003	-0.9	0.9	-1.7	2.5	2.9	4.7	68.7	-0.3	-0.2
2004	1.5	-0.1	1.6	3.1	3.6	1.9	68.9	1.8	0.9
2005	-0.2	-0.3	0.1	2.5	2.3	2.2	69.5	1.1	0.5
				Total economy (9)					
1992-1995	1.6	-1.4	3.0	3.7	4.1	1.0	75.6	0.8	-0.9
1996-2000	2.0	0.8	1.1	3.5	2.7	1.6	72.5	0.3	1.0
2001-2005	0.6	0.7	..	3.1	3.2	3.2	71.8	0.5	0.7
2001	1.9	1.8	0.1	3.5	3.2	3.0	70.5	-0.3	0.7
2002	0.3	1.3	-1.0	2.6	2.7	3.7	71.1	..	0.1
2003	-0.6	0.6	-1.2	3.2	3.7	5.0	72.2	0.2	0.5
2004	1.5	..	1.5	3.3	3.5	1.9	72.3	1.6	1.1
2005	..	-0.4	0.4	3.1	2.9	2.5	72.9	1.2	1.1

Source: Based on data from Istat, national accounts.

(1) Reference year, 2000. – (2) Output is value added at base prices, chain-linked volumes, reference year 2000. – (3) 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. – (4) Compensation per standard employee labour unit as percentage of output per standard labour unit; output is value added at base prices, chain-linked volumes, reference year 2000. – (5) Percentages. – (6) Labour income per standard employee labour unit deflated by the value added deflator at base prices. – (7) Compensation per standard employee labour unit deflated by the consumer price index. – (8) Includes wholesale and retail trade, hotel and restaurant services, transport and communications, financial intermediation services and sundry services to businesses and households. — (9) Net of rental of buildings.

and textile workers. Most recent agreements also introduced rules for the new "job-oriented" apprenticeship contract introduced by Law 30/2003. By offering training for the worker and lower costs for employers, this type of contract is designed to favour job market entry for young people.

The cost of labour per standard labour unit, including employer social security contributions, rose by 2.9 per cent in 2005.

In the private sector, excluding building rentals, labour productivity increased by 0.1 per cent and labour incomes by 2.3 per cent. The consequent 2.2 per cent increase in unit labour costs (compared with 1.9 per cent in 2004) exceeded the rise in the value added deflator (1.2 per cent), and labour's share in value added accordingly rose.

Again last year productivity and labour cost trends in industry excluding construction were incompatible with preserving competitiveness vis-à-vis Italy's main rivals. The cost of labour per employee rose by 2.4 per cent while per capita output fell by 0.7 per cent; unit labour costs increased by 3.2 per cent, significantly more than in 2004. Since the mid-1990s unit labour costs in industry excluding construction have risen at an average annual rate of 2.5 per cent in Italy, compared with reductions of 0.7 per cent in France and 1.0 per cent in Germany. Most of the disparity is due to divergent trends in labour productivity, which rose by scarcely 0.2 per cent per year in Italy over the decade, compared with 3.3 per cent in France and 3.2 per cent in Germany. Trends in the cost of labour have been much more uniform, with annual average rises of 2.8 per cent in Italy, 2.6 per cent in France and 2.1 per cent in Germany.

The distribution of earnings and household income

According to the Bank of Italy's biennial survey of Italian households' income and wealth, average real net monthly payroll earnings rose by 1.0 per cent per year between 2002 and 2004, the same as from 2000 to 2002 (Table 19). The increase was about the same for men as for women. Earnings rose more in the Centre and North than in the South (1.1 and 0.1 per cent respectively), whereas in the previous two years the opposite was true.

In 2003 and 2004 households' real equivalent per capita disposable income rose by 2.2 per cent per year (Table 20). As in the previous two years, the rise is more moderate (1.6 per cent) when household income is calculated net of imputed rental income from home ownership, which was increased by the sharp rise in house prices.

Table 19

REAL MONTHLY TAKE-HOME PAY IN ITALY, 1993-2004 (1)

(in euros at 2004 prices, values and percentages)

	1993	1995	1998	2000	2002	2004
	All employees					
Average compensation	1,322	1,270	1,242	1,260	1,287	1,312
Men	*1,442*	*1,391*	*1,348*	*1,375*	*1,396*	*1,423*
Women	*1,131*	*1,086*	*1,089*	*1,090*	*1,131*	*1,153*
Centre and North	*1,338*	*1,297*	*1,291*	*1,310*	*1,335*	*1,365*
South	*1,280*	*1,204*	*1,125*	*1,132*	*1,166*	*1,168*
Gini index (2)	0,241	0,234	0,241	0,240	0,251	0,242
Interdecile ratio (3)	2.8	2.8	3.1	3.1	2.9	3.0
Low-income workers (4)	15.7	13.7	18.3	16.9	17.8	15.4
Men	*9.7*	*8.2*	*13.0*	*11.2*	*10.6*	*9.7*
Women	*25.1*	*22.0*	*25.9*	*25.4*	*28.0*	*23.4*
Centre and North	*13.7*	*11.4*	*14.4*	*13.3*	*14.9*	*13.2*
South	*20.6*	*19.2*	*27.6*	*26.5*	*24.9*	*21.2*
	Full-time employees					
Average compensation	1,362	1,308	1,306	1,325	1,356	1,368
Men	*1,454*	*1,400*	*1,384*	*1,402*	*1,424*	*1,441*
Women	*1,198*	*1,151*	*1,177*	*1,189*	*1,242*	*1,245*
Centre and North	*1,383*	*1,340*	*1,349*	*1,368*	*1,402*	*1,426*
South	*1,307*	*1,233*	*1,200*	*1,207*	*1,239*	*1,213*
Gini index (2)	0.227	0.220	0.216	0.217	0.228	0.225
Interdecile ratio (3)	2.5	2.4	2.6	2.4	2.6	2.5
Proportion of low-income workers (4)	11.9	9.7	12.2	10.6	11.3	10.0
Men	*8.8*	*7.5*	*9.8*	*9.0*	*8.0*	*8.2*
Women	*17.3*	*13.5*	*16.1*	*13.4*	*16.9*	*13.0*
Centre and North	*9.4*	*7.0*	*8.6*	*7.4*	*8.6*	*7.5*
South	*18.1*	*16.3*	*20.9*	*19.3*	*18.4*	*16.7*

Source: Banca d'Italia, *Indagine sui bilanci delle famiglie italiane, Archivio storico* (Version 4.0 January 2006).

(1) Main jobs (i.e. excluding second jobs). Compensation is net of income and social security tax and is deflated by the cost-of-living index. The values in lire up to 1998 are converted into euros at the changeover rate of 1,936.27 lire per euro. – (2) The Gini index of concentration ranges from 0 (perfect equality) to 1 (maximum inequality). – (3) Ratio of the compensation of the 9th to the 1st decile. – (4) Percentage shares. According to the OECD definition, low-wage workers are those earning less than two-thirds of the median for full-time workers.

The Gini concentration index for equivalent household incomes rose from 33.0 per cent in 2002 to 34.3 per cent in 2004. Though statistically not significant, the change is in the direction of greater inequality, especially in the regions of the Centre and North. The degree of income inequality in Italy is one of the highest in the advanced countries, on a par with the other countries of southern Europe and with Ireland and the United Kingdom. The index is higher in the South (33.4 per cent) than in the rest of Italy (30.6 per cent). This gap narrowed slightly between 2000 and 2004 owing to the reduction in inequality in the South and its marginal increase in the Centre and North. Government-induced income redistribution via taxation and transfer payments has a much weaker equalizing effect in Italy than in the other EU countries.

Table 20

HOUSEHOLDS' REAL EQUIVALENT DISPOSABLE INCOME IN ITALY, 1993-2004 (1)

(in euros at 2004 prices)

	1993	1995	1998	2000	2002	2004
Average equivalent income	15,420	15,090	16,125	16,319	16,702	17,429
Centre and North	*17,836*	*17,526*	*19,006*	*19,030*	*19,674*	*20,600*
South	*11,170*	*10,831*	*11,065*	*11,538*	*11,412*	*11,711*
Production worker, apprentice, clerk	*11,928*	*11,986*	*12,038*	*12,170*	*12,318*	*12,247*
Clerical worker, technician, teacher	*18,159*	*17,878*	*17,414*	*18,053*	*18,290*	*18,742*
Manager	*32,208*	*30,415*	*31,784*	*31,316*	*36,496*	*34,324*
Self-employed worker	*18,253*	*17,751*	*21,748*	*20,080*	*20,908*	*24,381*
Pensioner	*13,388*	*13,635*	*14,904*	*15,540*	*15,489*	*15,700*
Non-employed non-pensioner	*5,732*	*4,734*	*6,421*	*6,555*	*5,977*	*8,935*
1 member	*14,295*	*14,260*	*16,623*	*16,642*	*16,274*	*19,960*
2 members	*17,046*	*16,931*	*18,640*	*18,682*	*18,982*	*19,886*
3 members	*17,476*	*16,974*	*17,657*	*17,852*	*19,198*	*18,174*
4 members	*15,365*	*14,398*	*15,034*	*15,260*	*15,553*	*16,610*
5 members or more	*11,947*	*12,309*	*12,499*	*12,586*	*12,205*	*11,824*
Home-owner	*16,993*	*16,741*	*17,857*	*17,973*	*18,328*	*19,277*
Tenant	*12,360*	*11,631*	*12,364*	*12,445*	*12,699*	*13,179*
Gini index (3)	0.336	0.337	0.348	0.335	0.330	0.343
Centre and North	*0.300*	*0.299*	*0.314*	*0.293*	*0.292*	*0.306*
South	*0.350*	*0.356*	*0.350*	*0.357*	*0.329*	*0.334*
Interdecile ratio (4)	4.7	4.7	4.8	4.6	4.4	4.5

Source: Banca d'Italia, *Indagine sui bilanci delle famiglie italiane, Archivio storico* (Version 4.0 January 2006).

(1) Total household income (including imputed rental income on home-owners' dwellings), net of income and social security taxes, deflated by the national accounts domestic consumption deflator and made comparable using a modified OECD scale of equivalence (assigning a weight of 1 to the first adult member of the household, 0.7 to every other member aged 13 and above, and 0.5 to those aged under 13). The figures in the table are weighted by the number of household members so determined, except the share of low-income households, which is calculated on the number of households. Up to 1998, lira values are converted into euros at the changeover rate of 1936.27 lire per euro. – (2) The employment status of the household is that of the head, defined as the person with the largest labour or pension income. – (3) The Gini index of concentration ranges from 0 (perfect equality) to 1 (maximum inequality). – (4) Ratio of the equivalent disposable income of the 9th to the 1st decile.

The proportion of low-income households – those with less than half the median equivalent disposable income – remained broadly unchanged at 12 per cent, while the population share of their members rose from 14.0 to 15.0 per cent, indicating that economic problems were concentrated among larger families (Table 21).

The trend of past years of income redistribution in favour of self-employed households and away from the households of wage and salary earners continued. Between 1996 and 2004 real equivalent disposable

Table 21

LOW-INCOME HOUSEHOLDS AND INDIVIDUALS (1)

(percentages)

	1993	1995	1998	2000	2002	2004
Low-income households (3)	12.4	12.5	13.0	12.4	12.2	12.0
Centre and North	*6.4*	*5.2*	*5.9*	*4.4*	*4.5*	*4.7*
South	*25.1*	*27.1*	*27.4*	*28.4*	*27.5*	*27.7*
Production worker, apprentice, clerk	*14.2*	*14.1*	*16.0*	*16.0*	*17.3*	*18.2*
Clerical worker, technician, teacher	*2.9*	*3.1*	*3.3*	*2.9*	*4.5*	*4.8*
Manager	..	..	..	*1.2*	..	*0.3*
Self-employed worker	*16.5*	*14.4*	*10.5*	*10.0*	*9.4*	*10.1*
Pensioner	*13.0*	*12.6*	*13.0*	*12.5*	*12.0*	*11.8*
Non-employed non-pensioner	*58.0*	*73.4*	*62.8*	*65.1*	*59.5*	*43.2*
1 member	*14.4*	*14.2*	*13.0*	*13.0*	*11.6*	*9.1*
2 members	*7.3*	*7.1*	*9.4*	*8.2*	*8.8*	*7.4*
3 members	*10.3*	*10.3*	*11.2*	*10.4*	*8.6*	*10.7*
4 members	*11.4*	*13.6*	*14.1*	*13.3*	*14.9*	*15.5*
5 members or more	*27.7*	*25.6*	*26.5*	*29.9*	*29.3*	*38.4*
Home-owner	*8.2*	*7.9*	*8.6*	*8.6*	*8.0*	*7.4*
Tenant	*19.6*	*21.3*	*21.7*	*21.3*	*21.8*	*21.9*
Individuals in low-income households (4)	14.1	14.1	14.4	14.1	14.0	15.0
Centre and North	*5.5*	*4.8*	*5.3*	*4.4*	*4.7*	*5.4*
South	*29.3*	*30.4*	*30.4*	*31.2*	*30.6*	*32.3*
Production worker, apprentice, clerk	*17.3*	*16.9*	*19.3*	*19.8*	*21.3*	*24.4*
Clerical worker, technician, teacher	*3.7*	*4.0*	*4.0*	*3.9*	*6.0*	*6.5*
Manager	..	..	..	*1.3*	..	*0.4*
Self-employed worker	*18.7*	*15.5*	*12.1*	*12.6*	*11.5*	*12.4*
Pensioner	*14.9*	*13.8*	*14.3*	*13.5*	*12.6*	*13.4*
Non-employed non-pensioner	*67.2*	*81.2*	*71.1*	*73.6*	*68.5*	*58.2*
Home-owner	*9.7*	*8.9*	*9.6*	*9.7*	*9.1*	*9.2*
Tenant	*22.8*	*25.0*	*25.0*	*24.4*	*26.0*	*28.4*

Source: Banca d'Italia, *Indagine sui bilanci delle famiglie italiane, Archivio storico* (Version 4.0 January 2006).

(1) "Low-income" is defined as an equivalent income less than 50 per cent of the median equivalent disposable income, as defined in Table 20. – (2) The employment status of the household is that of the head, defined as the person with the largest labour or pension income. (3) Percentage of all households. – (4) Percentage of all individuals living in households.

income (counting all incomes, not just wages and pensions) rose 0.2 per cent annually for the households of production workers and 0.5 per cent for those of non-production workers and teachers, against 3.6 per cent for the households of self-employed workers. For pensioner households the gain amounted to 1.6 per cent per year.

PRICES AND COSTS

The euro area

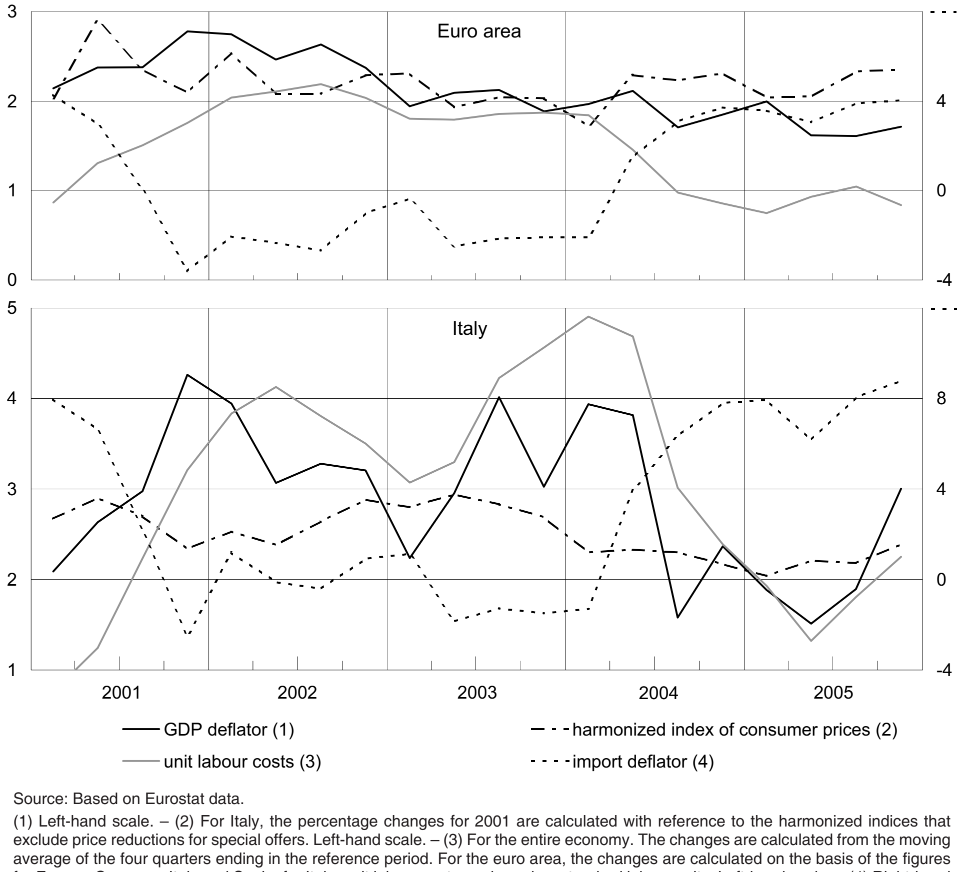
Consumer prices

Although the inflationary impact of higher oil prices was no longer offset by a stronger euro, as in 2004, consumer price inflation in 2005 measured by the harmonized index (2.2 per cent) was moderated by below-potential growth in economic activity, a small increase in domestic costs (Figure 11) and stable long-term inflation expectations.

Figure 11

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 four 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.

The rate of increase in consumer prices rose slightly during the year from an average of 2 per cent in the first half to 2.3 per cent in the second, reflecting the acceleration in the twelve-month growth in the prices of energy products from 8.2 to 11.9 per cent. In 2005 as a whole the energy component contributed about 0.9 points to euro-area consumer price inflation.

Core inflation – measured by the overall index net of unprocessed food and energy products – fell from 2.1 per cent in 2004 to an average of 1.6 per cent in the first half of 2005 and subsequently held steady at around 1.4 per cent.

The goods component of core inflation declined from 0.8 per cent in 2004 to 0.3 per cent on average in 2005, largely as a result of the non-recurrence of the sharp increases in some regulated prices, particularly for medical products in Germany. In Germany and France the prices of non-food and non-energy goods diminished slightly (Table 22); in Italy their rate of increase eased but was still about 1 percentage point higher than the euro-area average.

Table 22

HARMONIZED INDICES OF CONSUMER PRICES

(percentage changes on year-earlier period)

	Italy			Germany			France			Spain			Euro area		
	2004	2005	2006 Q1	2004	2005	2006 Q1	2004	2005	2006 Q1	2004	2005	2006 Q1	2004	2005	2006 Q1
Overall index	2.3	2.2	2.2	1.8	1.9	2.1	2.3	1.9	2.0	3.1	3.4	4.1	2.1	2.2	2.3
Core inflation (1)	2.3	2.0	1.7	1.6	1.0	0.7	2.4	1.2	1.2	2.8	2.7	3.1	2.1	1.5	1.4
Processed food	3.6	2.2	2.2	2.8	3.6	2.2	5.6	-0.4	0.6	4.2	3.5	4.3	3.4	2.0	2.0
Non-food and non-energy products ..	1.6	1.4	1.1	0.9	-0.4	-0.1	0.4	-0.2	..	1.0	1.0	1.5	0.8	0.3	0.3
Services	2.5	2.4	2.0	1.9	1.3	0.9	2.8	2.8	2.4	3.7	3.8	3.8	2.6	2.3	1.9
Unprocessed food	2.0	-0.7	0.5	-0.9	0.8	1.3	-0.1	1.0	1.2	3.7	3.3	3.8	0.6	0.8	1.4
Energy products	2.4	8.7	10.3	4.1	10.3	13.9	4.7	9.8	10.2	4.8	9.7	13.3	4.5	10.1	12.2

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

Service price inflation slowed gradually during 2005, from 2.4 per cent in the first quarter to 2.1 per cent in the fourth. Its difference with respect to the inflation rate for non-energy goods held at around 2 percentage points on average for the year, reflecting the differential increase in unit labour costs in the two sectors.

The dispersion of inflation rates within the area, measured by the standard deviation, increased slightly in 2005, owing to the geographically uneven impact of the rise in energy prices.

Producer and export prices

Producer prices in the euro area rose by an average of 4.1 per cent in 2005. They were driven up primarily by the acceleration in the prices of energy products (from annual growth of 3.9 per cent in 2004 to 13.4 per cent), which affected all the countries. Unlike consumer prices, producer price inflation net of the energy and food components increased, from 1.7 per cent in 2004 to 2.1 per cent.

The producer prices of non-food, non-energy final consumption goods, which had fallen in 2004, rose by 1.6 per cent as a consequence of the acceleration in the costs of imported inputs and the recovery of demand in the second half of 2005. The inflationary impulses were curbed only in part by the fall in the inflation rate for non-energy intermediate goods, which reflected the slowdown in international commodity prices, particularly of metals, in 2004 and the early months of 2005.

Euro-area firms' export prices rose more in 2005 than in the three previous years, reflecting the expansion of world demand and the slight weakening of the nominal effective exchange rate of the euro. According to national accounts data, the implicit deflator of goods exports rose by an average of 2.5 per cent, compared with 1.2 per cent in 2004. The pricing policies of national exporters diverged. Moderate increases for German and French exports (0.7 and 0.9 per cent respectively) contrasted with a much larger increase for Italian exports (6.6 per cent); the differences are greater than those for domestic costs.

Costs and profit margins

The pressures exerted by imported inflation intensified in 2005. The deflator of imported goods and services rose by an average of 3.7 per cent, more than twice as much as in 2004. The increase was due to the progressive rise in world non-energy commodity prices and the disappearance of the curbing effect that the strengthening of the nominal effective exchange rate of the euro had exercised in the two previous years. The jump in the dollar prices of oil, which rose by 42 per cent on average for Brent grade (on top of the increase of 33 per cent in 2004), was accompanied in the second half of the year by an upturn in the prices of non-oil commodities on international markets. In the first few months of 2006 oil prices surged further.

The increase in the prices of imported goods and services was moderate in Germany and France (2.2 and 3 per cent respectively), but particularly large in Italy (7.7 per cent) owing to the greater share of commodities in total imports.

The persistence of moderate growth in domestic costs attenuated the imported inflationary pressures. Set against a basically stable rate of increase in labour costs per employee (1.6 per cent), the annual growth in unit labour costs in the four largest countries rose from 0.5 per cent in 2004 to 1 per cent owing to the slowdown in labour productivity (Table 23). Unit labour costs grew by an average of 1.4 per cent in services, while in industry excluding construction they fell for the second successive year, benefiting from a sharp improvement in productivity.

Table 23

LABOUR COSTS PER EMPLOYEE, PRODUCTIVITY AND ITS COMPONENTS, AND UNIT LABOUR COSTS IN THE MAJOR EURO-AREA COUNTRIES

(percentage changes on previous year)

	Labour costs per employee (1)		Labour productivity						Unit labour costs	
					of which:					
					Value added (2)		Employment (1)			
	2004	2005	2004	2005	2004	2005	2004	2005	2004	2005
	Industry excluding construction (3)									
Germany	2.1	1.2	6.0	4.4	4.4	2.6	-1.5	-1.7	-3.7	-3.1
France	3.6	2.6	3.5	3.1	0.4	0.8	-2.9	-2.2	0.2	-0.5
Italy	4.0	2.4	2.5	-0.7	1.3	-2.3	-1.2	-1.6	1.5	3.2
Spain	3.9	2.8	1.5	0.8	0.6	1.1	-0.9	0.3	2.4	2.0
Euro 4 (4)	2.9	1.7	4.0	2.3	2.4	0.9	-1.6	-1.3	-1.1	-0.6
	Services (5)									
Germany	-0.3	-0.1	0.1	0.2	1.3	0.9	1.3	0.6	-0.3	-0.3
France	2.8	3.4	1.3	1.3	1.9	1.9	0.6	0.6	1.5	2.0
Italy	3.3	3.2	0.4	0.5	0.8	0.8	0.4	0.3	2.9	2.6
Spain	3.3	2.7	0.5	0.8	3.6	3.9	3.1	3.1	2.8	1.9
Euro 4 (4)	1.7	1.8	0.4	0.5	1.7	1.5	1.2	1.1	1.2	1.4
	Total economy									
Germany	0.3	0.2	1.7	1.3	2.1	1.0	0.4	-0.2	-1.4	-1.1
France	2.9	3.2	1.9	1.3	1.9	1.5	0.1	0.2	1.0	1.9
Italy	3.5	2.9	1.3	0.5	1.3	..	..	-0.4	2.2	2.4
Spain	3.3	2.5	0.4	0.2	3.0	3.4	2.6	3.1	2.9	2.3
Euro 4 (4)	1.8	1.6	1.3	0.6	2.0	1.3	0.7	0.6	0.5	1.0

Source: Based on Eurostat data.

(1) For France, Italy and Spain, refers to standard labour units. – (2) Chain-linked volumes. – (3) Manufacturing, mining and quarrying, and energy generation and distribution. – (4) Changes calculated on the basis of the sum of the figures for France, Germany, Italy and Spain. – (5) Comprises "wholesale and retail trade, repairs, hotels and restaurants, transport and communications", "financial, real-estate, renting and business services", and "public administration, education, health and social work, and other community, social and personal services".

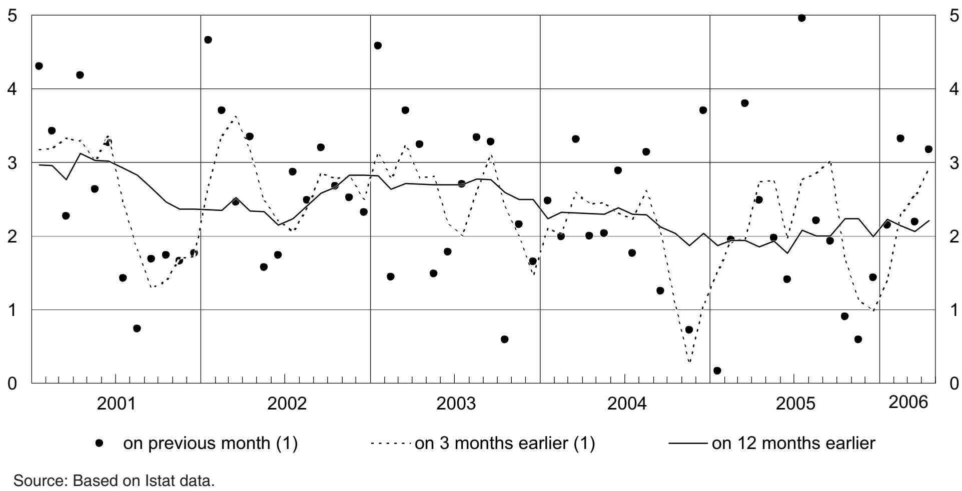
Italy

Consumer prices

Average consumer price inflation in Italy, measured by the index of consumer prices for the entire resident population, fell from 2.2 per cent in 2004 to 1.9 per cent, its lowest level since the beginning of the decade. During the year the twelve-month rate of increase rose from 1.9 per cent in the first quarter to 2.1 per cent in the fourth, reflecting the increase in energy prices; in the opening months of 2006 it remained virtually stable at around 2.1 per cent (Figure 12).

Figure 12

ITALY: INDEX OF CONSUMER PRICES FOR THE ENTIRE RESIDENT POPULATION
(monthly data; percentage changes)



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

The decline in average annual inflation was due to the slowdown in the prices of unregulated goods and services (Table 24), except for the energy component. The acceleration imparted to the overall index by the increase in petrol and fuels (11 per cent, compared with 5.8 per cent in 2004) was offset by the reduction in the prices of unprocessed food and the deceleration in the prices of processed foods, partly a consequence of the behaviour of food commodity prices on the international markets. Overall food price inflation fell virtually to zero, from 2.2 per cent in 2004. The increase in energy charges (up by an average of 6.1 per cent) caused a modest acceleration in the regulated price component of the index (to 2.1 per cent, from 1.9 per cent in 2004).

Table 24

CONSUMER PRICES IN ITALY (1)

	Percentage changes on year-earlier period		Percentage weights	Contributions to inflation (2)
	2004	2005	2005	2005
OVERALL INDEX	**2.2**	**1.9**	**100**	
Unregulated goods and services	**2.3**	**1.9**	**81.8**	**1.58**
Unprocessed food	2.0	-0.8	6.6	-0.05
of which: fruit	*3.7*	*-6.1*	*0.9*	*-0.05*
Processed food	2.3	0.7	10.0	0.07
Non-food and non-energy products	0.8	0.9	30.0	0.27
of which: computers	*-9.4*	*-10.6*	*0.2*	*-0.02*
telephones	*-23.3*	*-20.4*	*0.6*	*-0.12*
Services	3.4	3.0	31.9	0.96
of which: air transport	*11.6*	*18.1*	*0.8*	*0.14*
banking services	*6.6*	*8.3*	*0.7*	*0.06*
hotels and restaurants	*3.2*	*2.3*	*10.6*	*0.24*
Energy	5.8	11.0	3.3	0.36
Regulated goods and services	**1.9**	**2.1**	**18.2**	**0.38**
Medical products	-1.0	-5.1	2.8	-0.14
Tobacco products	9.8	8.9	2.1	0.19
Rents	2.8	2.4	3.0	0.07
Public services and utilities	0.9	2.6	10.2	0.27
of which: electricity and gas	*-1.2*	*6.1*	*2.8*	*0.17*
refuse collection	*3.9*	*4.4*	*0.6*	*0.03*

Source: Based on Istat data.
(1) Index of consumer prices for the entire resident population. – (2) Percentage points.

Unregulated service prices rose by 3 per cent, 0.4 percentage points less than in 2004, benefiting from the slight slowdown in unit labour costs in the sector. Especially marked increases were recorded for air transport (18.1 per cent, compared with 11.6 per cent in 2004), owing to the rise in fuel prices, and banking services (8.3 per cent, up from 6.6 per cent in 2004).

The inflation rate for unregulated non-food and non-energy goods remained about the same as in 2004 (0.9 per cent), despite the acceleration in domestic and imported costs. This reflected the weakness of demand, the growing pressure of international competition and the reduction in the prices of high-technology goods, whose contribution to curbing overall inflation was about one tenth of a percentage point, as in 2004.

The gap between official inflation and perceived inflation as found by household surveys, which had begun to narrow in 2004, continued to diminish in 2005 and in the most recent months disappeared; the gap had reached historically high levels in the two years 2002-03, in concomitance with the changeover to the euro. A similar pattern was also seen in the other major euro-area countries.

Producer prices, costs and profit margins

Producer prices of industrial goods in Italy rose by an average of 4 per cent in 2005, accelerating from 2.7 per cent in 2004. The effects of the surge in the energy component (15.5 per cent, compared with 2.4 per cent in 2004) were attenuated by slower growth in the prices of non-energy and non-food intermediate goods.

According to Istat's indicators of input and output prices, which are only available for the first nine months of 2005, output prices of manufactures sold on the domestic market grew significantly less than unit variable costs, indicating a substantial narrowing of manufacturing firms' unit profit margins. The costs of non-labour domestic inputs accelerated appreciably. According to the national accounts, for the year as a whole unit labour costs in manufacturing rose by 1.8 per cent, compared with 2 per cent in 2004, benefiting from a sharper deceleration in per capita compensation (from 4.2 to 2.5 per cent) than in productivity (from 2.2 to 0.7 per cent).

Unit labour costs in industry excluding construction rose by 3.2 per cent, in contrast with the reduction recorded in the other leading countries. In Germany and France they fell by 3.1 and 0.5 per cent respectively, driven down by productivity gains of 4.4 and 3.1 per cent (Table 23).

In order to compensate for at least some of the contraction in profit margins in the domestic market, Italian firms applied markedly higher price increases in foreign markets. The average unit values in euros of exported manufactures rose by 6.6 per cent in 2005. The prices of exports to other EU countries increased by 5.2 per cent, more than the increase applied by domestic producers in these markets; the increase on exports to non-EU countries was even larger (8.2 per cent).

In market services, the difference between the growth in output prices and that in unit variable costs was smaller than in manufacturing, so that that reduction in unit profit margins was more limited. The average annual increase in unit labour costs declined from 2.9 to 2.6 per cent.

Inflation persistence and expectations

The Inflation Persistence Network, the Eurosystem research project on the time it takes for inflation to return to its long-run level following a shock and on the price adjustment mechanisms in the euro area, completed its work in 2005. The study found that inflation persistence in the euro area is relatively limited at present, similar to that observed in the United States.

By contrast, the degree of price rigidity, i.e. the average length of time between two changes in the price of a good, is greater than in the United States; it varies considerably from sector to sector and is especially great in services, where it is associated with asymmetric downward stickiness.

The role of competitive pressures in pricing policies was examined on the basis of surveys of industrial and service firms in the individual countries (except Ireland, Greece and Finland). The findings suggest that in the area as a whole firms more exposed to competition (i.e. those whose strategies are strongly influenced by their competitors' pricing) are more flexible in their price-setting behaviour than those that operate in less competitive markets. Firms exposed to competition tend to review and change their selling prices more frequently: their prices remain unchanged for an average of 9 months, compared with about 14 months for the others. The rapidity of price adjustments is greater following a shock, especially on the demand side.

The positive correlation between price flexibility and competitiveness of the markets is confirmed by an analysis of a broad set of the elementary price quotes used by the national statistical institutes to calculate consumer price inflation in the various countries. In the euro area as a whole, only about 6 per cent of quotes are modified each month in the service sector, compared with about 9 per cent for industrial goods, whose market tends to be more exposed to competition.

Table 25

PROFESSIONAL FORECASTERS' INFLATION EXPECTATIONS FOR 2006 AND 2007 IN THE EURO AREA

(percentage changes on previous year)

	Forecasts for 2006 made in the period indicated				Forecasts for 2007 made in the period indicated	
	January 2005	June 2005	January 2006	May 2006	January 2006	May 2006
Italy	1.9	1.9	2.1	2.1	1.8	1.9
France	1.7	1.6	1.8	1.7	1.6	1.5
Germany	1.2	1.3	1.7	1.7	2.3	2.3
Spain	2.6	2.7	3.1	3.5	2.8	3.0
Euro area	1.7	1.7	2.0	2.1	2.0	2.1

Source: *Consensus Forecasts.*

In the second half of 2005 the inflation expectations for 2006 of the professional forecasters surveyed by Consensus Economics were revised upwards from 1.7 per cent in August to 2 per cent in December, taking account of strains in international oil markets. Expected inflation for Italy was slightly higher and was likewise revised upwards at the end of 2005.

According to the forecasts made in May 2006, inflation in Italy will average 2.1 this year and then fall to 1.9 per cent in 2007, while in the euro area it is expected to remain stable at 2.1 per cent in both years (Table 25). The professional forecasters' longer-term expectations are that inflation will basically hold steady at around 2 per cent, the same level implied by prices on the financial markets.

THE BALANCE OF PAYMENTS AND THE NET INTERNATIONAL INVESTMENT POSITION

Italy's current account deficit in 2005 amounted to €22.1 billion (1.6 per cent of GDP), up from €12.5 billion (0.9 per cent of GDP) in 2004 (Table 26). The deterioration was almost entirely due to the swing into deficit of the balance on goods and services, in turn largely caused by the disappearance of the surplus on merchandise trade. The swing into deficit of the balance on services was mainly due to the reduction in the surplus on travel. The decrease in the deficit on income was slightly larger than the increase in that on transfers.

The overall deficit of €20.3 billion on current and capital account was accompanied by €19 billion of net inflows on financial account. The surplus on direct and portfolio investment and financial derivatives increased from €26.3 billion to €28.2 billion. The deficit on other investment decreased slightly as a consequence of the net inflows received by banks. The official reserves decreased by €0.8 billion, compared with €2.3 billion in 2004.

Between the end of 2004 and the end of 2005 Italy's net external debt position improved from €90.3 billion to €77.9 billion (from 6.5 to 5.5 per cent of GDP), thanks to exchange rate and other valuation adjustments, which offset the increase in the debtor position caused by the net outflows recorded on the financial account.

The current and capital accounts

Goods. – After being in surplus for twelve consecutive years, the balance on goods fell to zero. Compared with 2004 the balance fell by €8.8 billion, with the growth in imports (9.1 per cent) exceeding that in exports (5.7 per cent) almost entirely as a result of price increases. Imports were affected by the large increases in the prices of metals and energy products, especially petroleum products, which accounted for almost the entire deterioration in the overall balance in 2005.

The deficit on energy products rose from €29.4 billion to €38.6 billion, whereas on a *cif-fob* basis the surplus on manufactures excluding refined petroleum products grew by €1.1 billion, to €37.6 billion or 2.7

per cent of GDP. The machinery and mechanical equipment sector, which contributes the largest surplus to the balance on merchandise trade, recorded an improvement of €1.4 billion, with the growth in exports exceeding that in imports. The deficit on electrical machinery contracted thanks to the good performance of exports of electrical motors and transmission equipment. The overall surplus of the main branches of Italy's traditional manufacturing industry (textiles, furniture, leather and leather products) contracted for the fourth consecutive year as a consequence of a fall in exports and a rise in imports.

Table 26

ITALY'S BALANCE OF PAYMENTS

(billions of euros)

	2001	2002	2003	2004	2005
Current account	**-0.7**	**-10.0**	**-17.4**	**-12.5**	**-22.1**
Goods	17.4	14.0	9.9	8.9	0.1
Exports	*273.6*	*267.6*	*263.6*	*283.3*	*299.6*
Imports	*256.2*	*253.5*	*253.7*	*274.5*	*299.5*
Services	..	-3.0	-2.4	1.2	-0.4
Exports	*64.6*	*63.8*	*63.4*	*68.2*	*72.5*
Imports	*64.6*	*66.8*	*65.8*	*67.0*	*72.9*
Income	-11.6	-15.4	-17.8	-14.8	-13.6
Transfers	-6.5	-5.6	-7.1	-7.7	-8.2
of which: EU institutions	*-5.6*	*-5.7*	*-6.3*	*-6.5*	*-8.0*
Capital account	**0.9**	**-0.1**	**2.3**	**1.8**	**1.8**
Intangible assets	-0.3	-0.2	-0.1	..	0.1
Transfers	1.2	0.1	2.3	1.9	1.7
of which: EU institutions	*1.7*	*1.6*	*3.6*	*2.8*	*3.2*
Financial account	**-3.3**	**8.5**	**17.3**	**8.2**	**19.0**
Direct investment	-7.4	-2.7	6.5	-2.0	-17.6
Outward	*-24.0*	*-18.2*	*-8.0*	*-15.5*	*-33.6*
Inward	*16.6*	*15.5*	*14.5*	*13.5*	*16.0*
Portfolio investment	-7.6	16.1	3.4	26.4	43.4
Equities	-11.5	-13.2	-16.0	0.5	-16.0
Assets	*-11.2*	*-6.0*	*-13.8*	*-12.9*	*-20.0*
Liabilities	*-0.4*	*-7.2*	*-2.2*	*13.4*	*4.1*
Debt securities	3.9	29.3	19.4	25.9	59.3
Assets	*-28.9*	*-10.9*	*-37.3*	*-8.2*	*-67.0*
Liabilities	*32.8*	*40.2*	*56.6*	*34.1*	*126.4*
Financial derivatives	-0.5	-2.7	-4.8	1.8	2.3
Other investment	11.7	1.0	13.7	-20.3	-9.9
of which: banks (1)	*27.6*	*-41.7*	*40.6*	*-10.8*	*27.0*
Change in official reserves	0.5	-3.1	-1.4	2.3	0.8
Errors and omissions	**3.1**	**1.5**	**-2.2**	**2.4**	**1.2**

(1) MFIs, excluding the Bank of Italy.

The surplus with the other EU countries increased slightly, from €0.7 billion to €0.9 billion. The growth in both exports and imports was the result of a reduction in volumes and an increase in average unit values. The deficit on merchandise trade with the euro-area countries decreased from €12.2 billion to €10.4 billion. The growth in the surpluses with France and Spain more than offset that in the deficit with Germany and the remaining euro-area countries. Exports to Germany, which is the most important market for Italian products, grew by only 2.9 per cent; once again they were held back by the fall in sales of textiles and clothing, leather products and footwear, and mechanical machinery.

There was a further reduction in the surplus with the new EU member states in 2005, as a result of a worsening in the balance for transport equipment and electrical machinery. The surplus with the United Kingdom contracted as a consequence of a fall of 2.7 per cent in exports (the only main sectors to show increased sales were electrical machinery and metal products) and a rise of 3 per cent in imports.

The surplus with the United States, the largest of all, increased slightly again in 2005; exports grew only thanks to the rise in average unit values. At least at current prices, the large increases in the value of exports of transport equipment, chemical products and machinery more than offset the further falls recorded by the traditional sectors.

The deficit with China increased further, to €8.7 billion. According to the foreign trade statistics, the limited growth in exports was due to the large fall in those of transport equipment, which stemmed in part from the anomalous level reached in 2004 as a result of the repair of aircraft. Exports of mechanical machinery also fell, while those of metal products rose as a result of higher prices. The main increases in imports were recorded by low-tech goods and electrical machinery.

The deficit with the OPEC countries increased by €6.6 billion to €13.8 billion. The growth in imports of oil was partially offset by that in exports of basic metals and mechanical and electrical machinery. The deficit with Russia, concentrated in the energy and basic metals sectors, rose by €0.9 billion; the growth in imports was partly offset by an increase of 22.2 per cent in exports (traditional consumer goods and machinery).

Services. – After improving for two years, the balance on services deteriorated last year, swinging from a surplus of €1.2 billion in 2004 to a deficit of €0.4 billion. The largest contributions to the deterioration came from travel, followed by "other business services" (professional and technical services, merchanting and other trade-related services, and operational leasing), the deficit on which had declined in 2003 and 2004, and IT and information services. The structural deficit on transport increased by €0.2 billion as a consequence of the rise in fuel prices, which brought a substantial increase in the deficit on the transport of goods; the latter was partially offset by the annulment of the overall deficit on auxiliary logistic services.

The decrease in the surplus on travel from €12.2 billion to €10.5 billion was due to the sharp recovery in Italians' spending abroad (up by 9 per cent, compared with a fall of 9.4 per cent in 2004) and the slight reduction of 0.7 per cent in foreign travelers' spending in Italy. The reduction in total inflows from travel was due to the fall in the spending of EU citizens (4.2 per cent) and especially the cut-back by euro-area citizens (6.7 per cent). The spending by non-EU citizens, which accounts for just over one third of the total, increased by 6 per cent.

After falling in 2004, Italians' spending on holidays abroad rose by 10.1 per cent, while spending on business travel rose by 6.3 per cent. The recovery regarded both EU and non-EU destinations.

Income. – In 2005 the deficit on the income account fell from €14.8 billion to €13.6 billion, a smaller reduction than in 2004. The deficit on compensation of employees rose from €0.2 billion to €0.6 billion as the increase in debits outpaced that in credits. By contrast the deficit on investment income fell from €14.6 billion to €13 billion, thanks above all to the contraction in the deficit on the portfolio investment component from €10.8 billion to €9.1 billion. The deficit on income from direct investment rose from €0.4 billion to €0.7 billion, while that on other investment income declined slightly.

Current account transfers. – Continuing the trend of the three previous years, Italy's deficit on this item rose slightly, from €7.7 billion to €8.2 billion. The deterioration was largely due to the increase in the deficit vis-à-vis EU institutions, which rose from €6.5 billion to €8 billion. As regards private-sector transfers, the increase in net outflows due to emigrants' remittances was more than offset by the swing into surplus of "indemnity payments, fines and penalties", mainly as a result of the penalty received by a large Italian industrial group.

The capital account. – Italy's capital account surplus remained unchanged last year at €1.8 billion and consisted almost entirely of the surplus on public transfers. The surplus on EU transfers increased by

€0.4 billion as a result of the larger amounts received from the Regional Development Fund.

Investment

Direct investment. – The sharp rise in net outflows of direct investment reflected the growth in gross outflows from €15.5 billion to €33.6 billion and was largely due to an Italian bank's acquisitions abroad. Foreign investment in Italy rose much less than outward investment but returned close to its level in 2001.

Direct investment abroad other than by the banking sector remained at the very low level of 2004 (€14.5 billion or 1 per cent of GDP). Investment in the energy sector declined, while there was an increase of €1.9 billion in investment in the service sector, especially insurance and banking services. Investment in manufacturing industry remained unchanged at €6.1 billion.

Excluding the banking sector, foreign direct investment in Italy rose from €13.2 billion to €15 billion. There were increases in investment in the energy and manufacturing sectors of respectively €4.5 billion and €4 billion; the chemical sector recorded a net inflow, compared with a net outflow of €2.8 billion in 2004. Investment in services fell sharply as a consequence of the reduction recorded by banking and insurance and the substantial disinvestment in transport and communications.

Portfolio investment and derivatives. – Net inflows of portfolio investment and derivatives rose from €28.3 billion in 2004 to €45.7 billion. The €16 billion of net outflows of investment in equity securities was more than offset by the large net inflows of investment in non-equity securities (€59.3 billion) and derivatives (€2.3 billion).

Whereas in 2004 inflows and outflows of investment in equity securities were of much the same size, in 2005 outflows rose from €12.9 billion to €20 billion and inflows fell from €13.4 billion to €4.1 billion. A large part of these inflows were in relation to the exchange of shares involved in the above-mentioned direct investment in the banking sector.

After contracting slightly in 2004, the flows of investment in non-equity securities grew significantly in 2005. Outflows jumped from €8.2 billion to €67 billion and inflows from €34.1 billion to €126.4 billion; in both cases the value for 2005 was higher than the previous peak for the last 15 years, recorded in 1999.

Foreign investment in Italian non-equity securities was concentrated in the first half of 2005 and consisted mainly of purchases of government securities. Although net issues were comparable to those in 2004, these purchases rose from €9.9 billion to €90.7 billion on an annual basis, with a clear preference for BTPs. The result may have been influenced by the widening of the spreads between Italian government securities and those of the other leading euro-area countries in the first half of the year.

The upturn in Italians' investment in foreign non-equity securities in 2005 can be interpreted as the first clear sign of a recovery in international portfolio investment after the stagnation that began in 2001. Not only were investment flows at their highest level in the period 2001-05 but indicators of the internationalization of portfolio choices also appear to point in the same direction.

"Other investment". – In 2005 net outflows of €9.9 billion were recorded under "other investment", less than half the €20.3 billion recorded in 2004. The decrease in the deficit was largely due to Italian banks, which recorded net inflows of €27 billion, compared with net outflows of €10.8 billion in 2004.

The net international investment position and the official reserves

At the end of 2005 Italy's net external debt amounted to €77.9 billion (5.5 per cent of GDP), down from €90.3 billion (6.5 per cent of GDP) at the end of 2004 (Table 27). The improvement was entirely due to exchange rate and other valuation adjustments, which exceeded the net inflow of capital recorded on the financial account. The exchange rate adjustments were relatively small and contributed above all to an increase in the non-banking sectors' assets (especially as regards direct investment and equity portfolio investment) and in those of the central bank. Other valuation adjustments made the largest contribution and primarily concerned the non-banking sectors and the central bank.

The rise in share prices was the main cause of revaluations and mainly affected the non-banking sectors' direct and portfolio investment holdings of equity assets and liabilities. In the case of the central bank's assets, most of the increase was due to the revaluation of the gold reserves. In fact the official reserves rose from €45.8 billion to €55.9 billion and the gold component from €25.3 billion to €34.3 billion.

Table 27

ITALY'S NET INTERNATIONAL INVESTMENT POSITION

(millions of euros)

	Stocks at end-2004 (1) (a)	January-December 2005					Stocks at end-2005 (1) (a)+(d)
		Flows (2) (b)	Value adjustments			Change in stocks (d)=(b)+(c)	
			(c)	Exchange rate (3)	Other		
	Resident non-banks						
Assets	**961,674**	**164,195**	**49,978**	**17,317**	**32,661**	**214,173**	**1,175,847**
Direct investment	191,478	15,590	10,078	5,339	4,739	25,668	217,146
Portfolio investment	594,690	89,399	39,363	11,539	27,824	128,762	723,452
of which: equities	*265,374*	*21,075*	*38,775*	*7,905*	*30,870*	*59,850*	*325,224*
Other investment	164,363	57,768	534	439	95	58,302	222,665
Derivatives	11,143	1,438	3	..	3	1,441	12,584
Liabilities	**1,045,351**	**125,289**	**15,234**	**6,858**	**8,376**	**140,523**	**1,185,874**
Direct investment	154,496	15,893	6,022	49	5,973	21,915	176,411
Portfolio investment	760,566	79,278	8,252	6,136	2,116	87,530	848,096
of which: equities	*41,792*	*-19,119*	*4,465*	*..*	*4,465*	*-14,654*	*27,138*
Other investment	118,254	20,820	964	673	291	21,784	140,038
Derivatives	12,035	9,298	-4	..	-4	9,294	21,329
Net position	**-83,677**	**38,906**	**34,744**	**10,459**	**24,285**	**73,650**	**-10,027**
	Resident banks						
Assets	300,389	40,936	2,021	4,293	-2,272	42,957	343,346
Liabilities	372,801	98,873	17,073	8,714	8,359	115,946	488,747
Net position	**-72,412**	**-57,937**	**-15,052**	**-4,421**	**-10,631**	**-72,989**	**-145,401**
	Central bank						
Assets	66,528	928	11,918	2,717	9,201	12,846	79,374
Liabilities	767	938	123	123	..	1,061	1,828
Net position	**65,761**	**-10**	**11,795**	**2,594**	**9,201**	**11,785**	**77,546**
OVERALL NET INTERNATIONAL INVESTMENT POSITION	**-90,328**	**-19,041**	**31,487**	**8,632**	**22,855**	**12,446**	**-77,882**

(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.

THE PUBLIC FINANCES

General government net borrowing in the euro area declined for the second successive year. The reduction, from 2.8 per cent of GDP in 2004 to 2.4 per cent in 2005, was slightly smaller than that indicated in the stability programmes submitted between the last part of 2004 and the first half of 2005. The ratio of debt to GDP rose further, from 69.8 to 70.8 per cent.

Net borrowing remained above the 3 per cent limit in Portugal, Greece, Italy and Germany; in France it was 2.9 per cent of GDP. In 2005 excessive deficit procedures were launched against Italy and Portugal; the procedures launched against Germany, France and Greece in respectively 2002, 2003 and 2004 are still under way.

On the basis of the most recent stability programmes, net borrowing in the euro area should decline to 2.3 per cent of GDP in 2006 and to 1.4 per cent in 2008. The forecasts published by the European Commission in April show the figure unchanged at 2.4 per cent in 2006; in 2007, on the assumption of no change in policies, it is seen as falling by 0.1 percentage points.

In Italy general government net borrowing in 2005 was 4.1 per cent of GDP, compared with 3.4 per cent in 2004; the deficit has been above the 3 per cent limit since 2003. The primary surplus fell to 0.4 per cent of GDP; in 1997 it had been equal to 6.6 per cent, in 2001 to 3.2 per cent and in 2004 to 1.3 per cent. In 2005 the ratio of primary current expenditure to GDP rose by 0.6 percentage points; the ratio of taxes and social security contributions declined by 0.1 percentage points to 40.6 per cent. Public investment contracted by 4 per cent in nominal terms.

Recourse to one-off deficit-reduction measures fell from 1.5 per cent of GDP in 2004 to about 0.5 per cent. Excluding the effects of these measures, the primary surplus has been virtually nil since 2003.

When Istat released the budget outturn for 2005 in March 2006, it announced statistical and accounting revisions that increased net borrowing by 0.2 percentage points in 2002, 2003 and 2004.

The objective for net borrowing in 2005, set at 2.7 per cent of GDP in July 2004, was raised in several steps to 4.3 per cent in July 2005. The revision reflected the deterioration in the trends on a current programmes basis, due in part to the worse-than-expected economic conditions, and shortfalls in the effects of the budget measures. The improvement ultimately achieved on the July 2005 objective was due to the postponement to 2006 of part of the cost of labour contract renewals in the public sector and the increase in the estimate of GDP.

In 2005 the general government borrowing requirement net of privatization receipts rose by 1 percentage point to 5.1 per cent of GDP. The increase reflects the reduction in the effects of one-off measures, from approximately 2 percentage points of GDP in 2004 to approximately 1 point in 2005. Excluding the effects of these measures, the borrowing requirement has been close to 6 per cent of GDP since 2003; the corresponding primary balance, in deficit since 2003, has been equal to more than 1 percentage point.

At 1 percentage point of GDP, the gap between the borrowing requirement and net borrowing was nearly twice the average of the preceding three years. The increase reflects the change in the balance on financial transactions and the fact that interest payments on a cash basis exceeded those on an accrual basis for the first time.

In 2005 the ratio of debt to GDP rose from 103.9 to 106.4 per cent, interrupting the downward trend under way for the previous ten years. The result was influenced by the smallness of the primary surplus, the stagnation of the economy and the decrease in privatization receipts (0.7 percentage points of GDP, compared with an average of 1 point in the five preceding years).

The Economic and Financial Planning Document published in July 2005 set an objective for net borrowing in 2006 of 3.8 per cent of GDP (with a primary surplus of 0.9 per cent). The debt ratio was expected to fall by 0.8 percentage points. GDP growth was forecast at 1.5 per cent.

In December a budget adjustment officially estimated at 1.4 percentage points of GDP was approved. This was 0.6 percentage points more than had been announced in September; the bolstering of the adjustment offset the parallel decrease in the receipts expected from the sale of buildings compared with those on a current programmes basis and allowed the objective for net borrowing in the Stability Programme to be set at 3.5 per cent of GDP.

In March 2006 the EU Council considered that, if fully implemented, the budget measures for 2006 would allow the excessive deficit situation to be overcome in 2007. The Council stressed that substantial additional corrective measures would be necessary for 2007.

The Quarterly Report on the Borrowing Requirement published in April 2006 revised the economic growth expected in 2006 down to 1.3 per cent; it also reduced the estimate of the primary surplus to 0.6 per cent of GDP and raised the objective for net borrowing to 3.8 per cent. Public investment was expected to contract further. The figures published in the Report assume that the budget measures are fully effective and that there is complete compliance with the restrictions on the growth of expenditure by government bodies at every level.

On the basis of the scenario depicted in the Report and assuming that the change in the debt coincides with the borrowing requirement, the debt ratio will rise by 1.6 percentage points in 2006.

According to the recent estimates published by the EU Commission, in the absence of additional corrective measures net borrowing in 2006 will be 4.1 per cent of GDP and the debt ratio will rise to 107.4 per cent.

It appears essential to revive the debt-reduction process as soon as possible. Achieving the Stability Programme's objective for net borrowing in 2007 (2.8 per cent of GDP) should bring a reduction in the debt ratio.

In the light of present trends and without considering the cost of possible measures to reduce the tax and contributions burden or give renewed impetus to public investment, the 2007 adjustment would need to be of the order of 2 percentage points of GDP.

Primary current expenditure grew in real terms at an average annual rate of 2.2 per cent in 1998-2001 and of 2.4 per cent in 2002-05. In order to eliminate the excessive deficit in 2007 and gradually reduce the debt in the following years, without increasing the tax burden, there will need to be a sharp reduction in this rate of growth.

The ratio of old people to those of working age is set to rise in Italy. The increase will be especially pronounced in the period after 2010, with a major impact on the demand for services and government transfer payments.

A significant reduction in the debt ratio over the next ten years would make management of the public finances easier when the demographic imbalances will be most severe and would make it possible, by reducing interest payments, to offset part of the expected increase in expenditure on pensions, health care and social assistance. To this end it is necessary to achieve an adequate primary surplus. For 2009 the Stability Programme indicates an objective for this aggregate of 3.2 per cent of GDP, which it considers to be compatible with the long-term sustainability of the public finances. This assessment is based on a simulation in which demographic developments do not have major effects on public expenditure until 2030. The impact of the changes in the country's demographics may be significantly greater. It therefore appears desirable to curb expenditure trends with structural reforms and achieve a larger primary surplus in the coming years.

BUDGETARY POLICY IN 2005

The euro area

General government net borrowing decreased for the second consecutive year, falling from 2.8 to 2.4 per cent of GDP (Table 28). The improvement involved most of the euro-area countries; it was slightly less than indicated in the national stability programme updates submitted in late 2004 and the first half of 2005 (0.5 percentage points of GDP). The area's economic growth was approximately one point less than indicated in the national programmes.

Table 28

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

(as a percentage of GDP)

	Net borrowing (1)				Debt			
	2002	2003	2004	2005	2002	2003	2004	2005
Germany	3.7	4.0	3.7	3.3	60.3	63.8	65.5	67.7
France	3.2	4.2	3.7	2.9	58.2	62.4	64.4	66.8
Italy	2.9	3.4	3.4	4.1	105.5	104.3	103.9	106.4
Spain	0.3	0.0	0.1	-1.1	52.5	48.9	46.4	43.2
Netherlands	2.0	3.1	1.9	0.3	50.5	51.9	52.6	52.9
Belgium	0.0	-0.1	0.0	-0.1	103.2	98.5	94.7	93.3
Austria	0.5	1.5	1.1	1.5	66.0	64.4	63.6	62.9
Greece	4.9	5.8	6.9	4.5	110.7	107.8	108.5	107.5
Finland	-4.1	-2.5	-2.3	-2.6	41.3	44.3	44.3	41.1
Ireland	0.4	-0.2	-1.5	-1.0	32.1	31.1	29.4	27.6
Portugal	2.9	2.9	3.2	6.0	55.5	57.0	58.7	63.9
Luxembourg	-2.0	-0.2	1.1	1.9	6.5	6.3	6.6	6.2
Euro area	2.5	3.0	2.8	2.4	68.1	69.3	69.8	70.8

Sources: For the euro-area countries apart from Italy, based on European Commission data (May 2006); for Italy's net borrowing, Istat (March 2006).
(1) The data do not include the proceeds of sales of UMTS licences but include the effects of swaps and forward rate agreements.

The primary surplus of the euro area increased from 0.3 per cent of GDP in 2004 to 0.6 per cent in 2005. Interest payments were basically unchanged at 3 per cent. Primary expenditure amounted to 44.5 per cent of GDP, compared with 44.4 per cent in 2004. Total revenue rose from 44.7 to 45.1 per cent of GDP.

Net borrowing was above the threshold of 3 per cent of GDP in Portugal (6 per cent), Greece (4.5 per cent), Italy (4.1 per cent) and Germany (3.3 per cent). After exceeding the threshold for three consecutive years, France brought its deficit down to 2.9 per cent.

The European Commission has estimated that the deficit on a cyclically adjusted basis and excluding the effects of one-off measures was 2.2 per cent of GDP, a reduction of 0.8 percentage points compared with 2004.

Euro-area debt grew in relation to GDP for the third consecutive year, rising from 69.8 to 70.8 per cent. There were significant increases in Portugal (5.2 percentage points), Italy (2.5 points), France (2.4 points) and Germany (2.2 points). Among the countries with large debts, Greece lowered its ratio by 1 percentage point.

The excessive deficit procedures against France, Germany and Greece are still in place. In 2005 procedures were launched against Italy and Portugal.

Italy

Budgetary policy. – The budgetary policy for 2005, laid down in the Economic and Financial Planning Document published in July 2004, set an objective of 2.7 per cent of GDP for net borrowing. This was confirmed in the November update of the stability programme (Table 29), which indicated a primary surplus of 2.4 per cent of GDP and a reduction of 1.9 percentage points in the debt ratio. The economy was expected to grow by 2.1 per cent.

In order to achieve the objective for net borrowing, the Government presented budget measures officially estimated at €24 billion (1.7 per cent of GDP). During the bill's passage through Parliament the Government introduced €4.3 billion of fiscal relief (0.3 per cent of GDP) and €1.8 billion of additional expenditure (0.1 per cent of GDP); the financing of these measures was provided for with €3.9 billion of additional revenue and €2.2 billion of expenditure cuts; the overall effect of the adjustment was left basically unchanged. The one-off measures in the budget amounted to approximately 0.6 per cent of GDP. Provision was made for disposals of buildings amounting to €7.1 billion or 0.5 per cent of GDP, a net reduction in primary expenditure of €8.7 billion or 0.6 per cent and a net increase in revenue of €5.2 billion or 0.4 per cent; in addition, an increase in interest receipts was expected amounting to €1.5 billion or 0.1 per cent. The remaining part of the adjustment was to come from amendments to the tables attached to the Finance Bill and the budget on a current legislation basis.

Table 29

PUBLIC FINANCE OBJECTIVES, ESTIMATES AND OUTTURNS FOR THE YEAR 2005

(billions of euros)

	State sector borrowing requirement (1)	General government				Memorandum items	
		Net borrowing	Primary surplus	Interest payments	Debt	Real GDP growth rate (%)	Nominal GDP
Objectives (2)							
EFPD (July 2004)	....	....	....	....	....	2.1	1,409.0
as a percentage of GDP	*4.2*	*2.7*	*2.6*	*5.3*	*104.1*		
EFPD update (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*		
Estimates released during the year (2)							
QRBR and FPR 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*		
EFPD (July 2005)	65.2	59.6	8.7	68.3	....	0.0	1,382.2
as a percentage of GDP	*4.7*	*4.3*	*0.6*	*4.9*	*108.2*		
FPR and EFPD update (September 2005)	65.2	59.6	8.7	68.3	....	0.0	1,384.0
as a percentage of GDP	*4.7*	*4.3*	*0.6*	*4.9*	108.2		
Stability programme update (December 2005)	....	....	....	....	....	0.0	....
as a percentage of GDP	....	*4.3*	*0.6*	*5.0*	*108.5*		
Outturns (3)	59.6	58.2	6.4	64.5	1,508.2	0.0	1,417.2
as a percentage of GDP	*4.2*	*4.1*	*0.4*	*4.6*	*106.4*		

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 2006; compared with the earlier estimates, it takes account of the statistical revisions in connection with the PO current accounts held by the private sector and the inclusion among liabilities of the Treasury account held by the EU. – (2) Figures released before the adoption of the new methods for calculating national accounting data on 1 March 2006. – (3) Figures released after the adoption of the new methods for calculating national accounting data on 1 March 2006 and, for net borrowing and the primary surplus, with account taken of the change in the treatment of SACE dividends in April 2006.

The European Commission forecasts published in April 2005 indicated a deficit of 3.6 per cent of GDP for Italy. In the same month the Quarterly Report on the Borrowing Requirement lowered the forecast of economic growth by approximately one percentage point and raised the estimate of net borrowing to 2.9 per cent, while indicating the existence of some risk factors that could increase the deficit up to 3.5 per cent. The Government nonetheless indicated that it would monitor the need for measures to keep the deficit within the limit established by the European budgetary rules.

On 1 March 2005 Istat published new data on the general government consolidated accounts. The statistical and accounting revisions for the years 2001-03 resulted in higher deficits. In May Istat further revised the data to comply with Eurostat's rulings on the accounting treatment of some transactions. The combined effect of these revisions was to increase net borrowing above the 3 per cent threshold in 2001, 2003 and 2004.

In July the European Council took note of the existence of an excessive deficit situation and gave Italy six months to adopt measures to bring the borrowing requirement below the 3 per cent threshold in 2007. The Council called for an adjustment amounting to 1.6 percentage points of GDP, to be made in the two years 2006-07; at least half of the adjustment was to be enacted in the first year and without recourse to one-off measures.

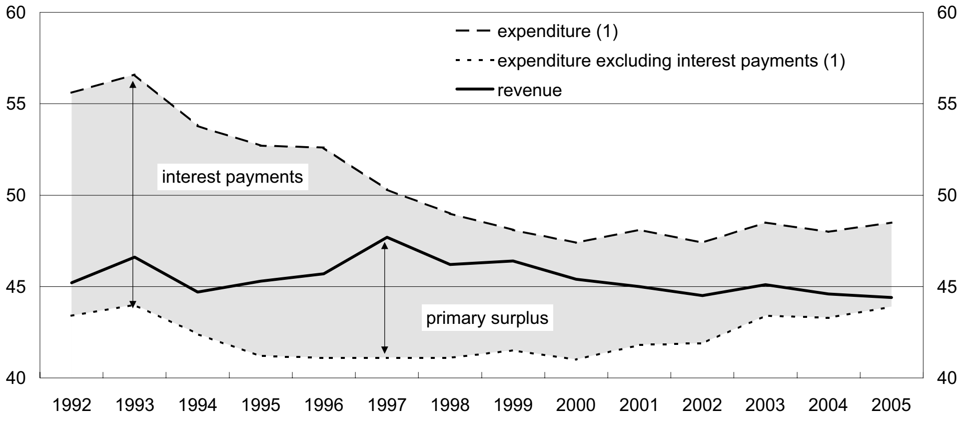
The Economic and Financial Planning Document for 2006-09 approved at the end of July 2005 took note of the overshoots of the previous years and revised the estimates for those to come. The figure for net borrowing in 2005 was raised to 4.3 per cent of GDP and the primary surplus reduced to 0.6 per cent; account was taken of the smaller-than-expected effects of some budget measures and real GDP growth was assumed to be nil. This scenario was confirmed in the subsequent budgetary documents, up to the update of the stability programme in December 2005.

The results. – According to the outturn published by Istat, net borrowing amounted to 4.1 per cent of GDP in 2005, an increase of 0.7 percentage points on 2004. The factors that contributed to the achievement of a better result than had been indicated in the Economic and Financial Planning Document included the postponement to 2006 of part of the costs arising from the renewal of labour contracts in the public sector and the upward revision of GDP following changes to the methods used in compiling the national accounts. The primary surplus continued to contract, falling from 1.3 to 0.4 per cent of GDP (Figure 13), owing largely to the growth in primary current expenditure (0.6 percentage points of GDP). Interest payments fell by one tenth of a point to 4.6 per cent of GDP, thanks in part to the use of swaps.

Figure 13

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.

One factor in the increase in the deficit was the reduced recourse to one-off measures, which in 2005 had lowered the deficit by about 0.5 percentage points, compared with some 1.5 points in each of the three preceding years. Excluding the effects of such measures, the primary surplus has been basically nil since 2003.

The performance of the economy is estimated to have accounted for approximately 0.1 percentage points of the contraction in the primary surplus between 2004 and 2005.

The methods used to prepare cyclically adjusted figures for the public finances permit uniform comparison of data over only a small number of years. In Italy's case the methods do not consider the fall in the rate of GDP growth since the early 1990s as cyclical. The cyclical component thus consists only of the relatively small fluctuations that occurred around a trend or potential growth rate that has fallen close to 1 per cent in the last few years.

Different methods can lead to slight divergences for some years. According to the Commission's latest estimates, the performance of the economy increased the budget deficit by 0.1 per cent of GDP in 2004 and 0.7 per cent in 2005. On the basis of the methodology used by the Bank of Italy, which takes account not only of the level of GDP but also of its composition, the cyclical impact was not significant in 2004 but increased the budget deficit by 0.1 per cent of GDP in 2005. The difference with respect to the Commission's estimate for 2005 mainly reflects the growth in the private-sector wage bill (4.5 per cent in nominal terms) and the fall in the unemployment rate.

In March 2006, together with the outturn for 2005, Istat published revisions that increased net borrowing for the years 2001-04 by an average of €2.7 billion per year. It also revised GDP upward by an average of €34.2 billion per year in the same period. The combined effect was to reduce the ratio of net borrowing to GDP compared with the earlier estimates by 0.1 percentage points to 3.1 per cent in 2001 and to increase it by 0.2 points to 2.9, 3.4 and 3.4 per cent respectively in 2002, 2003 and 2004.

In April 2006, in response to objections made by Eurostat, Istat revised net borrowing in 2005 marginally upwards. In particular, the receipts of SACE dividends included in general government revenue were reduced by €0.26 billion. The primary surplus was reduced accordingly, from 0.5 per cent of GDP as announced in March to 0.4 per cent.

In the last few years the general government consolidated accounts have undergone a series of significant revisions that have progressively increased net borrowing. The most important changes were made between

2002 and 2005 and concerned the accounting treatment of securitizations (in accordance with the rules laid down by Eurostat), health expenditure, transfers to the State Railways Group, the payments made in advance by tax collection agents in 2003 and 2004 and transactions with the European Union.

According to the latest Istat data, net borrowing in 2001 is 1.6 percentage points of GDP higher than the first estimate. For 2002, 2003 and 2004 the increase on the initial estimate is 0.6 points, 1 point and 0.4 points respectively.

Financial balances. – In 2005 the total general government borrowing requirement amounted to €68.5 billion, compared with €49.1 billion in 2004; as a ratio to GDP, it rose by 1.3 percentage points to 4.8 per cent (Tables 30 and 31). Settlements of past debts were virtually nil, as in 2004. Privatization receipts fell further, from 0.6 to 0.3 per cent of GDP.

Table 30

MAIN INDICATORS
OF THE GENERAL GOVERNMENT FINANCES IN ITALY (1)
(as a percentage of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Revenue	45.3	45.7	47.7	46.2	46.4	45.4	45.0	44.5	45.1	44.6	44.4
Expenditure (2) (3)	52.7	52.6	50.3	49.0	48.1	47.4	48.1	47.4	48.5	48.0	48.5
of which: interest payments ...	*11.6*	*11.5*	*9.3*	*7.9*	*6.6*	*6.3*	*6.3*	*5.5*	*5.1*	*4.7*	*4.6*
Primary surplus	4.2	4.6	6.6	5.1	4.9	4.3	3.2	2.7	1.7	1.3	0.4
Net borrowing	7.4	7.0	2.7	2.8	1.7	2.0	3.1	2.9	3.4	3.4	4.1
Total borrowing requirement	7.1	7.3	1.8	2.6	1.3	2.3	4.6	2.9	3.0	3.5	4.8
Borrowing requirement net of privatization receipts	7.6	7.6	2.9	3.3	3.4	3.6	4.9	3.0	4.3	4.1	5.1
Borrowing requirement net of settlements of past debts and privatization receipts ..	7.4	6.9	2.9	3.1	2.8	3.2	4.2	2.6	3.6	4.0	5.1
Debt	121.2	120.6	118.1	114.9	113.7	109.2	108.7	105.5	104.3	103.9	106.4

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.

As regards the financing of the borrowing requirement, net redemptions of short-term securities amounting to €0.9 billion (€1 billion in 2004) were accompanied by net issues of medium and long-term securities amounting to €40.3 billion (€41.6 billion in 2004). There was a further slight lengthening of the average residual maturity of government securities, from 6.5 to 6.6 years. Whereas €1.4 billion of bank loans had been repaid in 2004, the value of such loans increased by €5.6 billion in 2005. The proceeds of securitizations classified as loans and the loans disbursed by Cassa Depositi e Prestiti S.p.A grew overall by €0.7 billion (in 2004 they had contracted by €3.8 billion). Currency and deposits again made a significantly increased contribution (€21.6 billion, compared with €16.4 billion in 2004). More specifically, a contraction of €4.2 billion in post office deposits included among general government liabilities (€1.2 billion in 2004) was accompanied by an increase of €30.5 billion in the balance on current accounts held with the Treasury by entities outside general government (€14.9 billion in 2004). A contribution also came from the substantial increase of €22.9 billion in the balances on the accounts held by Cassa Depositi e Prestiti S.p.A. (€19.3 billion in 2004). The assets held by the Treasury with the Bank of Italy decreased by €1.2 billion (after growing by €2.6 billion in 2004).

Table 31

GENERAL GOVERNMENT BALANCES AND DEBT

(millions of euros)

	2001	2002	2003	2004	2005
Net borrowing	38,501	37,085	46,036	47,652	58,174
Total borrowing requirement	56,854	37,556	40,185	49,075	68,473
Borrowing requirement net of privatization receipts (1)	61,457	39,485	57,040	56,748	72,791
Debt	1,357,376	1,367,001	1,392,112	1,442,392	1,508,176
Memorandum items:					
Settlements of past debts (1)	9,310	5,328	8,537	533	403
Privatization receipts (–) (1)	-4,603	-1,929	-16,855	-7,673	-4,318

Source: For net borrowing, Istat.
(1) The figures for settlements of past debts and privatization receipts refer to central government.

The statistics on the borrowing requirement were also revised in March 2006, to take account of new data concerning PO current accounts held by the private sector and the inclusion among the liabilities of the Treasury account held by the EU. Taken together, these revisions led to an increase in the borrowing requirement of €4.4 billion and €0.9 billion respectively in 2001 and 2003 and to a decrease of €3.5 billion and €0.7 billion respectively in 2002 and 2004.

Excluding privatization receipts, the borrowing requirement rose by 1 percentage point to 5.1 per cent of GDP, reflecting the reduction in one-off measures, which amounted to approximately 1 percentage point of GDP in 2005, compared with 2 points in 2004. Excluding the effects of these measures, the general government borrowing requirement has been about 6 per cent of GDP every year since 2003; the corresponding primary balance, which has been negative since 2003, was equal to more than 1 percentage point.

In 2005 the borrowing requirement was curbed not only by one-off measures that influenced net borrowing, but also by the receipts from the sixth securitization of INPS credits, equal to nearly 0.4 per cent of GDP.

The breakdown of the borrowing requirement in 2005 shows that, excluding privatization receipts, central government accounted for €63.1 billion, up by more than €10 billion on 2004, and local government for €11.1 billion, up by €6.1 billion. The surplus of the social security institutions (€1.4 billion) was virtually unchanged.

The discrepancy between the balances. – In 2005 the difference between the general government borrowing requirement net of privatization receipts and net borrowing amounted to 1 percentage point of GDP. In the period 1999-2001 it had been more than 1.5 points; in the period 2002-04 it had averaged 0.6 points (Figure 14a). Calculated with reference to the primary balances, up to 2004 the gap was larger: 1.9 points on average between 1999 and 2001 and 0.8 points in the period 2002-04. In 2005 it was 0.9 points.

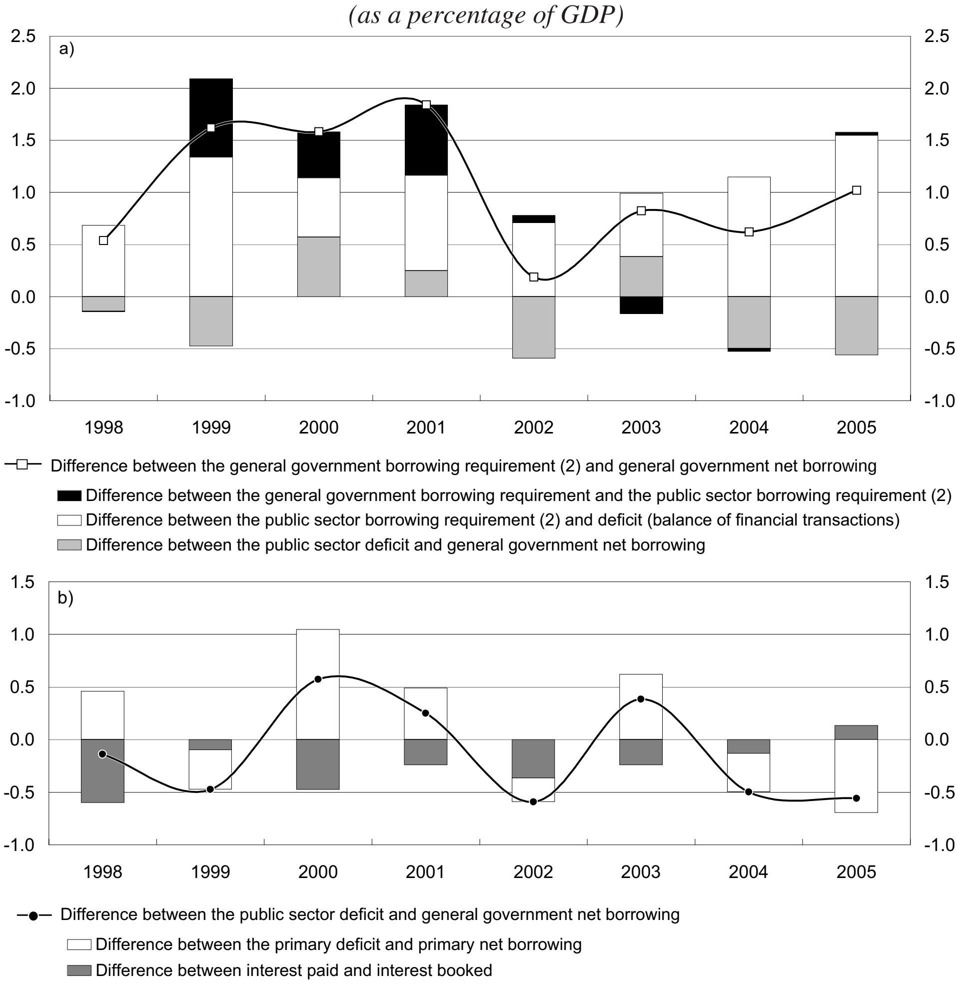
The gap can be divided into three main components: a) the difference between the general government borrowing requirement net of privatization receipts (calculated by the Bank of Italy on the financing side) and the public sector borrowing requirement (calculated by the Ministry for the Economy and Finance on the formation side), which primarily reflects statistical discrepancies; b) the balance of transactions in financial assets (calculated by the Ministry), which corresponds to the difference between the public sector borrowing requirement and deficit; and c) a residual component equal to the difference between the deficit of the public sector and net borrowing. The latter component mainly reflects the different accounting principles applied in calculating the two indicators (cash basis for the borrowing requirement, accrual basis for net borrowing).

In 2005 the first component was virtually nil, as in the previous three years, whereas in the period 1999-2001 it had averaged 0.6 percentage points of GDP. The gap last year was caused primarily by the balance of transactions in financial assets (1.5 points), which was significantly larger than previously (0.9 points on average in 1999-2001 and 0.8 points in 2002-04). By contrast, the residual component narrowed the gap by 0.6 points (compared with an average of 0.2 points in 2002-04 and a marginal widening effect in 1999-2001): the difference between interest payments on a cash and an accrual basis was positive for the first time (0.1 points), partly owing to the very large redemptions of PO savings certificates, the interest on which is paid at maturity (Figure 14b). The contribution of the difference between the primary balances had a negative value of 0.7 points, after being nil on average in 2002-04 and having a positive value of 0.4 points on average in 1999-2001.

Figure 14

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 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 estimate of the gap in the period 2001-04 was reduced by the successive revisions of net borrowing and, to a lesser extent, the borrowing requirement.

In some cases the upward adjustments to net borrowing were substantial. The borrowing requirement was also revised upward, above all as a result of new information on the size of PO current accounts and Eurostat's decisions with regard to the accounting treatment of securitizations, loans raised by Infrastrutture S.p.A. to finance high-speed railway lines and the payments in advance made by tax collection agencies in 2003 and 2004 (for the latest revisions, see the section on “Financial balances”).

For the years 2001-03, those most affected by the revisions referred to above, the difference between the gap based on the initial estimates of the balances and that based on the latest data is substantial. The former averaged 1.6 points of GDP and the latter about 1 point. The reduction was due to net borrowing increasing on average by 1.1 percentage points and the borrowing requirement by 0.5 points.

On the basis of the data published in March 2005, the gap for 2004 was equal to 0.6 percentage points of GDP. Following the revisions in connection with Eurostat’s decisions with regard to the debts incurred to finance high-speed railways and the payments in advance made by tax collection agencies, it widened to 1 point. As a result of the subsequent revisions of the borrowing requirement and Istat’s further upward revisions of net borrowing, the gap now stands at 0.7 points.

The public debt. – In 2005 the ratio of general government debt to GDP rose for the first time since 1994. The increase, equal to 2.5 percentage points of GDP, occurred despite the disposal of assets worth 0.8 per cent. At the end of the year the debt amounted to 106.4 per cent of GDP, which was above the level recorded in 2002.

Compared with the data published in March in *Economic Bulletin* No. 42, the figures for the debt in 2004 and 2005 have been revised upward by respectively €0.5 billion and €0.6 billion as a consequence of corrections to reports on bank lending.

The debt increased by €65.8 billion, as against €50.3 billion in 2004, primarily owing to the increase in the borrowing requirement from €49.1 billion to €68.5 billion. The variation in the exchange rate of the euro contributed €1 billion to the increase, whereas in 2004 it had led to a reduction of the same size. The growth in the nominal value of the debt was curbed by the reduction of €1.2 billion in the assets held by the Treasury with the Bank of Italy (as against an increase of €2.6 billion in 2004) and issue premiums amounting to €2.5 billion (€0.4 billion in 2004).

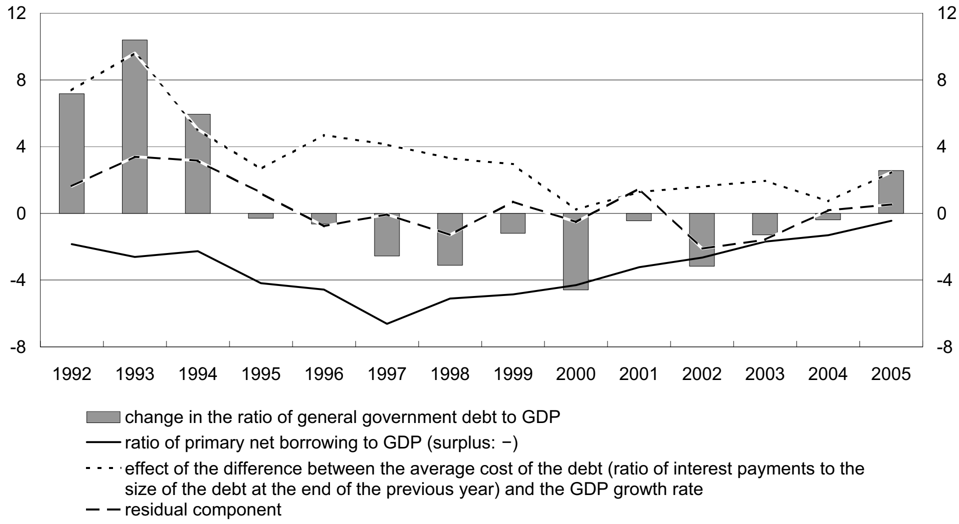
The nominal value of the PO savings certificates included in general government debt (those issued up to April 2001 and assigned to the Ministry for the Economy and Finance when Cassa Depositi e Prestiti was turned into a limited company) was €46 billion at the end of 2005 (compared with €53.1 billion at the end of 2004). The redemption value of these securities, interest on which is paid at maturity, was much higher: €115.1 billion (compared with €126 billion at the end of 2004).

The rise in the ratio of the debt to GDP is the result of three factors: the reduction of 0.4 points deriving from the primary surplus; the increase of 2.5 points attributable to the difference between the average cost of the debt and the GDP growth rate; and the increase of 0.5 points attributable to the residual component – the difference between the change in the debt and net borrowing (Figure 15).

Figure 15

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

(as a percentage of GDP)



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

In 2005 the residual component was affected by one-off measures amounting to 0.7 per cent of GDP that were in addition to those that reduced net borrowing. In the preceding years such measures had made a significant contribution to curbing the growth in the debt (nearly 1.5 percentage points of GDP on average in the years 2001-04).

In total, including privatizations, the one-off measures that curbed the rise in the ratio of the debt to GDP amounted to about 1.3 percentage points of GDP in 2005; in the four previous years they had amounted to more than 2.5 points on average. In the absence of asset sales and the conversion of bonds held by the Bank of Italy in 2002, the ratio of debt to GDP would already have started to rise again in 2001.

REVENUE AND EXPENDITURE IN ITALY

General government revenue

General government revenue grew by 1.6 per cent in 2005, rising to €629.1 billion; in relation to GDP it fell by 0.2 percentage points to 44.4 per cent (Table a15).

Tax revenue and social security contributions remained virtually unchanged in relation to GDP, declining from 40.7 to 40.6 per cent (Table 32). The fall in capital taxes of approximately 0.5 percentage points of GDP was almost entirely offset by the rise in indirect taxes and social security contributions. Excluding the effects of one-off measures, which are estimated to have boosted revenue by approximately 0.25 percentage points of GDP (more than 1 point in 2004), tax revenue and social security contributions rose by nearly 1 point, interrupting the downward trend of recent years and taking the ratio back to its level in 2002.

Table 32

GENERAL GOVERNMENT REVENUE (1)

(as a percentage of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Direct taxes	14.5	15.1	15.8	14.3	14.9	14.4	14.7	13.9	13.4	13.3	13.3
Indirect taxes	11.8	11.6	12.2	15.1	14.9	14.7	14.2	14.3	14.0	14.1	14.2
Current tax revenue	**26.2**	**26.7**	**28.0**	**29.3**	**29.8**	**29.1**	**28.9**	**28.2**	**27.4**	**27.4**	**27.6**
Actual social security contributions	12.7	14.3	14.6	12.2	12.2	12.1	12.0	12.2	12.4	12.5	12.6
Imputed social security contributions	1.7	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Current fiscal revenue	**40.6**	**41.4**	**43.0**	**42.0**	**42.3**	**41.5**	**41.2**	**40.6**	**40.0**	**40.1**	**40.5**
Capital taxes	0.6	0.3	0.7	0.4	0.1	0.1	0.1	0.2	1.3	0.6	0.1
Tax revenue and social security contributions	**41.2**	**41.6**	**43.7**	**42.3**	**42.4**	**41.6**	**41.3**	**40.8**	**41.4**	**40.7**	**40.6**
Other current revenue	3.9	3.9	3.7	3.6	3.6	3.4	3.5	3.5	3.4	3.6	3.5
Other capital revenue	0.3	0.1	0.3	0.3	0.4	0.3	0.2	0.2	0.3	0.3	0.3
Total revenue	**45.3**	**45.7**	**47.7**	**46.2**	**46.4**	**45.4**	**45.0**	**44.5**	**45.1**	**44.6**	**44.4**

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

Capital taxes fell from €7.9 billion to €1.8 billion because 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, which had amounted to €5.4 billion in 2004. They were also affected by the decrease of €0.6 billion in revenue from the regularization of building offences.

Direct taxes grew by 2 per cent, the result of increased receipts of corporate and personal income tax and the disappearance of one-off revenue from some flat-rate withholding taxes. Indirect taxes grew by 3.3 per cent and rose by 0.2 percentage points of GDP, thanks mainly to the good performances of VAT and the regional tax on productive activities. Actual social security contributions grew by 3.5 per cent.

The contributions paid by private-sector employers rose by 4 per cent, while gross earnings grew by 4.5 per cent; general government imputed social security contributions also rose by 4 per cent, compared with an increase of 4.2 per cent in gross earnings. The social security contributions paid by all payroll workers increased by 3.7 per cent, while those paid by the self-employed declined by 0.1 per cent after rising by 10.7 per cent in 2004; the downturn was partly due to the decrease of 4.1 per cent in the number of such workers (see the box "The second step of the reform of personal income tax" in *Economic Bulletin*, No. 40).

The main taxes. – Since the breakdown of tax revenue in the 2005 general government consolidated accounts is not yet available, the following analysis of individual taxes is based on receipts allocated to the State budget on a cash basis.

Personal income tax receipts grew by €4.9 billion or 3.9 per cent. Withholding tax on the incomes of employees and the like increased by €2.4 billion or 2.5 per cent, compared with increases in gross earnings and pensions of 4.4 and 3.1 per cent respectively. The growth in receipts was curbed by the effects of the entry into force of the second step of the personal income tax reform, officially estimated at just under €4 billion.

The main changes introduced by the second step of the reform, effective from 1 January 2005, were: the raising of the threshold of the first income bracket from €15,000 to €26,000; the reduction of the number of tax rates from 5 to 4; the lowering of the top rate from 45 to 43 per cent; and the replacement of tax credits for dependents with a deduction from taxable income that is inversely proportional to income, similar to the basic deduction introduced in 2003.

Self-assessed personal income tax receipts increased by €1.5 billion or 7.6 per cent. The result was influenced by the larger balances paid following the relatively low payments on account made in 2004. The tax accruing in

2004, the sum of the balances and payments on account referred to above, remained basically stable in nominal terms, despite the measures to enhance the effectiveness of sector studies contained in the budget for 2005.

The Finance Bill for 2005 envisaged more than €1 billion of additional self-assessed personal income tax following the revision of the rules on sector studies. In particular, provision was made for: the strengthening of the studies for assessment purposes, the introduction of a mechanism for their automatic annual updating on the basis of national accounts indicators, and periodic revisions, as in fact already envisaged in the original legislation. In December 2004 an amendment passed by the Senate eliminated the automatic updating and subsequently the other provisions were amended; the changes led to only a marginal decrease in the additional revenue expected.

Corporate income tax receipts increased by €5.6 billion or 20 per cent. The factors contributing to this result included: the raising of the payment on account from 99 to 102.5 per cent; the increase in the levy on firms in the energy sector introduced by the Finance Law for 2006; the more stringent taxation of cooperative societies; and the strengthening of sector studies provided for in the budget for 2005 (officially forecast to bring in more than €1 billion of additional revenue). Receipts were also affected by the effects of the reform of corporate income tax that entered into force in January 2004.

Receipts of the taxes on capital income grew by €1 billion or 12.1 per cent. More specifically, there was renewed growth in receipts of the tax on managed assets (€0.4 billion) and of that on interest income and capital gains in respect of assets held for administration (€0.5 billion). Receipts of the tax on bank interest income remained virtually unchanged.

Other direct taxes fell significantly, from €18.6 billion to €4.4 billion. The fall reflected: the drying up of receipts from regularization schemes (–€7.1 billion); the abolition of the tax on capital gains arising from the sale of businesses (–€3 billion), which reduced the related revenue to zero from the high level reached in 2004 in connection with the extraordinary corporate actions carried out by some large companies; the reduction in receipts of the tax on the revaluation of corporate assets (–€3 billion); the fall in receipts of the tax on insurance companies' mathematical provisions (–€1.2 billion) owing to the increase in the payment on account in 2004, which brought forward to that year most of the revenue for 2005; the fall in receipts of the tax on the revaluation of natural persons' equity holdings and of that on the revaluation of buildable land (together –€0.5 billion).

Among indirect taxes, VAT receipts grew by €5.5 billion, excise duties on mineral oils by €1.1 billion and those on methane by €0.4 billion. The receipts that decreased included those from regularization schemes (–€1.2 billion) and other business taxes (–€0.2 billion).

VAT receipts grew significantly faster than domestic consumption (5.5 per cent, as against 2.9 per cent).

Receipts of other business taxes fell by €0.2 billion or 1.2 per cent, despite the increases introduced during the year in the main unit taxes. The fall was related to the recovery by tax collection agents in February 2005 of the advance payments they had made in December 2004 (receipts not included as revenue in the general government consolidated accounts).

Excise duties on mineral oils grew by €1.1 billion or 5.2 per cent. The growth was in relation to the lower receipts in 2004 caused by the non-renewal of the payment on account required in December 2003. Excluding this factor, receipts would have been basically unchanged despite the increase in excise duties introduced during 2005. The excise duties on methane grew by €0.4 billion or 11.4 per cent.

Revenue from lotto and lotteries decreased by €2.3 billion or 15.8 per cent. The figure for 2004 had included prior-year items.

Receipts of sales taxes on tobacco products were unchanged. In 2005 they benefited from the raising of the basic rate at the end of 2004 and from the price increases introduced by the producers of many brands, especially during the summer.

General government expenditure

General government expenditure amounted to €687.3 billion, an increase of 3.1 per cent on 2004; in relation to GDP it increased from 48 to 48.5 per cent (Table 33). Interest payments declined from 4.7 to 4.6 per cent of GDP. Primary current expenditure increased by 3.5 per cent and rose by 0.6 percentage points to 39.9 per cent of GDP. Excluding the proceeds of sales of public-sector real estate, which are deducted from investment in the accounts, capital expenditure increased by 1.4 per cent, but in relation to GDP it was unchanged at 4.2 per cent.

Interest payments. –This item decreased by €1.2 billion or 1.8 per cent. Net receipts on swaps increased from €1 billion to €2.1 billion; excluding these transactions, the effect of the increase in the average stock of liabilities over the year (which was significantly larger than the year-end stock) was offset by the fall in the average cost of the debt from 4.6 to 4.4 per cent. As in the preceding years, the fall mainly reflected the redemption of relatively high-yielding securities issued in the first half of the 1990s.

Table 33

GENERAL GOVERNMENT EXPENDITURE (1)

(as a percentage of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Compensation of employees	11.0	11.3	11.5	10.6	10.6	10.4	10.5	10.6	10.8	10.8	11.0
Intermediate consumption	4.8	4.9	4.8	4.9	5.0	5.0	5.1	5.2	5.3	5.4	5.5
Market purchases of social benefits in kind	1.9	1.9	2.0	2.0	2.1	2.3	2.5	2.6	2.6	2.7	2.8
Social benefits in cash	16.3	16.5	17.0	16.7	16.9	16.4	16.2	16.5	16.8	16.9	17.1
Interest payments	11.6	11.5	9.3	7.9	6.6	6.3	6.3	5.5	5.1	4.7	4.6
Other current expenditure	2.7	2.8	2.5	3.2	3.1	3.1	3.2	3.3	3.6	3.6	3.6
Total current expenditure	**48.3**	**48.9**	**47.0**	**45.2**	**44.2**	**43.6**	**43.9**	**43.8**	**44.2**	**44.1**	**44.5**
Gross fixed investment (2)	2.1	2.2	2.2	2.3	2.4	2.3	2.4	1.7	2.5	2.4	2.4
Other capital expenditure (3)	2.4	1.5	1.2	1.4	1.5	1.4	1.8	1.9	1.8	1.5	1.7
Total capital expenditure (2)(3)	**4.5**	**3.7**	**3.4**	**3.8**	**3.9**	**3.7**	**4.2**	**3.6**	**4.3**	**3.9**	**4.0**
Total expenditure (2)(3)	**52.7**	**52.6**	**50.3**	**49.0**	**48.1**	**47.4**	**48.1**	**47.4**	**48.5**	**48.0**	**48.5**
of which: expenditure excluding interest payments (2)(3)	*41.2*	*41.1*	*41.1*	*41.1*	*41.5*	*41.0*	*41.8*	*41.9*	*43.4*	*43.3*	*43.9*

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”.

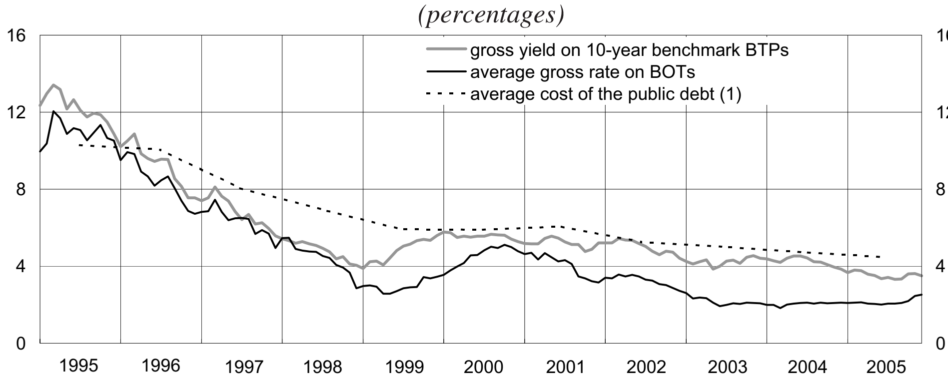
The ten-year BTPs with coupons between 8.5 and 10.5 per cent that matured in 2004 and 2005 amounted to €20.9 billion and €17.3 billion respectively. Between January and August 2004 the gross yield at issue on ten-year BTPs was stable at close to 4.4 per cent; it then declined gradually to stand at 3.5 per cent at the end of 2005 (Figure 16). In the two years 2004-05 the gross yields on new three-year BTPs were between 2.2 and 3 per cent and those on five-year BTPs between 2.6 and 3.8 per cent. In the first ten months of 2005 the average gross interest rate for the three main BOT maturities remained basically stable at the average level recorded in 2004 (2.1 per cent); it then rose to 2.5 per cent at the end of the year. At present the average gross interest rate on BOTs is 3.1 per cent and the yield on ten-year BTPs is 4.2 per cent.

At the end of 2005 short-term securities were 7.8 per cent of the total debt and variable rate securities 13.1 per cent. Assuming the maturity composition of the debt remains unchanged, it is estimated that an increase of one percentage point in issue rates at the beginning of a year increases expenditure by 0.2 percentage points of GDP in that year, another 0.3 points in the second year and another 0.1 points in the third.

Figure 16

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. – This item increased by 3 per cent, compared with 4.5 per cent in 2004, and rose to 17.1 per cent of GDP; the result reflected the growth in expenditure on pensions.

The automatic revaluation of pensions in line with consumer price inflation was equal to 1.9 per cent in 2005, compared with 2.5 per cent in 2004. The number of new pensions paid to former private-sector employees fell sharply, especially for long-service pensions. The latter were influenced by the tightening of the eligibility requirement based exclusively on the length of the contribution period (which occurred in 2004 but, owing to the so-called “windows” mechanism, also exerted an influence in 2005) and by the monetary incentives for delaying retirement. Subsidized pensions, social pensions and other old-age allowances, which account for approximately 8 per cent of total pension expenditure, grew by 2.2 per cent.

Other social benefits in cash grew by 2.3 per cent, compared with 9.6 per cent in 2004, but remained unchanged in relation to GDP at 1.7 per cent. Expenditure on unemployment benefits and wage supplementation rose by 5.9 per cent, compared with 12.8 per cent in 2004; as a ratio to GDP it remained unchanged at 0.4 per cent. Expenditure on family allowances grew by 0.6 per cent, compared with 7.2 per cent in 2004. Outlays for sickness, accident and maternity benefits grew by 2.9 per cent and those for public employees’ severance pay by 3.4 per cent.

Compensation of employees. – Staff costs increased by 4 per cent, compared with 3.4 per cent in 2004; in relation to GDP, they rose from 10.8 to 11 per cent. The result was affected by the renewal of some labour contracts, while the number of employees remained close to the levels of the two preceding years.

With the signing of the labour contracts for doctors, health service managers and local authority managers the renewals for the two years 2002-03 were virtually completed. In the second half of the year contracts were signed for the two years 2004-05 covering about 40 per cent of public-sector employees; the most important renewals were for school staff and ministry employees. The increases in wages and salaries amounted to 5 per cent, 0.7 percentage points more than envisaged in the Finance Laws for 2004 and 2005. The necessary additional resources were appropriated in the Finance Law for 2006.

On the basis of national accounts data gross earnings per labour unit in the public sector grew by 4.4 per cent, compared with 4.3 per cent in 2004. There continues to be a large gap between the rates of increase in earnings in the public and private sectors; in 2005 the figure for the private sector was 2.5 per cent.

Other primary current expenditure items. – Taken together, these increased by 3.9 per cent, compared with 6 per cent in 2004; in relation to GDP they rose from 11.7 to 11.9 per cent.

Intermediate consumption grew by 3.6 per cent, compared with 5.4 per cent in 2004, and rose by 0.1 percentage points to 5.5 per cent of GDP. Expenditure in 2005 was affected by spending on the development of the Eurofighter programme.

Market purchases of social benefits in kind, which consist mainly of expenditure under agreements with health-care operators in the private sector, rose by 4.9 per cent, compared with 9 per cent in 2004; in relation to GDP the item increased by 0.1 percentage points to 2.8 per cent. The increase was due in part to that in the spending on general health care as a result of the renewal of the national health service agreements with general practitioners and pediatricians. Spending on hospital care and pharmaceuticals decreased slightly; the latter item was curbed by the discount of 4.12 per cent on prescription drugs paid for by the health service, which was imposed on the pharmaceutical industry in June 2004 and remained in force until October 2005, and by the revision of the formulary, with reductions in the prices of the pharmaceuticals that had recorded the largest increases in 2004.

Capital expenditure. – Excluding the proceeds from the disposal of public real estate (€2.7 billion compared with €4.4 billion in 2004), investment fell by 4 per cent; investment grants rose by 6.7 per cent and returned to their level in 2002 after the sharp fall of 8.9 per cent recorded in 2004.

Local government

Local government expenditure and revenue other than transfers remained basically unchanged in relation to GDP in 2005; by contrast central government transfers increased by 0.2 percentage points. Consequently, local government net borrowing decreased from 0.9 to 0.7 per cent of GDP.

Local government expenditure and revenue other than transfers amounted to respectively 31.8 and 19 per cent of the corresponding figures for general government. In particular, local authorities accounted for more than 40 per cent of employee compensation and almost all the benefits in kind; they were also responsible for nearly 80 per cent of public investment.

Total revenue rose by 3.1 per cent to €208.1 billion; current revenue rose by €7.3 billion or 3.9 per cent, while capital revenue fell by €1 billion or 6.7 per cent. The latter result reflects the drying up of receipts from regularization schemes and the decrease in central government contributions to investment.

The tax component of current revenue grew by €2.2 billion or 2.5 per cent. Receipts of indirect taxes rose by 4.2 per cent, while those of direct taxes fell by 2 per cent. The regional tax on productive activities contributed to the rise in the former, while the reduction in receipts of the regional personal income surtax paid by the public sector contributed to the fall in the latter (Table 34).

Receipts of the regional tax on productive activities grew by 7.8 per cent to €36 billion. The part paid by the private sector grew by 10.5 per cent to €26.3 billion; it was affected only marginally by legislative measures: the effects of the increase in the taxation of firms operating in the energy sector were estimated to amount to about €0.1 billion, whereas the increase in the taxation of banks and financial companies and the relief granted in the Finance Law for 2005 for increases in employment did not make themselves felt in 2005. Moreover, no regions appear to have taken advantage of the power granted in the Finance Law for 2005 to increase the rate of the regional tax on productive activities or the regional personal income surtax to finance their health care deficits.

Regional personal income surtax receipts fell by 4.6 per cent to €6.4 billion, of which €3.9 billion came from the private sector. The fall was entirely due to the public-sector component, which contracted by 13.8 per cent, while the private-sector component grew by 2.4 per cent. Seven regions (Calabria, Lombardy, Marche, Molise, Piedmont, Umbria and Veneto) applied a supplement to the minimum rate of the surtax (0.9 per cent); some regions applied rates that varied according to the income bracket.

Central government current transfers grew by €5.5 billion or 7.5 per cent; the regions' share of VAT increased by 2.8 per cent.

In 2005 an agreement was reached in the Conference of the Presidents of the Regions and Autonomous Provinces on the mechanism for allocating the regions' share of VAT, which had been regulated by Legislative Decree 56/2000 but suspended since 2002. The agreement, incorporated in the Finance Law for 2006, will remain in force until the implementing provisions of Article 119 of the Constitution are enacted and assigns greater weight to past expenditure than provided for by the original decree and less weight to revenue-raising capacity.

Table 34

LOCAL GOVERNMENT CURRENT REVENUE (1)
(millions of euros)

	2002	2003	2004	2005
Direct taxes	**21,058**	**23,370**	**24,558**	**24,078**
Regions (2)	18,559	20,356	21,329	20,946
of which: personal income surtax	*4,975*	*6,166*	*6,741*	*6,430*
motor-vehicle taxes (households)	*3,521*	*3,528*	*3,478*	....
Municipalities	2,499	3,014	3,229	3,132
of which: personal income surtax	*1,096*	*1,571*	*1,615*	*1,555*
ICI (buildable land)	*1,044*	*1,084*	*1,147*	....
Indirect taxes	**59,706**	**62,086**	**62,347**	**64,989**
Regions (2)	42,571	44,018	43,357	46,171
of which: IRAP	*32,072*	*33,593*	*33,384*	*35,995*
share of excise duty on petrol	*2,885*	*2,911*	*2,727*	*2,334*
motor-vehicle taxes (companies)	*846*	*852*	*799*	....
surtax on methane	*438*	*583*	*576*	....
special tax for waste disposal in tips	*248*	*264*	*258*	....
Provinces	3,719	3,922	4,143	4,046
of which: tax on third-party motor-vehicle insurance	*1,827*	*1,942*	*2,022*	....
transcription tax	*1,066*	*1,150*	*1,184*	....
Municipalities	13,416	14,146	14,847	14,772
of which: ICI (excluding buildable land)	*9,581*	*9,951*	*10,534*	....
tax on advertising and bill posting rights	*347*	*382*	*405*	....
Transfers from public entities (consolidated)	**54,298**	**51,137**	**64,414**	**69,808**
Regions	43,026	39,357	50,886	55,542
of which: share of VAT	*28,370*	*30,328*	*34,492*	*35,447*
Provinces	2,712	3,030	3,190	3,649
Municipalities	15,408	16,600	17,993	18,400
Other current revenue	**17,524**	**19,012**	**21,431**	**20,890**
Regions	4,038	4,708	5,844	5,361
Provinces	1,182	1,337	1,466	1,584
Municipalities	12,304	12,967	14,121	13,945
Total current revenue	**152,586**	**155,605**	**172,750**	**179,765**

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 detailed in the table, include: the taxes on regional licences and central government licences (under "indirect taxes") and taxes for university attendance and professional certification (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 municipal 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.

Local government expenditure grew by 2.1 per cent to €218.4 billion; in 2004 it had grown by 7.8 per cent. Current expenditure increased by €6.2 billion or 3.5 per cent, while capital spending decreased by €1.7 billion or 4.3 per cent, as a consequence of the fall of 7.1 per cent in gross fixed investment. Intermediate consumption grew by 4.4 per cent and social benefits in kind, primarily in relation to health care, rose by 4.9 per cent. Compensation of employees increased by 1.6 per cent after rising sharply in 2004 as a result of the renewal of labour contracts for the two years 2002-03.

In 2005, for the second consecutive year, the growth in local government primary current expenditure (3.6 per cent, compared with 7.7 per cent in 2004) was less than that recorded by central government (4.1 per cent, compared with 9.9 per cent in 2004).

The slowdown in the growth of local government expenditure in 2005 is confirmed by the consolidated accounts on a cash basis published in the Quarterly Report on the Borrowing Requirement, which gives separate totals for the regions and for the provinces and municipalities. The result was influenced by the fall in fixed investment in 2005, both among the regions (€0.3 billion or 5.8 per cent) and among the provinces and municipalities (€2 billion or 9.9 per cent). On the basis of preliminary data disaggregated at the level of individual entities, the reduction in fixed investment appears to have been widespread.

The domestic stability pact for 2005 capped the nominal growth of total expenditure (except for some items, including health care) for ordinary-statute regions (as in the past) and for provinces and municipalities, which had previously had a cap imposed on their financial balances. These constraints derived from the application at local level of the more general cap of 2 per cent placed on the nominal growth of general government expenditure. The cap was set at 4.8 per cent in comparison with 2003 for the regions and at 10 per cent with respect to the average for 2001-03 for the provinces and municipalities (11.5 per cent for "virtuous" authorities). For the first time the cap applied to expenditure on investment, which had previously been exempt from the domestic stability pact.

In 2005 local government debt rose to 6.1 per cent of GDP, an increase of 0.7 percentage points on the previous year (Table a19). The debt of the regions rose from 2.1 to 2.2 per cent of GDP, while that of the provinces and municipalities rose from 3 to 3.4 per cent and that of other local government entities from 0.4 to 0.6 per cent.

In relation to the GDP of the corresponding macro-regions, there was a significant increase in the debt of them all. Assuming that the methodological changes in the calculation of GDP do not affect its geographical distribution, the ratio rose from 4.3 to 5 per cent in the North-West, from 4.1 to 4.6 per cent in the North-East, from 8.2 to 8.7 per cent in the Centre and from 5.9 to 6.7 per cent in the South.

Securitizations of private entities' trade receivables from bodies in the health sector rose from €0.5 billion to €2.1 billion in 2005 and were carried out in Lazio, Campania and Abruzzo. Transactions of this kind are not included in general government debt. Under the agreements governing the assignment of the claims, a part of the regions' future transfers to bodies in the health sector will have to be used to redeem the securities issued.

BUDGETARY POLICY
PROGRAMMES AND PROSPECTS

The euro area

According to the latest stability programme updates, euro-area general government net borrowing will fall from an estimated 2.5 per cent of GDP in 2005 to 2.3 per cent in 2006 (Table 35). A budgetary position close to balance or in surplus will not be achieved within the programmes' forecasting horizon; in 2008 the deficit will still be equal to 1.4 per cent of GDP.

The stability programmes indicate that the euro-area ratio of debt to GDP will come down by 0.2 percentage points in 2006 and then more sharply, by a total of 2.6 points, in the two following years, to stand at 68.3 per cent in 2008.

According to the European Commission forecasts released in May, euro-area net borrowing will fall to 2.4 per cent of GDP in 2006 and, on an unchanged policies basis, to 2.3 per cent in 2007. The debt ratio is forecast to decline by 0.3 percentage points in 2006 and by 0.4 points in 2007.

In December 2005 the EU Council approved a regulation on the quality of the statistics provided for purposes of the excessive deficit procedure.

Table 35

GENERAL GOVERNMENT NET BORROWING AND DEBT IN THE EURO AREA
(as a percentage of GDP)

	2005	2006	2007	2008
Net borrowing				
National stability programme objectives	2.5	2.3	1.8	1.4
Outturn and forecasts:				
European Commission	2.4	2.4	2.3	–
IMF	2.3	2.3	2.1	–
Debt				
National stability programme objectives	71.1	70.9	69.6	68.3
Outturn and forecasts:				
European Commission	70.8	70.5	70.1	–
IMF	71.2	70.8	70.1	–

Sources: Based on data published by the European Commission (*Spring Forecasts*, May 2006) and the IMF (*World Economic Outlook*, April 2006) and the updates to national stability programmes submitted between November 2005 and February 2006.

In February 2006 the European Commission and the Economic Policy Committee of the European Union published a report on the possible effects of population aging on public expenditure in the EU countries. Estimates of these effects are of key importance in the analysis of the long-term sustainability of budgetary policies. Within the framework of the European rules on the public finances, these estimates will eventually be taken into account in determining the individual countries' medium-term objectives. The report examines five sectors of expenditure: pensions, health, long-term care, education and income support for the unemployed. The estimates, based on relatively favourable hypotheses in some cases, point to a substantial increase in expenditure in the coming decades.

Italy

Budgetary policy in 2006. – The current programmes projections of the July 2005 Economic and Financial Planning Document indicated that general government net borrowing in 2006 would amount to 4.7 per cent of GDP and the primary surplus to 0.1 per cent (Table 36; Figure 17). The estimates included proceeds of property sales totaling €6 billion (0.4 per cent of GDP).

Table 36

OBJECTIVES AND ESTIMATES FOR THE PUBLIC FINANCES IN 2006
(billions of euros and percentages)

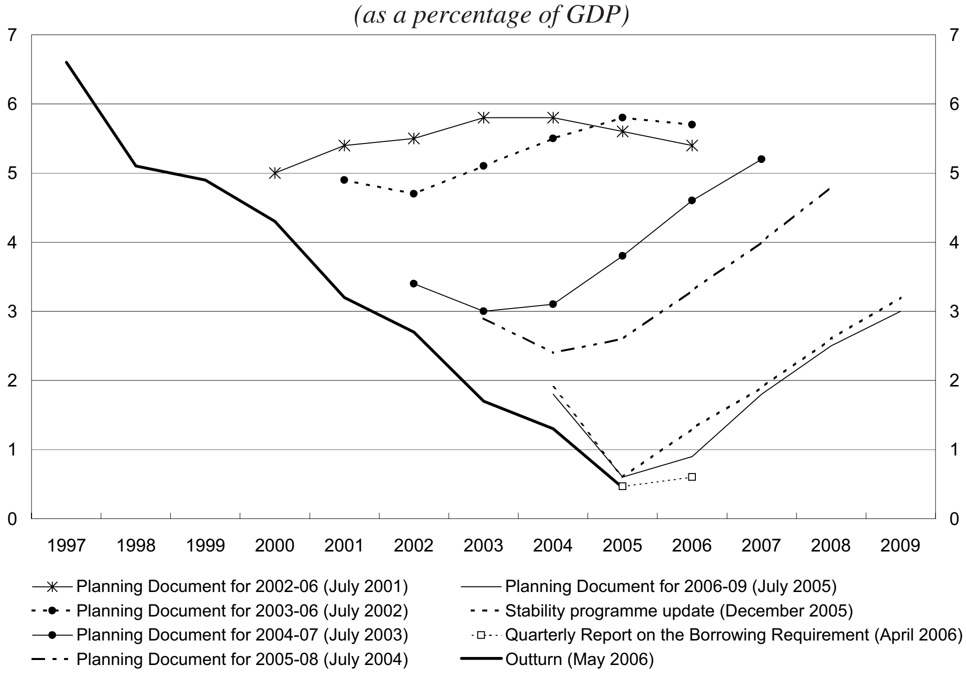
	State sector borrowing requirement (1)	General government				*Memorandum items:*	
		Net borrow-ing	Primary surplus	Interest pay-ments	Debt	Real GDP growth rate	Nominal GDP
Estimates on a current programmes basis							
Planning Document (July 2005)	67.9	67.3	0.7	68.0	....	1.5	1,436.1
as a percentage of GDP	*4.7*	*4.7*	*0.1*	*4.7*	....		
Quarterly Report on the Borrowing Requirement (April 2006)	66.5	*56.0*	9.4	65.4	....	1.3	1,463.9
as a percentage of GDP	*4.5*	*3.8*	*0.6*	*4.5*	....		
Objectives							
Planning Document (July 2005)	....	....	....	....	....	1.5	....
as a percentage of GDP	....	*3.8*	*0.9*	*4.7*	*107.4*		
Forecasting and Planning Report (September-November 2005).......	55.8	54.7	13.1	67.8	....	1.5	1,435.4
as a percentage of GDP	*3.9*	*3.8*	*0.9*	*4.7*	....		
Stability programme update (December 2005)	....	....	....	....	....	1.5	....
as a percentage of GDP	....	*3.5*	*1.3*	*4.8*	*108.0*		

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

Figure 17

PRIMARY BUDGET SURPLUS: OBJECTIVES AND OUTTURNS

(as a percentage of GDP)



The Document set an objective for general government net borrowing of 3.8 per cent and for the primary surplus of 0.9 per cent. The ratio of debt to GDP was to fall by 0.8 percentage points. A correction, with permanent effects, of 0.8 per cent of GDP was envisaged, in line with the request made by the EU Council at the beginning of July after the existence of an excessive deficit had been ascertained. The growth in GDP was forecast at 1.5 per cent.

The Forecasting and Planning Report, submitted to Parliament at the end of September at the same time as the budget for 2006, confirmed the GDP growth forecast and public finance objectives indicated in the Planning Document.

The budget the Government submitted was officially expected to bring an adjustment of €11.5 billion (0.8 per cent of GDP). During its passage through Parliament the size of the correction was increased twice: in November, by about €5 billion, to compensate for the reduction in the estimate of proceeds of property sales under the baseline scenario; and in December, by €4 billion, when the objective for net borrowing was reduced to 3.5 per cent of GDP.

According to official estimates, the budget approved by Parliament at the end of the year amounted to €20.5 billion (1.4 per cent of GDP). It was to make available €27.6 billion of additional resources, comprising

€17 billion of expenditure cuts and €10.6 billion of revenue increases. As well as serving to reduce the budget deficit, these resources were to be used to finance €3.7 billion of tax reliefs and €3.5 billion of additional expenditure.

The budgetary measures expected to produce expenditure savings included curbs on consumption by central government departments (€1.6 billion), reductions in current and capital transfers to firms (€3.7 billion) and retrenchment in gross fixed investment (€0.7 billion). Savings of €3.1 billion were projected to come from the provisions regarding the Domestic Stability Pact and of €2.5 billion from those concerning the health sector. Lastly, reductions in budget allocations and in the allocations established in the tables attached to the Finance Law were expected to decrease expenditure by about €2.5 billion.

The expected increase in expenditure regarded disbursements in favour of families (€0.8 billion) and for labour contract renewals (€0.7 billion), increases in outlays under existing legislation (€0.6 billion) and other minor measures (€0.9 billion).

The measures to increase revenue included: changes to the method of calculating entrepreneurial income (€4.8 billion); the introduction of an agreed assessment scheme and the possibility for taxpayers who take up the option to regularize their positions for the years 2003 and 2004 (€2 billion overall); the reintroduction for the fiscal year ended 31 December 2005 of the substitute tax on revaluation gains on corporate shareholdings and fixed assets (€0.9 billion); measures concerning betting and gaming (€0.7 billion); the introduction of a substitute tax on capital gains from the sale of buildings (€0.5 billion); and a series of minor measures, in part designed to recoup taxes and fight tax evasion.

The bulk of the tax reliefs included in the budget was to come from a permanent reduction of 1 percentage point in the social security contributions rate for family benefits (€2 billion); where this rate was lower than 1 per cent, the reduction was to be extended to contributions for maternity and unemployment benefits. The other minor items are connected mainly with the extension to 2006 of temporary reliefs granted in previous years to the agricultural sector, for some uses of energy products and for building renovation work.

One-off measures were expected to reduce the deficit in 2006 by about 0.3 percentage points of GDP. This largely involved receipts from some substitute taxes, from the regularization of tax positions for 2003 and 2004, and from property sales, still amounting to €1 billion under the baseline scenario. The impact of one-off measures had been approximately 1.5 points in 2004 and 0.5 points in 2005.

The stability programme update presented in December 2005 confirmed the macroeconomic forecasts contained in the Forecasting and Planning Report and, taking account of the strengthening of the budgetary correction, revised the net borrowing objective for 2006 to 3.5 per cent. The primary surplus was estimated at 1.3 per cent of GDP.

In March 2006 the EU Council found that the budget for 2006, if fully implemented, would ensure adequate progress towards eliminating the excessive deficit in 2007. However, the Council stressed that substantial additional measures would be necessary next year. The Council and the Commission will continue to monitor Italy's public finances carefully.

In the Quarterly Report on the Borrowing Requirement published at the beginning of April, the Government lowered the forecast for GDP growth in 2006 to 1.3 per cent and increased the estimate of net borrowing from 3.5 to 3.8 per cent, bringing it back to that indicated in the Planning Document. The expected primary balance in 2006 was revised downward, from 1.3 to 0.6 per cent of GDP; an estimated 0.2 percentage points of the change was due to the new criteria adopted by Istat for classifying imputed financial services. The estimates in the Quarterly Report assumed that the budgetary measures would be fully effective, particularly as regards compliance by all general government entities with the limits on the growth in expenditure.

The Quarterly Report attributed the worsening in net borrowing forecast for 2006 compared with the estimate contained in the stability programme update of December 2005 mainly to the statistical revisions and accounting reclassifications made by Istat to the national accounts. The effects of the downward revision of economic growth were estimated at 0.05 percentage points of GDP.

The Quarterly Report's projections for some items of the general government consolidated accounts differed significantly from those contained in the stability programme: primary expenditure was now set to grow by 2.8 per cent (against 1.8 per cent), interest payments by 1.4 per cent (against 3.7 per cent) and revenue by 3.3 per cent (against 3.9 per cent).

According to the Quarterly Report's forecasts, the ratio to GDP of the general government primary surplus will be 0.2 percentage points higher than in 2005. While revenue was expected to remain stable at 44.4 per cent of GDP, primary expenditure and interest payments were forecast to decline respectively from 43.9 to 43.7 per cent and from 4.6 to 4.5 per cent.

The forecast for primary expenditure assumed substantial savings with regard above all to social benefits in kind and intermediate consumption, which together were expected to fall from 8.3 to 8 per cent of GDP, and capital expenditure, set to decline from 4.2 to 3.9 per cent (net of the proceeds of property sales, which are included in the accounts as a reduction in capital expenditure). These savings were expected to be more than sufficient to offset the significant increase in social benefits in cash (forecast to increase by 4.8 per cent and to rise from 17.1 to 17.3 per cent of GDP) and the fall in proceeds of property sales from 0.2 to less than 0.1 per cent of GDP. On the assumption that the round of wage agreements for 2004-05 is completed, staff costs were expected to rise by 3.8 per cent; they would remain basically unchanged in relation to GDP, after increasing in 2005.

Achieving the expenditure savings written into the budget for 2006 will require a major improvement in operational efficiency in the health sector and, more generally, in the activity of general government and publicly owned corporations. In the absence of progress on this front or of additional measures, there is the risk that net borrowing will exceed 4 per cent of GDP.

The Quarterly Report on the Borrowing Requirement estimated that total expenditure for social benefits in kind (almost entirely attributable to the health sector) and intermediate consumption would fall by 0.1 per cent in nominal terms. These items rose by 4 per cent in 2005 (compared with a forecast of 1.9 per cent in the Forecasting and Planning Report for 2005) and by an average of 5.5 per cent in the three previous years.

Capital expenditure, excluding the proceeds of real-estate sales, were forecast to decline in nominal terms by 5.6 per cent. In particular, the Quarterly Report estimated that public investment would diminish by 0.8 per cent in 2006, after contracting by 4 per cent in 2005; and fall from 2.7 to 2.5 per cent of GDP. Other capital expenditure, consisting mainly of investment grants, was projected to fall by 13.2 per cent, owing in part to the sharp contraction in funds assigned to the State Railways Group.

In the past few years the outturns for net borrowing and the primary balance have frequently been worse than the forecasts, both those made in the previous year – with the publication of the Economic and Financial Planning Document in July and the Forecasting and Planning Report in September – and those contained in the Quarterly Report on the Borrowing Requirement in the spring. Substantial divergences remain even after adjusting for errors in forecasting GDP growth.

Compared with the forecasts contained in the Quarterly Report on the Borrowing Requirement, in the period 2000-05 the outturns for net borrowing and the primary balance (in the preliminary estimates made by Istat in the subsequent year) were worse by an average of 0.6 and 0.7 percentage points of GDP respectively, even though additional corrective measures were introduced in some years following the presentation of the Quarterly Report; on average, about 0.3 points of the difference was due to the deviation of actual GDP growth from that forecast. Moreover, it is necessary to consider that the estimates of the fiscal balances currently available are significantly worse than the preliminary estimated outturns – by an average of 0.7 points of GDP for net borrowing and 0.9 points for the primary balance.

According to the Quarterly Report, the public sector borrowing requirement in 2006, net of privatization receipts, would be equal to 5 per cent of GDP, compared with 5.1 per cent in 2005. In the first quarter of the year the borrowing requirement, net of privatization receipts, amounted to €33 billion, €5.7 billion more than in the first quarter of 2005.

In the December 2005 update of the stability programme, which assumed privatizations amounting to €10 billion (0.7 per cent of GDP), the ratio of debt to GDP was forecast to fall by 0.5 percentage points in 2006. The Quarterly Report, published in April, did not contain estimates of the debt or privatization receipts. According to its forecasting framework, the debt ratio will rise in 2006 by 1.6 percentage points in the absence of privatizations (assuming a nil overall impact of the factors that affect the debt but not the borrowing requirement).

At the beginning of May the European Commission forecast that net borrowing would amount to approximately 4.1 per cent of GDP unless additional corrective measures were taken. This projection assumed GDP growth of 1.3 per cent and was based on a prudent evaluation of the effects of the spending control measures included in the budget. On a cyclically adjusted basis and net of the effects of one off-measures, net borrowing was expected to fall by just under a quarter of a percentage point of GDP, a significantly smaller improvement than the 0.8 points requested by the EU Council in July 2005. The ratio of public debt to GDP was forecast to rise for the second consecutive year, from 106.4 to 107.4 per cent.

Programmes and prospects for the medium term. – The Economic and Financial Planning Document of July 2005 envisaged eliminating the excessive deficit in 2007, with net borrowing to equal 2.8 per cent of GDP. The stability programme update of December confirmed that objective, which required a correction amounting to 1.3 per cent of GDP with respect to the current legislation scenario.

In the light of current trends, achieving the stability programme's objective of net borrowing equal to 2.8 per cent of GDP in 2007 requires a correction of the order of two percentage points of GDP. Any measure to reduce the burden of tax and social security contributions or to revive public investment would necessitate finding additional resources.

On the hypothesis that the factors that affect the gap between net borrowing and the change in the debt remain constant at approximately the values observed in the two years 2004-05, achieving the objective for the deficit would make it possible to reduce the debt ratio in 2007.

For the two subsequent years the stability programme update indicates further reductions in the deficit, to 2.1 per cent of GDP in 2008 and 1.5 per cent in 2009. The primary surplus is projected to rise gradually and reach 3.2 per cent of GDP in 2009. A cumulative correction of about 3 percentage points of GDP in the three years 2007-09 will be necessary if this objective is to be achieved.

The correction should aim at curbing primary current expenditure, which has risen significantly in the last eight years in relation to GDP, from 37.7 per cent in 1997 to 39.9 per cent in 2005. The bulk of this increase occurred in the four years 2002-05, marked by relatively low average annual GDP growth (0.4 per cent, compared with 2.2 per cent in the years 1998-2001). The average rate of increase in expenditure in real terms was comparable in the two four-year periods (2.2 and 2.4 per cent respectively).

The medium-term objective for the primary surplus will have to take account of the need to reduce public debt in view of the significant growth expected in the coming decades in the expenditure items most closely linked to the demographic structure. As indicated by the EU Council, an appropriate strategy to cope with this trend should work along three lines: a) structural reforms to attenuate the growth in expenditure; b) measures to increase labour force participation rates and reduce unemployment; and c) achievement of a substantial reduction in the debt ratio in the coming years, when the demographics will still be relatively favourable. An appreciably lower level of debt than the current one would facilitate the management of the public finances when the imbalances in the demographic structure become more pronounced. In particular, the resulting decrease in interest payments would make it possible to offset part of the increase in spending on pensions, health and social assistance.

The latest Istat estimates indicate that the ratio of persons aged 65 and over to the population of working age in Italy is set to rise from its current level of about 32 per cent to 39.4 per cent in 2020 and 48 per cent in 2030, and to increase further in the subsequent years.

According to the stability programme update, achieving the objective for the primary surplus in 2009 (3.2 per cent of GDP) will be sufficient to ensure the sustainability of Italy's public finances in the long run. This view is based on long-term projections of primary net borrowing that assume that the changes in its ratio to GDP from 2010 onwards will only reflect the trend in expenditure linked to demographic developments (education, unemployment benefits, social security, health and long-term care). According to the State Accounting Office estimates used in the stability programme update, such expenditure will remain basically unchanged as a percentage of GDP until the end of the next decade, at around 25.5 per cent. Thereafter it is projected to rise to 28 per cent by 2040, owing to the increase in spending for pensions (from 14.2 per cent of GDP in 2010 to 15.9 per cent in 2040) and for health and long-term care (from 6.8 to 7.8 per cent of GDP).

It is possible that the expenditure items in question will increase sooner and more than the above-mentioned estimates indicate. It is therefore advisable to achieve higher structural primary balances than those established in the latest stability programme update, close to those indicated in the previous ones.

The forecasts for health care spending only consider the implications of the assumed changes in the demographic structure; they do no take into account other factors that, in all countries, have led to sharp increases in expenditure in recent years. The forecasts concerning pensions assume a sharp reduction in the ratio of the average benefit to per capita GDP, which could prove socially unsustainable. With regard to long-term care, the trend in life expectancy and the changes in family structure could require more ample forms of public support than those now provided. The macroeconomic framework, which assumes substantially higher growth in labour productivity than that seen in the past few years, could also turn out to be less favourable. Lastly, as in the recent past, the demographic projections could again underestimate the increase in life expectancy.

MONETARY POLICY, FINANCIAL INTERMEDIARIES AND THE MONEY AND FINANCIAL MARKETS

Monetary policy and the financial markets in the euro area. – Against a background of uncertainty as to the strength of the economic upturn in the euro area and with inflation expectations holding stable, the Governing Council of the European Central Bank kept official interest rates unchanged for most of 2005. In the autumn positive signs emerged for the prospects of growth, while the rise in oil prices, recorded during the summer, was reflected in a pick-up in inflation and higher medium-term inflation expectations. Faced with the change in cyclical conditions, the Governing Council raised official rates by 0.25 percentage points in December and again in March 2006.

Real short-term interest rates were virtually nil in 2005, turning slightly positive only in the first few months of 2006. The markets expect them to return in the months ahead to levels in line with those recorded in similar cyclical phases in recent decades.

The nominal effective exchange rate of the euro weakened by 7.1 per cent in 2005, thereby helping to keep monetary conditions more expansionary. The decline was partially reversed in the spring of 2006, when the prospect of a further widening of the US current account deficit led to a weakening of the dollar.

Yields in euros held stable for long-term maturities as well. This reflected both the area's modest growth and the conditions prevailing in the main international markets, marked by limited inflation and large-scale purchases of securities on the part of the authorities of countries running wide current account surpluses and by institutional investors. After diminishing slightly in the early part of the year, long-term yields rose gradually from October onwards in response to the improvement in the economic outlook.

Monetary conditions in the area favoured an expansion in the monetary and credit aggregates. M3 continued to grow rapidly, partly as a consequence of the demand for liquidity by non-bank financial intermediaries. There was a further increase in credit to households. Lending to firms accelerated significantly, owing both to the resumption of investment and to the growing demand for loans in support of mergers and acquisitions.

On the international bond market, the expansionary phase of the credit cycle persisted. Yield spreads with respect to government securities remained at the previous year's low levels, due to the abundance of liquidity, the appetite for risk and the decline in corporate bankruptcies.

The stock exchange indices of the main euro-area countries registered substantial gains. The low level of long-term yields and the improvement in profits contributed. The real cost of equity capital (calculated on the basis of expected earnings and stock market prices) remained slightly below its long-term average, despite equity premiums still being relatively high. Share prices continued to rise in 2006; a reversal took place in May.

The financing of households and firms and financial conditions in Italy. – In a prolonged phase of weak economic activity, the financial conditions of Italian households, firms and banks remained solid as a whole. The availability of funds continued to be abundant.

The flow of Italian households' financial saving was smaller than in the previous year, reflecting an increase in investment in houses. Their net financial wealth expanded significantly, by 7.1 per cent, largely as a consequence of the rise in share prices; it is currently about three times disposable income, a higher ratio than in the other main euro-area countries.

In their portfolio choices, households resumed purchasing instruments with higher levels of risk and expected returns, such as shares, investment fund units and corporate bonds, which they had shied away from after the fall in share prices in 2000-03 and the defaults of some bond issuers.

Low interest rates fostered a further increase in households' debt, mainly in the form of home mortgage loans. Despite the sharp rise in recent years, households' total debt remains low in relation to their wealth and income; the ratio of debt service to disposable income is still about half the euro-area average. However, the share of debt at variable rates is high, making the budgets of the borrowers more sensitive to rising yields.

The weakness of economic activity caused a decline in Italian firms' operating profitability. The low level of interest rates helped to limit the burden of debt service. Notwithstanding an increase in debt, firms' leverage remained stable overall, thanks to the effect of the rise in share prices on the value of their equity; for large listed firms it fell, though remaining at relatively high levels.

Bank lending rates held stable in 2005; in the first few months of 2006 they adjusted to the increases in official rates, but they are still low in both nominal and real terms. The strong demand for loans was fueled above all by households and sectors connected with the property market.

By contrast, despite a slight acceleration manufacturing firms' demand for credit remained modest, owing to their sluggish investment. The growth in bank lending to large firms largely reflected the appreciable expansion in loans made in connection with mergers and acquisitions.

Italian firms' sharply reduced their net bond issues, which had been substantial in 2004; issues by unrated or low-rated companies were negligible. By contrast, banks made considerable recourse to the bond market, especially through asset securitizations.

On the government securities market, the yield spread between ten-year BTPs and German Bunds of the same maturity, though small, widened by around 0.1 percentage points in the spring of 2005. It widened again in the early months of 2006 and is currently fluctuating around 0.30 points.

In Italy the rise in the stock market was smaller than that for the euro area and due mainly to the increases recorded in the banking sector, whose weight in the overall index is greater than in the rest of the euro area; the sector's performance reflected expectations of changes in the ownership structure of some leading Italian banks. The number of newly listed Italian companies grew in 2005.

MONETARY POLICY

Interest rates and the exchange rate

Short-term interest rates. – Forecasts of economic growth in the euro area were revised downwards in early 2005 as activity in the world economy slowed. The weakness of economic conditions helped limit the inflationary impact of the rise in oil prices that occurred in the first few months of the year. During this period the Governing Council of the European Central Bank (ECB) kept monetary conditions expansionary, leaving the minimum bid rate on its main refinancing operations unchanged at 2 per cent.

The economic climate gradually improved from the summer onwards, benefiting from the depreciation of the euro, the level of interest rates and the pick-up in economic activity worldwide. The further rise in the cost of energy was reflected in an acceleration in prices and a slight rise in medium-term inflation expectations to just over 2 per cent in the latter part of 2005. The rates of growth in credit and the money supply rose to levels just below the peaks recorded at the beginning of the third stage of Economic and Monetary Union (EMU). In order to adjust the monetary policy stance to the changed economic situation, the Governing Council of the ECB raised official interest rates by a quarter of one percentage point in December (Figure 18).

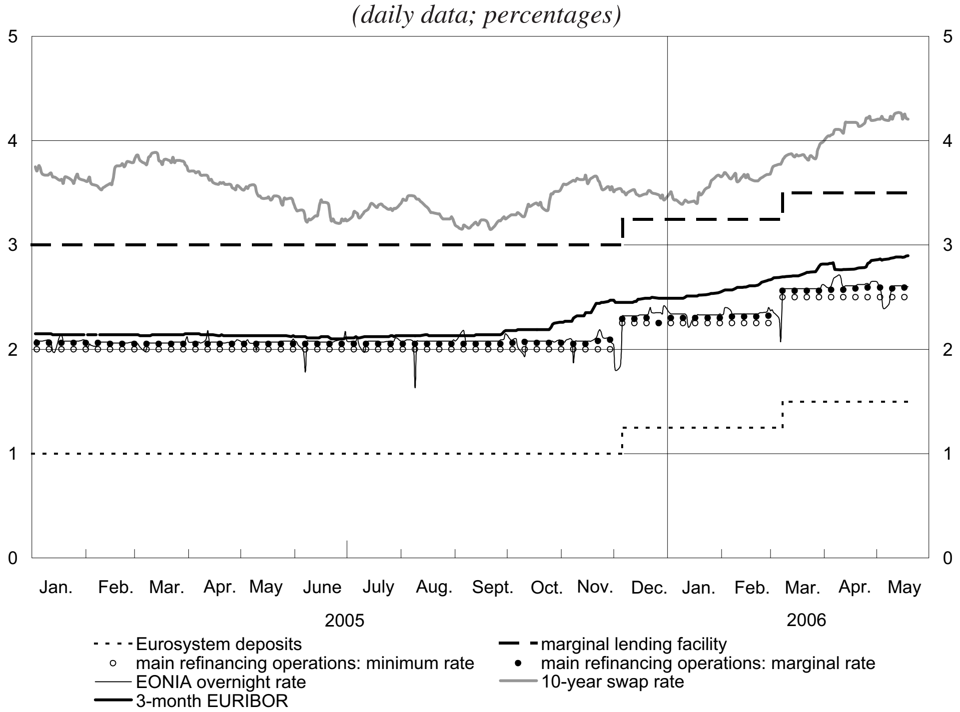
Economic indicators and surveys of economic conditions published in early 2006 point to a further strengthening of growth. The rise in oil prices fueled the acceleration in consumer prices and inflation expectations. Credit growth continued to pick up. In view of the improvement in the economic climate and the risks for price stability, at the beginning of March the Governing Council of the ECB raised the minimum bid rate on its main refinancing operations by a further quarter point to 2.5 per cent.

Expectations about monetary policy decisions, as deduced from the forward three-month yield curve, moved in line with the changes in the economic situation (Figure 19). In the first half of the year the yield curve gradually shifted downwards and became negatively sloped for the shortest maturities; it then shifted upwards again, reflecting an improvement in growth prospects and a slight rise in inflation expectations. At the end of December the curve indicated expectations of a rise of 50 basis points in official interest rates by the end of this year.

Figure 18

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

(daily data; percentages)



Sources: ECB, Reuters, Telerate.

The forward yield curve has continued to shift upwards since the beginning of January 2006, in anticipation of a more rapid return to less accommodating monetary conditions. Short-term rates have risen, reaching 2.9 per cent at the beginning of May.

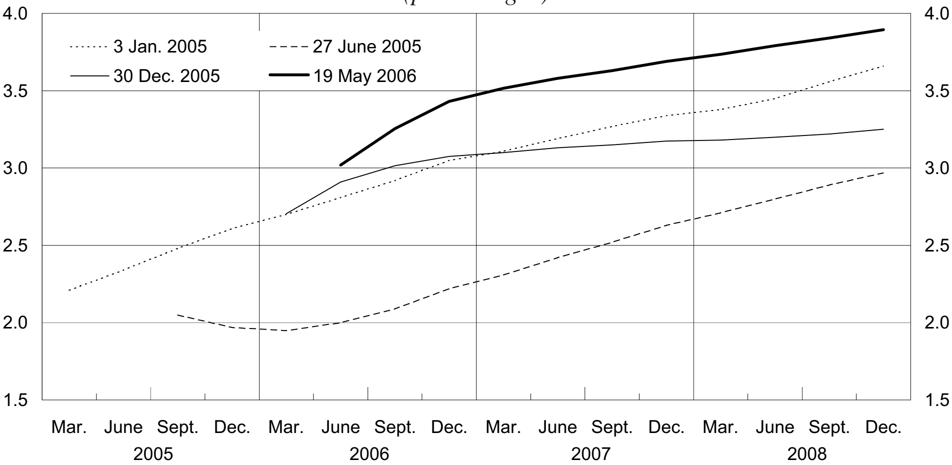
Adjusted for expected inflation, short-term interest rates were virtually nil in 2005. They rose slightly at the beginning of 2006, to 0.7 per cent in March, but are still low by comparison with similar phases of past cycles. According to market expectations, they are likely to continue to edge upwards during the year.

Long-term yields. – Long-term interest rates were affected both by conditions in international markets and by the uncertain prospects for growth in the euro area. Long-term euro rates declined in the first half of 2005, continuing a trend that had begun the preceding year; during the summer they fell to their lowest levels since the beginning of the third stage of EMU. In the first nine months of the year yields on ten-year interest rate swaps in euros declined by 0.6 percentage points to 3.2 per cent (Figure 18); they rose slightly to 3.5 per cent in the final quarter as signs of an improvement in economic conditions began to emerge.

Figure 19

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

(percentages)



Source: Reuters.

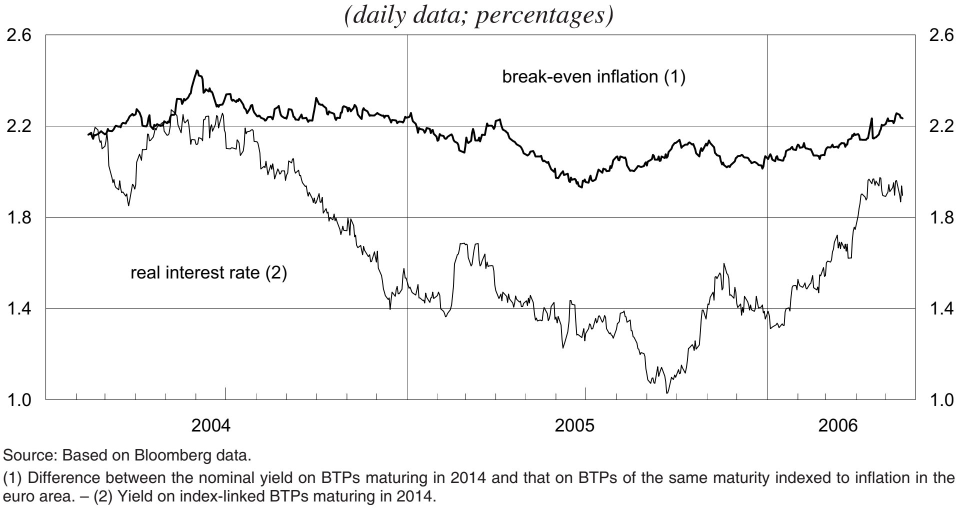
(1) Each curve relates to the trading session indicated in the legend. The horizontal axis shows the settlement dates (around the 15th of each month) for the futures contracts to which the yields refer.

Real rates moved broadly in parallel with the corresponding nominal rates. The rate of return on ten-year Italian government bonds indexed to consumer prices in the euro area declined from about 1.5 per cent at the beginning of 2005 to 1.1 per cent in September and rose again to 1.4 per cent at the end of the year. Long-term inflation expectations, calculated from the difference between the nominal yield on ten-year BTPs and that on corresponding bonds indexed to euro-area inflation (break-even inflation), fluctuated over a narrower range (Figure 20).

Figure 20

BREAK-EVEN INFLATION AND THE REAL INTEREST RATE

(daily data; percentages)



Source: Based on Bloomberg data.

(1) Difference between the nominal yield on BTPs maturing in 2014 and that on BTPs of the same maturity indexed to inflation in the euro area. – (2) Yield on index-linked BTPs maturing in 2014.

In the first four months of 2006 the improvement in economic conditions in the euro area and strengthening expectations of a more rapid return to less accommodating monetary conditions pushed up both nominal and real rates. Nominal yields on ten-year interest rate swaps rose by 0.7 points to 4.2 per cent, while real rates on government bonds indexed to consumer prices in the euro area increased by 0.5 points to 1.9 per cent. The yield differential between BTPs and German Bunds exceeded 30 basis points, about 10 basis points more than the average for 2005.

The launch of EMU fostered a narrowing of long-term yield differentials between euro-area countries by eliminating exchange rate risk, but the differentials did not disappear entirely, reflecting continued disparities in the state of the public finances and in the liquidity of the securities in question. Between 1992 and 1998 differentials between benchmark ten-year bonds in each euro-area country and the German Bund averaged about 2.2 percentage points; the average differential between BTPs and Bunds was 3.4 points. From 1999 onwards they came down to about 0.2 and 0.3 percentage points respectively.

Econometric studies show that there is a significant correlation between yield differentials on government bonds and various indicators of the public finances. In the euro-area countries between 1992 and 1998 an increase of three percentage points in the ratio of the budget deficit to GDP would, other things being equal, cause the yield differential vis-à-vis Germany to widen by an average of about one percentage point. After the introduction of the single currency this effect was reduced to about one tenth. However, analysis for the United States shows that during periods of pronounced deterioration in the public finances changes in debt indicators can have significantly greater effects on market yields than in normal circumstances.

The exchange rate. – In 2005 the euro depreciated by 7.1 per cent in nominal effective terms and by 6.6 per cent in real terms on the basis of producer prices, thus helping to make monetary conditions in the area more expansionary. The depreciation occurred mainly in the first half of the year and primarily reflected the appreciation of the dollar, which was fueled by the widening of the interest rate differential in favour of the US currency, and that of the currencies of Asian countries with better growth prospects than the euro area.

The trend was reversed in 2006. Between January and the beginning of May the euro strengthened by 3 per cent in nominal effective terms, aided by the improvement in economic conditions in the area. The appreciation was greatest in relation to the dollar (8.1 per cent), owing partly to fears of a further increase in the US current account deficit.

The money supply and credit

The euro area. – The expansion in the monetary aggregates continued apace in 2005. The rate of growth in the M3 money supply accelerated until the end of the summer, driven by the low level of interest rates, which reduces the opportunity cost of holding liquid assets, but it eased thereafter as households' investments in equities recovered. At the end of the year the twelve-month rate of growth in M3 was 7.4 per cent.

The accommodating lending conditions boosted credit. The rate of growth in bank lending to the private sector in the euro area rose significantly to a twelve-month rate of 9.2 per cent in December. Loans to households for house purchases increased rapidly, by 11.5 per cent. Corporate lending rose by 8.3 per cent, reflecting both the recovery in investment and strong demand for loans in support of special financial operations, in particular mergers and acquisitions.

Italy. – In 2005 the Italian component of M3, excluding currency in circulation, increased more slowly than the euro-area aggregate, rising by 6.1 per cent. Households began to show renewed interest in longer-term and less liquid assets.

Currency in circulation continued to grow rapidly. The demand for cash, measured on the basis of cumulative flows of euro banknotes distributed by the branches of the Bank of Italy less note withdrawals, increased by 14.1 per cent, compared with the euro-area average of 12.8 per cent. The sharp increase in issues of €500 notes (27 per cent, contributing 3.8 percentage points to the overall growth) lends credence to the supposition that in Italy, as in the euro area as a whole, a significant part of the increase in cash is unconnected with normal demand for currency for transaction purposes.

Lending to the private sector grew rapidly, rising by 11 per cent in the twelve months to December, compared with 7.9 per cent a year earlier. The acceleration can be attributed mainly to credit demand from households and financial companies; by contrast, borrowing by firms was subdued. Bank lending expanded strongly, by 8.7 per cent, with lending to households showing particularly vigorous growth. The increase in bond issues accelerated to 22.1 per cent, so that bonds now represent about 8 per cent of total finance to the private sector.

Monetary policy operations in the euro area

The average daily volume of liquidity provided by the Eurosystem via main refinancing operations rose from €242 billion in 2004 to €290 billion in 2005 in response to strong demand for banknotes and coin. The average number of banks participating in the auctions remained more or less unchanged (rising from 339 to 351 in the euro area and from 17 to 18 in Italy), as did the ratio between bid amounts and allotments (on average 1.27, compared with 1.26 in 2004). Italian banks were allotted a larger proportion of the total funds on offer than in the previous year (6.7 per cent, compared with 5.9 per cent). The daily average of excess bank reserves was very low, amounting to 0.52 per cent of minimum reserve requirements in the euro area and 0.33 per cent in Italy, thanks to the efficient operation of the screen-based interbank market.

The daily average volume of funds allotted by means of longer-term refinancing operations rose to €88 billion. An average of 151 euro-area banks participated at each auction.

The EONIA interest rate remained close to the minimum bid rate in the main refinancing operations in 2005, contributing to the transmission of appropriate signals about monetary policy. The differential between the two rates was very small (8 basis points) and stable, especially in the last few days of the compulsory reserve maintenance period, owing to the frequent use of fine-tuning operations.

THE HOUSEHOLD AND CORPORATE SECTORS

Households' financial saving and debt

In 2005 the financial surplus of the household sector (comprising consumer households, sole proprietorships with up to five workers and non-profit institutions serving households) declined by 14.6 per cent to €71 billion (Table 37). The decrease reflected an acceleration in investment in housing, as well as the smallness of the rise in disposable income. The surplus was equivalent to 5 per cent of GDP, or 2.6 per cent net of the loss of purchasing power due to the impact of inflation on the stock of households' net financial assets.

Table 37

ITALY: FINANCIAL BALANCES (1)
(millions of euros and percentages)

	2002	2003	2004	2005
Households	95,015	68,676	83,191	71,066
of which: external balance	*-9,613*	*2,098*	*1,323*	*41,971*
Non-financial corporations	-39,042	-27,408	-9,570	-27,555
of which: external balance	*5,521*	*21,534*	*13,607*	*49,161*
General government	-40,298	-46,032	-48,175	-55,576
of which: external balance	*-27,338*	*-63,988*	*-17,975*	*-88,182*
Monetary financial institutions	10,521	37,206	17,938	10,143
of which: external balance	*39,176*	*-25,137*	*28,787*	*-48,227*
Other financial intermediaries (2)	-40,099	-39,690	-27,127	244
of which: external balance	*-29,169*	*25,112*	*-44,691*	*5,783*
Insurance companies (3)	-1,379	-19,789	-22,905	-15,060
of which: external balance	*6,142*	*13,345*	*12,302*	*22,757*
Rest of the world account	15,282	27,037	6,647	16,737
	As a percentage of GDP			
Households	7.3	5.1	6.0	5.1
Non-financial corporations	-3.0	-2.1	-0.7	-1.9
General government	-3.1	-3.4	-3.5	-3.9
Financial corporations (4)	-2.4	-1.7	-2.3	-0.3
Rest of the world account	1.2	2.0	0.5	1.2
	As a percentage of GDP, adjusted for inflation (5)			
Households	5.1	2.9	3.7	2.6
Non-financial corporations	-2.0	-1.0	0.4	-0.7
General government	-1.0	-1.5	-1.5	-1.7

(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 currency with a fixed monetary value at maturity are taken into account in calculating the adjustment for inflation.

Financial assets. – The financial assets of Italian households rose to 3.3 times disposable income at the end of last year. Almost half of the increase of 7.1 per cent in relation to 2004 was due to a rise in the value of shares, and the remainder to the flow of saving. In relation to disposable income, the gross financial assets of Italian households are higher than the average for the euro area, where the ratio was 2.8 in 2004.

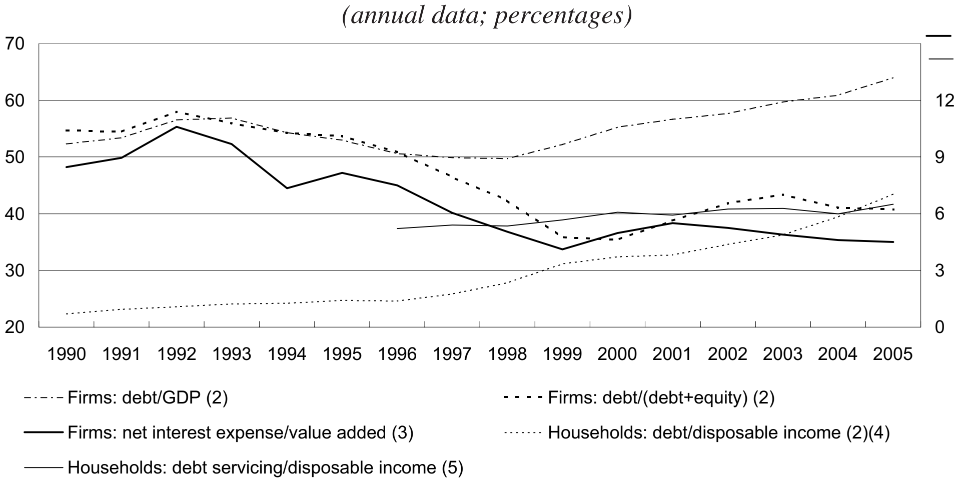
With short-term interest rates low and share prices high in 2005, households began to invest again in more risky financial assets offering higher expected returns. Their purchases of corporate bonds (which in 2004 had been affected by, among other things, the impact of major bankruptcies on investor confidence), investment funds units, shares and other equity increased by €49 billion, following net disposals of €18 billion in 2004. On the other hand, households sold short and long-term government securities worth €45 billion (Table 38).

Financial liabilities. – Between 1996 and 2005 households' financial debt grew from 25 to 43 per cent of disposable income (Figure 21), a proportion that is still very small by comparison with the situation in the euro area as a whole, where it is in excess of 80 per cent.

Figure 21

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

(annual data; percentages)



Sources: Bank of Italy, Istat.

(1) From 1995 onwards the data refer to the new definitions of instruments and sectors of economic activity introduced by ESA95. – (2) Left-hand scale. – (3) Right-hand scale. The figures for net interest expense are internal Bank of Italy estimates. Value added for 2005 is estimated from national accounting data.– (4) The figure for disposable income in 2005 is a Bank of Italy estimate. – (5) Right-hand scale. The ratio of debt servicing (total payments of interest and principal) to disposable income relates only to consumer households and is an internal Bank of Italy estimate.

The debt consists largely of medium and long-term liabilities, especially bank mortgage loans for house purchases, which have increased rapidly in the recent past owing to the reduction in interest rates and improvements in the supply of targeted financial products.

Table 38

FINANCIAL ASSETS AND LIABILITIES OF ITALIAN HOUSEHOLDS (1)

(millions of euros and percentage composition)

	End-of-period stocks			Flows	
	December 2005	Percentage composition		2004	2005
		December 2004	December 2005		
ASSETS					
Cash and sight deposits	552,660	16.9	16.9	32,961	36,670
of which: deposits	*476,552*	*14.7*	*14.6*	*23,544*	*27,300*
Other deposits	318,200	10.1	9.7	16,441	10,039
bank	*80,952*	*2.7*	*2.5*	*-1,960*	*-2,574*
post office	*237,247*	*7.4*	*7.3*	*18,401*	*12,613*
Short-term securities	2,003	0.6	0.1	8,819	-15,324
Medium and long-term securities	540,931	19.0	16.5	42,890	-25,895
of which: government	*180,376*	*6.6*	*5.5*	*12,115*	*-29,717*
corporate	*45,505*	*1.3*	*1.4*	*-3,128*	*7,111*
bank	*315,051*	*11.0*	*9.6*	*33,902*	*-3,289*
Investment fund units	270,248	9.3	8.3	-14,964	-4,072
Shares and other equity	712,610	19.6	21.8	-8,631	33,207
External assets	278,459	6.8	8.5	1,323	41,971
of which: deposits	*2,774*	*0.1*	*0.1*	*-5,329*	*807*
short-term securities	*708*	*0.0*	*0.0*	*50*	*294*
medium and long-term securities	*118,853*	*2.9*	*3.6*	*-1,911*	*27,728*
shares and other equity	*91,185*	*2.5*	*2.8*	*534*	*-656*
investment fund units	*64,939*	*1.3*	*2.0*	*7,979*	*13,797*
Insurance and pension fund reserves (2)	571,879	17.1	17.5	54,973	49,277
of which: life insurance reserves	*347,172*	*10.2*	*10.6*	*40,806*	*36,377*
Other financial assets (3)	21,611	0.6	0.7	1,614	3,594
Total assets	**3,268,601**	**100.0**	**100.0**	**135,426**	**129,467**
LIABILITIES					
Short-term debt (4)	53,173	10.8	9.7	-357	-10
of which: bank	*51,303*	*10.5*	*9.4*	*-944*	*-222*
Medium and long-term debt (5)	380,192	67.2	69.6	49,399	54,116
of which: bank	*340,932*	*60.9*	*62.4*	*43,777*	*46,030*
Other financial liabilities (6)	112,593	22.0	20.6	3,193	4,295
Total liabilities	**545,958**	**100.0**	**100.0**	**52,235**	**58,401**
BALANCE	**2,722,643**			**83,191**	**71,066**

(1) Consumer households, non-profit institutions serving households, and sole proprietorships with up to 5 workers. Rounding may cause discrepancies in totals. – (2) 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 corporations and other minor items. – (6) Staff pension provisions and other minor items.

On average, the cost of servicing household debt remains low. Payments of interest and principal amounted to 6.5 per cent of gross disposable income in 2005, compared with about 5 per cent in 1996 (see the box "Households' financial debt", *Economic Bulletin* No. 42, March 2006). The fact that the increase in debt servicing was relatively small, despite the rise in overall debt, was due partly to the decline in interest rates over the last ten years and to a reduction in the size of repayments as a result of a lengthening of the contractual maturity of mortgages.

The composition of households' financial assets and debt

Savers have increased their holdings of longer-term financial assets over the last ten years. According to the Survey of Household Income and Wealth, the proportion of families owning bonds, investment fund units or shares almost doubled, from under 9 per cent to 16 per cent. Differences in the composition of their financial portfolios according to income bracket and geographic area have become more pronounced over time. The 25 per cent of households with the highest incomes, who live predominantly in the Centre and North, hold a large proportion of their assets – around 36 per cent – in bonds, investment fund units and shares and a smaller part in the form of

Table 39

COMPOSITION OF HOUSEHOLDS' FINANCIAL ASSETS (1)
(percentages)

	1995					2004				
	Deposits or government securities	Bonds	Investment fund units	Shares	Other (2)	Deposits or government securities	Bonds	Investment fund units	Shares	Other (2)
	Proportion of holding households									
Geographic area										
Centre and North ..	91.3	3.6	5.9	5.5	4.5	91.6	8.1	11.3	10.0	6.6
South and Islands .	68.3	0.7	0.8	0.7	0.3	63.6	1.0	2.2	1.6	0.7
Annual disposable income										
1st quartile (3)	59.7	0.5	0.2	0.4	0.3	58.4	0.5	1.0	0.4	0.5
2nd quartile (4)	85.5	0.4	1.5	1.5	1.5	84.8	2.8	4.2	2.2	2.1
3rd quartile (5)	94.4	2.3	3.8	3.0	3.0	91.7	7.0	8.4	7.2	5.4
4th quartile (6)	97.9	7.7	11.8	11.3	8.1	95.7	12.8	19.8	19.5	10.7
Total	**83.7**	**2.6**	**4.2**	**3.9**	**3.1**	**82.7**	**5.8**	**8.4**	**7.4**	**4.7**
	Composition of financial assets									
Geographic area										
Centre and North ..	79.5	2.6	6.0	5.2	6.6	60.8	7.7	12.2	10.2	9.3
South and Islands .	89.6	5.7	1.2	1.9	1.6	82.5	1.6	8.8	4.1	3.0
Annual disposable income										
1st quartile (3)	95.7	1.5	0.5	1.9	0.5	93.2	1.3	3.1	1.6	0.8
2nd quartile (4)	93.6	0.5	2.3	1.6	2.0	83.1	4.0	7.5	3.1	2.4
3rd quartile (5)	90.7	1.6	3.3	1.6	2.8	73.1	5.8	8.0	6.2	6.8
4th quartile (6)	74.5	4.1	6.9	6.5	7.9	53.4	8.3	14.8	12.6	11.0
Total	**81.1**	**3.1**	**5.3**	**4.7**	**5.8**	**64.1**	**6.7**	**11.6**	**9.2**	**8.3**

Source: Bank of Italy, *Survey of Household Income and Wealth.*

(1) Related to the population as a whole. – (2) Includes equity in limited liability companies and partnerships, securities issued by non-residents and loans to cooperative societies. – (3) Up to €11,900 in 1995 and up to €15,800 in 2004. – (4) Between €11,900 and €18,500 in 1995 and between €15,800 and €24,200 in 2004. – (5) Between €18,500 and €28,800 in 1995 and between €24,200 and €37,200 in 2004. – (6) More than €28,800 in 1995 and more than €37,200 in 2004.

deposits (Table 39), while the 25 per cent with the lowest incomes invest more than 90 per cent of their financial wealth in deposits and government securities and the remainder mainly in investment fund units.

Table 40

HOUSEHOLDS' DEBT (1)

(percentages)

	1995			2004		
	Total debt			Total debt		
		of which: for house purchases	*of which: consumer credit*		*of which: for house purchases*	*of which: consumer credit*
	Proportion of indebted households					
Geographic area						
Centre and North ..	21.9	*15.1*	*8.7*	23.3	*13.3*	*13.0*
South and Islands .	17.6	*8.8*	*10.5*	18.5	*8.7*	*11.8*
Annual disposable income						
1st quartile (2)	10.5	*4.7*	*6.4*	9.6	*3.5*	*6.6*
2nd quartile (3)	17.5	*10.5*	*7.9*	18.1	*8.8*	*11.1*
3rd quartile (4)	25.9	*16.4*	*12.7*	26.9	*14.0*	*16.7*
4th quartile (5)	29.2	*21.6*	*10.6*	32.5	*20.9*	*16.2*
Total	**20.5**	***13.0***	***9.3***	**21.8**	***11.8***	***12.6***
	For indebted households: ratio of debt to assets (6)					
Geographic area						
Centre and North ..	8.0	*8.7*	*40.4*	10.9	*13.7*	*39.0*
South and Islands .	8.6	*9.8*	*53.2*	9.7	*14.4*	*40.0*
Annual disposable income						
1st quartile (2)	10.4	*15.4*	*60.4*	25.3	*32.4*	*102.0*
2nd quartile (3)	12.8	*13.4*	*101.1*	16.7	*21.0*	*63.4*
3rd quartile (4)	10.1	*11.2*	*53.8*	13.7	*19.9*	*49.5*
4th quartile (5)	6.0	*6.5*	*27.6*	7.8	*10.0*	*25.3*
Total	**8.1**	***8.9***	***43.5***	**10.6**	***13.8***	***39.3***
	For indebted households: ratio of debt to annual disposable income					
Geographic area						
Centre and North ..	52.6	*63.3*	*18.3*	80.7	*113.8*	*19.9*
South and Islands .	50.7	*72.3*	*17.9*	68.3	*99.8*	*24.6*
Annual disposable income						
1st quartile (2)	125.1	*249.5*	*31.2*	165.2	*393.7*	*36.3*
2nd quartile (3)	80.4	*112.4*	*27.1*	104.5	*168.1*	*36.8*
3rd quartile (4)	57.7	*76.0*	*19.4*	96.7	*159.4*	*22.7*
4th quartile (5)	38.9	*45.7*	*13.4*	60.0	*79.0*	*14.8*
Total	**52.2**	***65.0***	***18.2***	**77.9**	***111.0***	***21.1***

Source: Bank of Italy, *Survey of Household Income and Wealth*.

(1) Related to the population as a whole. Figures below the 1st percentile and above the 99th percentile are set to those of the percentiles mentioned. – (2) Up to €11,900 in 1995 and up to €15,800 in 2004. – (3) Between €11,900 and €18,500 in 1995 and between €15,800 and €24,200 in 2004. – (4) Between €18,500 and €28,800 in 1995 and between €24,200 and €37,200 in 2004. – (5) More than €28,800 in 1995 and more than €37,200 in 2004. – (6) Total debt and debt for house purchases are set in relation to total real and financial assets; consumer credit is set in relation only to financial assets.

The rapid rise in the value of households' real estate assets and their greatly increased activity in the property market were mirrored in an increase in average debt per household, which, including mortgage loans and consumer credit, rose from €14,000 in 1995 to €27,000 in 2004. The proportion of indebted households increased by little over one percentage point, however, to 22 per cent (Table 40); the increase in borrowing was especially marked among households in the quartile with the highest income, which accounts for around 40 per cent of total debt.

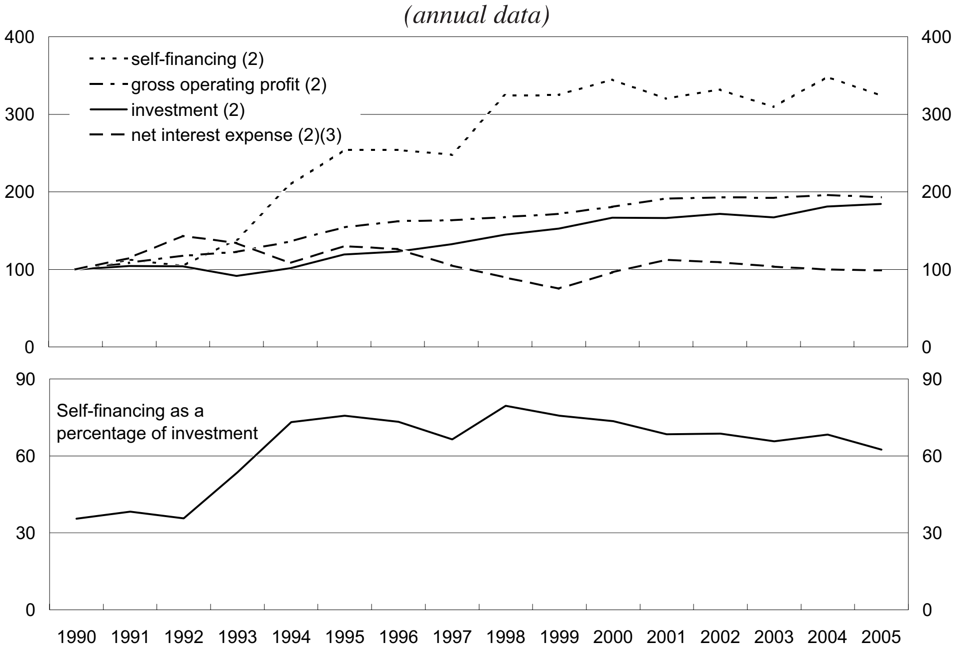
The financing of firms and their financial assets

Profitability and self-financing. – In 2005 the weakness of economic activity was reflected in a fall in the profitability of non-financial enterprises. Gross operating profit declined to 34 per cent of value added, about one percentage point less than in 2004 and below the average for the last ten years. Thanks partly to low interest rates, net interest expense remained virtually unchanged, at 4.5 per cent of value added (Figure 21). The proportion of investment financed internally fell from 68 to 62 per cent (Figure 22) and the financial deficit of firms increased from €10 billion to about €28 billion (Table 41).

Figure 22

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

(annual data)



Sources: Bank of Italy, Istat.

(1) Estimate based on national accounts data for the sector "non-financial corporations", 1980-2004. The data for 2005 are estimated on the basis of the national accounts for the year. Investment includes inventories. – (2) Indices, 1990=100. – (3) Bank of Italy estimate.

Table 41

FINANCIAL ASSETS AND LIABILITIES OF ITALIAN FIRMS (1)

(millions of euros and percentage composition)

	End-of-period stocks			Flows	
	December 2005	Percentage composition December 2004	Percentage composition December 2005	2004	2005
ASSETS					
Cash and sight deposits	151,936	10.5	10.5	14,950	15,790
Other deposits	10,680	0.8	0.7	1,928	235
of which: bank	*10,680*	*0.8*	*0.7*	*2,080*	*100*
Short-term securities	27	0.0	0.0	235	-302
Medium and long-term securities	44,165	3.1	3.1	11,631	2,061
of which: government	*10,746*	*0.9*	*0.7*	*1,023*	*-2,979*
corporate	*21,259*	*1.2*	*1.5*	*9,148*	*5,508*
Shares and other equity	534,206	37.0	37.0	-8,342	1,415
Investment fund units	3,764	0.3	0.3	-207	-56
Trade credit receivable	283,321	22.4	19.6	15,798	-6,251
Other financial assets (2)	60,979	4.3	4.2	4,752	5,867
External assets	353,435	21.6	24.5	29,030	50,524
of which: deposits	*20,956*	*0.5*	*1.5*	*183*	*14,212*
trade credit receivable	*60,317*	*4.6*	*4.2*	*2,371*	*1,334*
short-term loans	*77,841*	*3.7*	*5.4*	*23,824*	*28,441*
securities	*21,034*	*1.4*	*1.5*	*-902*	*2,638*
shares and other equity	*162,657*	*10.6*	*11.3*	*3,206*	*3,093*
Total assets	**1,442,513**	**100.0**	**100.0**	**69,774**	**69,283**
LIABILITIES					
Domestic liabilities	**2,388,589**	**89.2**	**89.4**	**63,921**	**95,475**
Short-term debt (3)	316,380	12.5	11.8	-5,249	3,577
of which: bank	*284,004*	*11.2*	*10.6*	*-6,920*	*3,227*
Medium and long-term debt (4)	450,082	16.4	16.8	45,389	46,003
of which: bank	*356,178*	*13.1*	*13.3*	*35,644*	*35,088*
Securities	47,371	1.7	1.8	10,340	5,082
of which: medium and long-term	*35,721*	*1.3*	*1.3*	*6,701*	*2,791*
Shares and other equity	1,164,299	42.1	43.6	-8,386	40,736
Trade credit payable	289,103	11.8	10.8	16,120	-6,378
Other financial liabilities (5)	121,354	4.7	4.5	5,707	6,456
External liabilities	**283,404**	**10.8**	**10.6**	**15,423**	**1,363**
of which: trade credit payable	*28,197*	*1.0*	*1.1*	*808*	*2,056*
financial debt	*93,567*	*3.2*	*3.5*	*3,084*	*14,085*
of which: medium and long-term securities	*13,789*	*0.6*	*0.5*	*2,423*	*-2,361*
shares and other equity	*155,161*	*6.4*	*5.8*	*12,892*	*-15,314*
Total liabilities	**2,671,993**	**100.0**	**100.0**	**79,344**	**96,838**
BALANCE	**-1,229,480**			**-9,570**	**-27,555**

Source: Financial accounts.

(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, domestic derivatives and other minor items.

Large companies fared better on the profitability front: on the basis of the consolidated accounts of the leading quoted industrial groups, both operating profit and ROE were higher than in the preceding year.

Debt. – The financial situation of firms remained broadly stable in 2005, despite weak economic conditions. Their financial debt rose by €69 billion to the equivalent of 64 per cent of GDP, an increase of around three percentage points. By contrast, leverage (calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices) remained at around 41 per cent, more or less the same as the previous year, benefiting mainly from an increase in equity due to the rise in the stock market.

The financial situation of large quoted companies improved considerably; the debt of the majority of the leading Italian industrial groups declined in relation to turnover, although it remained high in absolute terms.

A more accurate picture of changes in the financial situation of firms that takes account both of the level of debt and firms' ability to service it can be obtained by considering several balance-sheet ratios together, in particular leverage, financial debt to turnover, cash flow to interest expense and current assets to current liabilities. In the three years from 2002 to 2004 the number of firms in which at least two of these four indicators were below a reference level (for the methodology employed, see the box "The financial situation of Italian firms from 1990 to 2003", *Economic Bulletin* No. 40, March 2005) increased slightly by comparison with the preceding three years, to 14 per cent of the sample. However, their weight in terms of turnover declined by 1.5 percentage points to 13 per cent, reflecting the improvement in the financial situation of the largest firms, which was evident in all branches of activity but especially marked among firms in high-technology sectors.

In general, Italian firms are less indebted than those in the other leading industrialized countries; in 2004 the ratio of their financial debt to GDP was twelve percentage points lower than in the euro area and five less than in the United States.

The maturity of Italian firms' debt continued to lengthen in 2005, with medium and long-term financial debt rising to 56 per cent of the total. In 2000 medium and long-term debt had still accounted for only 43 per cent of the total, compared with 65 per cent in the euro area. Econometric analysis of a sample of more than 35,000 firms on the files of the Company Accounts Data Service and the Central Credit Register shows that around one tenth of the large increase in the proportion of medium and long-term borrowing can be attributed to debt restructuring by firms in difficulties; the renegotiation of debt appears to be associated with strong customer relations with banks.

Trade credit payable. – In 2005 domestic and foreign trade credit payable declined in Italy by about €4 billion; at the end of the year it amounted to 12 per cent of firms' total financial liabilities.

Project financing. – In recent years the central and local authorities of many countries have adopted arrangements involving the private sector in the financing of infrastructure projects (so-called public-private partnerships, the most common form of which is project financing). In the United Kingdom, where infrastructure development policies have encouraged extensive recourse to project financing for more than a decade, operations of this kind have brought significant reductions in the cost and time of executing public works projects. In Italy over the three years from 2002 to 2004 project financing procedures were used for around 7 per cent of the total value of public works put out to tender, involving an average of €2.3 billion a year; in 2005 the proportion rose to 13 per cent.

The distribution of the risks of such operations among the various parties involved (general government, financiers, construction and management companies) is a distinctive element of project finance and varies from one project to another. If the distribution does not give contracting firms an incentive to be efficient, for example if a large part of the operational risk falls on the public sector, the benefits of using project financing decrease significantly. In the case of Italy, analysis of a number of specific projects appears to indicate that the operations are often financed conventionally (for example, by means of bank loans secured on the assets of the company carrying out the project) and that a high proportion of the risk is borne by general government.

Share issues, venture capital and private equity. – In 2005 the increase in the net worth of firms due to retained profits and capital increases amounted to about €25 billion, compared with €4.5 billion in 2004. A large part of the increase was due to share issues amounting to about €8 billion by quoted companies (€1 billion in 2004), of which €3 billion was attributable to the conversion of Fiat's bank loans and €1 billion to the recapitalization of Alitalia.

According to the Italian Private Equity and Venture Capital Association, investment by private equity and venture capital companies in Italy more or less doubled last year to €3 billion. More than two thirds of these resources were invested in firms with more than 500 employees as part of operations involving changes of ownership. Venture capital to finance start-ups, by contrast, continues to account for only 1 per cent of total investment by such companies. Last year disinvestment by private equity and venture capital companies also increased, from €600 million to €1 billion, while their fund-raising declined to about €1.3 billion, the lowest level since 1999.

Financial assets and mergers and acquisitions. – With productive investment stagnating and the cost of capital low, firms' holdings of financial assets increased by €69 billion in 2005; much of the growth was in liquid assets (currency in circulation, deposits and government securities), which accounted for 13 per cent of the total stock. Their holdings of shares and other equity rose by around €5 billion, partly in connection with an increase in mergers and acquisitions, and contrasted with disposals of €5 billion in 2004.

The number and value of mergers and acquisitions were higher than in previous years; more than 120 transactions by Italian acquirers worth around €7 billion were announced, compared with an average of 80 operations worth €6 billion a year between 2002 and 2004. The greatest increase was in mergers between public utilities, which accounted for 15 per cent of operations by number and more than 60 per cent by value. Settlement of 95 per cent of the value of operations was in cash, often using borrowed funds, compared with around 80 per cent between 2002 and 2004.

Acquisitions of foreign companies accounted for 25 per cent of total transactions by Italian firms, the same as previously. The bulk of these were in euro-area countries; the proportion involving counterparties in Eastern Europe was negligible, whereas it had been 5 per cent in the preceding three years. Mergers and acquisitions involving Asian firms rose from 1 to 3 per cent. On the other side of the coin, around 50 Italian non-financial firms were acquired by foreign companies at a cost of more than €15 billion, two thirds of which related to a single operation in the telecommunications sector; in the three preceding years there had been an average of 35 operations a year worth about €3 billion.

BANKS AND OTHER CREDIT INSTITUTIONS

Lending

The expansion in lending by Italian banks in 2005 was extremely rapid, 8.7 per cent, a rate of growth that was in line with developments in the euro area (Table 42 and Figure 23). In Italy the ratio of total lending to GDP rose by almost five percentage points to 88 per cent (Figure 24).

Table 42

MAIN ASSETS AND LIABILITIES OF ITALIAN BANKS (1)
(end-of-period data)

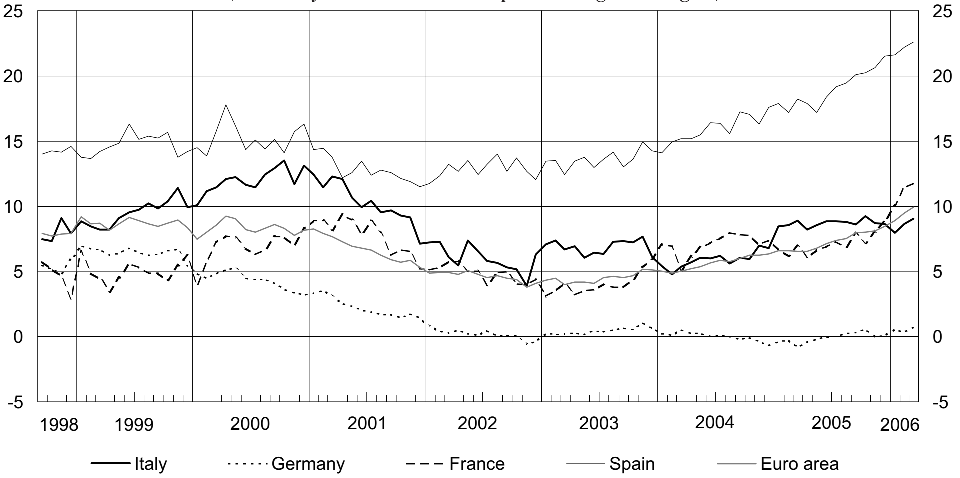
	Percentage changes								Stocks (millions of euros)
	On 12 months earlier			On previous quarter, annualized (2)					
				2005				2006	
	Dec. 2004	Dec. 2005	Mar. 2006	Q1	Q2	Q3	Q4	Q1	December 2005
Assets									
Securities	-2.8	19.4	13.1	6.9	20.8	20.5	28.8	-12.6	207,060
of which: government securities	*-12.4*	*14.5*	*4.5*	*4.3*	*14.0*	*14.2*	*24.3*	*-26.5*	*106,433*
Loans	6.7	8.7	9.1	10.9	8.7	6.5	9.1	12.2	1,250,201
of which (3):									
short-term (a)	*-4.4*	*2.0*	*2.4*	*6.1*	*2.7*	*0.1*	*0.1*	*6.7*	*443,493*
medium and long-term (b)	*14.2*	*13.0*	*13.2*	*14.2*	*11.7*	*12.4*	*13.6*	*15.3*	*749,171*
(a)+(b)	*6.0*	*8.6*	*9.0*	*11.0*	*8.1*	*7.6*	*8.4*	*12.1*	*1,192,664*
repos	*88.5*	*48.5*	*21.3*	*222.0*	*28.1*	*-68.4*	*273.4*	*43.4*	*7,788*
bad debts (4)	*6.0*	*-16.5*	*-13.9*	*-1.6*	*2.6*	*6.3*	*-54.6*	*10.9*	*45,412*
External assets	11.3	11.0	18.3	-3.0	25.3	6.1	17.5	25.3	275,868
Liabilities									
Domestic funding (5)	7.3	7.8	8.6	9.3	9.8	5.1	7.4	12.4	1,268,615
Deposits	5.2	6.9	7.7	7.5	9.0	5.5	6.1	10.5	784,199
of which (6):									
current accounts	*6.2*	*8.0*	*8.0*	*9.2*	*8.8*	*7.1*	*7.4*	*8.8*	*590,517*
with agreed maturity	*-4.0*	*2.7*	*5.0*	*1.8*	*-15.0*	*-3.4*	*33.1*	*11.4*	*42,883*
redeemable at notice	*4.7*	*2.5*	*0.3*	*4.8*	*4.4*	*1.3*	*-0.5*	*-3.8*	*69,596*
repos	*5.7*	*4.9*	*15.5*	*1.1*	*29.1*	*2.9*	*-9.5*	*48.2*	*72,990*
Bonds (5)	10.8	9.3	10.1	12.2	11.1	4.5	9.6	15.5	484,416
External liabilities	4.0	11.8	15.7	25.6	24.6	7.6	-7.1	43.7	341,000

(1) The figures for March 2006 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 seasonally adjusted data 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 percentage changes are not adjusted for debt cancellations and assignments. – (5) Includes bonds held by non-residents. – (6) Excludes those of central government.

Figure 23

LENDING BY MONETARY FINANCIAL INSTITUTIONS IN THE EURO AREA

(monthly data; 12-month percentage changes)



Source: Based on ECB data.

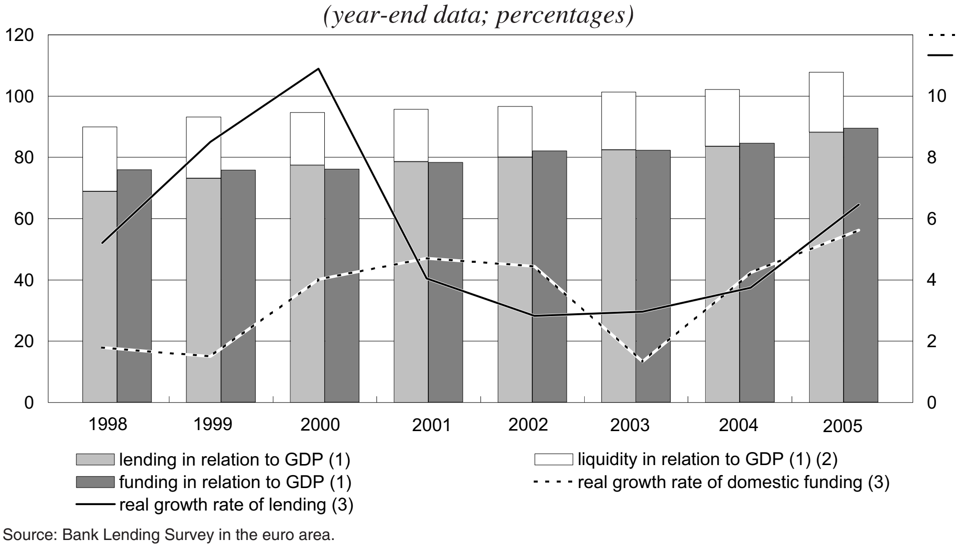
(1) Lending of monetary financial institutions (MFIs) of the euro-area countries, excluding the Eurosystem, to non-MFI resident customers.

Low interest rates fueled loan demand from the corporate sector, partly to finance special financial operations (mainly mergers and acquisitions), and from households, primarily for house purchases. The expansion was strongest in lending by banks in the smaller size categories, continuing a trend that has been under way since the mid-nineties.

Figure 24

BANKING INTERMEDIATION IN ITALY

(year-end data; percentages)



Source: Bank Lending Survey in the euro area.

(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 are deflated using the GDP deflator.

Lending to firms. – In Italy the growth in corporate credit accelerated to 6.5 per cent. On the basis of harmonized statistics, which include bad debts and repos, the increase in lending to non-financial companies was about two percentage points lower than the euro-area average. Lending increased more rapidly in Spain owing to the stronger expansion in investment but continued to contract in Germany, where slow economic growth has been accompanied by a sustained increase in self-financing.

After falling slightly in 2004, lending to Italian manufacturing firms increased by a modest 2.2 per cent. The growth was primarily in industries where signs of recovery have begun to appear (food processing and agricultural and industrial machinery); by contrast, there was a decrease in lending to branches of activity where capacity utilization rates have fallen (transport equipment and rubber and plastic products).

Credit to construction firms, especially those engaged in house building, accelerated rapidly. In the services sector, the rate of growth in loans to the telecommunications, transport and hotel branches picked up but that in lending to real-estate service companies eased.

Bank lending to medium-sized and large firms increased by 6.6 per cent, compared with 4.5 per cent in 2004. A good part of the acceleration was attributable to syndicated loans granted to a number of groups undergoing reorganization.

Lending to small enterprises (sole proprietorships and partnerships with fewer than 20 workers) rose by 6 per cent, similar to the rate recorded in 2004. The proportion of such loans backed by loan guarantee consortia has increased considerably in the last few years, and stood at 12 per cent at the end of 2005.

Short-term lending, which had been in decline since 2002, began to grow again in early 2005, albeit only modestly; in December it was 1.2 per cent higher than twelve months earlier. The rise involved all the main branches of economic activity but was more pronounced for firms in construction and in the branches of manufacturing where performance was strongest.

Bank lending to firms in the South and Islands increased by 11.2 per cent, far higher than the rate of growth of 5.8 per cent in lending in the Centre and North. A contributory factor was the reduction in self-financing due to the weakness of economic activity (see the box "Lending to firms in the South and Islands", *Economic Bulletin* No. 41, November 2005).

The stagnation in corporate activity was reflected in a sharp reduction in claims sold to banks for factoring and very modest growth in those sold to financial companies (Table 43). Leasing credit, on the other hand, increased strongly, thanks to the growth of the real-estate sector, which accounted for about half of the total; the expansion was greatest in the South and Islands.

Table 43

LEASING AND FACTORING IN ITALY

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

	Percentage change on previous year			Outstanding 2005 (1)	Percentage of total
	2003	2004	2005 (1)		
			Leasing		
Total credit	2.2	4.1	9.5	70,310	100.0
Financial companies	2.8	1.6	9.5	54,490	77.5
of which: real estate credit	*13.8*	*4.6*	*14.0*	*31,098*	*44.2*
Banks	-0.2	13.7	9.4	15,820	22.5
			Factoring		
Total credit	-0.2	-2.6	-0.6	38,096	100.0
Financial companies	-2.4	-3.0	1.2	34,021	89.3
Banks	19.8	0.2	-13.6	4,075	10.7

Source: Supervisory reports.
(1) Provisional.

Lending to households. – Bank lending to households continued to grow at a sustained rate of 13.2 per cent in 2005, almost four percentage points higher than the euro-area average. Its share of total bank lending also increased substantially but remains small by international standards (31 per cent, compared with 46 per cent in the euro area, 43 per cent in the United Kingdom and 48 per cent in the United States).

Credit to consumer households increased by 15.1 per cent; the growth was faster in the South and Islands (16.9 per cent) than in the Centre and North (14.6 per cent).

The rate of growth in lending for house purchases remained very high (18 per cent; Table 44). New loans amounted to €62 billion, 85 per cent of which was granted at indexed rates or rates renegotiable within one year, compared with 54 per cent in the euro area.

Consumer credit granted by banks and financial companies also continued to grow rapidly, especially credit secured against salary. Credit card debt accelerated further, to account for 14.1 per cent of total consumer credit at the end of 2005, compared with 9.9 per cent in 2000.

Table 44

LENDING TO CONSUMER HOUSEHOLDS

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

	Percentage changes on previous year			Outstanding 2005 (1)	Percentage of total
	2003	2004	2005 (1)		
	Loans for house purchases				
Total credit	15.9	20.7	18.0	198,859	100.0
up to 5 years	*-16.9*	*-4.0*	*-0.7*	*1,550*	*0.8*
over 5 years	*16.5*	*21.0*	*18.2*	*197,309*	*99.2*
	Consumer credit				
Total credit	12.2	18.1	19.4	72,320	100.0
of which: *credit cards*	*15.7*	*18.0*	*21.8*	*10,173*	*14.1*
for purchases of motor vehicles	*10.2*	*17.5*	*15.3*	*25,763*	*35.6*
Banks	9.9	16.3	17.2	41,726	57.7
of which: credit cards	*26.2*	*24.5*	*28.9*	*4,178*	*5.8*
for purchases of motor vehicles	*12.3*	*22.4*	*19.5*	*11,910*	*16.5*
Financial companies	15.9	20.8	22.5	30,594	42.3
of which: credit cards	*10.3*	*14.3*	*17.3*	*5,995*	*8.3*
for purchases of motor vehicles	*8.8*	*13.9*	*11.9*	*13,853*	*19.2*
	Other lending				
Total credit	-0.1	2.3	4.2	54,847	100.0

Source: Supervisory reports.
(1) Provisional.

Lending according to size of bank. – Smaller banks throughout the country continued to record higher rates of growth in lending to firms and households than did other intermediaries. In 2005 “small” and “minor” banks accounted for about half of the growth in lending to the private sector.

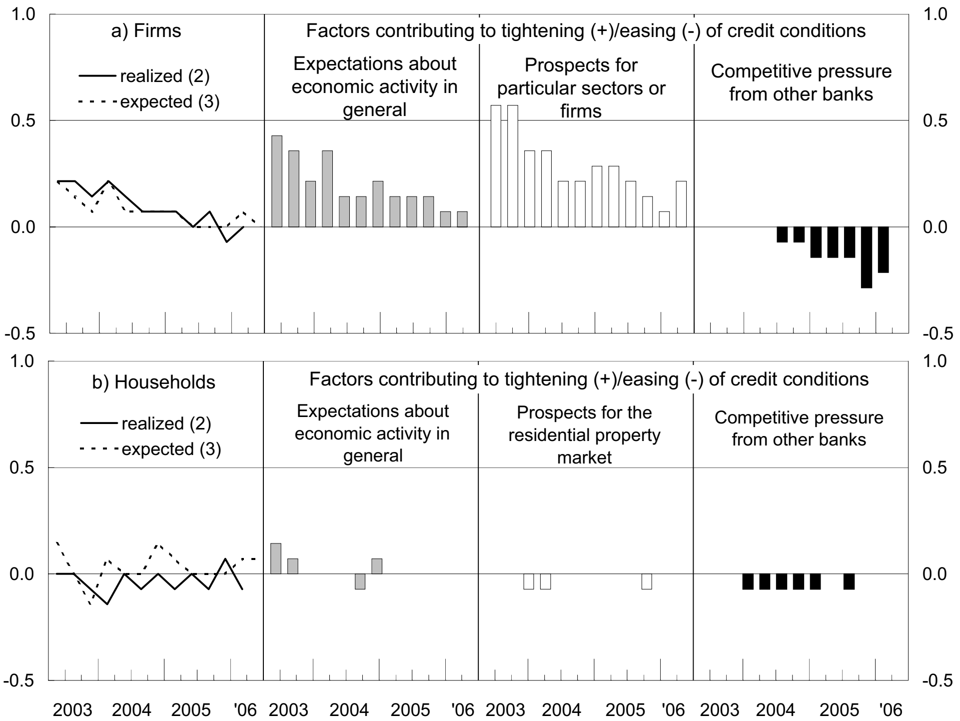
Bad debts. – New bad debts equal to 0.85 per cent of total lending were recorded in 2005, compared with 0.86 per cent the previous year. The default rate continued to be higher for customers in the South and Islands (1.29 per cent) than for those in the Centre and North (0.78 per cent). The ratio of the stock of bad debts to total lending fell from 4.7 to 3.7 per cent, owing mainly to massive securitization operations. The stock of substandard loans declined slightly in relation to total lending, to 1.6 per cent in the Centre and North and to 2.7 per cent in the South and Islands.

Lending conditions and interest rates

Credit supply. – Credit remained in abundant supply last year. According to information from the seven Italian banking groups participating in the Eurosystem's quarterly survey of bank lending in the euro area, the improvement in economic prospects and competitive pressure led to ever more favourable lending conditions for firms (Figure 25). The index measuring the tightness of lending conditions, calculated by aggregating the qualitative data provided by the banks, declined in December to its lowest point since the survey began.

Figure 25

INDICES OF LENDING CONDITIONS AND THEIR MAIN DETERMINANTS IN ITALY (1)



Source: Bank Lending Survey in the euro area.

(1) The indices are constructed by aggregating the qualitative replies from the 7 Italian groups participating in the quarterly Bank Lending Survey, weighted as follows: 1 = tightened considerably, 0.5 = tightened somewhat, 0 = basically unchanged, –0.5 =eased somewhat, –1 = eased considerably. The range of variation of the index is from –1 to 1. – (2) In the quarter in which the survey was conducted. – (3) Forecasts for the subsequent quarter.

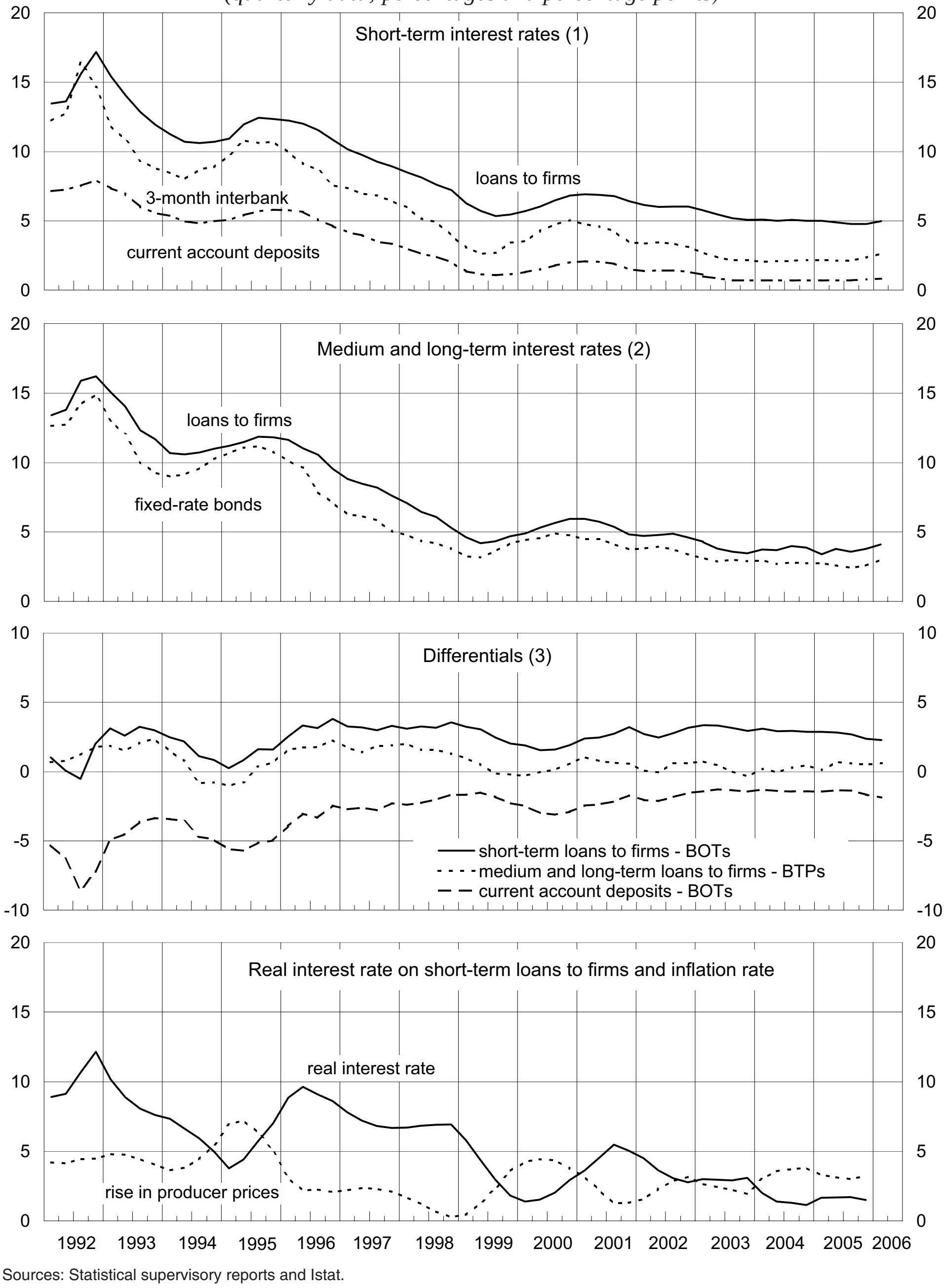
The survey shows that the conditions applied to loans to households also improved, with the loan-to-value ratio increasing and the average term to maturity lengthening. Towards the end of the year, however, as in the euro area as a whole, some intermediaries indicated that they had increased the margins they required for riskier classes of customer.

Interest rates. – Lending rates in Italy remained very low (Figure 26). At the end of December the average cost of outstanding bank credit was 4.3 per cent for firms and 5.3 per cent for households, compared with 4.2 and 5.1 per cent respectively in the euro area.

Figure 26

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

(quarterly data; percentages and percentage points)



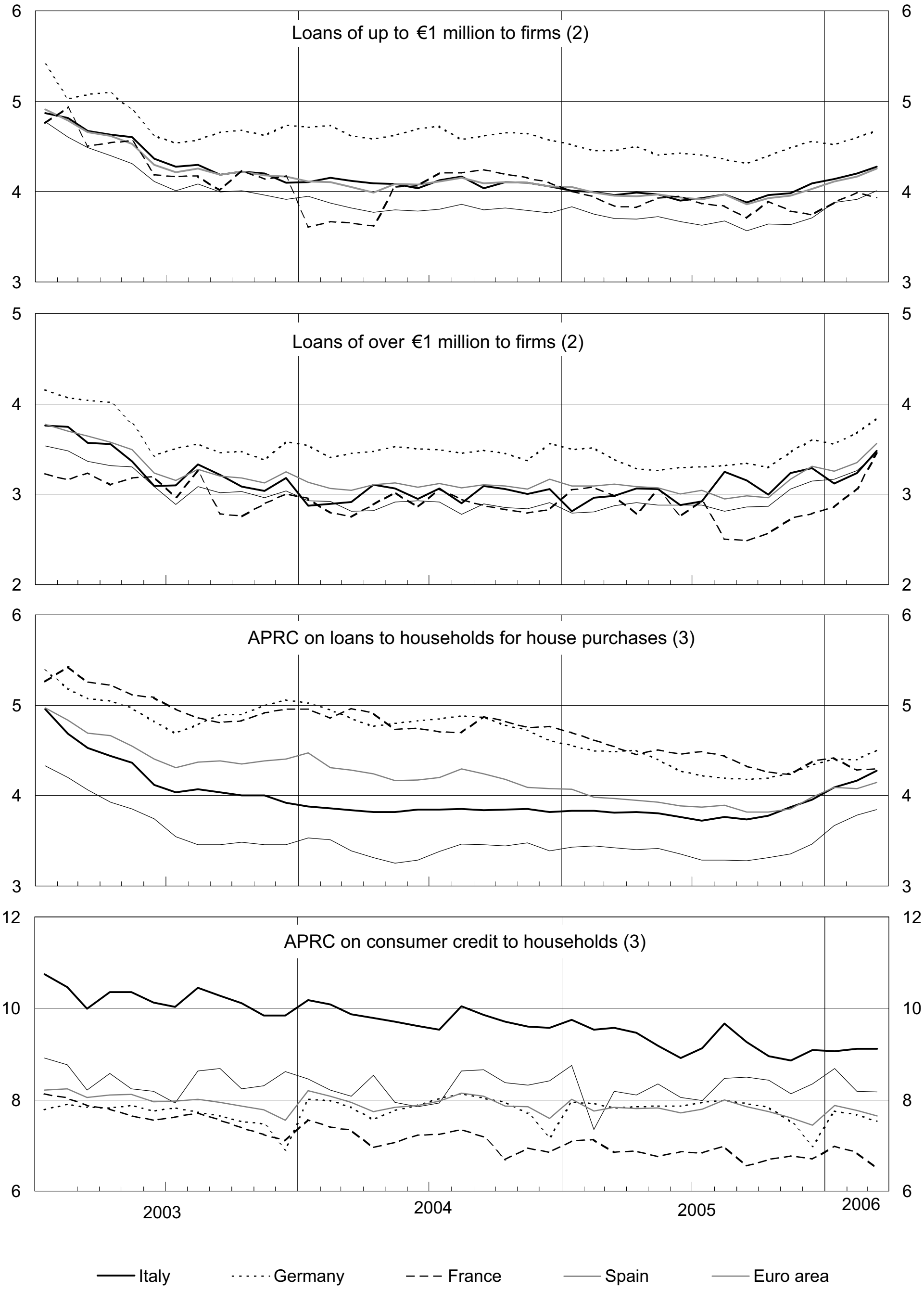
Sources: Statistical supervisory reports and Istat.

(1) The rate on short-term loans to firms relates to loans outstanding. – (2) The rate on medium and long-term loans to firms relates to new loans and that on bonds to new issues. – (3) The yield on BTPs relates to Treasury bonds traded on the stock exchange with a residual maturity of more than one year.

Figure 27

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

(monthly data; percentages)



Source: Based on ECB data.

(1) Contracts concluded during the reference period or which constitute a renegotiation of previous terms and conditions. – (2) Average lending rate for non-financial firms across all maturities, weighted by loan amounts. The latter refer to the amount of each individual transaction. Excluding overdrafts. – (3) The annual percentage rate of charge (APRC) includes ancillary expenses (administrative expenses, loan examination fees and insurance). It is calculated as the average rate across all maturities, weighted by loan amounts. Includes rates charged to producer households and non-profit institutions serving households.

The interest rate on new fixed-term loans of up to €1 million, which can be taken as an indicator of credit conditions for small firms, was 4.1 per cent, and that on loans of more than €1 million was 3.3 per cent. Both rates were broadly in line with the euro-area averages (Figure 27).

The differential between the rates on short-term loans to firms in the South and Islands and those charged to firms in the Centre and North remained unchanged at 1.9 percentage points.

In Italy and the euro area the annual percentage rate of charge (APRC) on new lending to households for house purchases stood at 4 per cent in December.

In 2005 the APRC on consumer credit from banks in Italy fell by 0.5 percentage points to 9.1 per cent, but there was still a large differential by comparison with the euro-area average of 7.4 per cent. Part of the disparity (0.6 percentage points) was due to intermediaries specializing in lending through retailers with which they have agreements, which usually charge additional fees; these intermediaries hold about one third of the banking market. The remainder of the differential can probably be ascribed to structural factors: the relatively small size of the market, which prevents economies of scale from being fully exploited; agreements with large distribution firms, which may restrict the entry of new competitors to the market in targeted credit; the smaller proportion of personal loans, which are cheaper than targeted credit as they involve a more direct relationship between the intermediary and the customer.

In December bank interest rates began to adjust to the rise in official rates. The adjustment was comparable in extent and speed to those observed in the past. Between November 2005, when rates were at their lowest, and the end of March 2006 the average lending rate on short-term loans to firms and households in Italy rose by 25 basis points, which was broadly in line with the average increase in the euro area.

Funding

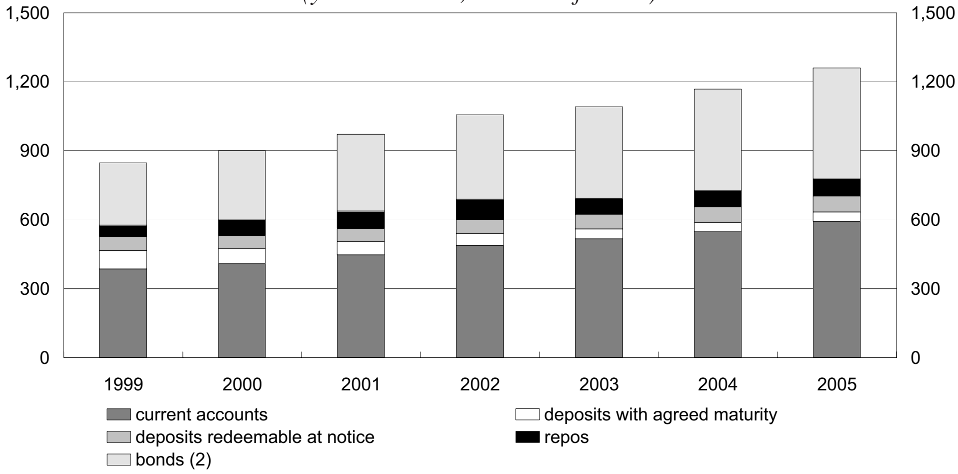
Banks' domestic funding rose by 7.8 per cent in 2005 (Table 42), reflecting the sustained expansion in current account deposits and bonds (Figure 28).

The acceleration in the growth of current account deposits to 8 per cent was largely attributable to a more rapid increase in deposits held by financial and insurance companies. Issues of bank bonds rose by 9.3 per cent; one third of new issues was placed on the Euromarket and around three quarters was at indexed rates.

Figure 28

BANK FUNDING 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 interest rate paid on current accounts rose by one tenth of a point to 0.8 per cent, thus moving into line with the euro-area average (Figure 29). The average rate on all deposits rose to 1 per cent in Italy, whereas it declined slightly in the euro area to 1.6 per cent; the contrasting movements reflected mainly differences in the deposit mix.

Bank deposit rates throughout the euro area were less responsive than lending rates to changes in monetary conditions. Between the low point recorded in November 2005 and the end of March 2006 the average rate on firms' and households' current accounts rose by 12 basis points in Italy and Germany, 9 in Spain and only 5 in France.

The banks' securities portfolio and net external position

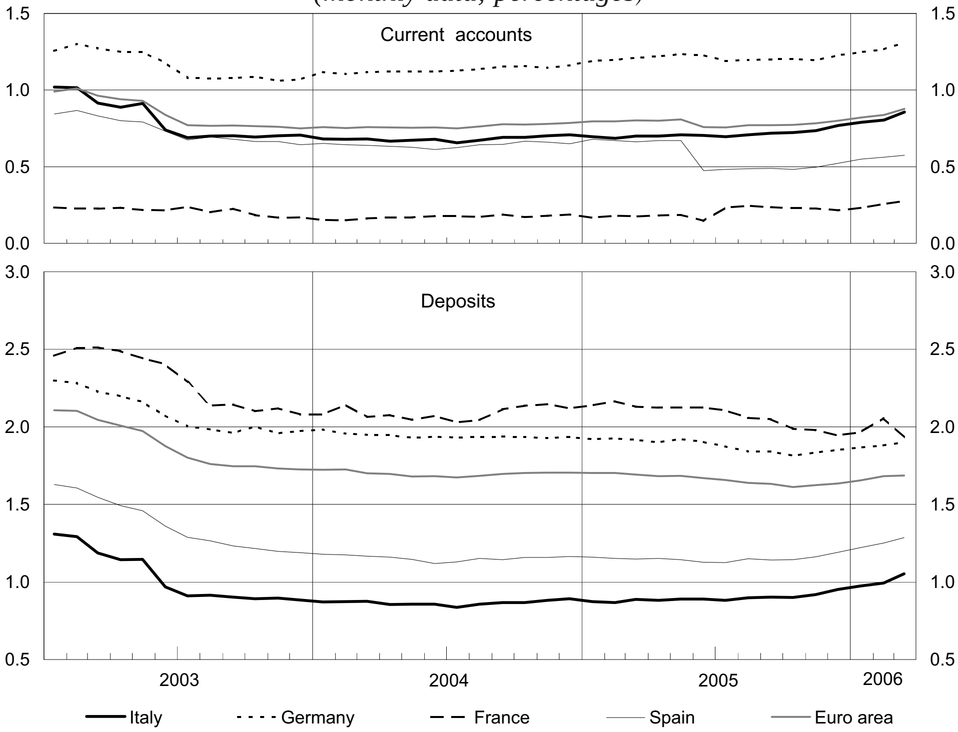
The securities portfolio. – On the basis of data that are not consolidated at group level and excluding the effects of price changes, the value of banks' holdings of securities increased by 19.4 per cent in 2005 (Table 42). The growth occurred entirely in securities issued by private sector companies, and especially bank bonds, whose share of the securities portfolio rose from 34 to 36 per cent.

The ratio of liquid assets (cash and securities other than shares) to the sum of lending and liquid assets rose by almost one percentage point to 16.3 per cent in 2005, thus reversing a trend that had begun in the mid-nineties; a small number of large Italian banking groups and branches of foreign banks accounted for most of the increase.

Figure 29

HARMONIZED INTEREST RATES ON DEPOSITS IN THE MAJOR EURO-AREA COUNTRIES

(monthly data; percentages)



Source: Based on ECB data.

On the basis of harmonized statistics, at the end of 2005 Italian banks' holdings of shares and other equity in euro-area non-banking companies amounted to €64.1 billion at market value, equal to 2.9 per cent of their total assets excluding interbank claims. The corresponding proportions were 5.2 per cent in Germany, 3.4 per cent in France and 4 per cent in Spain.

The net external position. – Excluding the effects of exchange rate and price changes, the net external debtor position of the Italian banking system rose by €9 billion in 2005 to stand at €65 billion at the end of December, equal to 2.6 per cent of the balance-sheet total. The increase was mainly due to positions in dollars, predominantly vis-à-vis counterparties from outside the euro area.

Profit and loss accounts

The operating profits of Italian banks rose in 2005, benefiting from the growth in total assets, the good performance of the financial markets and the smallness of the rise in costs. Return on equity (ROE), based on financial statements not consolidated at group level, was 9.6 per cent, compared with 9.5 per cent in 2004 (Table 45); this was in line with the average for euro-area banking systems and lower than in the major Anglo-Saxon countries.

Net interest income rose by 4 per cent, compared with 1.3 per cent in 2004; the acceleration was due to the large growth in the volume of business and a fall in the cost of hedging interest rate risk. However, the spread between the average lending rate and the average cost of funds narrowed by 0.2 percentage points to 3.3 points.

Income from services increased by 11.2 per cent, compared with 6.5 per cent in 2004. Two thirds of the growth was due to higher revenue from the distribution of third parties' insurance and portfolio management services. Income from asset management rose by 9.1 per cent, while commissions from collection and payment services increased by a modest 2.7 per cent. Net income from trading in securities and other assets declined by 48.6 per cent owing to losses on derivatives, especially those on interest rates. Gross income, excluding dividends on shares and other equity in banks (around half of total dividends), rose by 6.1 per cent.

Staff costs increased by 3.2 per cent, whereas in 2004 they had fallen by 1.3 per cent; net of the cost of early retirement schemes, the increase was 3.5 per cent. The number of bank employees fell by an annual average of 0.2 per cent. Staff costs per employee rose by 3.8 per cent to €68,100, reflecting wage increases under the national labour contract for the banking industry and the implementation of the new international accounting standards (IAS/IFRS), which provide for directors' remuneration and the value of stock options to be recorded among staff expenses. Net of the impact of the IAS/IFRS, staff costs per employee would have risen by 3.2 per cent.

Legislative Decree 38 of 28 February 2005 required the new international accounting standards to be applied to consolidated accounts as from the 2005 financial year. Although the requirement is not due to come into effect for unconsolidated accounts until 2006, the decree included a provision to bring the application of the IAS forward to the 2005 accounts. Only 52 of the 774 reporting banks, holding around one third of the total assets of the Italian banking system, have produced unconsolidated supervisory data based on the new accounting rules.

Operating costs other than staff expenses rose by 6.6 per cent, partly because of the increase in indirect taxes. Total operating expenses, which had remained virtually unchanged in 2004, rose by 4.8 per cent last year. Operating profit increased by 8.4 per cent, compared with 1.3 per cent in 2004.

Table 45

PROFIT AND LOSS ACCOUNTS OF ITALIAN BANKS (1)

	2002	2003	2004	2005	2002	2003	2004	2005
	As a percentage of total assets				**Percentage changes** (3)			
Net interest income (a)	1.91	1.77	1.67	1.58	4.9	0.8	1.3	4.0
Other net income (b) (2)	1.46	1.42	1.33	1.32	-12.0 *(-8.2)*	5.7 *(8.9)*	-0.7 *(-0.8)*	8.7 *(9.1)*
of which: trading	*0.07*	*0.13*	*0.08*	*0.04*	*-42.9*	*95.4*	*-39.4*	*-48.6*
services	*0.59*	*0.55*	*0.54*	*0.55*	*-7.7*	*1.0*	*6.5*	*11.2*
other financial operations (2)	*0.51*	*0.43*	*0.39*	*0.41*	*-19.0* *(-10.1)*	*-7.7* *(-4.4)*	*-3.6* *(-6.2)*	*13.5* *(19.5)*
Gross income (c=a+b) (2) (c=a+b) (2)	3.37	3.19	2.99	2.90	-3.1 *(-0.6)*	2.9 *(4.0)*	0.4 *(0.4)*	6.1 *(6.1)*
Operating expenses (d)	2.02	1.95	1.81	1.74	4.5	4.9	-0.1	4.8
of which: banking staff costs (3)	*1.10*	*1.07*	*0.98*	*0.93*	*4.9*	*5.2*	*-1.3*	*3.2*
Operating profit (e=c-d) (2)	1.36	1.25	1.18	1.17	-12.5 *(-8.6)*	-0.1 *(2.3)*	1.1 *(1.3)*	8.1 *(8.4)*
Value adjustments, readjustments and allocations to provisions (f)	0.56	0.52	0.29	0.28	-10.2	0.8	-39.4	4.2
of which: in respect of loans	*0.38*	*0.42*	*0.31*	*0.23*	*7.5*	*21.1*	*-20.0*	*-18.4*
Profit before tax (g=e-f) (2)	0.80	0.73	0.89	0.89	-14.1 *(-7.0)*	-0.7 *(3.8)*	29.9 *(40.2)*	9.4 *(10.2)*
Tax (h)	0.30	0.22	0.24	0.24	-18.8	-21.5	18.1	9.7
Net profit (g-h)	0.50	0.51	0.65	0.65	-11.0	12.1	34.9	9.2
Dividends distributed	0.33	0.34	0.38	0.48	-11.5	11.5	22.1	37.1
	Other indicators							
	Profit before tax				**Net profit**			
Profit as a percentage of capital and reserves (ROE) (4)	10.5	10.4	13.0	13.2	6.2	7.2	9.5	9.6
	Amounts				**Percentage changes**			
Total assets (*millions of euros*)	1,998,624	2,170,483	2,330,992	2,548,784	5.7	8.5	7.3	9.4
Average number of employees	342,555	339,381	338,017	337,306	-0.7	-1.1	-0.4	-0.2
of which: banking staff	*340,560*	*338,292*	*337,023*	*336,410*	*-0.4*	*-0.8*	*-0.4*	*-0.2*
Total assets per employee (*thousands of euros*)								
at current prices	5,835	6,395	6,896	7,556	6.5	9.7	7.7	9.6
at constant prices (5)	4,911	5,242	5,530	5,945	3.9	6.8	5.4	7.5
Staff costs per employee *(thousands of euros)*								
at current prices (6)	62.4	64.2	65.6	68.1	2.0	3.0	2.2	3.8
at constant prices (5) (6)	52.5	52.6	52.6	53.6	-0.6	0.4	0.0	1.9
Memorandum items: (7)								
Total assets (*millions of euros*)	2,006,179	2,174,905	2,334,273	2,552,370	6.0	8.4	7.3	9.3
Total number of employees (8)	341,615	337,696	337,311	336,783	-0.6	-1.1	-0.1	-0.2
of which: banking staff (8)	*340,440*	*336,661*	*336,354*	*335,910*	*-0.3*	*-1.1*	*-0.1*	*-0.1*

(1) Rounding may cause discrepancies. The data for 2005 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.

Value adjustments to assets and allocations to provisions rose by 4.2 per cent and absorbed about one quarter of operating profit. The renewed increase, following a sharp fall of 39.4 per cent in 2004, was due largely to the waning of the effects of Legislative Decree 37/2004 on the balance between extraordinary income and expenses relating to earlier years. On the other hand, value adjustments to loans decreased further to a historically low level of 0.23 per cent of total assets.

Profit after direct taxes rose by 9.2 per cent. The application of the new IAS/IFRS affected not only staff costs but also other items in the profit and loss account (income from trading, extraordinary income and expenses relating to earlier years), especially as regards the fair market value of items that had previously been recorded at historic cost. If the direct effects of the application of the IAS/IFRS are eliminated, net profit would have increased by 10.2 per cent.

INSTITUTIONAL INVESTORS

Consolidated net fund-raising by Italian institutional investors rose by 64 per cent to €69 billion in 2005 (Table 46). Their consolidated net assets increased by 10 per cent to €1,119 billion, thanks partly to the rise in share prices; as a percentage of GDP, they rose by 6 percentage points to 79 per cent.

Table 46

ITALIAN INSTITUTIONAL INVESTORS: NET FUND-RAISING AND ASSETS UNDER MANAGEMENT

(millions of euros and percentages)

	Net flows		End-of-period stocks			
					Percentage composition	
	2004	2005 (1)	2004	2005 (1)	2004	2005 (1)
Investment funds (2)	-15,166	-3,739	399,882	417,425	31.9	30.2
Insurance companies (3)	43,587	43,951	373,827	417,778	29.8	30.2
Pension funds (4)	1,366	3,563	30,481	34,045	2.4	2.5
Individually managed portfolios	14,669	35,410	448,738	512,714	35.8	37.1
Total ...	**44,456**	**79,185**	**1,252,928**	**1,381,962**	**100.0**	**100.0**
Consolidated total (5)...	**41,997**	**68,957**	**1,014,264**	**1,119,125**	–	–
as a percentage of GDP	*3.0*	*4.9*	*73.0*	*79.0*	–	–

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. – (5) Net of investments in Italian collective investment undertakings (CIUs) and SICAVs by the other categories of intermediary and net of investments by insurance companies and pension funds in portfolios individually managed by asset management companies.

The institutional investor sector as a whole is still smaller in Italy than in the other major countries (Table 47). At the end of 2004, the last year for which comparable data are available, the products offered by these intermediaries accounted for 24 per cent of households' financial assets in Italy (taking both Italian and foreign funds into consideration), compared with 36 per cent in the euro area, 42 per cent in the United States and 57 per cent in the United Kingdom. This reflects the underdevelopment of pension funds and the lower use made of insurance policies.

In 2005 Italian investment funds continued to record net redemptions, to the benefit of funds established abroad by Italian intermediaries. Italian management companies increased the range of hedge funds, closed-end real estate funds and other types of non-harmonized funds they offer, a trend that has been under way for several years. Exchange-traded funds (ETFs) continued to grow. There was a substantial increase in net inflows to individually managed portfolios.

Table 47

INSTITUTIONAL INVESTORS: NET ASSETS AS A PROPORTION OF HOUSEHOLDS' FINANCIAL ASSETS IN THE MAIN EUROPEAN COUNTRIES AND THE UNITED STATES

(end-of-period data; percentages)

	1995	2000	2002	2004	2005 (1)
			Italy		
Investment funds (2)	4.1	16.6	11.9	10.4	10.3
Insurance companies and pension funds	5.5	7.7	10.1	11.9	12.7
of which: pension funds	*1.2*	*0.9*	*1.0*	*0.9*	*0.9*
Other institutions (3)	1.7	1.9	2.4	2.6	2.7
Total	**11.3**	**26.2**	**24.4**	**24.9**	**25.9**
as a percentage of GDP	*19.6*	*61.0*	*52.5*	*56.1*	*59.6*
			France		
Investment funds (2)	13.4	11.3	10.5	9.8	9.6
Insurance companies and pension funds	24.0	29.8	32.9	33.7	33.4
Total	**37.4**	**41.1**	**43.4**	**43.5**	**43.0**
as a percentage of GDP	*53.1*	*71.9*	*71.2*	*76.5*	*81.0*
			Germany		
Investment funds (2)	7.1	11.3	11.5	11.4	....
Insurance companies and pension funds	26.2	27.9	30.2	29.9	....
Total	**33.3**	**39.2**	**41.7**	**41.3**	**....**
as a percentage of GDP	*50.3*	*69.0*	*71.8*	*75.8*	....
			Spain		
Investment funds (2)	10.1	13.7	12.4	13.2	13.5
Insurance companies and pension funds	10.0	13.9	16.1	15.2	14.9
of which: pension funds	*4.5*	*5.8*	*6.4*	*6.3*	*6.3*
Total	**20.1**	**27.6**	**28.5**	**28.4**	**28.4**
as a percentage of GDP	*28.5*	*45.8*	*42.4*	*46.1*	*47.6*
			Euro area (4)		
Investment funds (2) (5)	7.7	12.1	10.7	10.1	....
Insurance companies and pension funds	21.1	23.4	25.8	26.3	....
Total	**28.8**	**35.5**	**36.5**	**36.4**	**....**
as a percentage of GDP	*45.1*	*69.2*	*66.0*	*70.1*	....
			United Kingdom		
Investment funds (2)	3.7	4.9	4.1	4.5	....
Insurance companies and pension funds	50.8	52.4	52.9	52.5	....
Total	**54.5**	**57.3**	**57.0**	**57.0**	**....**
as a percentage of GDP	*148.7*	*187.4*	*145.8*	*155.5*	....
			United States		
Investment funds (2)	8.5	12.1	12.2	12.7	13.4
Insurance companies and pension funds (6)	28.1	28.3	28.2	29.3	29.1
of which: pension funds (6)	*19.9*	*20.3*	*18.2*	*19.6*	*19.3*
Total	**36.6**	**40.4**	**40.4**	**42.0**	**42.5**
as a percentage of GDP	*106.2*	*136.4*	*113.0*	*130.4*	*131.1*

Sources: Based on data from Bank of Italy, Banque de France, Deutsche Bundesbank, Banco de España, Federal Reserve and Eurostat.

(1) Provisional. The figures for France and Spain refer to the third quarter. – (2) Includes foreign funds. – (3) Households' individually managed portfolios net of investments in investment fund units. Partly estimated. – (4) Not including Ireland and Luxembourg. – (5) The 2004 figure does not include the Netherlands. – (6) The figure for pension funds relates to private, state and local pension funds; excludes federal government pension systems.

Italian investment funds and portfolio managers invested mainly in foreign corporate and government bonds; at the end of the year foreign assets made up 55 per cent of investment funds' portfolios and 51 per cent of individually managed portfolios.

The premium income of insurance companies increased considerably, after growing more slowly in the previous two years. Growth continued to be concentrated in traditional revaluable life policies, which generally offer a guaranteed minimum return, but sales of policies indexed to financial variables also recovered. The proportion of foreign bonds in the companies' portfolios increased substantially.

Pension funds continued to grow, but they remain very small, managing resources equivalent to 2.4 per cent of GDP. In the sectors in which occupational pension funds have been established, only one in eight employees has joined a supplementary pension scheme. The recent legislation, which will come into effect in 2008, is likely to lead to a very gradual increase in uptake.

Investment funds

Fund-raising and net assets. – In 2005 harmonized Italian investment funds suffered substantial net redemptions, although on a smaller scale than in the preceding year (€18.3 billion, compared with €30.6 billion in 2004; Table 48); by contrast, net subscriptions of foreign funds established by Italian intermediaries increased by €18.2 billion, compared with €14 billion in 2004. Overall, harmonized funds controlled by Italian intermediaries recorded a marginal net outflow of $0.1 billion, an improvement over the previous year, when redemptions had far outweighed subscriptions.

Italian intermediaries themselves encouraged domestic sales of foreign fund units; as part of that strategy, portfolio managers redeemed units in Italian funds and subscribed units in foreign funds, largely those controlled by their own group (see the section *Individual portfolio management*). For intermediaries, the main benefit of selling to their customers units in the investment funds of management companies established in other European countries lies in the low corporate tax rates in some foreign financial centres.

In the euro area, net fund-raising by investment funds almost doubled, with the strongest growth being in balanced and equity funds.

Italian subscribers redeemed units in short-term money-market and bond funds and in equity funds, switching their interest to funds specializing in medium and long-term bonds and those investing in both bonds and shares (flexible funds, mixed bond funds and balanced funds).

Table 48

SECURITIES INVESTMENT FUNDS: NET FUND-RAISING AND NET ASSETS IN THE MAIN EUROPEAN COUNTRIES AND THE UNITED STATES (1)

(annual data)

	Italy	Germany	France	Luxembourg and Ireland (2)	of which: controlled by Italian inter-mediaries	Euro area (3)	United Kingdom	United States
	Net fund-raising *(millions of euros)*							
Total								
2004	**-30,632**	**-5,964**	**54,920**	**113,731**	**13,952**	**174,180**	**9,015**	**42,813**
2005	**-18,344**	**10,148**	**58,800**	**236,278**	**18,209**	**319,520**	**21,516**	**204,990**
Equity funds								
2004	-6,627	-2,238	20,800	47,769	3,502	74,125	3,091	143,082
2005	-8,084	-900	32,900	77,675	4,286	109,299	5,785	109,077
Bond funds								
2004	-13,499	2,371	17,260	40,061	9,414	59,869	3,202	-8,665
2005	-2,774	6,626	-14,500	69,842	12,871	75,601	8,002	25,235
Balanced funds (4)								
2004	-1,299	577	120	27,070	-1,656	38,577	3,449	34,363
2005	3,925	5,052	10,700	85,683	-126	123,278	7,015	20,291
Money-market funds								
2004	-9,207	-6,674	16,740	-1,169	2,691	1,609	-727	-125,967
2005	-11,411	-630	29,700	3,078	1,177	11,343	713	50,387
	Year-end net assets *(billions of euros)*							
Total								
2004	**358**	**217**	**1,007**	**1,368**	**145**	**3,521**	**362**	**5,952**
2005	**353**	**248**	**1,168**	**1,731**	**179**	**4,146**	**443**	**7,133**
as a % of GDP								
2004	*25.8*	*9.8*	*61.1*	–	–	*45.5*	*21.6*	*65.7*
2005	*24.9*	*11.1*	*68.2*	–	–	*52.0*	*24.9*	*67.9*

Sources: Based on Bank of Italy, EFAMA, ICI and Assogestioni data.

(1) The data refer to open-end investment funds that invest mostly in listed securities and are offered to the public (for EU countries, harmonized funds). Funds of funds are included for some countries. – (2) For net fund-raising, refers only to Luxembourg, except for funds controlled by Italian intermediaries, where Irish funds are also included. – (3) For net fund-raising, does not include Belgium, Ireland and, in 2004, the Netherlands. – (4) Also includes other types of fund (flexible funds in the case of Italian funds and foreign funds controlled by Italian intermediaries).

In Italy, as in the United States, subscriptions of units in the various types of investment fund tend to be positively correlated with yields over the preceding months. The net outflow of resources from short-term money-market and bond funds, which has continued with scarcely a pause since the end of 2003, is a consequence of the fall in yields on such funds, which have been consistently below 2 per cent since that time and fell to 0.7 per cent in April 2006. Net subscriptions of bond and balanced funds also continued to show a strong correlation with average yields, but in the case of equity funds, which have also benefited from the substantial rise in stock market indices, the correlation between yields and net subscriptions was relatively weak, indicating caution on the part of savers towards investment in more risky funds.

At the end of 2005 the net assets of Italian harmonized investment funds amounted to €350 billion, slightly less than in the previous year. Including funds based abroad, the resources managed by Italian intermediaries totalled €530 billion; their share of the total net assets of investment funds in the euro area declined by more than one percentage point to 13 per cent.

Supply. – The development of the new types of investment funds continued in 2005. The number of open-end hedge funds and closed-end securities and real-estate funds increased significantly, but there was a small decline in that of non-hedge funds of funds (Table 49). The assets of closed-end real-estate funds showed further sustained growth.

Table 49

ITALIAN INVESTMENT FUNDS: MARKET STRUCTURE (1)

(amounts in millions of euros)

	Number of funds (2)		Net assets		Net fund-raising	
	2004	2005	2004	2005	2004	2005
Harmonized open-end funds	958	869	358,292	352,775	-30,632	-18,344
Open-end hedge funds	137	164	11,728	16,957	5,500	4,494
of which: funds of funds	*126*	*152*	*11,284*	*16,308*	*5,411*	*4,267*
Other types of open-end funds	199	194	19,996	33,301	6,219	6,812
of which: funds of funds	*157*	*143*	*12,544*	*19,043*	*4,535*	*5,643*
Total open-end funds	**1,294**	**1,227**	**390,016**	**403,033**	**-18,913**	**-7,038**
Closed-end securities funds	47	62	1,781	2,385	340	58
of which: reserved to qualified investors	*34*	*46*	*951*	*1,614*	*336*	*59*
Closed-end real estate funds	30	63	8,085	12,007	3,407	3,241
of which: reserved to qualified investors	*11*	*38*	*2,977*	*5,898*	*2,150*	*2,611*
Total closed-end funds.....	**77**	**125**	**9,866**	**14,392**	**3,747**	**3,299**
Total	**1,371**	**1,352**	**399,882**	**417,425**	**-15,166**	**-3,739**

(1) Includes SICAVs. – (2) Funds in operation at the end of the year indicated.

Exchange-traded funds continued to expand. These instruments, which replicate financial indices and are traded on regulated markets, have low management costs and are highly liquid. The number of ETFs traded on the Italian stock exchange rose from 20 to 28 and average daily turnover more than doubled; five of the new funds are benchmarked to euro-area share indices, two are linked to Chinese and Japanese share indices and one replicates an index of inflation-linked government securities. The number of ETFs also increased on the German stock exchange (from 54 to 77) and on Euronext (from 53 to 95).

Asset allocation. – Despite large net redemptions, Italian harmonized investment funds made only small net sales of securities, primarily because of the reinvestment of coupons and dividends. The net disposals related to Italian government securities and Italian and foreign equities, while net purchases were concentrated in foreign corporate bonds and government securities. At the end of the year more than half of the portfolio of Italian funds consisted of foreign securities; the proportion of Italian shares was very small (6 per cent).

Yields and fees. – In 2005 the average yield on Italian harmonized investment funds was 6.6 per cent, the highest return since the end of the 1990s. The good performance of the stock markets boosted the value of units in equity, balanced and flexible funds, which yielded 17.1, 9.9 and 9.1 per cent respectively. By contrast, the average returns on bond and money-market funds remained low, at 2.2 and 1.2 per cent respectively.

There was a marked positive correlation between the level and variability of yields on individual funds; on average, variability remained at the low levels reached in 2004, reflecting the low volatility of the financial markets.

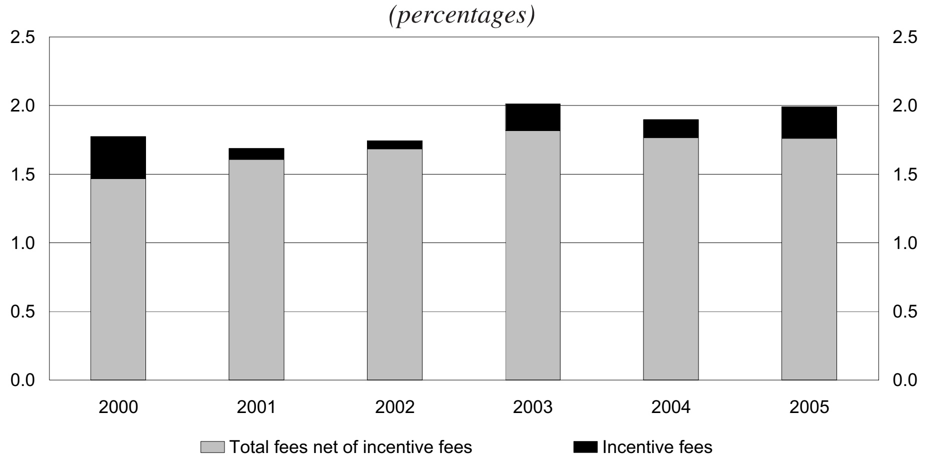
In 2005 the total fees paid by harmonized investment funds (management fees, incentive fees, fees paid to depositary banks, securities brokerage fees and other minor items) amounted to €4.9 billion, of which €4.3 billion was paid to management companies. The ratio of total fees to annual average net assets increased by 0.1 percentage point to 2.0 per cent (Figure 30) owing to a rise in incentive fees to 0.2 per cent caused by the increase in stock market prices.

The average total fees of equity, flexible and balanced funds amounted to respectively 2.72, 2.16 and 1.96 per cent of annual average net assets, compared with 2.49, 2 and 1.94 per cent in 2004. Incentive fees increased by 0.18 percentage points for equity and flexible funds and by 0.10 points for balanced funds; other fees rose by 0.05 percentage points for equity funds, remained virtually unchanged for flexible funds and declined by about 0.07 points for balanced funds. The total fees of bond and money-market funds were more or less unchanged, at 1.23 and 0.64 per cent respectively.

Figure 30

ITALIAN SECURITIES INVESTMENT FUNDS: TOTAL FEES (1)

(percentages)



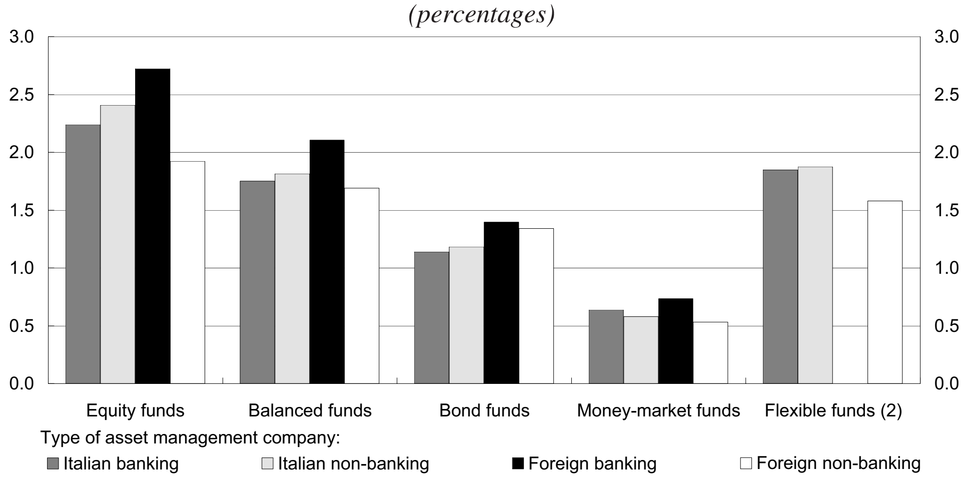
(1) Simple average of total fees paid by the individual funds, calculated as the percentage ratio of total annual fees to annual average net assets. The data relate to harmonized investment funds and SICAVs. The data for the last two years are provisional.

The dispersion of funds' fee expenses within each fund category remained high: 90 per cent of money-market funds paid total fees (net of incentive fees) of between 0.2 and 1 per cent, while the same percentage of bond funds paid between 0.7 and 1.7 per cent and that of equity funds between 1.3 and 3.6 per cent. Funds established by management companies belonging to Italian banking groups tend to be less costly than funds controlled by Italian non-banking groups or by foreign groups, either banking or non-banking (Figure 31).

Figure 31

ITALIAN SECURITIES INVESTMENT FUNDS:
TOTAL FEES ACCORDING TO TYPE OF GROUP IN 2005 (1)

(percentages)



(1) For each fund category and type of parent company, simple average of fees paid by the individual funds, calculated as the percentage ratio of total annual fees (net of incentive fees) to annual average net assets. Provisional data for harmonized investment funds and SICAVs. – (2) No figure is shown for asset management companies belonging to foreign banking groups as there are no flexible funds managed by companies of that kind.

According to the Italian stock exchange, in 2005 the total annual fees of ETFs listed in Italy averaged 0.42 per cent in the case of funds tracking share indices and 0.18 per cent in that of funds based on indices of bonds or government securities; figures for the other major European stock exchanges are similar.

Individual portfolio management

In 2005 the net flow of savings into individually managed portfolios more than doubled to €35.4 billion (Table 50). Total assets under management rose by 14.3 per cent to €513 billion.

Table 50

ITALIAN INDIVIDUALLY MANAGED PORTFOLIOS: SECURITIES PORTFOLIO

(millions of euros and percentages)

	2004	2005 (1)	2004	2005 (1)
	Net flows		**End-of-period stocks** (*percentage composition*)	
Italian government securities and corporate bonds	**10,412**	**-1,375**	**38.0**	**33.2**
Short-term and indexed	732	-9,485	11.7	8.3
BOTs	1,461	147	2.1	1.8
CCTs	-729	-9,632	9.7	6.5
Medium and long-term	9,680	8,110	26.2	24.9
CTZs	791	337	1.3	1.2
BTPs	5,416	3,784	18.5	17.1
Other government securities	-201	2,162	0.9	1.2
Corporate bonds	3,674	1,864	5.6	5.4
Italian equities	**2,680**	**1,970**	**3.4**	**3.7**
Italian investment fund units	**-13,151**	**-6,678**	**14.3**	**11.8**
Foreign securities	**24,637**	**51,160**	**44.0**	**51.1**
Government securities	6,287	15,271	5.8	8.1
of which: in euros	*6,155*	*14,582*	*5.5*	*7.8*
Corporate bonds	2,025	5,719	10.8	11.0
of which: in euros	*2,180*	*5,715*	*9.5*	*9.6*
Equities	-106	924	1.9	2.1
of which: in euros	*-50*	*1,028*	*1.2*	*1.5*
Investment fund units	16,431	29,246	25.6	29.8
Other financial assets	**-397**	**-127**	**0.3**	**0.2**
Total portfolio	**24,181**	**44,950**	**100.0**	**100.0**
Memorandum items:				
Net fund-raising	**14,669**	**35,410**	–	–
Banks	-17,916	3,203	–	–
Investment firms	303	-1,539	–	–
Asset management companies	32,283	33,747	–	–
Portfolio	–	–	**437,089**	**500,207**
Total assets under management	–	–	**448,738**	**512,714**

(1) Provisional.

Portfolio managers made considerable net purchases of foreign assets (government securities, corporate bonds and investment fund units) and net sales of Treasury credit certificates and Italian investment fund units. By the end of the year foreign securities accounted for 51.1 per cent of total portfolios. The proportion of Italian and foreign equities held directly remained small, at 5.8 per cent.

In the last three years the share of investment fund units in individually managed portfolios has remained at around 40 per cent. However, the split between Italian and foreign funds has changed radically, with the proportion of foreign funds rising from 20 to 30 per cent of total portfolios. Data on portfolios managed by asset management companies alone show that 85 per cent of the investment funds in which they held units were controlled by companies belonging to the same group as the manager; for units in foreign funds, the proportion was 83 per cent.

In 2005 the financial return of the portfolio management sector (measured in terms of the percentage increase in net assets excluding the inflow of funds) was 6.2 per cent, compared with 3.8 per cent in 2004.

Insurance companies and pension funds

Insurance companies. – In 2005 the premium income of insurance companies increased by 8.7 per cent, twice the rate of the preceding year (Table 51). The acceleration was attributable almost entirely to the life sector, where premium income from revaluable policies increased substantially and that from unit-linked and index-linked policies recovered. There was continued growth in the volume of insurance policies linked to personal pension plans, which had been established in 2001.

Insurance companies' technical reserves rose by 11.8 per cent to €417.8 billion. Both their securities portfolios and real-estate holdings increased. The share of Italian government securities suffered a further large reduction, from 35 to 31 per cent (Table 52), matched by a corresponding increase in the proportion of foreign euro-denominated corporate bonds from 24 to 28 per cent.

The Italian life insurance sector is smaller than the euro-area average, although it has grown very rapidly over the last ten years; at the end of 2004 its technical reserves were equivalent to 24 per cent of GDP, compared with 33 per cent in the area as a whole. Furthermore, the Italian market is relatively concentrated: in 2004 the five largest operators accounted for 63 per cent of total premium income in Italy, compared with 56, 42 and 32

Table 51

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		Technical reserves (4)	Net worth	
				Life sector					
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	294,702	272,096	22,606	62,780
2004	5,458	317,388	1,048	808	12,226	336,928	312,783	24,145	65,627
2005 (6)...	5,737	360,036	1,515	1,034	13,415	381,737	354,960	26,777	73,470
				Non-life sector (7)					
2002	2,965	58,746	-2,814	4,581	9,095	72,573	55,355	17,217	32,415
2003	2,571	63,418	-2,569	3,711	9,748	76,879	58,144	18,736	34,212
2004	2,398	67,427	-3,192	4,034	11,012	81,679	61,044	20,635	35,411
2005 (6)...	2,832	69,921	-1,799	4,776	11,532	87,262	62,818	24,444	36,308
				Total					
2002	8,035	290,730	-1,681	5,484	18,403	320,971	283,569	37,401	87,709
2003	7,748	342,221	-1,432	4,534	18,511	371,581	330,240	41,342	96,992
2004	7,856	384,815	-2,144	4,842	23,238	418,607	373,827	44,780	101,038
2005 (6)...	8,569	429,957	-284	5,810	24,947	468,999	417,778	51,221	109,778

Sources: Based on Isvap and ANIA data.

(1) Excluding Italian branches of companies based in other EU countries but including those of companies based in non-EU countries. – (2) Including assets entrusted to portfolio managers. – (3) Net of corresponding liabilities. – (4) Net of technical reserves of reinsurers. – (5) Italian direct insurance; includes premium income of branches in other EU countries. – (6) Partly estimated. – (7) Includes companies engaging solely in reinsurance.

per cent respectively in France, Spain and Germany. Finally, the range of products in which the financial management risk is borne mainly by the assured is highly developed in Italy: in that same year the percentage of technical reserves held in respect of unit-linked or index-linked policies was 40 per cent for Italian insurance companies, against an average of 22 per cent in the euro area.

In 2005 and the first four months of 2006 the share prices of Italian insurance companies rose by 20 per cent, a substantial increase but slightly less than the rise in the general index of the Italian stock exchange. They began to take off in the second half of last year, buoyed by good earnings results generated by income on their securities portfolios and the growth in the life sector's premium income. Nevertheless, the rise was less than that in insurance shares in the euro area as a whole (33 per cent); at a time of strongly rising stock exchange indices, this can be attributed to the smaller holdings of equities in the portfolios of Italian companies and the higher proportion of index-linked life policies, which reduce the exposure of their net assets to the risk of share price fluctuations.

Table 52

ITALIAN INSURANCE COMPANIES: SECURITIES PORTFOLIO (1)

(balance sheet values; end-of-period data in millions of euros)

	Securities denominated in euros					Securities denominated in other surrencies		Investment fund units	Total
	Government securities and corporate bonds			Equities (2)					
	Italian government securities	Corporate bonds					of which: equities (2)		
	Life sector								
2002	94,294	74,919	169,214	17,648	186,862	5,079	1,031	40,043	231,984
2003	100,278	101,770	202,048	20,132	222,181	4,875	964	51,747	278,803
2004	109,671	121,846	231,517	23,440	254,957	4,221	831	58,210	317,388
2005 (3)...	109,785	151,724	261,509	28,155	289,663	4,711	968	65,661	360,036
	Non-life sector (4)								
2002	25,170	8,880	34,049	22,057	56,106	1,280	673	1,360	58,746
2003	25,047	12,345	37,393	23,665	61,058	846	365	1,514	63,418
2004	25,631	13,297	38,928	25,875	64,804	665	373	1,959	67,427
2005 (3)...	22,837	16,849	39,686	26,858	66,544	696	377	2,682	69,921
	Total								
2002	119,464	83,799	203,263	39,705	242,968	6,359	1,704	41,403	290,730
2003	125,325	114,115	239,441	43,797	283,239	5,721	1,329	53,261	342,221
2004	135,302	135,143	270,445	49,315	319,761	4,886	1,204	60,169	384,815
2005 (3)...	132,622	168,573	301,195	55,013	356,207	5,407	1,345	68,343	429,957

Sources: Based on Isvap and ANIA data.

(1) Including assets entrusted to portfolio managers. The portfolio of assets in respect of pension funds, unit-linked and index-linked products and companies engaging solely in reinsurance is partly estimated. Excluding Italian branches of companies based in other EU countries but including those of companies based in non-EU countries. – (2) Shares and other equity. – (3) Partly estimated. – (4) Includes companies engaging solely in reinsurance.

Pension funds and non-INPS social security institutions. – In 2005 the assets managed by pension funds exceeded €34 billion, thanks to the substantial increase in the resources administered by funds established after the reform of 1993 (30.3 per cent; Table 53). The assets of non-INPS social security institutions rose by 6.9 per cent.

On the basis of data from the Pension Fund Supervisory Commission (COVIP), the growth in the number of subscribers to the new-style occupational and open pension funds accelerated from 2.7 to 7.5 per cent, but the total number of subscribers (1,554,000) is still modest in relation to the pool of potential members; for the occupational funds aimed at employees, the proportion was 12.5 per cent at the end of 2005.

The development of pension funds in Italy has been hampered primarily by the high replacement rate (the ratio of pension to salary at the time of retirement) under the compulsory public pension system. Membership of pension funds has also been held back by the reluctance of new employees to forgo severance payments, which perform an insurance function as well as providing a pension. The slow and uncertain progress of legislative reform has been a further factor; the perception that the legislative framework is still fluid has probably encouraged workers to defer decisions that would necessarily bind them for a long period of time.

Table 53

PENSION FUNDS AND NON-INPS SOCIAL SECURITY INSTITUTIONS IN ITALY: MAIN ASSETS (1)

(balance sheet values; end-of-period data in millions of euros)

	2004				2005 (2)			
	Pension funds			Non-INPS social security institutions (4)	Pension funds			Non-INPS social security institutions (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	**2,416**	**1,716**	**700**	**3,380**	**2,151**	**1,466**	**684**	**1,842**
Securities portfolio	**22,003**	**14,514**	**7,488**	**8,984**	**25,719**	**15,691**	**10,028**	**12,540**
Corporate bonds	14,744	9,913	4,832	6,158	16,300	9,969	6,331	9,507
Equities	3,122	1,336	1,786	940	3,992	1,566	2,426	1,034
Investment fund units	4,137	3,266	871	1,886	5,427	4,156	1,271	1,999
Mortgage loans and other financial assets	**2,549**	**2,571**	**-22**	**2,880**	**2,597**	**2,671**	**-74**	**3,177**
Real estate	**3,514**	**3,514**	**–**	**9,686**	**3,578**	**3,578**	**–**	**9,102**
Total assets	**30,481**	**22,315**	**8,166**	**24,930**	**34,045**	**23,406**	**10,639**	**26,661**

Sources: Based on data from Bank of Italy, COVIP, UIC and social security institutions.

(1) The composition is partly estimated. – (2) Provisional. – (3) Includes the Bank of Italy and UIC staff pension funds. The item “Mortgage loans and other financial assets” is net of liabilities. – (4) Data for 13 institutions.

Legislative Decree 252 of 5 December 2005 introduced provisions that should encourage the development of Italian pension funds. The main innovations are: 1) greater competition between the different types of supplementary pension: workers are now free to choose the one they prefer; they can change their decision after two years, although the portability of any employer contributions may be restricted under collective agreements, including ones at company level; 2) the principle of tacit assent to the transfer of severance pay entitlements to pension funds (from 1 January 2008 or the date of hiring in the case of new employees); 3) tax incentives, mainly relating to the pension benefits that will be paid in the form of an annuity.

The growth potential of pension funds depends heavily on there being an increase in the uptake of supplementary pensions by employees. According to simulations by COVIP, if half of workers joined pension funds over the next ten years, the assets of Italian funds would still amount to less than 20 per cent of GDP in 2030, a third of the current level in the United States; the ratio would rise to more than 25 per cent if uptake rose to 75 per cent and to over 30 per cent if there were 100 per cent coverage.

The percentage of pension funds' assets in the form of securities increased further, from 72 to 76 per cent, offset by a decline in the shares of liquidity, real estate and mortgage loans. Within the securities portfolio, the proportions of shares and fund units rose, at the expense of that of bonds, which declined from 67 to 63 per cent. By contrast, the proportion of bonds in the securities portfolios of non-INPS social security institutions increased considerably, from 69 to 76 per cent.

According to COVIP estimates, the average net return of the new-style pension funds was 8.5 per cent in 2005; occupational pension funds yielded on average 7.4 per cent and open pension funds 11.5 per cent.

THE SECURITIES MARKETS

Public-sector securities

Supply and demand. – In 2005 net issues of Italian public-sector securities totalled €38.2 billion, the same as in 2004 (Table 54), and the volume of outstanding securities rose from 87.3 to 88.2 per cent of GDP.

Issuance policy favoured the lengthening of the maturity of the public debt. The average residual maturity of outstanding government securities increased by one month compared with 2004 to 6 years and 6 months and their average duration by 6 months to 4 years and 10 months. There was a substantial rise in outstanding BTPs linked to the euro-area consumer price index, from €28.6 billion to €48 billion, while net redemptions were made of short and medium-term securities (BOTs and CTZs). There was a further increase in net issues of thirty-year BTPs, although at a slower pace than in the previous year; at the end of December stocks amounted to 12 per cent of outstanding government securities, as in the previous year.

Net local government bond issues rose again, from €5.1 billion in 2004 to €6.4 billion. At the end of the year the amount outstanding was €29.4 billion, equal to 2.4 per cent of total public-sector securities. In 2005 variable rate securities fell to just 30 per cent of total new local government issues, compared with 53 per cent in 2004, and their average duration rose from 20.8 to 21.4 years. As in the previous year all new issues were denominated in euros and rated from AA+ to A. Municipal issues recorded the largest increase, from 38 to 63 per cent of total local government issues, while the share of regional issues declined from 45 to 17 per cent and provincial government issues were stationary at around 18 per cent.

While net purchases of public-sector securities by non-resident investors increased further, there were net disposals on the part of Italian investment funds and households. Banks, which had made net disposals for several years, made net purchases in 2005. The share of the outstanding stock of public-sector securities held by non-resident investors rose to 55 per cent, while that of households and firms declined.

Interest rates. – In the first nine months of 2005 interest rates on long-term government securities continued the decline that had begun in 2004, before turning upwards in the autumn (Figure 32); year-on-year, the yield on

Table 54

BONDS AND PUBLIC-SECTOR SECURITIES: ISSUES AND STOCKS IN ITALY (1)

(millions of euros and percentages)

	Gross issues		Net issues		Stocks	
	2004	2005	2004	2005	December 2004	December 2005
Public sector	**444,125**	**415,460**	**38,228**	**38,231**	**1,212,769**	**1,249,897**
BOTs	221,300	212,666	-895	-944	118,750	117,806
CTZs	27,128	23,206	-8,198	-3,338	45,603	43,184
CCTs (2)	34,527	26,011	325	1,515	197,435	198,664
BTPs	134,803	131,064	33,558	29,947	734,713	761,780
Republic of Italy issues	14,000	12,264	2,469	1,620	85,263	87,801
Other (3)	12,367	10,249	10,968	9,432	31,005	40,662
Banks	**120,462**	**125,280**	**42,575**	**40,944**	**442,994**	**484,415**
Firms	**51,154**	**56,798**	**24,213**	**36,704**	**171,819**	**208,756**
Total	**615,742**	**597,538**	**105,017**	**115,880**	**1,827,581**	**1,943,068**
	Percentage composition (4)					
Public sector	**72.1**	**69.5**	**36.4**	**33.0**	**66.4**	**64.3**
BOTs	49.8	51.2	-2.3	-2.5	9.8	9.4
CTZs	6.1	5.6	-21.4	-8.7	3.8	3.5
CCTs (2)	7.8	6.3	0.9	4.0	16.3	15.9
BTPs	30.4	31.5	87.8	78.3	60.6	60.9
Republic of Italy issues	3.2	3.0	6.5	4.2	7.0	7.0
Other (3)	2.8	2.5	28.7	24.7	2.6	3.3
Banks	**19.6**	**21.0**	**40.5**	**35.3**	**24.2**	**24.9**
Firms	**8.3**	**9.5**	**23.1**	**31.7**	**9.4**	**10.7**
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
As a percentage of GDP	*44.3*	*42.2*	*7.6*	*8.2*	*131.6*	*137.1*

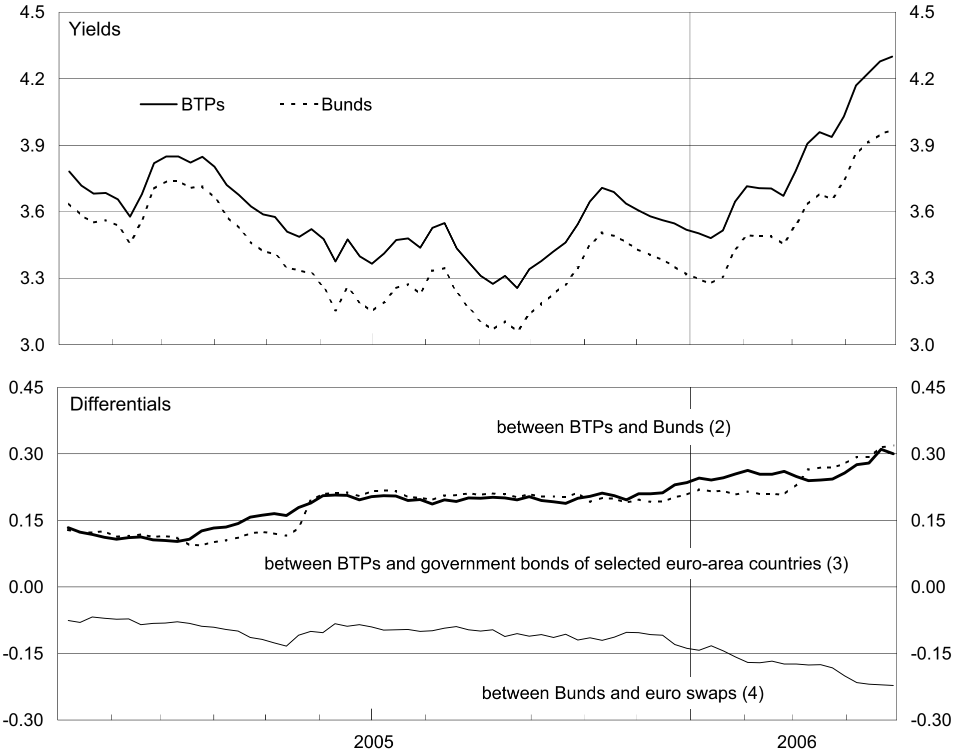
(1) Rounding may cause discrepancies. – (2) Comprises only variable-coupon Treasury credit certificates. – (3) Comprises securities issued in 2004 by Infrastrutture S.p.A. to finance the infrastructure for the high-speed/high-capacity rail network. – (4) The figures for the various types of public-sector securities are percentage ratios of total public-sector securities.

ten-year securities fell slightly from 3.8 to 3.6 per cent. By contrast, yields on shorter maturities increased, with that on the three-year benchmark BTP rising by 0.4 percentage points to 2.9 per cent. These movements resulted in a pronounced flattening of the yield curve. In the first four months of 2006 long-term interest rates rose by 0.5 percentage points, mainly as a result of the increase in real yields as the monetary stance became less accommodating.

Figure 32

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.

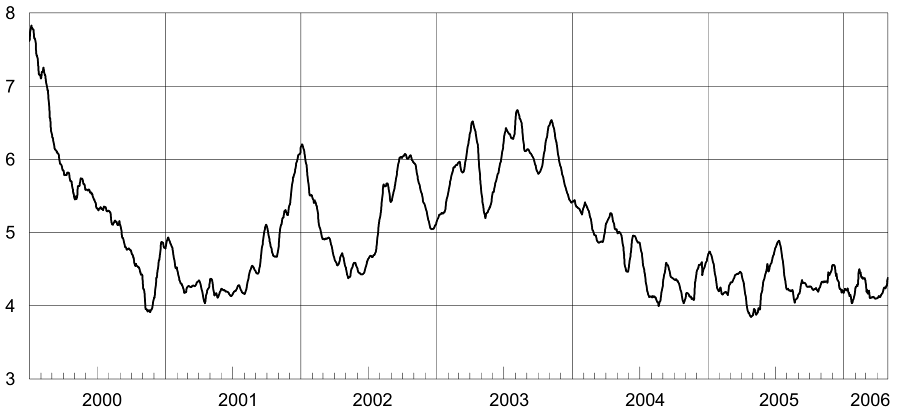
(1) Yields on benchmark ten-year bonds. – (2) Differential between BTPs and Bunds, adjusted to take account of differences in the residual life of the two securities. – (3) Differential between the yield on ten-year BTPs and the simple average of yields on corresponding government securities of the countries that recorded a budget surplus in 2005 (Belgium, Finland and Spain). – (4) Differential between ten-year Bunds and ten-year euro swaps.

The expected volatility of long-term interest rates implied by the prices of futures options on ten-year Bunds was extremely limited throughout the year, remaining close to the levels recorded in the second half of 2004, the lowest for five years (Figure 33). One of the salient characteristics of the financial markets in the last two years has been the low volatility of interest rates in both the industrial countries and the emerging economies, despite the uncertainties caused by the rise in oil prices, the US monetary tightening, natural disasters and geopolitical tensions. The phenomenon, which has been observed in a broad range of financial assets, can be ascribed to macroeconomic as well as microeconomic and financial factors. The cyclical economic expansion has made the fundamentals of the prices of financial assets (output growth, inflation and interest rates) less volatile, while another major contribution has come from the greater predictability of monetary policy decisions in all the major countries and more stable inflation expectations. The considerable improvement in the profitability and balance sheet situation of listed companies has also reduced uncertainty on the bond and share markets. Among the financial factors, the spread of derivatives has had an appreciable effect, as has the growing role of institutional investors, who have apparently increased market liquidity; developments in the US mortgage-backed securities market have helped to reduce the volatility of bond prices associated with interest-rate hedges. Finally, the volatility implicit in the prices of options has diminished in the last two years, probably in part because of the greater supply of these instruments, which investors use as a safeguard against market risks.

Figure 33

EXPECTED VOLATILITY OF TEN-YEAR BUNDS (1)

(20-day moving average ending on the date indicated; yearly percentage changes)



Source: Bloomberg.
(1) Volatility implied by futures options listed on Eurex.

The yield spread between ten-year benchmark BTP and the corresponding Bund widened in 2005. After falling from 14 to 10 basis points at the beginning of the year, it rose back to 22 points between mid-March and early June. The widening began on the eve of the European Council of 22-23 March at which the guidelines for amending the Stability and Growth Pact were approved; at this time the spread also increased with respect to the securities of other EU countries with a similar rating to Italy. In April and early May the spread on ten-year benchmark BTPs continued to grow in response to the downward revision of Italian GDP growth and negative results for the first quarter of 2005. In the first four months of 2006 the spread widened further to 30 basis points.

Real yields on ten-year BTPs linked to the euro-area consumer price index fell to an exceptional low of 0.6 per cent for most of 2005 before rising to 1.1 per cent towards the end of the year.

According to the findings of a recent study on the determinants of the term structure of interest rates, the level of long-term interest rates in the euro area may be due not only to the substantial decline in expected yields but also to the reduction in the risk premium investors demand for bonds; a similar phenomenon can be observed in the US. The risk premium is the difference between the observed yield and the yield required by a risk-neutral investor; the latter is calculated using a model of the financial and macroeconomic determinants of the term structure of Bunds from 1975 to 2005. The results of the study show that the risk premium increases with the duration of the bond; for the last six years the premium on ten-year securities has stood at 1.5 percentage points, one point less than the average for the previous twenty-five years. The consistently low level of risk premiums could be due to greater demand for longer-term fixed-interest securities on international markets by institutional investors and countries with a large trade surplus. The study also found that risk premiums tend to decrease during an economic expansion and to increase during a recession; accordingly, the cyclical recovery in the euro area brought premiums down in the second half of 2005 to the lowest value recorded in the estimation period (less than one percentage point).

Bank bonds and corporate bonds

Issuance. — Total net bond issues by Italian firms increased by 17 per cent in 2005 (Table 55). While net issues by non-financial corporations contracted sharply, issues by banks were again very substantial and those by other financial companies more than doubled. Also in the euro-area as a whole there was a marked increase in net issues by banks and firms; heavy recourse to the bond market by banks reflected not only the low cost of borrowing but also a policy of keeping the duration of assets and liabilities matched. Mortgage-backed securities and collateralized debt obligations expanded especially fast, above all in Italy, Spain and the Netherlands.

In Italy, where investment remains slack, the decline in net issues by non-financial corporations reflected the end of fund-raising by large telecommunications and motorway companies, which had made substantial issues in the previous year when the cost of borrowed funds was low; placements by unrated or low-rated private borrowers were negligible. In the euro area, net issues by non-financial corporations remained at historically low levels (€21 billion), reflecting the easy availability of bank credit and the good cash flow of large European corporations.

Table 55

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
	2003	2004	2005	2003	2004	2005	2005
				Italy			
Banks	32,036	43,048	41,502	399,820	442,868	484,370	34
Other financial corporations	25,156	14,796	35,314	111,914	126,685	162,077	11
Non-financial corporations ..	-987	8,940	1,433	36,340	45,134	46,646	3
Total ...	**56,205**	**66,784**	**78,249**	**548,074**	**614,687**	**693,093**	**49**
Memorandum item: International market (3)	40,432	50,179	48,752	331,367	379,970	431,625	30
				Euro area (4)			
Banks	202,445	297,798	293,122	2,952,848	3,266,100	3,627,270	45
Other financial corporations	119,082	73,822	177,487	640,626	729,524	919,732	12
Non-financial corporations ..	51,285	11,754	20,996	490,287	504,775	523,150	7
Total ...	**372,813**	**383,374**	**491,606**	**4,083,761**	**4,500,399**	**5,070,152**	**64**
Memorandum item: International market (3)	532,913	529,994	658,061	3,266,106	3,757,374	4,498,203	56

Source: For the euro area, based on ECB 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) Source: BIS. 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 companies in connection with securitization transactions more than doubled (from €15 billion to €31 billion) compared with the previous year, when they had contracted as a result of large-scale redemptions. As in previous years, the majority of securitizations were originated by banks, mainly in connection with mortgage loans. Issues by public-sector entities remained substantial; the largest operations were guaranteed by the proceeds of property sales or by INPS credits, amounting to €4.4 billion and €5 billion respectively.

According to data released by the Bond Market Association, gross issues of asset-backed securities in Europe reached a record high of €524 billion in 2005. Securitizations, which account for around 61 per cent of the total, increased by 32.5 per cent and issues of covered bonds resumed growth. Gross securitization issues in Italy fell from 14 to 10 per cent of the European market, while the shares of the Netherlands and Germany rose (from 8 to 11 per cent and from 3 to 7 per cent respectively) and those of Britain (45 per cent), Spain (13 per cent) and France (3 per cent) were virtually stationary.

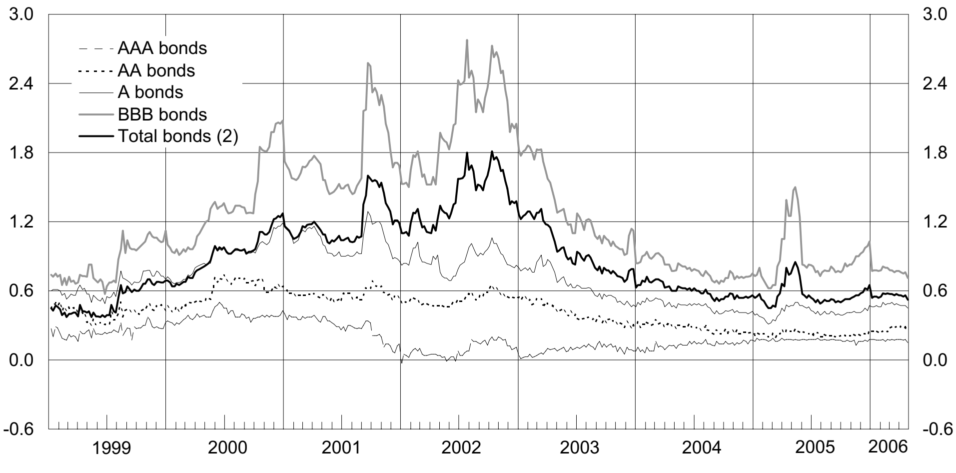
Yields. – Yields on euro-denominated private-sector bonds remained low in 2005. Yields on issues by Italian companies on the primary and secondary markets were in line with those of securities of comparable characteristics issued by borrowers from other countries. The yield spread of bonds issued by the FIAT automobile company over those of its main European competitors narrowed when news of its good results was released; that of Telecom Italia bonds also decreased as its leverage diminished.

Yields on corporate Eurobond issues were low for all categories of firms. The yield on bonds of non-financial corporations rated at least BBB- or Baa3 was unchanged at 3.6 per cent, despite rising briefly in the first half of the year as an indirect result of the downgrading of the issues of two leading US automobile companies. The yield spread over government securities of comparable maturity was also stationary at around 0.5 percentage points (Figure 34). The spreads on lower-rated issues increased slightly above the historical low recorded in February 2005.

Figure 34

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).

Towards the end of 2005 there was an increase in the yields on bonds issued by telecommunication companies owing to the sector’s high leverage. Other factors may have been the downgrading of a large Spanish corporation engaged in a major leveraged buy-out, as well as the growing competition from operators specializing in new technologies.

Yield spreads were not affected by the slight deterioration in credit ratings in the second half of 2005, even though the default rate remained low. Downgrades were partly due to higher leverage with the rise in corporate mergers and takeovers; bond issues may also have become riskier as more funds were allocated to shareholders in the form of share buy-backs and increases in dividends. Moreover, the less expansionary stance of monetary policy in the euro area may have had an effect on more heavily indebted or lower-rated issuers.

In the first four months of 2006 the yield spread on high-rated bonds remained stationary while that on riskier securities declined substantially as the financial situation of the leading automobile companies improved.

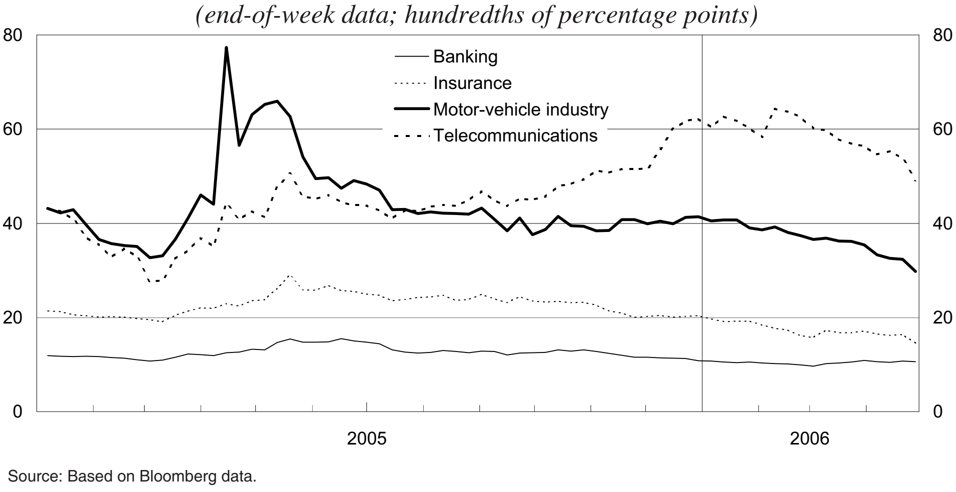
The credit derivatives market. – The international credit derivatives market continued to expand rapidly in 2005. According to an estimate by the International Swap and Derivatives Association, notional value more than doubled for the second year running, topping $17 trillion. The share of credit default swaps rose to more than 50 per cent.

The premiums on CDSs for euro-area banks and insurance companies held steady in 2005, while part of the large increase recorded for automobile manufacturers in the second quarter of the year was absorbed in the second half. CDS premiums for telecommunications companies rose towards the end of 2005 when the sector was engaged in financial consolidation operations and earning prospects were adjusted downwards (Figure 35).

Figure 35

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.

In Italy CDS premiums for the leading banks rose briefly in the second quarter of 2005 but otherwise remained at the low levels of end-2004. They decreased for the leading automobile, telecommunications and insurance companies.

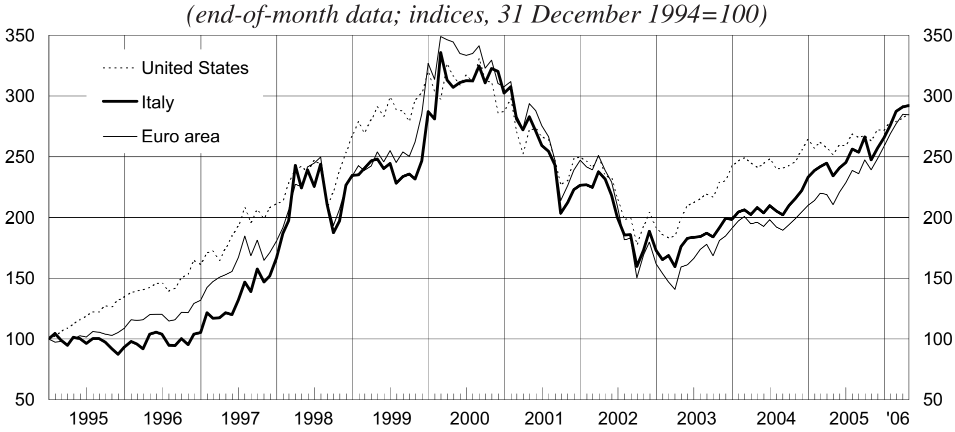
The equity market

Share prices and trading. – Share prices rose rapidly in Italy in 2005 (14 per cent) although more slowly than in the euro area, where the Dow Jones Euro Stoxx index of the shares of the largest companies in terms of market capitalization gained 23 per cent for the year (Figure 36). Italy's TechSTAR index of innovative companies in high-tech sectors rose by 47 per cent, compared with 20 per cent for the UK Techmark index and 1 per cent for the US Nasdaq.

Figure 36

SHARE PRICES (1)

(end-of-month data; indices, 31 December 1994=100)



Source: Based on Bloomberg data.
(1) Indices: MIB for Italy, Dow Jones Euro Stoxx for the euro area, Standard & Poor's 500 for the United States.

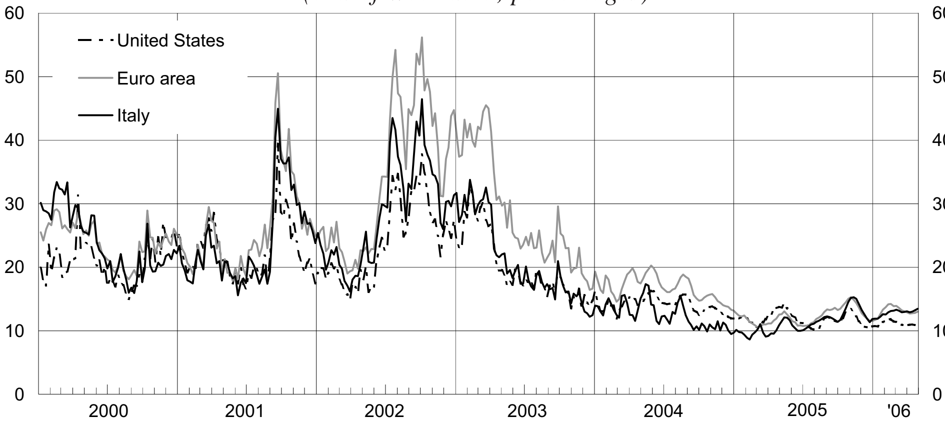
Share prices continued to gain in the first four months of 2006 in both Italy and the euro area before falling brusquely in May. The sharp rise was due to the improvement in expected profits, boosted by good operating results and prospects of a recovery in economic activity. The further decline in real long-term interest rates, albeit partly reversed in the last quarter of the year, and the small decrease in the risk premium on equities also contributed. The volatility of share prices remained low (Figure 37).

Despite the substantial increase in current profits, the earnings/price ratio declined further owing to the sharp rise in equity prices; at the end of April 2006 it was 6 per cent in Italy, 6.2 per cent in the euro area, and 5.4 per cent in the United States (Figure 38). These values are in line with the

Figure 37

EXPECTED VOLATILITY OF SHARE PRICES ON THE MAIN INTERNATIONAL STOCK MARKETS (1)

(end-of-week data; percentages)



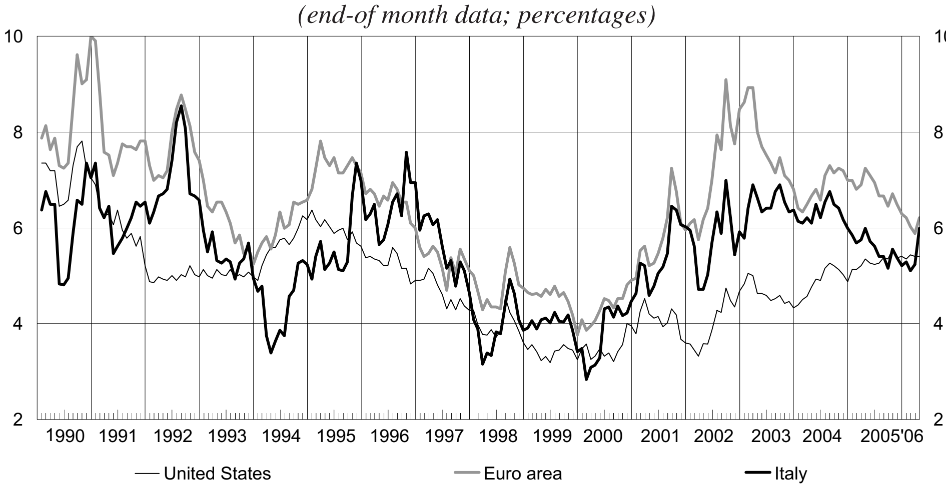
Source: Based on Bloomberg data.
(1) Volatility implied by stock index options.

averages for the period 1990-2005. According to the Institutional Brokers Estimate System, the expected short and long-term growth in the profits of listed companies remained high at 11 per cent in Italy and 9 per cent in the euro area (Figure 39).

Figure 38

CURRENT EARNINGS/PRICE RATIOS IN SELECTED INDUSTRIAL COUNTRIES

(end-of month data; percentages)



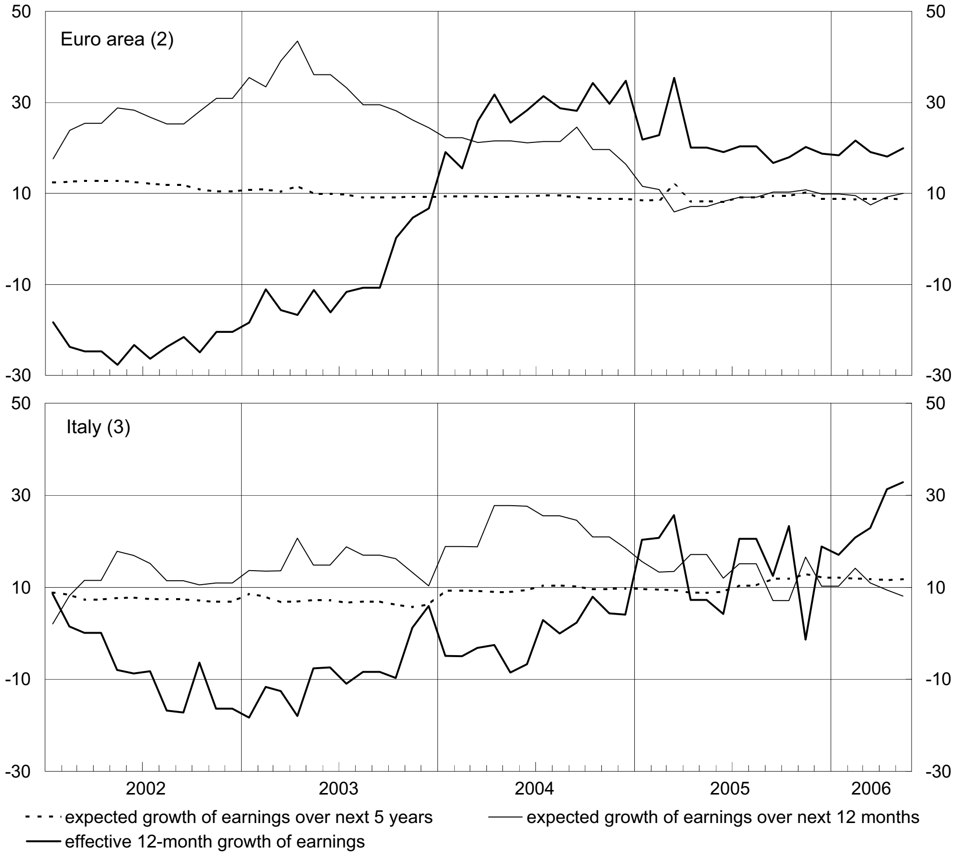
Source: Thomson Financial.

The premium demanded by investors in equities declined during 2005, although at the end of December it was higher than the average for the period 1990-2005 (Figure 40). Based on the prices of options, equity investors' attitude to risk remained extremely conservative (Figure 41). The equity

Figure 39

ACTUAL AND EXPECTED EARNINGS OF LISTED COMPANIES (1)

(end-of-month data; percentage changes; indices, January 2005=100)



Source: Based on IBES data.

(1) From January 2005 data comply with the new IAS/IFRS. – (2) Earnings per share of companies listed in the Dow Jones Euro Stoxx index. – (3) Earnings per share of companies listed in the BCI 30 index.

risk premium is measured by the difference between the expected real rate of return demanded by investors in order to hold equities (the cost of funds on the equity market), estimated on the basis of professional forecasts of corporate profit growth, and real long-term rates of interest. Despite the very low level of the latter, the cost of equity issues remained virtually stationary, indicating that the equity risk premium was still high.

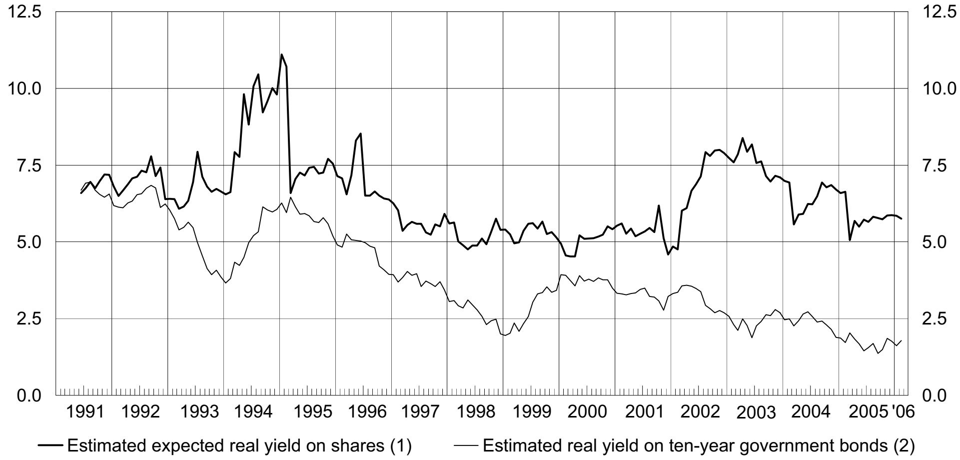
Within the euro area, the gain in equities was associated with an increase in share buy-backs and a rise in the profit pay-out ratio from 30 per cent in 1997-2001 to 37 per cent in 2003-05. This can probably be ascribed to the reduction in investment opportunities for listed companies, as well as to efforts to bolster shareholders' confidence.

Mergers and acquisitions picked up in the euro area in the second half of 2005 and first quarter of 2006, rising from €750 billion in 2004 to €947

Figure 40

EXPECTED REAL YIELDS ON EURO-AREA SHARES AND GOVERNMENT BONDS

(monthly data; percentages)



Sources: Based on IBES data, Consensus Forecasts and Bloomberg.

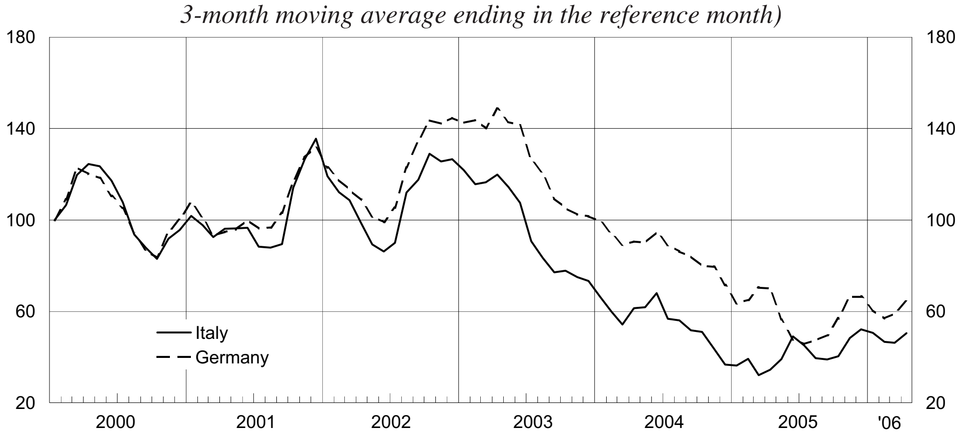
(1) The expected real yield is estimated as the spread between the rate of return implicitly used by investors to discount expected future dividends and long-term inflation expectations according to Consensus Economics. Stock market variables refer to a weighted average of the MSCI indices for Germany, France and Italy. – (2) Spread between the interest rate on ten-year government bonds and long-term inflation expectations.

billion last year. Both listed firms and private equity funds had substantial recourse to leveraged buy-outs. Although the average premium paid over the stock market price increased, it was still fairly low. The upsurge in mergers and acquisitions, together with the increase in share buy-backs and in the profit pay-out ratio, could raise the credit risk attached to investment in corporate bonds.

Figure 41

INDICATORS OF RISK AVERSION

(monthly data; indices, January 2000=100; 3-month moving average ending in the reference month)



Sources: Bloomberg and Bank of Italy data.

Within the euro area, the largest rises in share prices were posted by firms in the oil industry (37 per cent), insurance (33 per cent), banking and electronics (26 per cent) and the automobile and pharmaceutical industries (23 per cent). Smaller rises were registered in the media sector (13 per cent) while the share prices of telecommunication companies fell by 8 per cent.

On the Italian stock exchange the largest gains were recorded by oil companies (33 per cent), banks (30 per cent) and automobile manufacturers (28 per cent). The sharp fall in the prices of shares of electricity and telecommunication companies, down by 5 and 20 per cent respectively, brought them back into line with those in the euro area. The performance of bank shares was influenced by expectations of mergers among some leading Italian banks. Telecommunication shares, which had performed well in the previous two years, were adversely affected by potential competition from operators specializing in new technologies. The STAR segment performed particularly well, rising by 31 per cent. The STAR segment of the equity market was set up in 2001 for small and medium-cap firms that meet higher standards in terms of transparency for investors and corporate governance than those currently in force in Italy. Better legal protection of shareholders tends to encourage the growth of equity markets and helps to reduce the risk premium requested by investors, thus lowering the cost of capital for the companies. Between 2001 and 2005, the prices of shares quoted on the STAR segment rose faster than those of firms listed on the general market. Econometric estimates indicate that the good performance of these shares is not due to a different risk profile or to other individual features but apparently to that greater transparency and the better governance rules. For the companies in this segment the average cost of raising capital is lower than for firms of comparable size and earning capacity listed on the general stock market.

Average daily turnover of Italian shares increased in 2005, reflecting the rise in share prices, but 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/MIB blue-chips index fell from 89 to 85 per cent, pointing to a growing interest of investors in lower-cap companies.

Supply and demand. – In Italy new listings continued to increase, fostered by the rise in share prices. Sixteen new companies made initial public offerings last year, compared with 8 in 2004, including 6 on the Expandi market (2 in 2004); the STAR segment had 4 new entries (2 in 2004), while for the second year there were no new listings on the TechSTAR (Table 56). Total fund-raising by new and already listed companies was three times the figure for 2004. The exchange-traded funds segment continued to grow. The euro area also registered substantial new listings, 95 in 2005 compared with 72 in 2004. In the United States 203 companies went public in 2005, compared with 194 in 2004.

Table 56

MAIN INDICATORS OF THE ITALIAN STOCK EXCHANGE

(millions of euros, except as indicated)

	2000	2001	2002	2003	2004	2005
Annual change in prices (1)	5.4	-25.1	-23.7	14.9	17.5	13.9
Listed Italian companies (number at end of year)	291	288	288	271	269	275
of which: on the STAR segment	..	*37*	*41*	*40*	*46*	*71*
Total market capitalization (2)	818,384	592,319	457,992	487,446	568,901	676,606
as a percentage of GDP	*70.2*	*48.6*	*36.3*	*37.5*	*43.1*	*49.3*
percentage breakdown: (3)						
industrials	*21*	*23*	*25*	*23*	*23*	*26*
insurance	*14*	*13*	*11*	*12*	*12*	*12*
banking	*25*	*23*	*22*	*26*	*25*	*32*
financials	*3*	*3*	*3*	*4*	*3*	*4*
services	*37*	*39*	*39*	*35*	*37*	*26*
Total	**100**	**100**	**100**	**100**	**100**	**100**
Gross share issues (4)	9,148	6,171	3,894	8,710	3,197	12,599
of which: on the STAR segment	..	*86*	*264*	*26*	*89*	*279*
Market value of newly-listed companies (5)	29,764	10,554	5,142	1,412	5,999	6,405
of which: foreign companies	..	..	*2.067*	..	..	..
of which: on the STAR segment	..	..	..	..	..	*797*
Dividends distributed (6)	15,711	15,889	18,650	17,030	22,517	23,708
Earnings/price ratio (7)	4.5	6.0	5.9	6.4	6.0	5.2
Dividend yield (7)	2.1	2.8	3.8	3.4	3.4	3.0
Turnover:						
spot market (8)	*845,193*	*620,004*	*572,940*	*580,703*	*641,376*	*893,853*
S&P/MIB30 index futures (9)	*984,392*	*829,416*	*673,836*	*527,024*	*467,122*	*585,445*
S&P/MIB30 index options (9)	*323,166*	*246,555*	*176,513*	*153,998*	*152,839*	*209,526*
Turnover ratio (10)	109	88	109	123	121	144

Source: Thomson Financial Datastream.

(1) Percentage change in the MIB index during the year. – (2) Italian companies; at end of period. – (3) Excludes the Expandi Market. – (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: up to 2003, 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. Italian companies.

At the end of the year the Italian Stock Exchange listed 275 companies, up from 269 twelve months earlier. Owing above all to the rise in prices, total market capitalization increased from €581 billion to €677 billion and from 43 to 49 per cent of GDP. The ratio to GDP was 46 per cent in Germany, 88 per cent in the four Euronext countries (Belgium, France, the Netherlands and Portugal), 147 per cent in the United Kingdom and 136 per cent in the United States. The relative level of stock market capitalization in the main countries has remained basically stable over the past fifteen years.

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 2005.

Identifying the potential threats to financial stability and drawing up common standards and rules for international banks were the main issues dealt with by the organizations for international cooperation in which the Bank of Italy participates. The Financial Stability Forum focused on the rapid spread of transactions involving complex financial products and the nature and magnitude of exposures to hedge funds. The Basel Committee and the Committee of European Banking Supervisors worked assiduously on the problems of implementing the new capital adequacy requirements and defining the methods of cooperation between the authorities responsible for supervising cross-border banking groups.

A "side letter" to the Memorandum of Understanding of August 1993 was signed by the Bank of Italy and the German authorities regarding supervision of the group resulting from last October's merger of UniCredito Italiano with Bayerische Hypo- und Vereinsbank (HBV).

On the domestic level, the Bank of Italy, Isvap and Consob signed an undertaking on the procedures for identifying financial conglomerates and the methods of calculating their capital adequacy, with a view to further agreements on other aspects of supplementary supervision. Seven financial conglomerates were identified, two operating mainly in insurance and five in banking.

Law 262 of 28 December 2005 on the protection of savings and the regulation of the financial markets contains provisions that will have a substantial impact on the structure and functions of the supervisory authorities. The antitrust powers of the Bank of Italy for the banking industry are transferred to the Antitrust Authority itself; other provisions are designed for greater transparency of decisions and more systematic coordination among the various authorities.

The most important aspects of secondary legislation concerned the coordination of banking and financial regulations under the new company law; the amendment of capital adequacy rules following the adoption of the new international accounting standards; and the opening of consultations on the new prudential legislation. Measures were taken to simplify prudential regulations according to principles of aggregate risk control agreed at the international level.

Operations conducted in 2005 and the early months of 2006 to transfer the control of some leading banks greatly accelerated the integration of Italy's banking system with the rest of Europe.

The salient events of 2005 were the competing takeover bids of Italian and foreign companies for two domestic banking groups. The irregularities that came to light led to civil, administrative and penal action by the supervisory authorities and the judiciary. The cases are now closed as regards ownership of the banks, but the legitimacy of the actions is still under investigation.

Allowing for the mergers and acquisitions completed in 2006, the market shares of branches and subsidiaries of foreign intermediaries in Italy increased respectively from 6.1 to 6.8 per cent and from 3.1 to 10.0 per cent of the total assets of banks operating in Italy. The foreign subsidiaries' assets of the five leading Italian groups increased from 11 to 41 per cent of total assets.

Competition from the leading foreign banking groups also intensified in the field of asset management. The presence of foreign intermediaries stepped up considerably with Crédit Agricole's acquisition of control of Nextra SGR, previously part of the Banca Intesa group.

The quality of loans continued to improve in 2005 thanks to further refinements to banks' risk selection and management techniques and to the stability of firms' financial conditions. The profitability of a broadly representative sample of banking groups also improved, partly owing to increased revenues from the sharp rise in the volume of business and partly to the reduction in net write-downs. The ROE was 12 per cent, 2 percentage points higher than in the previous year. The capital of the banking system, excluding the UniCredito-HVB group, was generally stable, as increased cash-flow from higher operating profits and capital increases offset the effects of the first-time adoption of the international accounting standards and new rules for banks' shareholdings in insurance companies. The rise in risk-weighted assets caused the solvency ratio to fall by 1 percentage point to 10.6 per cent.

Off-site analyses conducted by the Bank of Italy in 2005 found a decline in the number of banks that were in an anomalous situation. Unfavourable assessments were given to 82 banks, which accounted for 9.2 per cent of the banking system's total assets. In general, the overall assessments given to non-bank intermediaries showed an improvement, with those rated unsatisfactory accounting for only a small proportion of total business. In accordance with the results of off-site analysis, inspections focused on the problems of risk measurement and management and on organizational aspects.

With a view to the entry into force of the new capital adequacy rules, eight Italian banking groups, accounting for 50 per cent of the banking system's total assets, were subjected to checks, including on-site controls, to assess their progress in bringing internal rating systems into line with the standards. The findings indicated a generally acceptable level of governance of the projects by senior management and sufficiently reliable statistical methods. However, improvements are needed in the areas of data quality and IT procedures for supplying data to the models. After the criteria for recording doubtful debts had been amended to comply with the new regulations, the reporting of overdue loans or breaches of overdraft ceilings began in June 2005. In the area of risk mitigation, banks were called on to run constant checks on the compliance of their operating and management systems with the requirements for the eligibility of guarantees and the control of the other risks (legal, operational, liquidity, market) their use might entail. A survey was carried out among a group of banks to assess the state of advancement of operational risk management procedures; the findings indicated that progress had been made in collecting and checking the information needed to create internal models for the calculation of the capital adequacy requirements.

THE REGULATORY FRAMEWORK

International cooperation

Cooperation for financial stability. – At its meetings in September 2005 and March 2006, the Financial Stability Forum gave a positive judgment on financial institutions' progress in risk management and the strengthening of market infrastructures. Considering that the favourable macroeconomic conditions could induce financial institutions to take excessive risks, the Forum called for a lengthening of the time horizon of the risk assessment and control procedures in order to capture the impact of potential factors of vulnerability.

The Forum reaffirmed that financial institutions should carefully assess the operational and counterparty risks connected with the rapid growth in transactions in complex financial products and the nature and size of exposures to hedge funds. To this end the Forum vigorously advocated implementation of the recommendations of the Counterparty Risk Management Policy Group, consisting of experts from the leading private international financial institutions. Among other things, the Group suggests considering the possibility of periodically gathering information on the activities of hedge funds, on an informal basis.

As regards offshore financial centres, the Forum stressed the importance of cooperation between authorities, the exchange of information and the upgrading of supervisory authorities' staffs.

The Basel Committee on Banking Supervision supplemented its new capital adequacy rules in 2005, establishing more precise criteria for assigning assets to the trading or the banking book; new rules on counterparty risk; and reduced capital charges on certain assets backed by guarantees when there is a low risk of joint default by the principal debtor and the guarantor. The Committee issued clarifications on the method to be used in estimating loss in the event of default during cyclical downturns.

Greater attention was devoted to the problems of applying the rules in national law, especially as regards cooperation between national authorities in the supervision of groups operating in more than one country. In April

2006 the Committee released a consultation paper on Core Principles for Effective Banking Supervision and their adaptation to developments in banking and financial business and supervisory practices.

The IMF assessment of the Italian financial industry. – In March 2006 the International Monetary Fund issued its Financial System Stability Assessment for Italy. The Fund found that Italian regulations were almost all in compliance with international regulatory and supervisory standards and that the standards of transparency in the supervision of banks and securities firms were met.

Overall the financial system is sound. The banking system has remained stable through a long period of slow economic growth. For the future the flow of earnings and the capital resources of banks in excess of the minimum requirements appear to be capable of absorbing the impact of even exceptionally unfavourable economic scenarios.

The IMF assessment also offered indications on specific issues. It suggested stricter criteria for the classification of loans and the regulation of connected lending; the Bank of Italy had already acted on the matters under its jurisdiction. Closer correspondence of Italy’s rules with the new recommendations of the Financial Action Task Force for the fight against money laundering and the financing of international terrorism was called for. The IMF also reaffirmed the need for rules like those in the other leading countries to relieve supervisory employees of liability for acts done in good faith in the performance of their duties.

European cooperation and regulations

Within the European Union, a memorandum of understanding between central banks, supervisory authorities and finance ministries for coordination and exchange of information in managing systemic financial crises with effects in more than one member state went into force on 1 July 2005.

During the year the Banking Supervision Committee of the European System of Central Banks published its annual reports on the structural evolution and stability of the EU countries’ banking systems. The findings were made available in the ECB’s twice-yearly Financial Stability Review.

The European Commission published its white paper on financial services strategy for 2005-2010, setting the following priority objectives:

consolidation and full implementation of Community legislation, further convergence in supervisory practices, and more competition, especially in the supply of retail financial products and services. During the year the Commission also issued green papers on mortgage credit and UCITS. In addition, it began revising the rules on the acquisition of qualifying holdings in credit institutions (Directive 2000/12/EC, Article 16) and presented a proposal for a directive on consumer credit.

The European Parliament and the Council approved Directive 60 of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing. The Directive incorporates the new wording of the FATF recommendations and extends the rules for the prevention of the financing of international terrorism.

In September and October the Parliament and the Council approved amendments reshaping Directive 2000/12/EC on banking and 1993/6/EEC on the capital adequacy requirements for banks and investment firms so as to incorporate the new Basel capital adequacy accord. Entry into force is scheduled for 1 January 2007 or, for intermediaries opting for advanced methods of calculating credit and operational risk, a year later.

The Lamfalussy Procedure Committees. – Last year the Committee of European Banking Supervisors assigned priority to implementation of the directive on banks' capital adequacy. Numerous guidelines for supervisory authorities and banks were approved.

The guidelines on cooperation in supervising international groups define the respective responsibilities of home- and host-country authorities and the machinery for effective collaboration. The degree of involvement of the host-country authority depends in part on the relative importance of the foreign branch or subsidiary in the local market. The rules on information exchange distinguish between essential and relevant information. The former (such as that concerning changes to the structure of the group, the calculation of capital requirements and reporting format) must always be communicated, the latter only at the request of the authority involved.

The guidelines on common frameworks for prudential and statistical reporting are designed to reduce the costs for banks that are subject to more than one supervisory authority. Both frameworks provide for essential data and supplementary data. Using the taxonomy of the Committee of European Banking Supervisors, member states can vary both the range of data required and the frequency of reports.

The guidelines on procedures for validating internal models (approval, off-site and on-site controls) for advanced methods of assessing credit and operational risk reflect a shared approach to determining the elements subject to verification. They seek to reduce intermediaries' cost burden by simplifying the validation procedure as much as possible.

The guidelines on the accreditation of external credit assessment institutions for use of their ratings in the risk weighting of assets are designed to achieve consistency in the handling of applications in different member states, providing for joint recognition by the national authorities involved. The single authorities retain the power to conduct further evaluations and full independence in making the ultimate decision.

The guidelines on prudential controls (the "second pillar") specify: (i) the responsibilities of corporate bodies in determining the capital necessary to face all the risks of business, including those not covered in computing minimum capital requirements (the "first pillar") and in determining strategic objectives, propensity for risk, organizational arrangements and internal control systems; (ii) the duties of the authorities, which are responsible for reviewing the banks' processes and evaluations; (iii) the procedures for dialogue between banks and supervisory authorities; and (iv) the instruments to be used to correct any anomalies detected in the course of verifications, such as the setting of business limits and higher capital requirements.

Finally, the Committee of European Banking Supervisors prepared a uniform framework for implementing Article 144 of the capital adequacy directive, which requires supervisory authorities to report on the implementation of Community regulations using procedures that make it possible to compare the approaches taken in various member states.

In the securities sector, the committees envisaged by the Lamfalussy procedure continued to work for the implementation of Directive 2004/39/EC on markets in financial instruments and of Directive 1985/611/EEC on UCITS.

Bilateral cooperation. – Memorandums of understanding lay down the operating procedures for cooperation between authorities in different countries, covering in particular the exchange of information and inspections of establishments abroad. The capital adequacy directive provides for memorandums as a means of strengthening cooperation in the consolidated supervision of institutions with establishments in more than one EU country.

Between 1993 and 1999 the Bank of Italy signed memorandums of understanding with supervisory authorities in all the main EU countries. Between 2001 and 2004 there followed agreements with the Czech Republic, Slovenia, Slovakia and Hungary, all of which became EU members in May 2004, and with Bulgaria and Romania. In 2005 and early 2006 cooperation agreements were concluded with Croatia, China and Switzerland, and the negotiations with Poland entered the final phase.

In 2005 the Bank of Italy, the Bundesanstalt für Finanzdienstleitsungs-aufsicht and the Bundesbank signed a specific agreement to arrange for supervision over the group resulting from the merger of UniCredito Italiano and Bayerische Hypo- und Vereinsbank (HVB). As the institution responsible for consolidated supervision, the Bank of Italy coordinates the exchange of information, plans supervisory activities and assesses the overall risk of the new group. The Bundesanstalt, which has jurisdiction over the HVB sub-group, provides the Bank of Italy with the assistance and information required for consolidated supervision, working in close cooperation with the Bundesbank.

Italian legislation

Introduction of the new international accounting standards. – Legislative Decree 38 of 28 February 2005 on the application of the IAS/IFRS international accounting standards required banks and other supervised intermediaries to draw up their consolidated accounts in compliance with those standards starting with the 2005 financial year. For unconsolidated accounts, the requirement goes into effect with the 2006 financial year, but institutions wishing to do so could apply the new rules as of 2005.

The Decree provides that the Bank of Italy's regulatory powers over the technical forms of the accounts of banks and other financial institutions (envisaged in Legislative Decree 87/1992) are to be exercised in conformity with the international standards. It also governs the distribution of profits and reserves deriving directly from the fair value measurement of some types of assets and lays down criteria to strengthen the safeguards for shareholders' equity and creditor protection.

Transposition of the directive on the supplementary supervision of financial conglomerates. – Legislative Decree 142/2005 introduces supplementary supervision, over and above that in place for all sectors, for banks, insurance companies and investment firms belonging to financial conglomerates. It subjects the conglomerates to specific prudential rules on capital adequacy, risk concentration, intragroup transactions, internal controls and risk management procedures.

Transposition of the directive on distance selling of financial services. – Legislative Decree 190/2005 strengthens protection for consumers who acquire banking, investment, insurance or individual retirement saving services by means of distance selling techniques (Internet, fax, telephone, etc.). Consumers must be given detailed pre-contract information and have the right of withdrawal for up to 14 days. There are also measures concerning the supervisory authorities' powers of control and sanction (including the Bank of Italy for services that are governed by the Consolidated Law on Banking and provided by intermediaries referred to in Article 107 of that Law).

The law on the protection of saving. – Law 262/2005 on the protection of saving and on financial markets will have a substantial impact on the structures and powers of the control authorities (Bank of Italy, Consob, Isvap, the pension fund supervisory authority, Covip, and the Antitrust Authority) as well as on intermediaries' conduct of business.

The law responded to the need to improve market transparency and strengthen investor protection. It modifies the rules on securities issuers (governance mechanisms, disclosure) and on intermediaries (contract transparency, code of conduct, conflicts of interest, dispute settlement machinery); it toughens sanctions; and it introduces specific rules to protect investors (indemnity mechanisms, a guarantee fund, a savers' charter, a code of conduct for financial institutions). The law also enhances the transparency of the decision-making and regulatory processes of authorities and strengthens coordination among them, instituting such forms of liaison as regular meetings, agreements, committees and information exchange).

The competition function for the credit industry is transferred from the Bank of Italy to the Antitrust Authority. The law provides for acquisitions of significant holdings in banks, pursuant to Article 19 of the Consolidated Law on Banking, and of concentrations involving banks, pursuant to Article 6 of Law 287/1990, to be authorized by the two institutions in a single act. In this context, the evaluation of sound and prudent management remains the province of the Bank of Italy, while the Antitrust Authority examines the effects on the degree of competition in the market.

With specific regard to the Bank of Italy, the law provides that the Directorate must act collegially on measures with external effects, that minutes must be kept of the meetings of governing bodies, and that the Bank must report twice a year on its activities to the Parliament and the Government. In addition, all the control authorities must comply with new procedures for the adoption of measures, both those bearing on single institutions and those of a general or regulatory nature.

The law thus makes a valuable contribution on a number of matters, but it is not without its problematic aspects. As to the single joint act of the Bank of Italy and the Antitrust Authority, although there are some doubts concerning the interpretation of the legislation, on grounds of consistency it is reasonable to hold that the dual authorization applies only to acquisitions that constitute concentrations, as transfers of non-controlling stakes do not fall within the scope of antitrust legislation.

On conflicts of interest, the use of primary legislation to regulate a matter previously governed, for technical matters, by the supervisory authorities reduces the adaptability of the rules to the evolution of markets and products. Furthermore, the means for preventing conflicts of interest in portfolio management consist mainly of quantitative limits rather than the sort of organizational and transparency requirements increasingly relied on by international and Community law.

A number of enabling acts are envisaged to implement the law, notably to align the consolidated laws on banking and on finance and the other special laws with the changes introduced by the reform; this legislation can also be used to eliminate several interpretative doubts.

The reform of bankruptcy law. – Legislative Decree 5/2006 concluded the reform of Italian bankruptcy rules initiated by Decree Law 35/2005, ratified by Law 80/2005. Some of the changes, involving the management and recovery of credits, are of special importance to the banking and financial system. These include changes to the rules on voidable acts, shortening the “suspect period” and reducing the scope of voidability for ordinary acts; the revision of “minor procedures” with the abrogation of controlled administration and a restructuring of the procedure for composition with creditors; recognition of out-of-court settlements to deal with debts, a common practice among banks to facilitate the financial restructuring of debtor firms in difficulty.

Supervision of mutual banks. – On 22 December 2005 the Ministry for Productive Activities issued a regulation on the contents and procedures for the supervision of mutual banks (*banche di credito cooperativo*), to check that they satisfy the requirements of mutualism. The regulation seeks to avoid duplication between banking supervision and supervision of cooperatives and relies on the specialization of professional associations in carrying out the controls.

Secondary legislation

Financial intermediaries in the special register. – A regulation issued in May 2005 clarified the rules on risk concentration for institutions in the special register that do factoring business.

Risk exposures of banks with related parties. Alignment with the new company law. – The authorization and information requirements vis-à-vis the Bank of Italy for allowable shareholdings of banks and other intermediaries (investment firms, asset management companies, electronic money institutions, and intermediaries in the special register under Article 107 of the Consolidated Law on Banking) were adapted to the reformed company law.

A Credit Committee resolution of 19 July 2005 supplemented the authorization and notification requirements for shareholdings in banks (above 5 per cent) with the notion of significant holding, which it defines as: i) the possession, on whatever basis, of shares, including non-voting shares, representing at least 10 per cent of the bank's paid-up share capital; ii) the possession of more than 5 per cent of shares giving the right to vote, including on a conditional basis, on matters of special importance for the management of the bank; or iii) the possession of financial instruments representing participation in the capital that enable their holder to appoint directors or equivalent officers or to influence strategic choices on organization or management. The Bank of Italy extended the reporting requirements on the acquisition of significant holdings in non-bank intermediaries under its supervision to new instruments of participation carrying rights of direction.

The rules on fund-raising by non-bank intermediaries were also aligned with the new company law, which significantly extends the possibility for private and public companies to raise funds by issuing bonds and other financial instruments. The measures implementing Article 11 of the Consolidated Law on Banking were revised by a Credit Committee resolution adopted on 19 July 2005 and amended on 22 February 2006 to take account of the changes introduced by Law 262/2005.

In order to take account of Law 262/2005, a second Credit Committee resolution of 22 February 2006 required the Bank of Italy to set specific quantitative limits on banks' exposures to persons with significant holdings of their capital or other related parties as defined in Article 53 of the Consolidated Law on Banking. The rules govern unconsolidated and consolidated exposures to related parties individually and in the aggregate.

The Bank of Italy may define categories of related parties in addition to those envisaged in the law and modulate the exposure ceiling, depending on the type of relation with the bank, up to a maximum of 20 per cent of the bank's supervisory capital. The implementing instructions will also cover decision-making procedures, internal controls, any derogations for mutual banks and intragroup transactions, and transitional provisions.

Application of IAS/IFRS to the accounts of banks and financial companies. – On 22 December 2005 the Bank of Italy issued the new regulations on the annual accounts of banks, completing the rules laid down by Regulation (EC) 1606/2002. The new regulations take account of the results of consultation with intermediaries and all interested parties.

In February 2006 the Bank of Italy published the required formats for the annual accounts of supervised non-banking intermediaries that prepare their accounts according to IAS/IFRS. The rules are consistent with those for the accounts of banks and ensure comparability between intermediaries that conduct the same types of business.

In April 2006 the instructions for compiling reports on supervisory capital and capital ratios were adapted to the new accounting rules. Corrections to the data in the financial statements (so-called prudential filters) were introduced to safeguard the quality of banks' supervisory capital and reduce its potential volatility. The general principles of the new rules had been made known to the banking industry in November 2005. The measure also provides for the deduction of holdings of insurance companies' capital, pursuant to Directive 2002/87/EC on financial conglomerates, and holdings of the Bank of Italy's capital.

The new rules apply to banking groups as of December 2005 and to single banks starting in June 2006. In order to attenuate the impact on supervisory capital and the capital adequacy ratios, transitional rules are laid down on the treatment of forward purchase commitments involving own equity instruments, the deduction of holdings of the Bank of Italy's capital, and value readjustments of equity securities available for sale.

Incorporation of the new capital adequacy rules. – The Bank of Italy initiated a public consultation for the transposition into Italian law of the European rules on capital adequacy of banks and investment firms.

A first consultation paper released in December concerns techniques of credit risk mitigation and securitizations. In March 2006 the Bank released consultation papers on the scope of the rules, the standard method of calculating the capital requirement for credit risk, and the basic and standardized methods for calculating operational risk.

Regulatory simplification. – To facilitate adaptation to the new rules on asset management companies introduced in April 2005 – permitting greater flexibility in fund management – the Bank of Italy specified the changes to investment fund rules that the management companies can make independently, without specific authorization by the Bank.

In October 2005 the thresholds for exemption from mandatory prior notification and eligibility for simplified notification procedures under Article 129 of the Consolidated Law on Banking were raised substantially for securities with standardized features. At the same time, the category of "standard" securities was redefined to include new types of financial instruments that have come into common use in the market.

In December the regulations on the door-to-door selling of banking products and services were simplified. For the promotion and sale of banking and financial products and services not covered by the Consolidated Law on Finance, in addition to the agents previously contemplated – employees, tied agents, other banks and investment firms, insurance undertakings, insurance agents, the financial intermediaries referred to in Articles 106 and 107 of the Consolidated Law on Banking and financial business agents – banks are now allowed to use, under an agreement, other persons primarily engaged in professional or commercial activity to which the distribution of banking products is functional.

In February 2006 it was decided that the notification to the Bank of Italy of the acquisition of equity holdings for purposes of credit recovery and in firms in temporary financial difficulty no longer had to take the form of a special report but could be made in the framework of intermediaries' regular reporting of their equity holdings.

In March 2006, implementing the Credit Committee resolution of 22 February, the Bank of Italy abrogated its supervisory instructions on maturity transformation and medium and long-term lending to firms. It maintained the prudential limit on equity interests, under which the value of holdings of property and equity must not exceed supervisory capital.

THE STRUCTURE OF THE FINANCIAL SYSTEM

At the end of 2005 the Italian financial system comprised 784 banks, 108 investment firms, 179 asset management companies, 3 SICAVs and 409 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. and Cassa Depositi e Prestiti (Table 57). Compared with the end of 2004, the number of foreign banks with branches in Italy, asset management companies and "Article 107 intermediaries" rose while that of investment firms fell.

Table 57

THE STRUCTURE OF THE ITALIAN FINANCIAL SYSTEM

	31 December 2004			31 December 2005		
	Number of intermediaries			Number of intermediaries		
	Group members	Non-group	Total	Group members	Non-group	Total
Banking groups			**83**			**85**
Banks	**227**	**551**	**778**	**230**	**554**	**784**
limited company banks	*198*	*44*	*242*	*201*	*42*	*243*
cooperative banks (banche popolari)	*18*	*19*	*37*	*18*	*18*	*36*
mutual banks (banche di credito cooperativo)	*11*	*428*	*439*	*11*	*428*	*439*
branches of foreign banks	–	*60*	*60*	–	*66*	*66*
Investment firms	**25**	**90**	**115**	**23**	**85**	**108**
Asset management companies and SICAVs	**69**	**93**	**162**	**61**	**121**	**182**
Financial companies entered in the register referred to in Article 106 of the Consolidated Law on Banking	**213**	**1,306**	**1,519**	**215**	**1,362**	**1,577**
of which: entered in the special register referred to in Article 107	*98*	*278*	*376*	*101*	*308*	*409*
Other intermediaries (1)	**–**	**2**	**2**	**–**	**2**	**2**

(1) Bancoposta and Cassa Depositi e Prestiti.

At the end of the year banks and other supervised intermediaries administered respectively €1,780 billion and €760 billion of financial assets in Italy belonging to non-financial customers (including €920 billion and €720 billion of assets held for safekeeping or under management) and held

€1,600 billion of claims on the private sector in the form of loans and €430 billion in the form of securities. Banks had total staff of 337,000 and other supervised intermediaries, 22,000.

Bancoposta’s funding at the end of 2004 consisted of €34 billion of current accounts and €238 billion of savings books and savings certificates. Cassa Depositi e Prestiti used €123 billion of these resources, together with €4 billion raised on the market, within the separate fund for the financing of public bodies and other eligible entities. A total of €53 billion of such financing was provided. In 2005 the ordinary fund for the financing of infrastructures began operations, with disbursements amounting to €400 million.

Banking groups numbered 85 at the end of 2005, compared with 83 a year earlier. Their domestic members comprised 230 banks, 23 investment firms, 61 asset management companies, 27 financial holding companies (5 of them parent companies) and 215 other financial companies. The foreign component consisted of 278 intermediaries, 68 of which were banks.

Banks and banking groups

Ownership of banking groups and banks. – In June 2005 UniCredito Italiano launched an exchange tender offer worth approximately €20 billion for all of the capital of the German group Bayerische Hypo- und Vereinsbank A.G. (HVB). The offer, which ended in October 2005 with the acquisition of 93.93 per cent of HVB’s capital, created a group with a market value of about €60 billion and total consolidated assets of more than €700 billion. The capital increase carried out in connection with the acquisition strengthened the presence among UniCredito Italiano’s shareholders of foreign insurance companies, which now hold about 10 per cent of its capital. Banking foundations hold a total of about 14 per cent of the ordinary shares.

At the end of 2005 control of Banca Antoniana Popolare Veneta S.p.A. was acquired by the Dutch banking group ABN AMRO, which already held 12.7 per cent; the transfer of the shares was completed at the beginning of 2006. On 31 March 2006, at the conclusion of the subsequent mandatory tender offer, ABN AMRO held 98.9 per cent of the Italian bank’s capital.

In March 2006 the French banking group BNP Paribas was authorized to acquire control of Banca Nazionale del Lavoro S.p.A. At the beginning of April, following disposals of equity interests by some major shareholders, BNP Paribas held 50.4 per cent of the capital. On 16 May, at the conclusion of the mandatory tender offer, its equity interest stood at 97 per cent.

According to data from the Consob archive, following the above-mentioned transactions an average of 20 per cent of the capital of the top ten Italian banking groups, weighted by the value of the consolidated assets of the units operating in Italy, was held by non-residents (16 per cent held by banks, 2 per cent by financial companies and 2 per cent by insurance companies). An average of 16 per cent was owned by banking foundations and the market held 56 per cent.

In the last ten years mergers and acquisitions have involved 439 Italian banks (Table 58). Compared with 1996-2000, in the period 2001-2005 the importance of the transactions carried out on the domestic market declined: the share of the Italian banking system's assets attributable to Italian banks merged into or acquired by other Italian banks decreased from 37 per cent in 1996-2000 to 8 per cent. By contrast, the importance of cross-border acquisitions increased: the assets of Italian banks acquired by foreign entities and of foreign banks acquired by Italian intermediaries rose from 3 per cent of the system's total assets in 1996-2000 to 27 per cent in 2001-05.

Table 58

MERGERS AND ACQUISITIONS OF BANKS (1)

	Mergers between Italian banks				Acquisitions of Italian banks		Acquisitions of foreign banks by Italian banking groups	
	No. of transactions		Assets (2)		No. of transac-tions	Assets (2)	No. of transac-tions	Assets (2)
		of which: mutual banks		*of which: mutual banks*				
Total 1996-2000 (3)	**159**	**102**	**5.99**	**0.33**	**113**	**32.12**	**20**	**1.88**
2001	31	21	0.08	0.06	10	1.87	4	0.33
2002	18	16	0.06	0.05	12	5.03	3	0.41
2003	20	14	0.18	0.05	9	1.55	4	0.19
2004	10	7	0.04	0.02	7	0.34	4	0.06
2005	4	3	0.02	0.00	7	2.39	4	22.94
Total 2001-2005 (3)	**83**	**61**	**0.39**	**0.18**	**45**	**10.66**	**19**	**23.92**

(1) The table refers to concentrations between Italian banks and between Italian and foreign banks. 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. Intra-group transactions are excluded. Transfers of assets and liabilities are treated as mergers. 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. – (2) Non-consolidated assets of the target banks as a percentage of the total assets of banks operating in Italy at December of the year preceding the transaction or at the date of the first available supervisory report for foreign target banks. The figure for foreign target banks with total balance sheet assets of less than €50 million is not available. – (3) For banks acquired more than once during the period, only the first transaction is counted. Acquisitions by foreign banks accounted for 1.2 per cent of the total assets of the Italian banks acquired in the period 1996-2000 and 2.6 per cent in the period 2001-2005.

At the end of 2005 there were 34 listed Italian banks, one more than a year earlier. Twenty-eight of them headed banking groups and 5 belonged to groups; altogether, they accounted for 74 per cent of total system assets. Only 3 of the top 20 groups by consolidated assets are not listed on the stock exchange.

Structural evolution and internationalization of the system. – Both the international penetration of Italian banks and the presence of foreign intermediaries in Italian markets grew during the year. At the end of 2005 there were 25 Italian groups established abroad, the same as a year earlier. Including the effects of the acquisition of the HVB group by UniCredito Italiano, the Italian banking system operated abroad with 71 branch structures and 115 subsidiaries. The share of external assets in total system assets was 25 per cent, approximately 90 per cent of which was attributable to subsidiaries.

The main outlet markets for Italian groups remain those of Eastern Europe, a target of their business development strategies in recent years, to which the German and Austrian markets have now been added as a consequence of the UniCredito transaction. In Croatia Italian-owned banks account for about half of the banking system's total assets, while in other countries (Slovakia, Bulgaria, Poland and Austria) their market share is about 20 per cent. By contrast, Italian banks still have only a limited presence in the main countries of Western Europe (Table 59).

Table 59

PRESENCE OF FOREIGN BANKS IN SELECTED EUROPEAN COUNTRIES (1)

(31 December 2005)

	Number of banks			Assets		
	Total	*of which:* *foreign-controlled*	*of which:* *Italian-controlled*	Total (billions of euros) (2)	*% share held by foreign-owned banks (3)*	*% share held by Italian-owned banks (3)*
Austria	844	50	15	723.9	19.9	18.0
Belgium	105	79	1	1,123.4	19.7	0.1
Bulgaria	28	....	3	13.7	....	24.4
Croatia	38	17	6	36.2	91.4	54.9
Czech Republic	36	27	3	103.4	94.4	8.0
France	418	161	10	4,646.1	10.8	0.1
Germany	2,089	130	16	6,903.2	10.5	5.0
Hungary	208	33	4	74.5	83.0	14.2
Luxembourg	155	150	17	792.4	94.5	5.3
Netherlands	401	32	1	1,749.6	14.2	..
Poland	649	43	4	152.1	70.0	20.1
Romania	41	30	13	35.0	62.2	10.7
Russia	1,205	51	3	285.2	8.3	1.7
Slovakia	23	21	3	38.6	97.3	24.7
Slovenia	25	9	1	29.3	22.6	7.2
Spain	268	86	5	2,073.3	10.9	0.1

Sources: Preliminary calculations based on data provided by national central banks and supervisory authorities and Bureau Van Dick-Bankscope archive; individual supervisory reports; the data for the banks acquired by UniCredito Italiano through HVB are estimated on UniCredito Italiano data.

(1) Austria: includes building savings banks; excludes special banks (*Banken mit Sonderaufgaben*) having the nature of real estate funds, investment companies and severance funds. Belgium, Netherlands and Luxembourg: includes commercial banks, savings banks, mortage banks and building societies. Croatia: includes commercial banks and housing savings banks. France: includes *établissements de crédit à vocation générale*, among which are cooperative banks; excludes *établissements de crédit*. Germany: includes *Landesbanken*, cooperative banks, cooperative banks' central credit institutions and banks with special tasks. Hungary: includes savings cooperatives. Poland; includes cooperative banks. Romania: includes commercial banks and cooperative organizations. Slovakia: includes commercial banks and building societies. Slovenia: includes commercial banks and savings banks. Spain: includes deposit institutions only. – (2) Total assets shown in company accounts.

Including transactions completed in 2006, 66 foreign banks and 20 subsidiaries of foreign banks are active in Italy, with 108 and 2,113 branches respectively; at the end of 2004 the foreign banks numbered 60 and the subsidiaries of foreign banks 15 (with 366 branches). Branches and subsidiaries of foreign banks account for respectively 6.8 and 10.0 per cent of the total assets of units operating in Italy, up from 6.1 and 3.1 per cent at the end of 2004. The share of total assets attributable to the equity interests exceeding 2 per cent held by foreign intermediaries in the largest Italian groups is equal to 5.9 per cent.

Distribution channels. – At the end of 2005 banks operated through 31,501 branches and 31,225 tied agents. The network of branches and automated channels (ATMs and POS units) grew by about 3 per cent during the year. Door-to-door sales networks, including financial shops, underwent further rationalization: the total number of tied agents either employed by or acting for banks and banking groups (including those working for banks' subsidiary investment firms) fell by more than 5 per cent and that of financial shops by 11 per cent. Use of telephone and Internet banking services continued to grow.

Relations between banks and insurance companies. – Banks are the most important channel of distribution of life insurance products. In 2005 they accounted for 74 per cent of the value of new business and €39 billion of premium income, compared with 72 per cent and €47 billion in 2004; 68 per cent of these policies, almost exclusively of a financial nature, were distributed by the six main banking groups.

At the beginning of 2006, 10 insurance companies, including 4 foreign companies, held equity interests in 35 Italian banks. Ten banks were controlled by insurance groups; they accounted for 1 per cent of the total assets of units operating in Italy, 7 per cent of the insurance products and services sold and 6 per cent of premium income.

At the end of last year 177 banks held equity interests in 130 insurance and brokerage companies, of which 91 Italian. Among the interests in Italian companies, those at least equal to 20 per cent numbered 62, including 26 in the life sector; there were 31 controlling interests (11 in the life sector).

Under the Coordination Agreement between the Bank of Italy, ISVAP and Consob, with reference to data for the 2004 financial year the three supervisory authorities identified two financial conglomerates prevalently engaged in insurance (Mediolanum and Unipol) and five prevalently engaged in banking (Banca Intesa, UniCredito Italiano, Sanpaolo IMI, Monte dei Paschi di Siena and Carige). At the end of 2004 the five bank-based conglomerates held 45 per cent of the assets of the banking system; their insurance components accounted for an average of 8.9 per cent of their estimated balance sheet assets.

Asset management companies

Intermediaries. – There were 179 registered asset management companies and 3 registered SICAVs at the end of 2005 (Table 60). The companies established during the year tended again to be specialized in managing innovative funds: 8 of the 24 new companies authorized during the year specialize in hedge funds, 5 in private equity funds and 7 in real estate funds, while only 4 engage in managing traditional open-end funds. The number of companies that have introduced innovative products (106) has overtaken that of companies specialized prevalently in managing open-end funds (76). The rationalization of group organizational structures led to 4 asset management companies being merged into other intermediaries. Eleven foreign harmonized management companies notified the start of the provision of services in Italy; 4 of them operate through branches.

Table 60

ASSET MANAGEMENT COMPANIES AND SICAVs

	31 December 2004		31 December 2005	
	Total	*of which: bank investee companies* (1)	Total	*of which: bank investee companies* (1)
Asset management companies and SICAVs	**162**	**92**	**182**	**90**
of which specializing in:				
open-end funds (2)	*76*	*47*	*76*	*43*
closed-end securities funds	*40*	*19*	*44*	*17*
closed-end real estate funds	*17*	*8*	*24*	*9*
hedge funds	*29*	*18*	*38*	*21*
Memorandum items:				
Companies offering individual portfolio management	68	43	63	55
Companies managing funds instituted by others	16	12	17	8
Companies that have instituted open pension funds	15	13	15	12
Foreign asset management companies and SICAVs (3)	**254**		**263**	
of which: *SICAVs*	*187*		*194*	

(1) Companies at least 50 per cent of whose equity is held by Italian or foreign banks. – (2) Eleven companies (ten in 2004) also manage closed-end funds. – (3) Companies that market their units/shares to the general public in Italy pursuant to Legislative Decree 58/1998, Article 42.

The main trends. – Italian companies confirmed their central role in the asset management industry. At the end of 2005 they had more than

€607 billion of assets under management, 6.8 per cent more than a year earlier (Table 61). With the assets of traditional open-end investment funds remaining basically stable, the largest contribution to growth came from individually managed portfolios, which increased by 15.8 per cent net of the portions invested in collective investment undertakings.

Table 61

PORTFOLIOS MANAGED BY BANKS, ASSET MANAGEMENT COMPANIES AND INVESTMENT FIRMS

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

	Open-end and closed-end funds (1)	Individually managed portfolios (1)	Open pension funds (2)	Total by type of intermediary (3)	Market share by type of intermediary
			2004		
Banks	–	77,171	297	77,468	9.2
Investment firms	–	16,664	566	17,230	2.0
Asset management companies	387,370	180,582	844	568,796	67.4
Foreign collective investment undertakings	180,084	–	–	180,084	21.3
Total	**567,454**	**274,417**	**1,707**	**843,578**	**100.0**
			2005		
Banks	–	80,082	397	80,479	8.4
Investment firms	–	16,428	715	17,143	1.8
Asset management companies	397,229	209,096	1,128	607,453	63.6
Foreign collective investment undertakings	250,139	–	–	250,139	26.2
Total	**647,368**	**305,606**	**2,240**	**955,214**	**100.0**

(1) Total assets net of the portion invested in investment funds. – (2) Net assets earmarked for benefits. – (3) Includes net individually managed portfolios.

Italian management companies' share of total assets under management by the different categories of intermediary declined from 67.4 to 63.6 per cent as a consequence of the significant rise in the share managed by foreign undertakings for collective investment in transferable securities (UCITS) marketed in Italy, which rose from 21.3 to 26.2 per cent and amounted to more than €250 billion.

The decrease in Italian management companies' share is a result of the supply strategies of the largest banking groups, which in recent years have steered customers towards products alternative to investment funds, such as insurance policies and bank bonds. They have also stepped up the transfer of fund management abroad by increasing their supply of funds run by their own foreign subsidiaries, sold to Italian customers largely through individually managed portfolios of funds. The increase in net subscriptions of the funds managed by these companies has more than offset the decrease in the assets of traditional open-end funds. The combined assets of Italian open-end funds (€366 billion at the end of 2005) and of the products of foreign companies controlled by Italian intermediaries (€179 billion) grew by more than more 8 per cent during the year.

Last year saw intensifying competition exerted by major foreign groups either directly in Italy, through Italian asset management subsidiaries or joint ventures with Italian intermediaries, or through distribution agreements with small and medium-sized Italian networks that market third parties' funds alongside their own products. Recently the networks of large Italian groups have also begun to market funds of foreign intermediaries, primarily within the context of individually managed portfolios of funds. The presence of foreign intermediaries in the sector was boosted by the Crédit Agricole group's acquisition of 65 per cent of the capital of Nextra, an asset management company previously wholly owned by the Banca Intesa group. Partly owing to this transaction, the total assets of funds managed by foreign-owned Italian companies or sold in Italy by foreign intermediaries grew from about €54 billion in 2000 to €158 billion at the end of 2005 and their share of the total assets of funds marketed in Italy rose from 9.6 to about 25 per cent.

Independent asset management companies, which are of limited size, increased their supply of specialized funds. At the end of 2005 their market share was equal to 4.6 per cent, compared with 4.2 per cent a year earlier.

Italian hedge funds continued to expand in 2005. Intermediaries and institutional investors hold approximately 54 per cent of the investment in these funds. Asset management companies not belonging to Italian banking groups play a very significant role in this sector, with a market share of nearly 49 per cent. Products that invest in units of other funds, especially foreign funds, account for almost the totality of the assets of Italian hedge funds (96 per cent); 35 of the 40 new funds established during the year were funds of funds.

Closed-end real estate funds, particularly those reserved to institutional investors, continued to grow. Their net asset value rose from €8.1 billion to nearly €12 billion, of which 53 per cent attributable to intermediaries not belonging to Italian banking groups, while their year-end property holdings were valued at €14.6 billion. Transactions in sectors other than residential property, which accounts for the bulk of Italian real estate funds' activity, made up about 25 per cent of their volume of business in 2005.

Closed-end securities funds had assets worth €2.4 billion at the end of 2005, 33 per cent more than a year earlier; the share attributable to intermediaries not belonging to Italian banking groups was equal to 65 per cent. At the end of the year participants' uncalled subscriptions available for additional investments could be estimated at €2 billion.

Investment firms

At 31 December 2005 there were 108 registered investment firms (including 7 trust companies), down from 115 a year earlier as a result of the deletion from the register of 11 firms (5 of them foreign-controlled) and the addition of 4. Five of the deleted firms had ceased carrying on business owing to losses and operating imbalances, 3 were merged or transformed into banks, and 3 were merged with other investment firms. The deletions of bank-controlled investment firms are mainly the consequence of the tendency of banking groups to centralize investment services in banks and asset management companies.

Financial companies

At 31 December 2005 there were 409 financial companies in the special register referred to in Article 107 of the Consolidated Law on Banking following 49 additions and 16 deletions during the year (Table 62). Securitization special purpose vehicles accounted for the bulk of the new entries (35) and for more than half of the financial companies in the register at the end of the year. The entry of new intermediaries other than special purpose vehicles (14) was spurred by the rationalization carried out within banking groups, which led to the creation of specialized product companies.

At the end of 2005 financial companies belonging to banking groups had 66 per cent of the leasing market, independent financial companies 12 per cent and banks 22 per cent. In the factoring market the corresponding shares were 63, 25 and 12 per cent; the market share of companies not belonging to banking groups, for the most part subsidiaries of industrial groups, declined further, bringing the cumulative loss in the three years 2003-05 to 10 percentage points. In the consumer credit sector, which includes personal loans as defined in Article 121 of the Consolidated Law on Banking, banks made 58 per cent of the loans; in contrast with its contraction in the previous years, the market share of financial companies expanded from 15 to 21 per cent.

There was a sizeable further increase in the presence of foreign intermediaries, which at the end of the year directly or indirectly controlled 38 financial companies entered in the special register. Foreign intermediaries are particularly active in the consumer credit and leasing markets, where their financial companies hold market shares of 19 and 15 per cent respectively.

Table 62

SPECIAL REGISTER OF FINANCIAL COMPANIES

	Number of companies				
	31 December 2004		Registra-tions	31 December 2005	
		of which: bank investee companies			*of which: bank investee companies*
Principal activity: (1)					
Financing	139	68	8	137	64
Leasing	*54*	*36*	*2*	*54*	*37*
Factoring	*35*	*13*	*2*	*34*	*13*
Other lending	*23*	*6*	*2*	*20*	*1*
Consumer credit	*27*	*13*	*2*	*29*	*13*
of which: secured by salary	*7*	*2*	*1*	*8*	*2*
Issue and management of credit cards	11	2	2	13	2
Equity investment	9	3	2	9	3
Securitization servicing	9	2	2	12	5
Foreign exchange intermediation	2	0	0	1	0
Total intermediaries	**170**	**75**	**14**	**172**	**74**
Special purpose vehicles under Law 130/99 (2)	206	43	35	237	42
Total special register	**376**	**118**	**49**	**409**	**116**

(1) Determined by statistical reports and inquiries conducted during the year; companies may thus move from one category to another during the reference period. – (2) Special purpose vehicles as defined by the Bank of Italy's regulation of 16 December 2002 are entered in a special section of the special register.

Banks' company pension funds

Pursuant to Legislative Decree 124/1993 the Bank of Italy supervised the pension funds set up at banks and banking groups. Legislative Decree 252 of 5 December 2005 transferred this task to the Pension Fund Supervisory Authority. At that date there were 117 bank pension funds with a total of 115 defined-benefit sections and 40 defined-contribution sections, set up by 82 banks and five companies belonging to banking groups.

PROFITABILITY, RISKS AND CAPITAL ADEQUACY OF INTERMEDIARIES

Banks and banking groups

Credit risk. – The improvement in the quality of bank lending continued throughout 2005, benefiting from refinements to banks' risk selection and management techniques and the financial conditions of firms.

At the end of the year bad debts amounted to €45.4 billion (Table 63), a 16.4 per cent reduction with respect to the previous year that was partly due to the resumption of securitizations, up from €300 million to €8.6 billion. If those securitizations are included among bad debts, the reduction was 0.6 per cent, compared with an increase of 6 per cent in 2004. The ratio of bad debts to total loans fell by 1 percentage point to 3.7 per cent (Table a31). Net of write-downs, bad debts of units operating in Italy amounted to €19.1 billion, equal to about 12 per cent of their supervisory capital, compared with 15.8 per cent in 2004.

Table 63

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)	Securitizations (5)	
	Performing loans		Bad debts (2)			Performing loans	Bad debts
		Substandard loans					
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	1,096,052	21,280	54,347	4.7	0.9	12,602	335
2005	1,192,544	20,780	45,411	3.7	0.8	16,948	8,585

Sources: Central Credit Register and prudential reports.

(1) Lending to resident customers by units 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 ratio of loans newly classified as adjusted bad debts to outstanding performing loans at the start of the year was 0.8 per cent, slightly less than in 2004. The figure was higher for loans to residents in the South (1.3 per cent) and to agricultural and manufacturing firms (respectively 1.4 and 1.3 per cent). The banks with the lowest values of the ratio were also those with the fastest growth in lending and highest level of capital adequacy.

Non-performing loans, consisting of bad and doubtful debts, amounted to €66.2 billion, or 5.3 per cent of outstanding lending, compared with 6.6 per cent in 2004. The cover ratio, i.e. the ratio of write-downs to gross non-performing loans, rose from 46.7 to 47.4 per cent.

Loan concentration. – The banking system's large exposures (those which, on a risk-weighted basis, exceed 10 per cent of a bank's supervisory capital) increased from €58.9 billion to €66.9 billion, although they declined from 4.5 to 4 per cent of risk-weighted assets. The number of banks and groups with loans exceeding the limit of 25 per cent of capital increased from 27 to 39; the overshoots, which were small on average and mainly concerned small banks, rose from €492 million to €660 million.

The quarterly reports of the leading groups on their ten largest borrowers indicated a risk-weighted exposure of €106.7 billion in 2005, 18 per cent higher than in the previous year. This result reflects the increase in large loans of the UniCredito Italiano group following its takeover of Bayerische Hypo- und Vereinsbank A.G. (HVB). Leaving UniCredito aside, the aggregate amount of exposures rose by 2.4 per cent, compared with 0.6 per cent in 2004. Large exposures decreased slightly in relation to supervisory capital.

Country risk. – At the end of 2005 Italian banks' exposure to developing countries and offshore centres amounted to €91.5 billion, equal to 4.5 per cent of the total assets of the units operating in Italy and 27 per cent of total foreign exposure. A large part of the 19.6 per cent increase with respect to 2004 was due to the appreciation of the dollar against the euro. Exposure to industrialized countries increased by just 3.4 per cent.

Italian banks' market share of total lending to non-industrial countries declined from 2.9 to 2.5 per cent, which was slightly less than Italy's share of world GDP at constant prices and exchange rates.

Exposures adjusted in accordance with supervisory rules on country risk amounted to €13.2 billion. Value adjustments were lower than in previous years, amounting to €800 million and 0.5 per cent of supervisory capital.

Market risk. – At the end of 2005 the capital requirements for market risk, calculated on a consolidated basis, amounted to 5.6 per cent of total supervisory capital. This was in line with the figure for 2004 and substantially less than the capital requirements for credit risks, which exceeded 70 per cent.

In order to assess the interest rate risk for the balance sheet as a whole, a simulation was carried out on the capital and reserves of banking groups in 2004 and 2005. The findings indicated that a rise in interest rates would entail a loss overall because the decline in the present value of assets would be larger, owing to their longer duration, than that of liabilities. The average loss would be 6.3 per cent of supervisory capital, compared with 8.6 per cent at the end of 2004, and would vary considerably from one banking group to another. At the end of 2005 the average loss incurred by banks in the riskiest quintile would be 17 per cent.

Profitability. – In 2005 it became compulsory for banking groups to adopt the new international accounting standards (IAS/IFRS) in drawing up their consolidated accounts.

The profitability of banking groups improved with respect to the previous year, partly owing to the increase in revenues and partly as a result of the decrease in net value adjustments to loans. Profits grew by 45 per cent, while return on equity rose by 2 percentage points to 12 per cent. The main banking groups' ROE increased by 5 points to 16.2 per cent (Table 64).

Table 64

PROFIT AND LOSS ACCOUNT OF ITALIAN BANKING GROUPS

(millions of euros; growth rates and percentage indicators)

	Banking system			Main banking groups (1)		
	2004	2005	Change	2004	2005	Change
Net interest income (a)	30,199	31,842	5.4	19,758	20,895	5.8
Non-interest income (b)	28,851	32,360	12.2	19,458	22,044	13.3
of which: commissions	*20,840*	*22,969*	*10.2*	*14,583*	*16,197*	*11.1*
Gross income (c=a+b)	59,050	64,202	8.7	39,216	42,939	9.5
Operating expenses (d)	37,218	38,252	2.8	25,020	25,405	1.5
of which: staff costs	*22,408*	*22,375*	*-0.1*	*15,388*	*14,965*	*-2.7*
Operating profit (e=c-d)	21,833	25,950	18.9	14,196	17,534	23.5
Allocations to provisions and net value adjustments (f)	8,392	6,784	-19.2	5,749	3,652	-36.5
of which: in respect of loans	*6,010*	*4,979*	*-17.1*	*3,961*	*2,553*	*-35.5*
Ordinary profit (g=e-f)	13,441	19,166	42.6	8,447	13,882	64.3
Extraordinary profit (h)	919	890	-3.2	757	826	9.1
Gross profit (i–g+h)	14,360	20,056	39.7	9,204	14,708	59.8
Taxes (l)	4,628	6,357	37.4	2,857	4,386	53.5
Profit from categories of assets undergoing disposal (after tax) (m)	163	127	-22.2	122	39	-68.0
Profit of minority interests (n)	974	894	-8.2	614	445	-27.5
Profit of parent company (o=i-l+m-n)	8,921	12,932	45.0	5,855	9,916	69.4
Indicators						
Ratio of non-interest income to gross income	48.9	50.4		49.6	51.3	
Cost-income ratio	63.0	59.6		63.8	59.2	
Value adjustments in respect of loans as a percentage of operating profit	27.5	19.2		27.9	14.6	
ROE	10.0	12.0		11.0	16.2	

Source: Ad hoc survey of consolidated profits for 2005 of Italian banking groups.
(1) Six largest groups by total assets.

Gross income rose by 8.7 per cent as a result of the increase of 5.4 per cent in interest income and 12.2 per cent in other income. Given the small rise in operating expenses, operating profit grew by 18.9 per cent. Provisions and value adjustments declined by almost one fifth. In particular, among the latter, those for loans absorbed 19 per cent of operating profit, compared with 28 per cent in 2004, and benefited from write-backs connected with the discounting to present value of the recoverable amount of impaired loans with the first-time adoption of IAS/IFRS.

Gross profit grew by 39.7 per cent. At 32 per cent the incidence of taxes was virtually unchanged from 2004.

Capital adequacy. – In December 2005 the banking system's consolidated supervisory capital amounted to €174.7 billion, compared with €148.7 billion at the end of the previous year (Table 65).

Table 65

CAPITAL ADEQUACY OF ITALIAN BANKS AND BANKING GROUPS (1)
(millions of euros)

	Banking system		Main banking groups (2)	
	2004	2005	2004	2005
Allocations to supervisory capital	7,047	7,471	3,093	3,707
Capital increases (3)	2,863	4,031	1,302	339
Supervisory capital	148,650	174,651	78,198	97,752
Solvency ratio (%)	11,6	10,6	11,4	10,0
Capital excesses	46,929	44,012	23,781	19,763
Capital shortfalls	145	15	–	–

(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 data on supervisory capital were heavily affected by the UniCredito Italiano group's acquisition of the German group HVB and the consequences of adopting the new international accounting standards. Excluding the UniCredito group, supervisory capital rose by about €800 million, equal to 0.6 per cent.

Leaving UniCredito aside, the banking system's tier-one capital increased by €2.3 billion. This was attributable both to self-financing and, to a smaller extent, to capital increases. The effect of the first-time application of IAS/IFRS was negative, mainly owing to larger write-downs of impaired loans. Supplementary capital increased by €1.1 billion. There was a substantial rise in deductions, mainly ascribable to the new implementing rules on shareholdings in insurance companies adopted after transposition of the financial conglomerates directive, which led to deductions rising by €4.1 billion.

The 8.8 per cent increase in risk-weighted assets led to a decline in the overall solvency ratio of 1 percentage point to 10.6 per cent, while that of the six main banking groups fell by 1.4 points to 10 per cent. Capital in excess of the minimum requirements amounted to €44 billion, €2.9 billion less than in 2004 (Table 65). The banking system's solvency ratio for tier-one capital alone fell from 8.6 to 7.9 per cent.

At the end of 2005 free capital was estimated to be €56.9 billion, compared with €40 billion in the previous year. The increase can be ascribed to the decline in net bad debts as a result of securitizations and the increase in the amount of capital associated with the UniCredito-HVB transaction. The rise in real estate assets was due in part to value adjustments made with the first-time adoption of the new accounting standards.

A comparison with European banks. – The findings of the annual Report on EU banking sector stability prepared by the Banking Supervision Committee of the European System of Central Banks indicate that in 2004, the last year for which comparable consolidated data are available, non-performing loans averaged 3.1 per cent of total lending in the euro-area countries. In Italy the ratio was 6.6 per cent, almost halved since the second half of the 1990s; in 2005 it declined further to 5.3 per cent.

As to profitability, the Italian banking system's cost/income ratio and return on equity amounted respectively to 57.9 and 10.6 per cent in 2004, compared with averages of 63.7 and 10.5 per cent for euro-area banks. The contribution of non-interest income to gross income was below the average; in 2004 it was equal to 38.8 per cent, compared with an average of 47.2 per cent for the area as a whole.

The capital adequacy of Italian banks and banking groups was slightly above the area average. At the end of 2004 the overall solvency ratio was 11.6 per cent and the solvency ratio for tier-one capital was 8.6 per cent, against euro-area averages of 11.5 and 8.4 per cent.

Results of the fifth Quantitative Impact Study of the new Capital Accord. – Towards the end of 2005 the Basel Committee on Banking Supervision conducted its fifth Quantitative Impact Study of the new Capital Accord on the balance sheets of banks in the leading countries. In all, some 380 banks took part in the exercise, over 200 of which from G10 countries.

The results for the 10 Italian banking groups that took part in the study were similar to the average data for the leading countries and in line with objectives. The minimum capital requirements under the new rules are much the same as those imposed by current regulations for banks opting for the new standard method and less strict for those adopting the advanced techniques.

Financial Sector Assessment Programme and stress tests. – Simulations were carried out by the Bank of Italy (for the entire banking system) and by the nine largest banking groups, accounting for 62 per cent of total assets, as part of the FSAP for Italy. Stress tests were conducted for the main risks (credit, liquidity and interest rate risk, the risk of a fall in equity prices, and exchange rate and country risk), together with simulations of sudden, major changes in the macroeconomic scenario (rise in the price of oil, drop in world equity prices, depreciation of the dollar against the euro) that do not take account of potential feedback effects and give only limited consideration to possible interrelationships between the macroeconomic variables.

The results of the tests, based on data for June 2005, indicated that on average the banking system's profits were sufficient to cover the losses caused by very severe tensions. In a few cases there might be a reduction in capital in excess of the minimum requirements, although coverage of the latter would nonetheless be assured.

Asset management companies

Profitability. – Asset management companies made net profits of €699 million in 2005, compared with €427 million in the previous year (Table 66), and return on equity rose from 25.5 to 39.3 per cent. The improvement came from the 10.3 per cent increase in commissions receivable for the management of own products and a smaller rise in fees payable (6.3 per cent).

Staff costs went up by 12.8 per cent in 2005. There was a similar increase in other operating expenses owing to higher IT costs (15.1 per cent) and larger outlays for other administrative services (9.8 per cent). The cost of outsourcing rose by 20 per cent compared with 2004.

The final outturn for 2005 reflected the reduction in extraordinary expenses, which had been particularly high in 2004 owing to the settlement reached by one of the leading asset management companies in connection with the Parmalat crisis.

Table 66

PROFIT AND LOSS ACCOUNT OF ASSET MANAGEMENT COMPANIES

(millions of euros and percentages)

	2004		2005		Percentage change
	Amount	Percentage (1)	Amount	Percentage (1)	
Revenue from management of own products	5,723	337.8	6,310	312.2	10.3
of which: from open-end funds	*4,764*	*281.2*	*5,014*	*248.1*	*5.2*
Revenue from management of others' products	263	15.5	273	13.5	3.8
of which: from open-end funds	*94*	*5.5*	*133*	*6.6*	*41.5*
Fees payable	4,292	253.4	4,562	225.7	6.3
of which: maintenance fees	*3,113*	*183.8*	*3,404*	*168.4*	*9.3*
Gross operating profit	1,694	100.0	2,021	100.0	19.3
Administrative expenses (–)	965	57.0	1,087	53.8	12.6
of which: staff costs (–)	*405*	*23.9*	*457*	*22.6*	*12.8*
Value adjustments to tangible and intangible fixed assets (–)	100	5.9	70	3.5	-30.0
Other operating expenses (–)	17	1.0	30	1.5	76.5
Total operating costs (–)	1,082	63.9	1,187	58.7	9.7
Other operating income	91	5.4	123	6.1	35.2
Net operating profit	703	41.5	957	47.4	36.1
Result on financial operations	129	7.6	171	8.5	32.6
Result on ordinary activities	832	49.1	1,128	55.8	35.6
Extraordinary income/expense	-131	-7.7	-7	-0.3	-94.7
Net change in provision for general financial risks	12	0.7	2	0.1	-83.3
Taxes (–)	286	16.9	424	21.0	48.3
Net profit (loss) for the year	427	25.2	699	34.6	63.7

(1) Amount as a percentage of gross operating profit.

The net profits of asset management companies belonging to Italian banking groups grew by just 9.1 per cent as a consequence of their specialization in less profitable traditional sectors. Overall, banks' asset management companies contributed net revenues to their groups amounting to more than €4.2 billion.

Supervisory capital and minimum requirements. – At the end of 2005 the supervisory capital of asset management companies amounted to €1,390 million, compared with €1,337 million in 2004. Tier-one elements amounted to €1,504 million, while supplementary capital and deductions amounted respectively to €9 million and €123 million.

Minimum capital requirements stood at around €344 million (€511 million in 2004), almost entirely in respect of "other risks", equal to 25 per cent of fixed operating costs. The decline was due to the implementation of the new rules, which cut the capital requirement based on the net asset value of open-end funds under management from 0.5 to 0.02 per cent of the total, bringing them into line with EC regulations. At the end of 2005 only two companies did not comply with the requirements, for a total of less than €1 million.

Investment firms

Profitability. – Italian investment firms made profits of €205 million in 2005, more than twice the figure for the previous year (Table 67). The improvement came mainly from an increase of 22.2 per cent in total revenues from investment services, over half of which from dealing for customer account and placement, which increased in volume by 28.6 and 44.2 per cent respectively.

Table 67

PROFIT AND LOSS ACCOUNT OF INVESTMENT FIRMS (1)

(millions of euros and percentages)

	2004		2005		Percentage change
	Amount	Percentage (7)	Amount	Percentage (7)	
Revenue from dealing for own account (2)	62	10.7	58	8.2	-6.5
of which: interest and dividends	*85*	*14.7*	*167*	*23.7*	*96.5*
Revenue from execution of orders on behalf of customers (3)	266	46.1	332	47.1	24.8
Revenue from individual portfolio management	113	19.6	124	17.6	9.7
Revenue from door-to-door selling	90	15.6	120	17.0	33.3
Revenue from other business (4)	33	5.7	57	8.1	72.7
Revenue from securities management (5)	13	2.3	14	2.0	7.7
Total revenue	577	100.0	705	100.0	22.2
Operating costs (–)	463	80.2	465	66.0	0.4
Net operating profit	114	19.8	240	34.0	110.5
Other income/expense (6)	31	5.4	32	4.5	3.2
Gross profit (loss) for the year	145	25.1	272	38.6	87.6
Taxes (–)	50	8.7	67	9.5	34.0
Net profit (loss) for the year	95	16.5	205	29.1	115.8

(1) Based on prudential returns. – (2) Includes net interest. – (3) Securities and foreign exchange trading, placement and collection of orders. – (4) Revenues from additional services (consulting, safekeeping and administration of securities, etc.). – (5) Result of securities management by investment firms not authorized to deal for own account. – (6) Includes allocations to provisions and extraordinary items. – (7) Amount as a percentage of total revenue.

The increase from around €10 billion to €16 billion in door-to-door sales of products boosted the related revenues by 33.3 per cent, while management of individual portfolios contributed an increase of only 9.7 per cent. The reduction of 20.3 per cent in the volume of trading for own account caused revenues to fall by 6.5 per cent. Operating expenses were basically unchanged from the previous year.

Capital and risks. – At the end of 2005 the supervisory capital of investment firms amounted to €689 million, compared with €706 million a year earlier. The decline was due to the closure of firms during the year: taking a constant sample, supervisory capital increased by around 3 per cent. The total capital requirements of investment firms amounted to about €161 million, compared with €183 million in 2004.

Financial companies

Credit risk. – There was a decrease in the mostly severely impaired loans: the ratio of new positions classified as bad debts to total outstanding loans declined from 2.5 to 1.5 per cent. There was a small increase in total new positions overdue by more than 120 days, from 6.1 to 6.2 per cent of loans outstanding at the beginning of the year.

The concentration of loan portfolios diminished further. The measures taken by the supervisory authorities helped to achieve a substantial reduction in the number of intermediaries with individual positions in excess of the current limit of 60 per cent of capital.

Profitability. – 2005 saw an improvement in the performance of financial companies. Net profits rose by 9.6 per cent to €1.1 billion.

Net interest income increased by 12 per cent to €3.7 billion, thanks to the rise in interest income as a result of the growth in the volume of business. A further contribution came from services, commissions on which boosted gross income by 11.5 per cent. Operating costs rose by 10.6 per cent; consumer credit companies recorded particularly large increases in their administrative expenses and distribution costs and also took on significant numbers of new staff (6.8 per cent).

Capital adequacy. – The supervisory capital of financial companies amounted to €10.8 billion at the end of the 2005, an increase of 7.7 per cent that was mainly due to self-financing. The ratio of leasing, factoring and consumer credit companies' supervisory capital to their risk-weighted assets was 7.9 per cent at the end of the year, close to the 7.7 per cent recorded in 2004. For leasing and consumer credit companies the ratios were respectively 6.3 and 5.1 per cent, mainly owing to large positions in junior notes from the securitization of their own claims. For factoring companies the ratio was 11 per cent.

SUPERVISORY ACTIVITY

Developments in supervisory action

Supervision of intermediaries with establishments abroad. – The growing internationalization of the Italian banking system requires greater coordination with supervisory authorities abroad, making it necessary to extend the sphere of cooperation, make the exchange of information systematic and increase the convergence of supervisory practices. For banking groups with substantial establishments abroad for which it is responsible for consolidated supervision, the Bank of Italy is consulting with the authorities of the main host countries to specify the functions and tasks of each authority, decide the procedures for the transmission of information and coordinate and plan the carrying out of controls. The main issues addressed concern the sharing of information necessary for the performance of the authorities' respective functions, including the exchange of evaluations of the situation of the group's various components and the performance of joint inspections at foreign subsidiaries; discussion of analytical methods; and cooperation in the validation of internal models.

Cooperation with other financial supervisory authorities. – The Bank of Italy began cooperation with Isvap, the supervisory authority for the insurance industry, for the performance of supplementary supervision on financial conglomerates. In November 2005 the two authorities concluded an agreement on the procedures for identifying financial conglomerates and the methods of calculating capital adequacy and stated their intention to reach additional agreements with the other institutions responsible for supplementary supervision. In March 2006 the agreement was signed jointly by the Bank of Italy, Isvap and Consob; Consob thereby formalized its adherence, which it had already agreed to in November 2005.

In the field of securities intermediation, the Bank of Italy and Consob, implementing Articles 4 and 5 of Legislative Decree 58/1998 (the Consolidated Law on Finance), had signed a protocol in July 1999 governing the procedures for the exchange of information and the granting of opinions required by the authorization procedures within the scope of their respective authority, with a view to rationalizing and coordinating the examination of applications for authorization and minimizing the costs incurred by intermediaries. In

December 2005 the two authorities began a revision of the protocol, which had been made public in the meantime, in order to adapt it to the Bank of Italy regulation of April 2005 concerning collective investment undertakings and asset management companies and to the Consob regulations implementing the European directive on investment funds.

Application of the new rules on capital adequacy. – The new directive on the capital adequacy of banks and investment firms (2006/49/EC), which incorporates the rules drafted by the Basel Committee, accompanies minimum capital requirements (first pillar) with controls by banks and the supervisory authority on the capital adequacy and overall functioning of the intermediary's procedures (second pillar) and strengthened disclosure requirements designed to favour discipline by the market (third pillar).

With regard to the first pillar, checks were run at eight banking groups, accounting for 50 per cent of the total assets of units operating in Italy, on the state of progress of the projects to bring internal rating systems into line with the standards established by the directive. The review was designed to obtain a picture of the management of the projects, the characteristics of the internal rating systems being created, and the time frame for implementing the planned measures.

The assessment, which involved corporate portfolios, found disparate situations. While project governance by top management was generally adequate and the statistical methods used were in most cases sufficiently reliable, weaknesses were discovered with regard to the quality of data, IT input procedures, the estimation of parameters for measuring losses in the event of default and the exposure at the time of default. Improvements were also found to be needed in the actual use of rating systems in the main phases of the lending process. The supervisory checks will be extended to other portfolios.

Following adaptation of the criteria for measuring doubtful debts to the new rules, reporting of past due and overdrawn positions began in June 2005.

In December 2005 the banks operating in Italy reported past due and overdrawn positions for a total of €15.8 billion, of which €5.8 billion between 90 and 180 days overdue and €10 billion more than 180 days overdue. The total amount was equal to 1.28 per cent of loans to non-bank customers (0.81 per cent the amount overdue by more than 180 days) and to 19 per cent of impaired loans, which also included bad debts and substandard and restructured loans. Past due and overdrawn positions exceeded 5 per cent of loans to non-bank customers at 39 banks, of which 29 were mutual banks.

The new prudential rules give all intermediaries greater scope to use credit-risk mitigation techniques in order to reduce the minimum capital requirements. The Bank of Italy invited all intermediaries to verify constantly the compliance of their organizational and management systems with the requirements for the eligibility of collateral and for the control of the other risks that its use may give rise to (legal, operational, liquidity and market risks). The Bank emphasized again that adaptation to the rules constitutes an opportunity to make collateral management more efficient and improve the prospects of credit recovery.

In the first quarter of 2005 a survey of the banking system was conducted to ascertain the method (basic, standardized or advanced) that banks intend to use to calculate the capital requirement against operational risks and determine the stage of development of the management of those risks in accordance with the type of method chosen. The survey covered 10 banks and 21 banking groups that participate in the collection of structured data on operational losses organized by the DIPO consortium promoted by the Italian Banking Association (ABI). One third of the intermediaries interviewed planned to use advanced methods.

The survey found more widespread awareness concerning the management of operational risks. Data sharing has assisted a structured process of data collection and verification, with the use of homogeneous criteria for identifying and classifying losses. It was found that intermediaries intending to use more sophisticated methods of calculation needed to increase the resources allocated to the project.

Supervision of banks and banking groups

Methods of analysis and inquiry. – For larger banking groups and those with a complex structure, an analytical procedure was designed that will produce a summary evaluation similar to that for individual banks. In addition, a method was devised that integrates numerous data sources and thereby makes it possible to classify the group’s entire loan portfolio by homogeneous types of risk, starting from the individual reports sent to the Central Credit Register by the group’s banking and financial components. Analysis can promptly pick up signs of deterioration in loan quality and detect discrepant valuations within the group.

In the field of securities intermediation, it is increasingly advisable to differentiate surveys in relation to the supervised entity’s type and operational complexity. During 2005 an analytical method targeted to banks and groups with significant securities intermediation operations was developed. It uses information additional to that offered by the current reporting format and, through stress-testing, checks whether capital is adequate to face particularly unfavourable market situations. The method is also used for periodic checks on the three banks whose internal models were validated for purposes of calculating the capital requirement against market risks.

With regard to business continuity, a new survey was made of the progress of the projects begun by intermediaries in order to adapt their emergency plans to the regulatory requirements. Disaster recovery plans for information systems had reached an advanced stage, whereas delays were found in the implementation of the projects designed to ensure the continuity of other critical processes. In addition, a draft regulation was prepared that would establish more stringent technical and organizational requirements for the largest operators in the field of payment services and access to the financial markets. A consultation on the draft regulation is being held with the main banking groups.

Evaluations of banks' situations. – The supervisory analyses performed during 2005, based on data for the 2004 financial year and available information for the first half of 2005, showed a reduction in banks with an anomalous overall situation. Favourable evaluations were made of 294 banks. The number of banks awarded partially favourable evaluations rose to 335. Unfavourable evaluations were assigned to 82 banks accounting for 9.2 per cent of the banking system's total assets; 28 of these belonged to banking groups.

The number of banks showing technical and operational anomalies has fallen significantly in the last ten years. In 1995 unfavourable evaluations were assigned to 158 banks accounting for 21 per cent of the system's total assets; 22 of them displayed acute problems.

The Bank of Italy continued the action it began in 2001 to promote the strengthening of the banking system's capital base by recommending capital ratios above the minimum for the first 13 banking groups: 6 per cent of risk-weighted assets for tier 1 capital and 10 per cent for total capital. At the end of last year 11 groups satisfied the target ratio for tier 1 capital, compared with 4 in December 2000, and 4 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 9.8 per cent.

Supervisory interventions. – In 2005 supervisory interventions were carried out at 372 banks through action letters or meetings called with banks' corporate officers. A total of 477 such meetings were held, half of them at the Head Office and half at the Bank's branches. Ample recourse was made to meetings for the further investigation of specific matters concerning, above all, banks' organizational structure and lending.

Reflecting the results of analysis of prudential reports, interventions in the form of action letters focused on the problems of risk limitation and on the improvement of risk measurement and management procedures. A significant proportion of the points raised regarded organizational issues, in particular the necessity of formulating strategic guidelines and preparing reorganization plans. During the year large-scale interventions were carried out at 23 banks (compared with 53 in the two years 2003-04), where on-site controls had revealed a significant deterioration in the company's situation.

At the end of last year 88 banks were required to satisfy a solvency ratio higher than the minimum. During the year the ordinary ratio was reinstated for two banks, while for seven other institutions the Bank of Italy reduced the specific ratio in the light of the progress made following reorganization.

The comprehensive revision of banks' bylaws in connection with the reform of company law gave rise to significant supervisory activity. Amendments to the bylaws of more than 500 banks were examined, most of them having to do with the required revision of the bylaws of banks formed as cooperatives to conform with the new provisions of civil law applicable to such intermediaries pursuant to Legislative Decree 310/2004. Banks showed little interest in using the newly introduced governance models or issuing special classes of shares.

The Bank of Italy examined 244 geographical expansion plans for the opening of a total of 880 branches; it denied authorization in 15 cases, on the grounds that the plan was incompatible with the applicant bank's situation. Virtually all the additions to branch networks were made in the domestic market; for expansion abroad banks availed themselves of the freedom to provide services without a permanent establishment, in non-EU as well as EU countries, or acquired local banks.

Controls on access. – Ten authorizations to engage in banking were issued in 2005. Most of the authorizations were for banks with traditional operations and a simplified organizational structure characterized by outsourcing of functions and business segments. Two were for specialized intermediaries. There were frequent cases of shareholding or marketing agreements with larger intermediaries, providing the newly formed banks with the necessary support during the start-up of business. Two applications were rejected during the year.

Mergers, acquisitions and spin-offs. – The Bank of Italy authorized 43 mergers, acquisitions and spin-offs during the year. Eighteen of the authorizations were for mergers and acquisitions of control of banks for the purpose of growth in size or penetration of new markets. Most of the remaining proposed operations were intra-group transactions set in the framework of plans for the rationalization of the business and simplification of corporate structures.

The complex affair that ended with the acquisition of control of Banca Antoniana Popolare Veneta (Banca Antonveneta) by the Dutch group ABN AMRO unfolded during the year. The Dutch group was long challenged for control of Banca Antonveneta by Banca Popolare di Lodi, which at the end of June was renamed Banca Popolare Italiana – Banca Popolare di Lodi (BPI).

The change of ownership originated with the termination of the shareholders' agreement in December 2004, with effect from 15 April 2005. The agreement covered 30.8 per cent of the capital of Banca Antonveneta, with ABN AMRO the largest single participant (12.7 per cent).

On 14 February 2005 the Bank of Italy authorized BPI to acquire up to 14.9 per cent of the capital of Banca Antonveneta.

On 30 March the ABN AMRO group asked the Bank of Italy for authorization to acquire control of Banca Antonveneta by means of a tender offer for all its shares and, simultaneously, for permission to exceed the shareholding thresholds of 15 and 20 per cent independently of the tender offer.

In early April BPI asked for authorization to increase its equity interest in Banca Antonveneta up to 29.9 per cent. On 7 April the Bank of Italy granted this authorization, on the basis of a capital strengthening plan submitted by BPI and with the proviso, already stated in the previous authorization measure, that the shares would be acquired in a gradual manner to ensure constant compliance with the capital requirements.

On 22 April BPI filed prior notification of a plan for the acquisition of control of Banca Antonveneta by means of an exchange tender offer. A preliminary evaluation dated 28 April found that the plan was very ambitious and not easy to execute but had business merits. In the final analysis, on the basis of the information available it was considered compatible with sound and prudent management. However, some important aspects remained to be clarified.

Since an exchange tender offer launched by a bank for control of another bank does not involve outlays of money, it generally does not have significant effects on the capital adequacy of the banks in question or on the financial sustainability of the transaction.

The authorizations to cross the 15 and 20 per cent thresholds were issued to ABN AMRO on 19 and 27 April and to acquire control on 6 May. The Dutch group's appeal to the Lazio Administrative Court against the authorizations granted by the Bank of Italy to BPI was rejected both in the ruling on the applicant's request for suspension of the authorizations (28 April) and in the decision on the merits of the case (13-19 July).

On 5 May BPI, after reaching 29.5 per cent of Banca Antonveneta's capital and obtaining the election of the candidates it had put forward for Banca Antonveneta's governing bodies by the shareholders' meeting of 30 April, applied for authorization to acquire control of the bank through an exchange tender offer.

On 10 May Consob found that an undeclared shareholders' agreement existed for the concerted acquisition of Banca Antonveneta shares and the exercise, individually or jointly, of a dominant influence over the bank. This made it mandatory for the parties to the shareholders' agreement to launch a cash tender offer.

Consob identified the following natural and legal persons as acting in concert: Banca Popolare di Lodi, Emilio Gnutti, Fingruppo Holding S.p.A., G.P. Finanziaria S.p.A., Tiberio Lonati, Fausto Lonati, Ettore Lonati and Danilo Coppola (through Finpaco Project S.p.A. and Tikal Plaza S.A.). Together they held 38.6 per cent of Banca Antonveneta's capital.

According to Consob's reconstruction of the events, the parties to the agreement made most of their acquisitions between December 2004 and February 2005 by buying shares from persons who had benefited from loans granted by Banca Popolare di Lodi with anomalous procedures. As a consequence, the voting rights attaching to the shares acquired by the persons acting in concert were suspended in May and June, the Bank of Italy opened sanction procedures against the parties to the undisclosed agreement and against BPI, and the Court of Padua annulled the resolution appointing Banca Antonveneta's governing bodies. In addition, the criminal justice authorities launched investigations.

On 17 May BPI, following the conclusion of a shareholders' agreement, requested the Bank of Italy for authorization to acquire control of Banca Antonveneta through a new operation, which included a cash tender offer for all of the bank's shares, as prescribed by law.

On 8 June the Bank of Italy suspended the time limits for the issue of authorization in order to acquire additional information on the ability of BPI's capital base to sustain the operation. On the 20th of the same month an inspection of BPI was initiated.

During May and June, upon examining the documentation transmitted by BPI the Bank of Italy found serious inconsistencies in the information provided by BPI concerning its capital. In particular, discrepancies were found between the notifications to the Bank of Italy and what was done in executing the different purchases and transactions to strengthen own funds, with the consequent emergence of a temporary, significant shortfall of BPI's capital ratio between the last ten days of April and the end of June. Accordingly, a sanction procedure was initiated in early July against the members of the bank's board of directors and board of auditors.

Against this background, on 8 July the competent supervisory departments of the Bank of Italy concluded their examination of BPI's application for authorization to acquire control of Banca Antonveneta with a negative opinion. The irregularities that Consob had ascertained to have been committed by BPI and its corporate officers were considered to vitiate BPI's ability to ensure the sound and prudent management of Banca Antonveneta in the capacity of controlling shareholder. In addition to possible adjustments as a result of the inspections being conducted, emphasis was laid on the serious uncertainty regarding the outlook for BPI's capital, notably with reference to the effects that would have emerged at the end of 2005 with the application of the new international accounting standards (IAS/IFRS) to the put options that BPI had issued to third parties on shares of group companies and to BPI's commitment to purchase the Banca Antonveneta shares held by the other members of the shareholders' agreement.

On 11 July, taking into account the documentation submitted by BPI, the report on the authorization application and the opinions of outside consultants who considered that the irregularities found at BPI were not an impediment to the issue of authorization, the Bank of Italy authorized BPI to acquire control of Banca Antonveneta through a cash and exchange tender offer. The authorization required BPI to take some steps in order to avert uncertainty regarding its prospective capital adequacy.

Nevertheless, further irregularities for which BPI was held accountable emerged after the authorization was issued.

On 22 July Consob ascertained the existence of another undeclared agreement between BPI and Magiste International S.A. and found that BPI had made repeated purchases of Banca Antonveneta shares through two foreign funds before 30 April 2005.

In connection with the penal proceedings under way, on 25 July the judicial authorities ordered the sequestration of the Banca Antonveneta shares belonging to the parties to the shareholders' agreement and on 1 August issued injunctions against the corporate officers of the bank who were involved in the case. On 27 July Consob ordered the precautionary suspension of the cash tender offer and the cash and exchange tender offer made by BPI. Subsequently, on 12 October, Consob declared them null and void.

At the end of July the supervisory inspection found credit derivative agreements, neither approved by the competent bodies nor reported to the Bank of Italy, entered into with the London branch of Deutsche Bank whose amounts, maturities and contract dates basically coincided with the disposals of minority shareholdings in group companies carried out by BPI during the months of May and June in order to have adequate capital to cover its investment in Banca Antonveneta. Subsequent reports by the inspectors clarified that the complex transaction actually annulled the contribution of the sales of the minority shareholders to the bank's capital base. In addition, repeated omissions in accounting records, supervisory reports and notifications to the Bank of Italy were found, as well as operational opacity and unreliability of the organizational structure, inadequacies of the internal control systems and significant shortcomings of the governing bodies.

Accordingly, the Bank of Italy suspended its authorization on 30 July and revoked it on 15 October.

The Governor of the Bank of Italy reported on the matter to the Interministerial Committee for Credit and Savings in two meetings held on 19 July and 26 August.

In early October ABN AMRO, whose previous tender offer had ended on 22 July with minimum acceptances, announced that it had concluded an accord with BPI and other parties to the shareholders' agreement for the purchase of shares that would bring its overall equity interest in Banca Antonveneta to above 50 per cent and filed a new application for the acquisition of control. Authorized on 18 October by the Bank of Italy, the Dutch bank acquired the shares held by BPI at the end of October; subsequently, the holdings of the other parties to the agreement were purchased and the further, mandatory tender offer was successfully completed. ABN AMRO currently holds approximately 99 per cent of the capital of Banca Antonveneta.

Following the resignation of BPI's managing director on 16 September 2005, new top executives were appointed and a major operational, organizational and accounting restructuring was begun. On 28 January 2006 the shareholders' meeting changed virtually all the members of the governing bodies and approved new financial statements for year ended 31 December 2004.

In support of the business plan for relaunching the bank approved by the new governing bodies, BPI recently decided a capital increase of approximately €720 million, over and above the increase of €1.5 billion carried out in July 2005 to finance the tender offer for Banca Antonveneta.

The other important transfer of control concerned Banca Nazionale del Lavoro (BNL). At the beginning of 2005 the ownership of BNL was marked by the existence of two opposing shareholders' agreements: the parties to the first included Banco Bilbao Vizcaya Argentaria (BBVA), Assicurazioni Generali and Dorint Holding S.p.A.; those to the second included Caltagirone, Statuto, Coppola, the Lonati brothers, Bonsignore, Grazioli and Ricucci. Both agreements covered holdings amounting to approximately 28 per cent of the bank's capital. The parties to a third shareholders' agreement were Monte dei Paschi di Siena (4.5 per cent) and Banca Popolare Vicentina (3.5 per cent).

On 29 March BBVA applied to the Bank of Italy for clearance to acquire control of BNL by means of an exchange tender offer; authorization was granted on 13 May for the acquisition of a holding of more than 50 per cent of the bank's capital. In response to a request for clarifications from the European Commission, the Bank of Italy specified that the authorization was to be understood as extending to dominant influence as defined in Article 23 of the Consolidated Law on Banking. On 14 July BBVA, which had submitted a request to this effect, was authorized to acquire up to 30 per cent of BNL's capital.

On 18 July the UNIPOL insurance group – which had already been authorized by the Bank of Italy to acquire up to 15 per cent of BNL's capital – entered into shareholders' agreements with other shareholders that, taken together, covered approximately 41 per cent of the bank's capital and thus triggered the obligation to make a cash tender offer for all the remaining shares.

On 29 July BBVA – whose exchange tender offer had closed unsuccessfully on 22 July – lodged an appeal with the Lazio Regional Administrative Court requesting the annulment of the authorizations granted by the Bank of Italy to UNIPOL to acquire up to respectively 10 and 15 per cent of BNL's capital.

On 4 August UNIPOL applied to the Bank of Italy for clearance to acquire control of BNL by means of a mandatory cash tender offer. Subsequently some essential parts of the application were corrected.

If successful, such a tender offer would have created a financial conglomerate in which the banking component would have been prevalent, so that the Bank of Italy would have been the supervisory authority responsible for coordinating supplementary supervision. In that capacity the Bank's duties would have included evaluating the conglomerate's compliance with the capital requirements laid down by Legislative Decree 142/2005, which called expressly for the continuous monitoring of such compliance.

As part of the assessments required under Article 19 of the Consolidated Law on Banking, the Bank of Italy accordingly checked UNIPOL's ability to guarantee compliance with the capital requirements introduced in the above-mentioned legislation to safeguard the stability of financial conglomerates.

The investigations carried out by the Bank of Italy required complex technical and legal analyses, since this was the first application of the new rules on supplementary supervision. Account also had to be taken of the imminent entry into force of the new international accounting standards (IAS/IFRS).

Close cooperation with Isvap, the supervisory authority for the insurance industry, led to the definition of procedures for the exercise of supplementary supervision on financial conglomerates; on 16 November a coordination agreement was signed regarding the measurement of capital and its adequacy.

In connection with the application of the new rules on supplementary supervision and annual accounts, the insurance company took several steps to raise additional capital. In particular, the final estimates of the conglomerate's capital adequacy were submitted to the Bank of Italy on 2 December.

In addition to legal matters, the cooperation with the supervisory authority for the insurance industry also concerned the requested authorization, in the form of a request by the Bank of Italy for Isvap's opinion on the aspects of the capital and financial soundness of the UNIPOL group falling within the scope of its authority. There was also an intense exchange of information with Consob, since UNIPOL was to acquire control of BNL by means of a mandatory cash tender offer.

The available documentation and data on the insurance and banking groups were examined by the Bank of Italy and Isvap to determine the capital adequacy of the proposed conglomerate. On 30 December Isvap sent its final opinion to the Bank of Italy.

The checks that the Bank of Italy made using IAS/IFRS revealed a significant shortfall in capital resources in the case of the maximum possible disbursement consequent on the tender offer, even after considering the UNIPOL group's proposed capital strengthening measures. In evaluating the capital items of the insurance component, the Bank of Italy took account of Isvap's observations.

Following the prescribed preliminary notification of the grounds for refusing the application on 10 January and the examination of the insurance company's submissions, on 3 February the Bank of Italy informed the

UNIPOL group that the conditions did not exist for granting the requested authorization.

On the same date BNP Paribas notified the Bank of Italy that it had concluded an agreement with UNIPOL and other BNL shareholders to buy approximately 48 per cent of the bank's capital; on 20 February it applied for clearance to acquire control.

On 20 March 2006, upon completion of its examination of the application, the Bank of Italy authorized BNP to acquire control of BNL. After it had acquired an interest of more than 50 per cent, on 21 April BNP made its mandatory cash tender offer for the remaining BNL shares. The tender offer closed on 16 May, with the French group owning 97 per cent of BNL's capital.

Supervision of asset management companies and investment firms

Methods of analysis. – The Bank of Italy has developed a method for analyzing the systems used by intermediaries to measure and control financial and operational risks.

A start has also been made on a project to devise instruments with which to analyze the organizational arrangements of asset management companies specialized in hedge funds. A series of meetings were held with management companies to examine their manner of selecting investments, relations with consultants and methods of measuring financial risks; in view of the prevalence on the Italian market of funds of hedge funds, the checks focused mainly on the process of selecting the funds in which to invest.

Last year saw the asset management companies belonging to the leading Italian banking groups submit plans for entrusting – pursuant to Article 38, paragraph 1, subparagraph a-*bis*) of the Consolidated Law on Finance – their depositary bank (which normally belongs to the same group) with the task of calculating the value of fund units.

Analysis of intermediaries' situations. – The supervisory evaluations of intermediaries for 2004 and the first half of 2005 show an improvement in the average overall scores. For investment firms, in particular, the improvement reflects the upturn in profitability and the deletion from the register of firms with major technical and organizational weaknesses.

The number of intermediaries found to have anomalous situations fell from 37 to 30 (23 investment firms and 7 asset management companies);

in 24 cases the unfavourable assessment confirmed that of the previous year. The 23 investment firms whose situations were anomalous accounted for 16.7 per cent of the sector's gross revenues, down from 18.5 per cent in 2004. The share of total assets under management accounted for by asset management companies whose situations were anomalous was again marginal (0.13 per cent). Among the intermediaries with intermediate scores, the Bank of Italy identified 20 as needing action to prevent the situation from deteriorating; in 2004 it had identified 18 such cases.

Supervisory interventions. – In 2005 the Bank of Italy sent 199 action letters to intermediaries and held 129 meetings with corporate officers; these measures involved a total of 190 intermediaries (115 asset management companies and 75 investment firms). Thanks in part to the increasing participation of the Bank's branches, between 2001 and 2005 the number of interventions rose from 130 to 328, while the number of intermediaries subject to supervision remained basically unchanged.

A total of 42 requests for change of ownership were examined, 20 for asset management companies and 22 for investment firms. The most important of these transactions concerned the top-ranking fund manager in the Italian market (Nextra Investment Management SGR, subsequently renamed CAAM SGR), control of which was transferred from Banca Intesa to the French Crédit Agricole banking group.

Access to the market. – In 2005 the Bank of Italy issued 443 clearances for intermediaries and products, up from 377 in 2004. A total of 115 meetings were held to examine the technical and legal aspects of the more complex initiatives.

The Bank examined 24 applications for inclusion in the register of asset management companies; most of these initiatives were in the more innovative sectors. In view of the high level of outsourcing of management companies' functions, the checks carried out mainly concerned the adequacy of the human and technical resources serving to ensure the effective management of organizational risks.

A total of 126 notifications were received regarding the distribution in Italy of new funds and sub-funds of harmonized foreign funds pursuant to Directive 85/611/EEC. In each case the Bank of Italy evaluated the adequacy of the organizational arrangements intended to ensure investors resident in Italy would be able to exercise their administrative and property rights.

Supervision of financial companies

Analysis of companies' situations. – In 2005 there were 26 financial companies whose situations showed anomalies, down from 30 in 2004. Their share of the total assets of the financial companies subject to supervision nonetheless rose, from 9.8 to 11.6 per cent, owing to the worsening of the situations of three large companies. The number of companies with intermediate scores decreased from 26 to 22 and their share of total assets declined from 19.8 to 17.8 per cent.

Supervisory interventions. – A total of 185 supervisory interventions were carried out; the majority (127) consisted of meetings with corporate officers at the Bank of Italy's Head Office or one of its branches.

Inspections

On-site activity. – In 2005 normal on-site activity was supplemented by that deriving from the new rules on capital adequacy, which involved visits to some banking groups to check on the preparations for the adoption of methods of credit risk measurement based on the use of banks' own internal rating systems.

The Bank of Italy initiated 195 inspections in 2005 (compared with 209 in 2004), with those performed by branches numbering 136. Inspections lasted 49 days on average, up from 47 in 2004.

Inspections of a comprehensive nature or restricted to specific sectors – excluding those concerned with rating systems – involved 162 banks accounting for 19.8 per cent of the banking system's total assets (14 per cent in 2004). The inspections carried out in the three years 2003-05 involved a total of 526 banks (518 in the three years 2000-02) accounting for 56.1 per cent of the banking system's total assets (47.9 per cent in the preceding three years).

In accordance with procedures that have now been well tested, inspections at larger and more complex banks were on a sectoral basis, while those at other banks covered the whole range of their operations.

Inspections at six of the leading banking groups focused on banks specialized in distribution, product companies or specific areas of risk; in some cases the investigations covered important components of the group's international networks. In response to requests made by Consob pursuant to Article 10.2 of the Consolidated Law on Finance, in two cases the investigations also concerned the distribution of OTC derivatives to non-financial clients.

In addition, 30 reports were sent to Consob on irregularities that inspections revealed in banks' performance of investment services or in the conduct of agents.

The distribution of the results of inspections shows that favourable and partially favourable assessments were equally divided and together accounted for 87 per cent of the total. The unfavourable assessments referred to 21 banks (13 per cent) that accounted for 2.36 per cent of the banking system's total assets (0.25 per cent in 2004).

The unfavourable assessments reflected anomalous situations with regard to banks' operating results and financial condition caused by inconsistent growth strategies, shortcomings in the activity of the governing bodies and weaknesses in internal control systems.

As for mutual banks, 16 of the 126 inspected received unfavourable assessments (13 per cent, as in 2004). Over the last five years the percentage of unfavourable assessments has halved.

Ten inspections were carried out pursuant to the Consolidated Law on Finance, as against 14 in 2004; they involved 6 investment firms and 4 asset management companies. Twelve inspections were carried out at financial companies entered in the special register referred to in Article 107 of the Consolidated Law on Banking, as against 15 in 2004. Of these inspections 3 were carried out by branches.

Three inspections were carried out in the depositary bank sector in relation to the changes in the rules, including that allowing more tasks and responsibilities to be assigned in connection with the valuation of clients' investment fund units.

Crisis procedures

Special administration and compulsory administrative liquidation of banks. – In 2005 four special administration procedures were initiated involving mutual banks. Three of these (Cassa Raiffeisen di Rifiano – Caines, BCC Adriatico Teramano and BCC del Nord Barese) had recorded large deteriorations in their operating results and capital ratios as a result of serious organizational shortcomings and numerous operational irregularities, primarily in their lending business. In the case of BCC Sofige Gela serious administrative irregularities were found as well as serious violations of rules and regulations.

Two special administrative procedures initiated in 2004 were concluded in 2005. At the end of the year there were 4 such procedures under way.

At 31 December 2005 there were 22 compulsory administrative liquidation procedures under way. Five of these (involving Banca Popolare di Catanzaro, BCC del Baianese, BCC di Volturara Irpina, BCC del Tirreno – San Ferdinando and BCC Valle dell'Irno) had basically been completed, since the final liquidation accounts were filed, with the Bank of Italy's approval, early in 2006.

The compulsory administrative liquidation of Sicilcassa continued with the recovery of claims, as in the past primarily through out-of-court settlements, which permitted faster results than legal proceedings.

Other proceedings. – The collection company Società per la gestione di attività (SGA) continued to recover the impaired assets it had acquired from Banco di Napoli and Isveimer. Its annual accounts for 2005 closed with a profit of €15 million.

Last year saw further progress in the realization of Isveimer's assets and the extinction of its liabilities.

Special administration and compulsory administrative liquidation of investment firms. – Last year saw Bregliano SIM placed under special administration for serious irregularities, violations of the law on the provision of investment services and a large loss. The special administration of Financial Consultants Brokers SIM was concluded during the year with the resolution of the shareholders' meeting to put the company into voluntary liquidation.

At 31 December 2005 there were 11 investment firms in compulsory administrative liquidation; the statement of assets had been drawn up for all these procedures and in all but two cases partial allotments or restitutions of clients' monies had been made. The duration and outcome of procedures of this kind depend mainly on the settlement of the related legal disputes, which in some cases prevent allotments and restitutions.

The protection of transparency in banking and financial transactions

Action continued to verify compliance with the legislation on the transparency of contractual conditions. Bank of Italy branches made checks at 1,046 branches of 150 banks, compared with 844 branches of 158 banks in 2004. They also examined about 300 banks' information sheets on products and services.

Last year also saw checks carried out at 101 branches of Poste Italiane S.p.A., which is required to comply with the rules on transparency in the performance of its bancoposta banking activity pursuant to Presidential Decree 194/2001.

Upon completion of the transparency checks and information sheet examinations appropriate supervisory interventions were decided, depending on the seriousness and nature of the infractions. In particular, administrative sanction procedures were initiated against 7 banks (16 in 2004), while another 118 banks were invited to improve their compliance with the rules (62 in 2004).

The Bank of Italy continued to make checks on the notices announcing changes in contractual conditions to the detriment of customers that banks publish in the *Gazzetta Ufficiale*. A total of 22 banks were invited to comply with the law because they had made changes with retroactive effect with respect to the date of publication of the notice; the number of such banks in 2004 was 25. Where banks were found to have actually applied the new conditions retroactively, they were invited to return the amounts in question to their customers. More generally, the Bank of Italy called on the various trade organizations to increase the banking system's awareness of the need to comply with the relevant legislation.

The transparency checks carried out as part of ordinary on-site inspections found irregularities at 54 mainly small banks and 3 financial companies entered in the special register. Sanction procedures were initiated in 13 cases.

Access to the securities markets

More than 1,600 notifications of issues and offerings of securities were examined last year, as in 2004. Notifications concerning the placement of foreign securities rose from 48 to 58 per cent of the total.

A total of 125 transactions were blocked (110 in 2004). Most of these cases involved structured securities with complex derivative components that made it hard to understand the relationship between risk and return or to compare the securities with others already present on the market. In some cases the proposed transactions contained features that did not comply with the rules on the solicitation of investors.

According to the results reported to the Bank of Italy pursuant to Article 129 of the Consolidated Law on Banking, Italian banks' bond issues on the domestic market amounted to €102.8 billion in 2005, down by 9 per cent on 2004. Issues of securities by non-banks declined from €5.6 billion to €5 billion, of which 68.4 per cent consisted of issues by local authorities.

The foreign securities placed in Italy amounted to €235.5 billion, a substantial increase on the €73.7 billion recorded in 2004. Of the securities placed, 75.6 per cent were bonds – almost all of which paid a fixed rate or coupons indexed to the most commonly used market parameters – and 19.4 per cent were certificates, derivatives whose underlyings are mostly shares and stock market indices. Banks and other financial companies were the main issuers of foreign securities, while residents of emerging countries played only a marginal role.

A total of 44 securitizations under Italian law were notified to the Bank of Italy pursuant to Article 129 of the Consolidated Law on Banking and cleared. The corresponding issues of asset-backed securities amounted to €38.4 billion, a substantial increase on the €29.1 billion recorded in 2004 that reflected the growth in the average size of the transactions. The most important involved public-sector credits and leasing instalments originated by banks and financial companies entered in the special register referred to in Article 107 of the Consolidated Law on Banking.

As regards structured finance transactions, Cassa Depositi e Prestiti S.p.A. and Infrastrutture S.p.A. issued covered bonds for a total of €6.9 billion.

In 2005 the Bank of Italy, together with the European Central Bank and other national central banks belonging to the ESCB, cooperated with market players on the Short-Term European Paper (STEP) initiative, which is shortly to be launched. The aim of the initiative, promoted by the Financial Markets Association (ACI), is to create a Europe-wide market for short-term paper issued by financial intermediaries and firms.

Sanctions

The proposals submitted by the Bank of Italy to the Minister for the Economy and Finance for the imposition of administrative fines for irregularities discovered in the course of supervision rose from 63 to 80. The decrees imposing fines issued by the Minister for the Economy and Finance fell from 85 to 71. A total of 17 decrees were appealed to the Court of Appeal, unsuccessfully in almost every case.

The procedures for the imposition of administrative fines referred to in Article 145 of the Consolidated Law on Banking and Article 195 of the Consolidated Law on Finance were modified during the year, by Article 26 of Law 262/2005 and Article 9 of Law 62/2005 respectively.

Cooperation with the judicial authorities and other governmental bodies. The prevention of financial crime

Last year saw the Bank of Italy cooperate intensely with the judicial authorities and the investigative bodies responsible for preventing and repressing criminal activity in the financial sector. To some extent this cooperation reflected the complexity of the cases before the courts involving intermediaries subject to supervision.

A total of 582 requests for data, information and documents were received, down from 715 in 2004. In some cases the requests were for the reports prepared at the end of inspections.

The Bank transmitted 22 reports to the judicial authorities on suspected penal offences discovered in the course of supervisory controls. In addition, four inspection reports were turned over to the Direzione Investigativa Antimafia under special cooperation agreements.

The analysis of the financing of international terrorism continued, together with the exchange of information among the members of the Financial Security Committee. In the latter respect the Bank of Italy both provided technical support and liaised for the banking and financial system.

During 2005 the Bank of Italy received 157 requests for information in connection with the preparation of responses to parliamentary questions.

COMPETITION POLICY IN THE BANKING SECTOR

Throughout 2005 the Bank of Italy continued to promote competition, analyze its dynamics and study its effects on the markets for banking products.

Two investigations were completed during the year, one involving the payment system and the other the standardized contract covering third-party guarantees for bank transactions drawn up by ABI (see "The activity of safeguarding competition" section in this chapter of last year's Report).

Article 19 (11) of Law 262/2005 abrogated paragraphs 2, 3 and 6 of Article 20 of Law 287/1990 assigning the Bank of Italy antitrust powers for the banking industry. On 12 January 2006 these powers passed to the Antitrust Authority, with which arrangements were made to hand over the ongoing investigations.

The development of competition

At the beginning of the 1990s banks controlled by the Treasury or by banking foundations held almost 70 per cent of total assets. The system was split into a multitude of banks, all small by international standards, many of which engaged in traditional banking business within a restricted geographical area.

Privatization reduced the assets of banks whose foundations held over 50 per cent of their capital to 9 per cent of the total. It also led to a far-reaching transformation that encouraged the banking system to improve its operational efficiency. Once the ownership of banks became contestable, the financial market's discipline over their management increased.

In parallel with the privatization of banks, domestic markets began to open up in response to provisions eliminating the administrative restrictions on entry and geographical expansion. Competition was further promoted by the creation of the single European market for banking services and the liberalization of capital movements.

Banks reacted to the increased competition in a number of ways: by enlarging their scale of operations and broadening their range of services, especially in the field of professional asset management; by honing their risk management techniques; and by investing in technology to improve productivity.

The consolidation of the banking system was not prejudicial to competition. The entry of new operators in local markets and the increasing overlap of banks' distribution networks have been beneficial to the development of competition.

Although the total number of banks has fallen from 1,064 to 784 since 1990, the average number per province has risen from 29 to 36; there are 31,501 bank branches in Italy, over 14,000 more than in 1990. This is equivalent to more than 5 branches per 10,000 inhabitants, which is in line with the figures for the other main European countries. The Herfindahl-Hirschman index of concentration for regional loan markets on a consolidated basis has declined by more than 22 per cent from its peak at the end of the 1990s; that for provincial deposit markets has dropped by 14 per cent.

The effects of competition are apparent in the narrowing of the spread between lending and deposit rates and in the redistribution of market shares. In the deposit-taking and lending sector, product standardization (now well-established) and legal transparency requirements make it easier to compare terms and conditions and help customers reach well-informed decisions. In some areas associated with asset management, where it is harder to compare terms, the effects on charges have been less marked.

In December 2005 the interest rate on new loans to firms was 3.6 per cent in Italy, while the annual percentage rate of charge (APRC) on new loans to households for home purchases was 4 per cent. Both were in line with the averages for the euro area.

Since the middle of the 1990s, the average annual rate of change in market shares, excluding the effects of mergers and acquisitions, has been 3.5 per cent for deposits and over 5 per cent for loans; it is 5.5 per cent for households' mortgage loans.

In the field of professional asset management, the last decade has seen a substantial reduction in investment funds' entry and exit fees. By contrast, the management and performance fees that asset management companies charge directly to the funds have fluctuated, tending to rise slightly in more recent years. Some 70 per cent of the fees collected by asset management companies are used to pay their group's distribution network.

Foreign banks are a potential source of increased competition; they have progressively enlarged their operations in Italy. In addition to wholesale banking (assistance in bond and share issues, syndicated loans, consultancy on mergers, acquisitions and corporate restructuring), they have expanded their retail services, notably as regards mortgage loans and consumer credit.

In the retail market, banks are facing growing competition from Poste Italiane. In December 2005 current accounts held by customers with BancoPosta accounted for around 13 per cent of the total for the banking system. Moreover, with more than 5 million cards outstanding, BancoPosta is the largest issuer of debit cards in Italy.

The profound structural changes in Italy's banking system were highlighted in the International Monetary Fund's annual report for 2005, prepared in compliance with Article IV of its Statute, and in its financial system stability assessment. According to the Fund, the competition and performance indicators for Italy's banking system are basically in line with those of the other main European countries.

Enquiry into banking and financial services

In December 2004 the Bank of Italy, working in close cooperation with the Antitrust Authority, opened an enquiry pursuant to Law 287/1990. Its purpose was to verify the charges and procedures involved in closing the main retail banking and financial services, with special reference to current accounts and the safekeeping and administration of securities.

In order to gather information on the economic and other contractual terms and conditions applied to closures, in 2005 the Bank of Italy's branches carried out on-site inspections at 300 branches belonging to 88 banks. The terms and conditions applied to more than 2,500 current accounts closed in the year prior to the inspection were examined. The findings were submitted to the Antitrust Authority, which issued an order on 18 January 2006 opening an investigation into the charges for banking services.

The inspections, which were conducted among a small but statistically significant sample of bank branches, represented only the preliminary stage of the enquiry and follow-ups are envisaged. The findings therefore must not be regarded as conclusive.

The results indicated that the average charge for closing a current account was €34. For 75 per cent of the accounts closed the charges did not exceed €50; for 30 per cent no charge was made. Charges in excess of €75 were found for 6 per cent of the closures.

The survey showed a very wide variation in tariffs for keeping and handling accounts. In 46 per cent of the cases examined transactions were made free of charge against payment of a yearly tariff, which, after tax and deduction of expenses for compliance with transparency rules, amounted to about €76, inclusive of Bancomat debit card costs.

The rest of the accounts were charged a fixed yearly tariff that averaged €66 and included a limited number of free transactions; these amounted on average to 70. The accounts were also subject to an additional yearly management charge depending on the number of transactions made. Assuming (probably as an overestimate) an average of 125 transactions, which is the figure for the whole banking system derived from prudential reports, on the basis of the terms and conditions applying to each account (free transactions and tariff) the additional charge averaged about €100 a year.

In addition, both types of current account were subject to extra charges for specific services, such as credit transfers, cash advances from other banks' ATMs and direct debts. Assuming average use of these services, the extra cost came to around €38 a year.

Contracts for the safekeeping and administration of securities were examined to assess the amounts charged to customers to transfer positions. In only 190 out of some 1,500 securities accounts closed (approximately 13 per cent) were the positions transferred to another bank. The average amount charged for transferring customers' securities was €101, rising to €136 when inter-group transfers are excluded. The average charge found for purchases of securities belonging to a single issue was €39; it was over €50 in 25 per cent of the cases examined.

The safeguarding of competition

Since 1990 the Bank of Italy has examined a total of around 780 concentrations and several agreements between banks. This activity, which involved the analysis of the product markets and geographical areas covered by the banks in question, led to 57 investigations, a considerable number not only by international standards but also compared with other sectors of the national economy. The investigations looked into 23 concentrations, 29 agreements and 5 alleged abuses of a dominant position.

Concentrations. – In 2005 a total of 28 concentrations were examined by the Bank of Italy pursuant to Law 287/1990. It was found that nine did not fall within the scope of the provisions and the remaining 19 did not restrict competition in the relevant markets. The Antitrust Authority agreed with these findings.

Agreements between banks. – Many of the 29 investigations conducted found the agreements to be detrimental to competition and resulted in their amendment. Particular focus was placed on the standard format of contracts for customer transactions and services drawn up by trade associations. The Bank ordered the elimination of all the clauses designed to fix prices or make consumers' choices difficult.

More than half of the enquiries into agreements concerned the payment system, a sector in which cooperation within the context of trade associations may be essential to guarantee links between operators and widespread availability of the services. Authorization was granted for interbank agreements considered necessary to ensure the operation of the sector and allow consumers access to widely-used products, such as credit and debit cards.

The review of the interchange fee for the PagoBancomat debit card service. – In 2005 the method of calculation of the PagoBancomat interchange fee presented by Cogeban in compliance with the Bank of Italy's Decision no. 49 of 1 July 2004 was examined. Cogeban's Board of Directors passed a resolution introducing, as of 1 January 2006, an interchange fee of €0.18 plus 0.1190 per cent of the amount of the transaction, to remain in force for the period 2006-07.

Proceedings for breach of "multi-bank" principles. – The Bank of Italy's Decision no. 54 of 30 March 2005 ordered Cogeban to set up, by 1 October of last year, a new system for managing PagoBancomat transactions based on multi-bank principles. According to these, retailers that have arrangements with PagoBancomat should be allowed to send information on transactions made at a given POS to several banks instead of dealing with just one. In this way, payments made with PagoBancomat could be directed to the bank that had issued the card, possibly reducing the processing costs. Cogeban pointed to the operational difficulties encountered in attempting to comply with the requirements but did not offer any clear indication of the preparation of a suitable plan.

In Decision no. 283/A of 22 October 2005 the Bank of Italy charged Cogeban with violation of Article 15 (2) of Law 287/1990 for failure to comply with Decision no. 54 of 2005. The records of the proceeding were transferred to the Antitrust Authority, which on 15 February 2006 issued an order setting 28 April 2006 as the deadline for completion of the enquiries. This was postponed to 7 July 2006 by a decision of 4 April.

The renewal of exemptions for Bancomat debit cards, automated bank receipts (Riba) and direct debits (RID). – In July 2005 ABI and Cogeban applied for renewal of the exemptions granted under Article 4 of Law 287/1990 for multilateral interchange fees on collection and payment services: Bancomat debit cards, automated bank receipts (collection order, collection order via agent, advice of non-payment) and direct debits (commercial payment, utilities payment, express payment).

In order to evaluate whether the agreements notified to the Bank of Italy could have serious repercussions on trade between member states, in September 2005 the deadline for opening an investigation established by Law 287/1990 was suspended and the parties were asked to report on the development since 1993 of cross-border supply of and demand for the services concerned and of the participation of branches and subsidiaries of foreign banks in the associated interbank agreements. The parties were also asked to indicate whether the services were designed to be available only in Italy, their importance in the decision of foreign banks or financial institutions to enter Italy, and the likelihood of a debit card network being set up in Italy in competition with the Bancomat system.

The documents relating to ABI's and Cogeban's application were transferred to the Antitrust Authority, which issued a Decision on 29 March 2006 opening an investigation under the terms of Article 81 of the EU Treaty that is to terminate on 31 March 2007.

MARKET SUPERVISION

In 2005 further mergers were carried out and cross-border cooperation agreements made between trading systems for financial instruments. In the field of settlement and guarantee services, the corporate and technological integration projects initiated in the preceding years proceeded. Competition between system operators increased. The trend towards the demutualization of market infrastructures and their operation by profit-making corporations was confirmed.

At Community level, the definition of the legal framework for the creation of the single market in financial services is proceeding. A White Paper has been published on the strategies to be implemented in the next five years. At the beginning of May a study by the EU Commission underscored the boost to economic growth that would derive from greater integration of European clearing and settlement systems.

In Italy the law on the protection of savings confirmed the Bank of Italy's supervisory powers with respect to markets in financial instruments and central securities depositories under Part III of the Consolidated Law on Finance.

Italian market and market-infrastructure operating companies have developed strategies for growth in size, process innovation and expansion of their range of services. A recent European Commission study shows that the cost of trading, clearing and settlement services in the Italian share market is the lowest among the Union's financial marketplaces.

International cooperation

In February 2005 the Joint Forum of international financial supervisory organizations published *Outsourcing in financial services*, a report examining the implications and risks for supervised entities of entrusting third parties on an ongoing basis with the performance of activities of major importance for their own operations.

The Financial Stability Forum began a consultation on a document titled *High-level principles for business continuity*, which will eventually provide guidelines for national legislation and practices to ensure the operational continuity of systems in the event of disasters.

As part of the Financial Sector Assessment Programme, in March 2006 the IMF published its report on the Italian financial system. The Fund found a high degree of conformity of the Italian structures with the international standards for the sector (IOSCO, *Principles for Securities Regulation*, and CPSS-IOSCO, *Recommendations for Securities Settlement Systems*).

The Bank of Italy will periodically check the compliance of the financial markets' infrastructures with the standards agreed in the fora for international cooperation.

European legislation

In December 2005 the European Commission published a White Paper on the strategies it proposes to implement in the next five years in the financial services sector.

In June the Commission published a report describing the configuration of market infrastructures and, in particular, the links and agreements existing between trading systems and settlement and guarantee systems. The Commission is conducting further analysis on the basis of a fact-finding survey of European operating companies. In Italy the Antitrust Authority began examining competitive aspects of Italian trading and post-trading services.

No decision has yet been made regarding the issue of a directive governing the freedom to provide guarantee and settlement services on the basis of common requirements.

Following the publication in October 2004 of the preliminary report on European standards for securities clearing and settlement, the joint working group set up by the European System of Central Banks and the Committee of European Securities Regulators completed the adaptation to the European context of the CPSS-IOSCO Recommendations for Central Counterparties (published in November 2004 by the BIS and IOSCO).

Italian legislation

Law 62/2005 transposed Directive 2003/6/EC (the Market Abuse Directive) into Italian legislation; it amended the Consolidated Law on Finance as regards insider trading, market manipulation and sanction procedures. On a general basis, the Bank of Italy and Consob took over the powers of sanction previously assigned to the Minister for the Economy and Finance with regard to regulated markets, organized trading, central securities depositories, and guarantee and settlement systems.

In line with the regulatory practices of the main countries and in conformity with international standards, the Bank of Italy, in agreement with Consob, issued guidelines for the management of outsourcing of activities of major importance for the operation of markets and settlement and guarantee systems.

The wholesale market in government securities

The cash market. – The volume of trading on the MTS cash market fell further in 2005, reflecting a contraction in inter-dealer transactions due to the thin margins on market-making and low price volatility. The decline, which concerned all categories of government securities except BOTs, was accompanied for the first time by a modest widening of the bid-ask spread. The number of market participants fell again in 2005; participation in the market is tending to be reduced to larger specialized intermediaries. The concentration of activity among dealers diminished. There was a sharp increase in trades settled via central counterparties.

Despite expectations of rising interest rates, the prices of CCTs weakened owing to large-scale selling by institutional investors. This problematic situation was reflected in the quantities quoted and bid-ask spreads. The uncertainties affecting this segment were probably due to the competition of other indexed or structured products.

A significant increase in the supply of index-linked securities was recorded in the euro area and in other countries, such as the United Kingdom and the United States, which took advantage of the demand from institutional investors especially as regards longer maturities.

The repo market. – After the large increases recorded in the previous years, turnover on the MTS repo market declined slightly in 2005. Despite the greater utilization of central counterparties, which ought to favour the lengthening of maturities for hedging counterparty risk, there is a persistent tendency to use the Italian platform for transactions of limited duration (almost exclusively one day).

In 2005 MTS S.p.A. introduced a new electronic platform in the repo market that allows more flexible trading procedures.

BondVision. – Transactions on this wholesale market for trades with institutional customers, operated by MTS S.p.A., rose appreciably, with average daily turnover surpassing the high levels reached in the preceding years. A contribution came from the greater number and increased trading of foreign participants. The largest increases in trading involved European government securities (French and Belgian issues in particular). The internationalization of BondVision was enhanced by the expanded supply of tradable products.

The interbank deposit market (e-MID)

In January 2005 e-MID S.p.A. introduced a new electronic platform permitting more flexible trading procedures and easier access to the different segments of the money market.

Turnover in euro funds grew by 5 per cent, most markedly for very-short-term maturities other than the overnight maturity, thanks to the larger contribution of foreign intermediaries and the large-deal segment. The degree of concentration of market volume declined slightly. Turnover in dollar funds was in line with that of the previous year.

In 2005 the market again reflected the monetary conditions in the euro area effectively and promptly. Moments of tension – marked by a slight widening of bid-ask spreads – occurred only towards the end of November, when the ECB decided to raise reference rates.

Post-trading systems

European post-trading systems increased their business and expanded the range of services offered to participants. The adaptation of settlement procedures to TARGET2 is continuing. The development of links and the interoperability between European guarantee and settlement structures are not keeping pace with the growth in cross-border transactions; the handling of such transactions increasingly tends to be concentrated at specialized international intermediaries.

Monte Titoli S.p.A. and Cassa di Compensazione e Garanzia S.p.A. strengthened their ability to interact with foreign markets and clearing and settlement systems.

Central securities depositories

Like the other main European central securities depositories, Monte Titoli recorded significant growth in business in 2005. The company was again the third-largest depository in Europe by value of securities held. The number of participating intermediaries decreased again in 2005, reflecting the continuing trend among both foreign and Italian operators to use specialized intermediaries for access to central depository and settlement services.

Settlement of securities transactions

Net settlement. – Last year saw further growth in the activity of Express II, the system for the settlement of transactions in financial instruments operated by Monte Titoli.

The daily average of transactions settled on the due date was in line with the levels of the previous year. The system ensured the completion of all the operational phases even on the days when there was a significant shortage of the securities and cash due by participants. However, there was a gradual shift of the actual time of settlement from the overnight to the daytime cycle. This development, which appears to be attributable mainly to an increase in cross-border transactions by participants, tends to shorten the time available for the completion of the phases of the settlement process. Accordingly it requires that timely adjustments be made to the system's technology and organization and, if necessary, its architecture.

Some operational anomalies have revealed the need for improvements to the settlement system, most notably with regard to the technological component.

On 31 January 2006, in particular, a significant shortfall of securities precluded full activation of the arrangement for automatic collateralization in Express II's overnight cycle, leading to a spike in the amount of fails. The backlog of transactions pending settlement affected the operations of the following days. A revision of some procedures is now under way with a view to strengthening the system's operational capacity at moments of tension.

The number of participants in the settlement system continued to diminish in 2005, paralleling the trend for central depository services. In the net settlement component it decreased from 143 at launch (end of March 2004) to 126 at the end of 2004 and 121 at the end of 2005.

Gross settlement. – The results of gross settlement improved in 2005. While both the value and the number of transactions handled by the system rose considerably, the queuing time for settlement shortened and the proportion of transactions pending settlement at the end of the day decreased.

As with the net component, the concentration of transactions per participant rose further. The proportion of transactions settled directly on the cash accounts of agent banks remained about the same.

The number of participants in the gross settlement service fell from 131 at the end of 2004 to 129 at the end of last year. This was a direct consequence of the decline in the number of participants registered by the gross component of Express II.

Clearing and guarantee services

Cassa di Compensazione e Garanzia (CC&G) recorded growth in business on both the equity market and the bond market. The amount of average daily margins collected rose by 71 per cent. The good performance of the markets guaranteed by CC&G and the increase in the number of intermediaries using a central counterparty on MTS contributed to the expansion in activity.

CC&G handled 47.9 million contracts on the spot share market (34.6 million in 2004) with a daily average value of €3.7 billion (€2.9 billion in 2004). The notional value of the derivative contracts guaranteed rose by 31 per cent to €925,736 million. On MTS, CC&G guaranteed transactions worth an average of €7 billion per day (€3 billion in 2004).

At the end of 2005 CC&G had 87 members in the derivatives segment (unchanged from 2004), of which 27 general, 21 individual and 39 non-clearing, and 110 members in the MTA share market (109 in 2004), of which 19 general, 41 individual and 50 non-clearing. There were 11 members on MTS (7 general, 1 individual and 3 non-clearing). At the end of the first quarter of 2006 there were 26 members in the central counterparty service on MTS, equally divided between CC&G and LCH.Clearnet.

CC&G maintained a prudent stance in managing counterparty risk; the procedure for the deposit of intraday margins was activated on 154 days (94 in 2004) for an average amount of approximately €100 million.

Supervisory action

Supervision of trading and post-trading systems is based on close monitoring of their operations throughout the day, with a view to verifying their orderly functioning from the standpoint of continuity and efficiency.

By contrast, supervision of operating companies focuses on compliance with the relevant rules and regulations, the adequacy of their organizational arrangements and the proper management of risks. The execution of major corporate projects and the introduction of new trading platforms made continual contacts with the operating companies necessary.

Analysis of the management and technological aspects and of the quality of internal controls drew on the reports that the companies are required to file each year on their organizational and IT structure and on their risk management.

Checks were made on the action taken by operating companies and providers of post-trading services to bring their business continuity plans into conformity with the guidelines issued by the Bank of Italy in October 2004. The disaster recovery tests that the companies ran during the year were examined, inter alia in the light of the recommendations received from the IMF. The tests produced satisfactory results as to the degree to which individual supervised entities were prepared for an emergency.

In November 2005 MTS S.p.A. imposed a sanction – consisting in a one-month suspension from the activity of market maker – on Citigroup Global Capital Markets Ltd. for having carried out anomalous trades in government securities in August 2004. The operating company's decision came after that of the UK Financial Services Authority, which fined the British intermediary £14 million for failing to show due diligence in the conduct of business and for shortcomings in its internal controls. The Bank of Italy followed the procedural developments of the affair through exchanges of information with the other supervisory authorities and with the judicial authority.

Ad hoc supervisory interventions were carried out on the occasion of some critical situations that developed in the settlement system on three working days between October 2005 and February 2006. The Bank of Italy asked Monte Titoli to take steps to avert the repetition of similar events in the future. The Bank also began discussions with the intermediaries most active in Express II; together with Consob, it called the attention of all the participants to the need for cooperative behaviour.

CC&G was admitted to the intraday advance facility of the Bank of Italy. The procedure requiring authorization by the European Central Bank was adopted, since clearing companies are not counterparties of monetary policy operations.

Supervisory activity in 2005 continued to verify the compliance of amendments to markets' operating rules with national legislation. The Bank of Italy provided its opinion to the Ministry for the Economy and Finance and Consob on the changes to the bylaws and rules of the markets operated by MTS S.p.A. The reorganization of ownership, decided in order to find a strategic partner with which to diversify the range of products offered, involved amendments to the bylaws aimed at safeguarding the role played by the market in government securities for public debt management and the Italian financial system.

The acquisition of MTS S.p.A. caused a change in the composition of shareholders: 60.4 per cent of the share capital is now held by MBE Holding and the rest by market participants (34.3 per cent foreign and 5.3 per cent Italian).

Additional changes to the bylaws regarded the adoption of the two-tier governance system, which MTS S.p.A. considers will reduce potential conflicts of interest and permit more effective control of the company's operations.

The Bank, in agreement with Consob, approved some changes to the operating rules of clearing and settlement services and the central counterparty and guarantee system.

The rules of Express II were amended to permit the extension of the splitting mechanism to all trades not settled, including those not guaranteed by a central counterparty; the deadline for the settlement of transactions entered into the gross settlement procedure was unified with that for transactions handled by the net settlement cycle in order to simplify the structure of the working day.

The new rules enabled CC&G to extend the scope of its activity beyond regulated markets.

PAYMENT SYSTEM OVERSIGHT AND SERVICES

Last year European central banks' action to strengthen infrastructures and improve the efficiency of payment execution rested on two key projects for the integration of European payment services: the new TARGET2 large-value settlement system and the Single Euro Payments Area (SEPA), conceived as a fully integrated, competitive market with no difference between the processing of domestic and cross-border payments. The SEPA is consistent with the Council's Lisbon Agenda for growth and innovation.

In the large-value payments segment, TARGET2 is now well on the way towards completion. The main technical and operational problems have been solved, and the system's framework for contracts and pricing is now being defined. In view of TARGET2's greater complexity, which is partly due to the introduction of new functions at participants' request, the launch of the new system has been postponed from January to November 2007. The migration of national financial marketplaces to TARGET2 has been rescheduled accordingly.

With a view to the new system, market participants expressed the need to extend rationalization and reinforcement to the management of collateral for the credit operations of the Eurosystem, so as to fully realize the potential for operational and functional integration with TARGET2. The proposed revision of the present correspondent central banking model (CCBM) is for a shared technical platform used by all the national central banks to manage both domestic and foreign collateral, with the possibility of including bank loans.

On retail payments, the SEPA projet affects institutional and organizational arrangements profoundly, inducing significant changes in the methods of carrying out transactions, in technical standards and in the rules for transfers of funds. The authorities will have to reconcile the various interests involved in a context in which the needs of end users are ever more extensive and pressing.

In March 2006, after extensive consultation with national banking industries, the European Payments Council, which is the decision-making body of the banks responsible for the SEPA, approved the rulebooks for the three main payment instruments (credit transfers, direct debits and payment cards) and the regulatory framework for the development of SEPA - compliant infrastructures that correspond to the SEPA's requirements.

The adoption of the rulebooks opens a critical phase in the adaptation of domestic payment instruments and infrastructures to European standards. Now the Eurosystem is moving to strengthen organization and cooperation between the various stakeholders. As in the changeover to the euro, effectiveness once again depends on adequate communication to the market, in the interests of transparency, of the objectives set and the strategies followed. A key step in this direction was the joint statement on the project issued by the Eurosystem and the Commission on 4 May 2006.

The Bank of Italy's objective is to bring the Italian system into line with the European scenario by adapting the systems that it operates and refining its control procedures; reinforcing the business continuity of infrastructures; and spurring the diffusion of innovative payment service technology in response to the needs of households, firms and government. In the field of public payments, on 1 January 2006 the information system on transactions of public sector entities was successfully launched, and some 3,000 entities now transmit detailed data on their cash receipts and disbursements. The work on the Computerized Public Administration Payment System proceeded.

The Bank continued to contribute to the work of international organizations in designing policies for financial stability by strengthening payment infrastructures and enhancing the reliability and efficiency of cross-border payments. Financial stability was reinforced, among other things, by the activities of the Financial Stability Forum and the Bank for International Settlements directed at identifying standards for business continuity even in situations of extreme risk and at cooperative oversight of SWIFT by the G10 central banks.

In the field of cross-border retail payments, in March 2006 the G10 central bank governors approved, for consultation, a report laying down general principles for international payment services relating to migrants' remittances. The OECD's Financial Action Task Force completed its note on the interpretation of Special Recommendation VII on payers' information to be included in payment messages, in order to combat the financing of terrorism. As part of the reciprocal assessment of FATF members, the IMF assessed the Italian system's compliance with the recommendations.

In 2005 the IMF completed its examination of the Bank of Italy's activities in the payment system as part of the Financial Sector Assessment Program. The Bank demonstrated the degree of transparency in oversight and in the measures taken in response to the IMF's recommendations for full compliance of the BI-REL real-time gross settlement system with the core principles laid down by the BIS. The IMF's judgment on both aspects was strongly positive.

Oversight activities

The legal framework. – European regulatory action is designed to overcome the remaining legal barriers to the creation of a single European market in payment services and thus to the SEPA. A key measure in this regard is the Payment Services Directive, which is now at the stage of negotiation with the EU Council. It aims to harmonize the rules on payment services within the EU, both those concerning persons authorized to provide services and those on the conditions at which they are provided.

Other regulatory actions are sectoral in focus. The main seat of reconciliation and coordination is the Commission. The principal initiatives include: i) impact assessment – on prices and competition – of EC regulation 2560/2001 requiring equal prices for domestic and correspondent cross-border payments; ii) activities towards issuing a Community regulation for the harmonized application of FATF Special Recommendation VII throughout the EU, considered as a single area.

Italian regulatory activity is consistent with the policies of the Eurosystem and with the general provisions on the exercise of payment system oversight issued by the Bank of Italy pursuant to Article 146 of the Consolidated Law on Banking. On 11 November 2005 the Bank of Italy issued oversight provisions instituting a new framework for the operation of its BI-COMP retail clearing system. The provisions abrogated the Treasury Minister's decree of 7 May 1991 governing the operation of the retail clearing system. It limits the activity of the Bank of Italy to the final phases of clearing, in line with the most common arrangements in the main European countries for central banks' provision of retail clearing and settlement services. It is also intended to make BI-COMP consistent with the initiatives of the European banking industry and the EU authorities for the institution of the SEPA. To this end it extends the range of eligible participants, in keeping with the principle of non-discrimination within the European Economic Area; it requires the payment infrastructures to favour technical and procedural standards that permit fully automated handling of transactions and that are consistent with the solutions adopted by the SEPA project; and it provides that the Bank of Italy as system operator may enter into relationships with entities that provide clearing and settlement services outside of Italy. It endorses the principle of cost recovery, in compliance with the undertaking of European central banks that directly provide retail payment services in competition with the market.

On 16 March 2005 the Bank of Italy issued a regulation modifying that of 29 January 2002 on the interbank database of irregular cheques and payment cards. The regulation supplements the existing legal framework, in response to operational necessities that have arisen since the database came into being.

The Bank continued to cooperate with the national authorities with legal responsibilities in fields relevant to the payment sector. In particular, it works with the various ministries with jurisdiction over matters treated by the Oversight function and with the Privacy Authority for those connected with the treatment of the data acquired by the Bank.

Traditional payment instruments. – The number of transactions settled using non-cash bank and postal instruments increased by 2.4 per cent last year. Among bank instruments, the use of cheques again declined, by 5.1 per cent, while that of credit transfers and direct debits rose by 3.0 and 2.2 per cent respectively and POS debit card payments increased by 7.9 per cent. The number of such cards rose by 1 million to 26.6 million at the end of the year. The number of credit cards rose to nearly 29 million and were used for 460 million transactions, an increase of 6.9 per cent.

Poste Italiane S.p.A. further strengthened its presence in the payment services industry, with some 400,000 new post office current accounts, representing growth of 10 per cent by comparison with the end of 2004. The number of post office debit and credit cards also increased by about 10 per cent to nearly 5.5 million.

Overall the use of non-cash instruments in Italy is still far below the European average, with an average of 60 transactions per capita in 2004, compared with an average of 142 in the EU-25 and 150 in the euro area.

As in the previous years, the Bank of Italy conducted surveys of banks concerning the procedures and charges for the most common payment instruments. The findings can be usefully integrated with the data supplied by ABI's "PattiChiari" project. While the handling time for payments by cheque has been perceptibly shortened, the process is still too slow. The implementation of structural measures that have been under study for some time should result in significant progress. In the framework of the PattiChiari project, ABI had originally set the maximum time limit for the availability of funds to the beneficiary at 8 working days, shortened to 7 in October 2004. Designed especially for merchants and small businesses who issue and receive a large number of cheques, the initiative is intended to shorten the waiting period before fund availability by facilitating comparison between the various offers. In March 2006, the 87 participating banks (up from 84 a year earlier) held nearly 75 per cent of all customer current accounts. Sixteen of these banks (up from 13) claimed time to availability of 6 days in their publicity materials, and ten (up from 5) claimed 5 days (Table 68).

A project is currently under study to transfer digital images of cheques, which should cut handling times even further, reducing the present interbank settlement cycle and thus the current period of 3 working days for sums to become irrevocable from the payer.

Table 68

PROCESSING TIME FOR CHEQUES AND CREDIT TRANSFERS

(number of working days)

	Average			Minimum			Maximum		
	2003	2004	2005	2003	2004	2005	2003	2004	2005
Cheques									
Value date	4.0	3.9	4.0	2.1	2.0	2.1	6.1	6.1	6.1
Availability of funds ...	6.4	6.4	6.3	5.4	5.3	5.2	7.5	7.5	7.4
Finality	9.3	9.1	9.0	7.9	7.5	7.7	10.5	10.4	10.5
Credit transfers									
Value date	2.0	2.0	1.9	1.8	1.6	1.5	2.8	3.3	3.2
Availability of funds ...	2.4	2.3	2.3	1.9	1.6	1.6	3.7	3.7	3.6

Source: Surveys conducted in March 2004, 2005 and 2006.

For credit transfers, handling time and prices improved overall. ABI took steps to introduce rules and mechanisms for certainty consistent with the solutions adopted by the SEPA project. The average handling time stabilized at two days, and even less for the larger banks. The reduction in charges was due in part to greater use of more economical procedures, such as Internet transactions and automated credit transfers, which accounted for a full 62 per cent of all credit transfers in 2005 (Table 69). A new agreement shortened the maximum execution time for credit transfers to 3 working days from the date of acceptance of the order by the payer's bank to the availability of funds to the beneficiary. In June 2005 ABI and Confindustria signed a protocol to realize a project concerning the maximum handling time for domestic credit transfers and to increase the transparency and comparability of the charges by means of Internet access to standard information sheets prepared by the participating banks.

Value dates continue to be a significant factor in banks' implicit charges for payment services. Not only for cheques and credit transfers but also for the collection of banker's drafts, direct debits and bank receipts the number of days remains high, and this cost is in addition to ordinary charges to customers.

The Oversight Office is taking part in the ongoing project to introduce the "multibank system" into the PagoBancomat POS circuit, in particular as regards matters of security and reliability under the Office's jurisdiction. The institution of the multibank system can be combined with the migration to smart card technology. The two projects can merge into a virtuous circle favouring quicker adaptation to more advanced, SEPA-compliant security technology.

Table 69

CHARGES FOR DOMESTIC CREDIT TRANSFERS

(in euros)

	Ordered via Internet	Ordered via telephone	Payments via Freccia bank form	Standing payment orders	Ordered at branch with current account debit	Ordered at branch for cash
Average value	0.83	1.26	1.43	1.94	3.32	5.17
Maximum value	2.80	5.00	2.60	5.00	5.50	8.50

Source: ABI - PattiChiari (March 2006).

The problem of payment card fraud has long been a focus of attention for the European and national authorities. The central office against payment instrument falsification at the Ministry for the Economy and Finance continued its work last year on a fraud-prevention system, with the participation of the Oversight Office. The statistical reports of banks and other intermediaries indicate that credit card fraud represented just over 1 per mille of the value of transactions last year. For debit cards the level was lower but increased nearly threefold between 2004 and 2005, from an estimated value of 0.1 per mille to 0.3 per mille. In both the debit and credit card circuits, the cross-border component of fraud – due to cloning – was much greater than the domestic component and increased considerably in the course of 2005. The incidence of cross-border fraud is estimated at over two-thirds of the total value of frauds in 2005.

The migration to smart card technology should sharply reduce fraud. Under the project the entire security system will hinge on smart cards, which increase reliability in identifying the cardholder and in authorizing transactions, thanks to new terminals that can read the cards even without a remote link to the issuer. The migration, which is subject to observation as part of the SEPA project, is further behind in Italy than in many other European countries. The Oversight Office is following the process closely and has initiated monitoring of ABI aimed at stepping up incentives to intermediaries and counterparties. The study of the migration to smart cards is also related to the current trends in Europe towards the possible merging of existing infrastructures within and between member states.

Innovative payment instruments. – The use of electronic money and pre-paid bank and post-office payment cards increased very substantially. At the end of the year there were 3.3 million pre-paid instruments in circulation (11.4 per cent of all credit cards), and more than 4 million counting those issued by institutions doing business in Italy under the freedom to provide services. The diffusion of these instruments was accompanied by an even sharper increase in their use (from 9 million transactions in 2004 to 20 million in 2005) and in the average value of transactions (from €61 to €79).

In March 2006 a total of 32 schemes were in operation, roughly the same as a year earlier. After the issue of the supervisory instructions on e-money institutions in March 2004, four applications for authorization had been submitted, and the e-money company register included one company, not yet operational, sponsoring four schemes, plus an EU company operating one scheme under the freedom to provide services.

Internet payments again increased more than those via other channels. The trend was led by the 52 per cent increase in credit transfers ordered on-line to 35 million, or 8.5 per cent of all credit transfers. Next came Internet payments via credit card, which gained 27 per cent. Though less substantial in absolute terms, on-line payments using pre-paid cards and e-money increased threefold to over 5 million, almost entirely owing to pre-paid post office debit cards.

The shift in households' and firms' preferences among ICT instruments towards on-line credit transfers is consistent with the relative costs of the various payment channels and instruments (Table 69) and the progressive spread of e-banking. These trends are confirmed by the Bank of Italy's survey on the use of electronic payment instruments by households and firms, described in the forthcoming report *I progressi nella diffusione delle tecnologie dell'informazione e della comunicazione nel sistema dei pagamenti*.

More generally, the survey confirms the appreciable progress of firms in the use of new technology but also the persistent delay in integrating financial and trade flows, which is fundamental to the efficient use of payment services. In this context, and with a view to optimizing Italian payment services within the SEPA, actions to adapt the interbank corporate banking (CBI) infrastructure were scheduled for completion by the end of 2006. This will enable firms not just to have access to the usual information and transaction services but also to exchange electronic invoices in integrated mode with CBI services (payments, collection, advances on bills).

Given firms' increasing tendency to centre cash management on payment procedures, it has become necessary to foster intersectoral standards as these are indispensable for the integration of operational processes.

Within the euro area, following a comprehensive discussion among countries whose positions were quite distant, the adoption of innovative solutions (electronic invoicing, digital signatures) for the design of SEPA instruments is explicitly mentioned in the documents issued by the ECB (including the Fourth Progress Report in February 2006) and by the Commission. The aim is to improve the supply of services with the close involvement of users (firms in particular) in setting intersectoral standards.

In this context the banking industry has taken steps to adapt Italian procedures to open standards with a view to accreditation with international organizations. One of the most important of these standards is the definition of the "invoice header", which combines all the commercial and financial data in a single electronic document; this facilitates transaction reconciliation and offers an automated support for the management of advances, in a natural technical evolution of the current automated bank receipt procedure. In April 2006 the CBI successfully completed its registration within the UNIFI – ISO 20022 international standard; it is thus in the vanguard as the European standard for the realization of optional services within the SEPA.

Payment infrastructures and systems. – Checks were begun last year on the adaptation of systemically important infrastructures (Interbank Company for Automation (SIA) and standardized applications centres) to the "guidelines for business continuity" issued by the Bank of Italy in November 2004. Significant progress was observed in operators' risk assessments and in the technological adaptation of infrastructures. More generally, there was increased sensitivity on the part of senior officials to the management and operational aspects of business continuity.

The guidelines are consistent with the principles now being set both by the Financial Stability Forum and within the ESCB for the operation of systemically important infrastructures. Together with those issued in close coordination by the Banking and Financial Supervision Department and the Market Oversight Office, the guidelines provide a frame of reference for the main domestic payment system operators.

Checks are based on twice-yearly reports by operators and joint evaluation with them in bilateral meetings. The checks have highlighted significant gains in the adaptation of technological infrastructures (dual sites, duplication of data, network redundancy, etc.) and in the drafting of operational documents, and in system testing and fine-tuning. Attention is now focused on the performance of integrated tests, with the involvement of infrastructures and operators, to check the adequacy of business continuity in links even in extreme emergencies.

At European level, consolidation is under way between payment industry infrastructures designed for the objectives of integration set within the SEPA for the pan-European payment card schemes and clearing systems. In this context the Eurosystem reaffirmed the importance of defining common open standards accessible to all service providers and infrastructure operators for euro payments within the EU as a prerequisite for interoperability and effective competition between service providers.

Significant action concerning the projects for the creation of a pan-European clearing house (PEACH) includes not only the rules, mentioned above, on clearing of items, but also the Office's oversight on the initiative of seven Italian banks (shareholders in EBA) to migrate payments between them to the STEP2 system through SIA, which operates the STEP2 infrastructure.

The Office's analysis of the seven banks' project involves governance, rules and conditions for access, and operational links between the different parts and levels of the service, to determine the impact on the national payment system. Oversight of the activity of SIA focuses on the operational management of the infrastructure and the procedural links with other systems. The latter activity is conducted as part of shared tasks with the Eurosystem to assess compliance with the standards for retail payment systems.

In the field of so-called quasi-private systems, in accord with the Supervision Department a plan was approved for the reform of correspondent current accounts of the central credit institution of Alto Adige, in order to make the legal framework clearer and more transparent and to enhance the effectiveness of risk control.

Direct provision of payment services

Cash settlement. – The flow of funds processed through the Bank of Italy's clearing and settlement systems amounted to nearly €43.3 trillion in 2005, or 30.6 times Italy's GDP, an increase of 17.7 per cent. The BI-REL gross settlement system (the Italian component of TARGET) handled 86.8 per cent of all payments, by value, processing over 49,000 transactions a day worth €168 billion (Table 70). Payments channelled through the BI-

COMP retail clearing system accounted for 7.3 per cent of total payments and the multilateral cash balances of the securities settlement system for 5.9 per cent.

Table 70

LARGE-VALUE GROSS AND NET SETTLEMENT SYSTEM IN THE EU

(average daily flows in billions of euros)

System and country	2004				2005				Total percentage change 2005/2004
	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 (2)	76.2	32.2	32.2	140.6	87.4	40.3	40.3	168.0	19.5
Germany	344.7	143.1	143.2	631.0	378.2	160.7	160.7	699.6	10.9
France	337.9	80.7	80.6	499.2	380.4	94.0	94.0	568.4	13.9
Spain	265.0	22.6	22.6	310.2	268.5	22.7	22.7	313.9	1.2
Netherlands	41.4	49.7	49.7	140.8	38.1	57.5	57.5	153.1	8.7
Other EMU	58.9	115.4	115.4	289.7	73.3	131.3	131.3	335.9	15.9
Total EMU	**1,124.1**	**443.7**	**443.7**	**2,011.5**	**1,225.9**	**506.5**	**506.5**	**2,238.9**	**11.3**
Non-EMU countries	25.9	120.4	120.4	266.7	35.0	134.8	134.8	304.6	14.2
Total EU	**1,150.0**	**564.1**	**564.1**	**2,278.2**	**1,260.9**	**641.3**	**641.3**	**2,543.5**	**11.6**
Net settlement									
Paris Net Settlement (PNS)				67.5				60.9	-9.8
EBA Euro Clearing System (Euro1)				170.4				167.1	-1.9
Total other systems .				**237.9**				**228.0**	**-4.2**

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. – (2) Includes the Polish system Sorbnet (€0.3 billion for domestic flows and €0.007 billion for cross-border flows).

TARGET is by far the biggest of the large-value euro payment systems and has consolidated its position in this regard over the years. The central banks of the countries that joined the EU in May 2004 can access TARGET either through their own settlement systems or by other arrangements, including correspondent accounts with a Eurosystem central bank. Taking the latter option, in March 2005 the Polish central bank's link to TARGET via BI-REL went operational, after two years of preparatory activity that required constant cooperation between the two NCBs and the

ECB. Estonia's access to TARGET by the same procedure will be effected by the end of 2006.

On 31 March 2006 participation in BI-REL was virtually identical to twelve months earlier: direct participants numbered 118 rather than 119, indirect participants 646 rather than 645.

Transactions settled in BI-REL via the optimization of queued domestic payments averaged 900 per day for a value of €4.6 billion. The potential savings of liquidity for participants thanks to this mechanism amounted to 33 per cent of the value of the payments optimized. The average use of intraday liquidity came to €4.6 billion in 2005, an increase of 30 per cent. The increase stemmed from the sizeable growth of interbank payments, which led banks to have greater recourse to central bank credit. The use of intraday liquidity remained practically unchanged in proportion to the flow of payments (4 per cent) but increased by comparison with the value of the securities deposited as collateral (from 23 to 29 per cent).

Most of the payments entered for settlement into BI-REL come from ancillary systems (BI-COMP and EXPRESS II), from the screen-based interbank deposit market (e-MID) and from international payment systems (CLS and Euro 1). The clearing balances of BI-COMP came to more than €370 billion, an increase of 16 per cent for the year. The value of the clearing balances settled by intermediaries through BI-REL in the two EXPRESS II clearing cycles averaged €9.9 billion a day (€7 billion of which was settled in the overnight cycle), an increase over the average of €8.2 billion for the first 11 months of full operation ending in December 2004.

The gross component of EXPRESS II generated more than 1,000 payment orders a day in BI-REL for transactions other than monetary policy repos (compared with 760 in 2004), for a value of €14.3 billion (€9.9 billion in 2004).

Transactions on e-MID between domestic counterparties settled automatically through BI-REL remained broadly unchanged at €5,714 billion.

The two Italian banks participating directly in the CLS multicurrency foreign exchange settlement system settled payments worth over €250 million a day in BI-REL, about the same as in 2004. The volume of business handled by CLS soared by nearly 40 per cent for the year.

The Italian banks participating in the Euro1 system recorded a slight worsening of their net credit positions. The debit balances settled through BI-REL increased by 10 per cent to a daily average of €550 million, while the average value of credit balances was unchanged at about €1 billion.

Analysis and monitoring of BI-REL and BI-COMP. – Oversight activities concerning BI-REL have been described in a manual drafted in accordance with the guidelines of the ESCB's TARGET Oversight Guide, which provides national central banks with a minimum common framework for the oversight function.

The manual calls for analysis of BI-REL's risk and efficiency using a set of qualitative information and quantitative indicators broader than those recommended by the ESCB. There was no change in the established patterns of type of participation, payment turnover, levels of efficiency, financial risk and operational risk.

The assessment of BI-REL's technical and operational reliability focused on malfunctions and the adequacy of subsequent intervention. There were seven malfunctions with consequences of some significance last year. However, none caused participants to lose payments, and none had systemic effects. The business continuity of BI-REL continued to be at a higher level (99.87 per cent) than the ESCB's mandated level for TARGET as a whole (99.5 per cent).

The quantitative indicators for simulating the liquidity impact on the entire Italian payment system of the shutdown of a system linked to BI-REL were determined.

In August 2005 the ECB released its report on retail payment systems' compliance with the ESCB's standards of stability and efficiency. All the systems examined were judged to be up to the relevant oversight standards, albeit some at higher levels than others. BI-COMP was broadly compliant.

Correspondent banking services. – Within the framework of the Eurosystem Reserve Management Services, available to the institutions of new EU member states and non-EU countries since 2004 under harmonized rules and prices, user demand was directed mainly at the investment of end-day liquidity.

Payments. – The collection and payment transactions for foreign correspondents via straight through processing numbered more than 6,500 in 2005 for a total value of over €7.5 billion. More than 4,600 of these transactions, worth €2.3 million, involved the payment of pensions from euro-area countries. About 28,700 transactions were processed manually, mostly on behalf of public sector entities and foreign correspondents. The Bank of Italy began the process of joining the European STEP2 system for cross-border retail payments, which includes not only a number of commercial banks but also several Eurosystem central banks.

Foreign securities posted as collateral for Eurosystem credit operations continued to follow a rising trend. The average daily value went up by 22.7 per cent to €400 billion. More than four fifths of the collateral consists of securities transferred via the CCBM. As a correspondent institution the Bank of Italy handled about 15 per cent, by value, of the collateral posted in favour of other ESCB central banks, compared with 20 per cent in 2004. The decline of about €10 billion was due entirely to a decrease in demand from British counterparties (which fell by 48 per cent, in value terms). Correspondent business continues to be highly concentrated with just a few NCBs; German and British banks continue to hold three quarters of the collateral posted with the Bank of Italy in favour of their respective central banks.

Payment infrastructures in the European scenario

TARGET2 will be launched on 19 November 2007, ten months behind the original schedule. The new date was set by the ECB Governing Council in October 2005 in acknowledgment of the greater complexity of the system owing, among other things, to the development of the new functions requested by the market in the course of public consultations.

The general strategy for the migration to TARGET2 had already been approved in December 2004. It calls for a gradual transition to the new system by groups of countries in such a way as to minimize risks and ensure adequate operational and functional flexibility. In October 2005 the ECB Governing Council published its second "Progress Report on TARGET2" clarifying the aspects of the project that had been pending until then.

The realization of the single shared platform within TARGET2 is at an advanced stage. In December 2005 operators were given the final detailed functional specifications; in January the three central banks assigned to set up and operate the platform (Bank of Italy, Deutsche Bundesbank and Banque de France) began functional integration testing. At the start of 2007 tests with the other central banks will be initiated, and in May trials will be held with the first group of intermediaries that will migrate to the new system.

For the Italian financial marketplace, trials will begin in September 2007 with the pilot group of banks and in November with the rest of the system.

The project for a single euro payments area (SEPA) calls for the creation of area-wide infrastructures for the clearing and settlement of retail payments (PEACH). Each PEACH must meet a number of basic requirements: it must be able to process pan-European payment instruments; it must be technically and functionally integrated with the European infrastructures that will handle retail payments; and it must guarantee that every institution can receive the payments directed to it.

Measures involving the Bank of Italy's BI-COMP clearing system move in this direction. The provision issued by the Governor on 11 November 2005 concerning the oversight of retail payment systems was a first, significant step in defining the characteristics of the system from this standpoint.

Additional measures will be taken in 2006, with the adoption of communication standards in use internationally and performance by the Bank of Italy of activities preparatory to the determination of the clearing balances of the retail sub-system. For this latter purpose the Bank will set up its own service centre that will operate on a market-based philosophy. The Bank of Italy is scheduled to join STEP2 to settle its cross-border retail payments as well as those of the Italian banks that elect to take advantage of the Bank of Italy's intermediation.

In response to the requests of banks for more efficient management of collateral against Eurosystem credit operations, a study was begun on ways of improving the current arrangements, based on national infrastructures for domestic collateral and the CCBM for cross-border collateral. The CCBM2 project aims to implement, in the medium term, a technical platform – shared by the NCBs – for the management of domestic and foreign collateral. Consideration will also be given to the possibility of extending the service to bank loans.

Cashier's cheques and deposits against banker's drafts. – The issue of cashier's cheques and banker's drafts diminished again. The Bank of Italy's issues of ordinary and special cashier's cheques fell in number from 413,055 to 377,292 and in value from €8 billion to €7 billion.

The interbank database on irregular cheques and payment cards. – This register of persons whose authorization to write cheques has been revoked listed 60,425 persons and 241,175 cheques at the end of 2005 for a total amount of €968.5 million. The number of persons and the number of cheques were practically stable, while the total amount decreased by 5.3 per cent, as the average amount of the bad cheques declined from €4,230 to €4,016.

Most of the bad cheques were drawn on just a few banks. More than half the value and 59 per cent of the number of the cheques entered in the register were drawn on just 9 banks, or 1.6 per cent of the 565 banks that reported bad cheques to the database during the year.

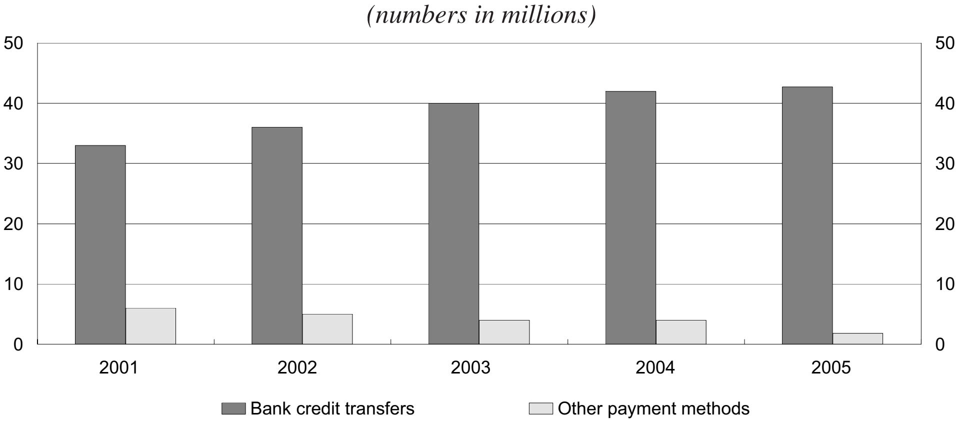
The database registered 62,956 persons for improper use of payment cards in 2005, a decrease of 12.8 per cent. At the end of the year a total of 4,397,900 cards were registered, an increase of 4.2 per cent by comparison with a year earlier.

Government payment services. – The Bank of Italy took steps last year to fully realize the electronic state treasury services within the Computerized Public Administration Payment System. In this context the finalization of a flexible IT architecture will permit the swift adaptation of payment and collection procedures to SEPA standards. For the full implementation of the computerized treasury service, a number of initiatives are under way to computerize the spending of state agencies and departments. The procedure enabling treasuries to use credit transfers in order to credit paper-based spending instruments to creditors' accounts went operational. This will eliminate the manual processing of banks' administration accounts. With the introduction of the procedure the integration of the state treasury into the payment system is virtually complete. In 2005 the interbank channel was used for 98 per cent of the 44 million state treasury payments (Figure 42).

Figure 42

SETTLEMENT CHANNELS OF TREASURY PAYMENTS

(numbers in millions)



Credit transfers for tax and social contribution payments using the unified tax payment form amounted to €373 billion in 2005. In accord with the Ministry for the Economy and Finance, technical and regulatory measures were prepared to permit the use of credit transfers for payments directly to the state treasury. The computerization of the state treasury service required major regulatory simplification. The revision of the "General Instructions on Treasury Services" was completed in cooperation with the State Accounting Office.

Work on the information system on transactions of public sector entities intensified. After final testing of transmissions between the Bank of Italy and the treasurers, the procedure went operational on 1 October 2005 and was used to experiment the total abrogation of the single state treasury payment system pursuant to the ministerial decree of 8 July 2005. As of 1 January of this year some 3,000 entities transmit information to the system. The Ministry, as recipient, has tested the reliability and rapidity of the data required to prepare the quarterly report on the borrowing requirement.

Since March the Bank of Italy has made the data breakdowns prepared in concert with the Ministry available to the public sector entities; as of November the latter will be able to obtain further data from a website set up by the Bank, either by entering a user ID and password or by using the national public service card. The coming months will see the start of trials with the banks acting as treasurers for towns with up to 20,000 inhabitants and for local authorities required to transmit data to the system as of 1 January 2007.

The Bank and the Ministry for the Economy and Finance reached an agreement on a procedure for exchanging information on trends in the state treasury account with a view to improving their predictability and facilitating the conduct of Eurosystem monetary policy; the procedure was tested in the course of 2005. A convention was stipulated in accordance with the ministerial decree of 30 December 2005 containing "instructions on the management of the state treasury account for cashier services" to regulate the timing and methods of exchanging data. By Decree of 19 September 2005 the Ministry, exercising a right granted under the law instituting the account, reduced the minimum end-month balance from €15.5 billion to €10 billion.

Last year saw an increase in activity connected with payment services for public entities. Some 5.8 million payments were made in 2005, an increase of 22 per cent compared with the previous year.

THE GOVERNOR'S CONCLUDING REMARKS

THE GOVERNOR'S CONCLUDING REMARKS

As I take the floor for the first time before this annual meeting, allow me to begin by conveying my best wishes to the President of the Republic, Giorgio Napolitano, to whom I confirm the continuing institutional commitment of the Bank of Italy to serving the nation. In the same spirit of invaluable institutional continuity, I pay my respects to the Government that led Italy for the duration of a legislature and wish the Government that has just taken its place success in its endeavours.

In December of last year Antonio Fazio resigned as Governor of the Bank of Italy. He had joined the Bank in 1965, become Head of the Research Department and then Central Manager for Economic Research. As Governor since May 1993, he directed the monetary policy that accompanied Italy's entry to Economic and Monetary Union.

His actions towards the end of his tenure are still open to judgement. To him I wish to express recognition that is not merely formal for having dedicated his entire professional life to the service of this institution.

The end of last year brought with it the conclusion of a convulsive period of scandal and speculation, during which it had seemed that the market, the savings of Italians, and the destiny of companies in key sectors of the national economy were prey to the caprice, self-interest and schemes of a few individuals.

The action of the judiciary prevented these schemes from succeeding. The outcome of the judicial proceedings now under way is awaited. Although the institutional integrity of its supervisory structure was unscathed, the Bank of Italy has been wounded. As President Carlo Azeglio Ciampi did me the honour of appointing me Governor, on the proposal of Prime Minister Silvio Berlusconi, it was and it is my responsibility to lead the Bank in the restoration of the prestige it has always enjoyed, and to guide its evolution in a national and international environment radically different from the one that has shaped its history.

The field of action is vast: contributing substantively to the formulation and implementation of monetary policy in the euro area; expanding and strengthening banking supervision while adapting it to the new international rules; making the Bank once again the trusted, independent advisor to Parliament, the Government and the general public; and, internally, reconfiguring the central administration and branches, with a rethinking of their tasks and structure, and reconsidering the role of the Italian Foreign Exchange Office. These are the lines of action to be undertaken. In tackling the evolution of the Bank in these new circumstances, the contribution of the staff and of the trade union representatives is essential. In a few days' time I shall set out these strategy guidelines to them in practical terms, confident that they will share my belief in their necessity.

At its next meeting the Board of Directors will discuss the proposed amendments to the Statute of the Bank, in compliance with the new legislation. This begins the mandated procedure, which will culminate in examination by the Government and the issue of a decree by the President of the Republic.

I know, to borrow an expression from Guido Carli, that my strength is not equal to the objectives. I would doubt ever being able to attain them if I could not count on the integrity, professional competence and sense of institutional responsibility of the entire staff of the Bank. But there is also something else on which I am certain I can rely: the rightful pride of this institution, which has always transformed difficulties into a spur to growth. In the Bank of Italy, which from Einaudi to Ciampi has provided the nation with Presidents of the Republic, Prime Ministers and cabinet Ministers, I have found an institution of excellence, where the nobility of public service is deeply felt.

It is to that service that I, like other Governors before me, intend to dedicate my efforts. It is from this collective sentiment that I shall draw my strength.

Returning to growth

The cyclical recovery that is now beginning in Italy cannot by itself solve the growth problem that has afflicted the country for more than a decade, but it will facilitate the necessary structural changes.

If slow growth persists for long, it stifles an economy's ability to innovate, saps the aspirations of the young and portends regression. It is especially worrying in a country such as ours, with its adverse demographic trend and high public debt.

Financial stability is a necessary condition for economic growth, but in Italy growth is in turn a prerequisite for financial stability. It is essential, while preserving the one, to rekindle the other.

The international context

In the last two years the world economy has grown at an average rate of 5 per cent, the euro-area economy at an average of 1.7 per cent. World trade has increased by just under 9 per cent. Increasing demand, supply bottlenecks and geopolitical tensions have driven up the prices of raw materials and energy. The latter have more than doubled in real terms in the last three years.

Monetary policies are becoming less accommodating everywhere, though differences in the timing and intensity of the change reflect different cyclical conditions and inflationary risks. Fiscal policies have not yet taken advantage of global growth to make the adjustments to the public finances that are necessary to reduce imbalances and cope with the ageing of the population. A rise in interest rates tends to increase the cost of servicing the public debt. The higher the debt, the greater the effect; Italy is particularly exposed.

Balance-of-payments disequilibria have become more pronounced. While current account surpluses are widely distributed, the deficit is concentrated in the United States, where it has reached nearly 2 per cent of world GDP, a record high. A rise in the US domestic saving rate, a recovery in growth in Europe and Japan and an acceleration in domestic demand in China and the oil-producing countries may lessen the danger that the inevitable correction of the disequilibria will come about by means of disorderly changes in exchange rates.

The expansion in world liquidity and low interest rates contributed to the rise in the prices of financial assets and housing. Interest rate differentials and the volatility of the financial variables fell to historically low levels. The possibility that investors will underestimate risk is a potential source of instability. The volatility of exchange rates and securities prices has increased in recent weeks, triggering a rapid unwinding of carry trade positions that in its turn has affected exchange rates.

These factors of fragility are counterbalanced by the credibility of monetary policies, which has subdued inflation expectations. The recent rise in energy prices has not affected core inflation, which has been contained partly by international competition. The talent, capital and technology now available in the financial markets have increased their ability to reallocate risk and strengthened their resilience to shocks. However, the rapid spread of derivatives may amplify the transmission of shocks, with systemic implications that have still not been fully quantified.

Persistent disequilibria, high oil prices and the protracted, rapid growth in liquidity are a cause of concern to monetary authorities in view of their potential repercussions on inflation, the prices of financial assets and exchange rates.

The distinctive features of the international scene today are the development and spread of new information technology and the rapid growth of the large emerging economies.

The digital revolution that took place at the end of the last century has triggered an efficiency competition between national economies. It is essential to rise to the challenge.

The emerging economies' share of world exports of manufactures has risen to 30 per cent, and the proportion of their products with a medium or high intensity of capital and technology is increasing. Consumers in the advanced countries have derived large and immediate benefits. Producers can meet the fierce challenge from competitors with low labour costs if they seize the opportunities offered by the internationalization of production and the emergence of new markets.

In a situation of continuing rapid growth in the world economy and world trade, we must be guided by the optimism of initiative, not by melancholy regret for a protectionism that has had its day.

Italy's productivity crisis

Since the middle of the 1990s output per hour worked has risen much less in Italy than elsewhere: on average, by over one percentage point less each year than in the OECD countries. The delay in adapting the technological and organizational capacities of firms and the economy in general has caused total factor productivity to decline, making Italy unique among industrialized countries.

Improvements in efficiency are being impeded by the skewed size distribution of firms, which is scarcely compatible with the new paradigms of technology and competition. This is accompanied by sectoral specialization that is still excessively geared towards traditional products. Removing the obstacles to the expansion of firms is a prerequisite for seizing the opportunities offered by market globalization and for stimulating the widespread and systematic application of innovations in corporate organization, production processes and product ranges. This is the way to regain international competitiveness and to stimulate renewed growth.

Defending competitiveness by devaluing the currency, which in any case gave only temporary relief from the effects of a productivity gap, is now impossible. The only options are increasing output per man-hour and containing nominal incomes. In the long run, only rising productivity generates economic well-being.

This year the growth in gross domestic product could be close to 1.5 per cent, thanks to a recovery in exports and investment. The cyclical upturn may facilitate measures to encourage adjustment in the economy.

Stability: a necessary condition for growth

Macroeconomic policies contribute to stimulating renewed growth by ensuring a framework of stability.

The common monetary policy has given the euro area price stability and protection from the volatility of the financial markets. Between 1999 and today, actual and expected consumer price inflation in the area has been barely above 2 per cent, albeit with significant rises in the prices of some items, in particular in sectors less exposed to competition. The price stability objective established by the Eurosystem anchors the expectations of producers, consumers and the social partners. Testifying to the credibility that the European Central Bank has acquired, short-term interest rates in the euro area reached their lowest level in fifty years.

The convergence towards price stability has served the interests of all the participants in the monetary union, and continues to do so. The benefits of the euro are especially valuable in Italy. The decline in interest rates enabled firms to keep their financial costs low in relation to value added, even during a downturn in which corporate debt increased. The interest rate differential between Italian and German long-term government bonds had averaged 340 basis points between 1992 and 1998; between 1999 and 2005 it fell to just 25 basis points. Interest expenditure on new issues of public debt was drastically reduced.

The benefits of the single currency for the public finances have been largely dissipated, however. The upward trend in rates now calls for urgent action on the structural determinants of public spending. The burden of the public debt must begin to diminish again. Its ratio to GDP increased by 2.5 percentage points last year to 106.4 per cent, despite asset disposals worth about one point. General government net borrowing rose to 4.1 per cent of GDP; it exceeded the limit set by the Treaty of Maastricht for the third consecutive year. The primary surplus has steadily declined, from 6.6 per cent of GDP in 1997 to 0.4 per cent last year. Net of privatization receipts and excluding the effect of one-off measures, the borrowing requirement – on which the trend in the public debt depends – came close to 6 per cent of GDP.

Net borrowing may again exceed 4 per cent of GDP in 2006; the debt ratio would rise further.

To bring the public finance balances back to levels that permit a predictable, continuous and permanent reduction in the debt ratio, structural adjustments affecting the main expenditure items and all levels of government are necessary. In the light of current trends, a correction of around two percentage points of GDP is needed to achieve the net borrowing objective of 2.8 per cent of GDP set out in government programmes for 2007 and to begin to reduce the ratio of debt to GDP again. Additional resources would have to be found to fund any measures to ease the burden of taxation or boost public investment.

Primary current expenditure, which has risen in real terms by 2.5 per cent per year over the past decade, has to be curbed. In addition to containment of the operating cost of government, there are two unavoidable priorities: tackling the problem of the average age at which people retire and making regional and local governments fully responsible for controlling their expenditure.

Pension outlays amount to 15.4 per cent of gross domestic product. Almost one quarter of this consists of old-age and seniority pensions paid to persons under 65 years of age. The greatest number of workers retire when they meet the minimum pension requirements. In recent years, as a result of the reforms that tightened the eligibility requirements, the average age at retirement has been about 60 in Italy; it is 61 in Germany, 62 in the United Kingdom and over 65 in the United States. At age 60, women can expect to live another 25 years and men another 21. In the future, together with the development of supplementary pension schemes, only a significant rise in the average age at retirement can square the payment of adequate pensions with the financial sustainability of the contributions-based pension system. A lengthening of the working life will also help raise the labour force participation rate.

Regional and local governments account for more than 40 per cent of total general government expenditure on labour costs; they make nearly 80 per cent of total public investment. Health care, which is a regional responsibility, constitutes more than 13 per cent of general government spending. The decentralization of government functions can improve the overall efficiency of the system only if a close link is created between spending and responsibility for its financing. The decentralization of spending has not yet been accompanied by sufficiently broad powers of taxation, transparent and systematic criteria for revenue equalization and effective constraints on borrowing.

In order to contribute to stimulating renewed economic growth, not only must budget balance be restored but the composition of expenditure must also be modified. Savings on other items would release resources with which to improve infrastructure, strengthen social security, thus facilitating the operation of the labour market, and reduce the tax burden to enhance competitiveness. A lasting impact on the budget requires a decisive change in the laws and rules on expenditure. Otherwise, as experience has shown, even dramatic budget adjustments produce only short-lived results.

Measures to stimulate renewed growth

Heightened competition and a broadening of the scope for market mechanisms to operate are necessary for a revival in production and complementary to decisions regarding equity. Competition is the best agent of social justice in an economy, and in a society such as Italy's in whose history the privileges of the few have commonly been rooted in the protection of the State.

In recent years numerous areas of action have come to the attention of observers and economic policy-makers as crucial for restoring the growth of the economy: employment, education, services and the legal and administrative environment are issues of particular importance.

Labour costs are affected directly or indirectly by the level of wages, by taxation and social security charges and by the rigidity of regulations.

The coordination of wage bargaining at national level not only safeguards equity but also helps to ensure that wage trends in sectors where there is little competition and areas of the country with low unemployment do not become incompatible with price stability. The 1993 agreements between employers and trade unions assigned the distribution of productivity gains to decentralized bargaining. The adoption of employee-compensation schemes explicitly linked to the firm's productivity is still very limited, however, and remains concentrated among large industrial enterprises.

In 2005 State levies, in the form of taxes and social security contributions but not counting the regional tax on productive activities, amounted to 45.4 per cent of the cost of employing a typical worker in industry. The average in the OECD countries is 37.3 per cent. Too large a tax and contribution wedge distorts resource allocation and hampers growth.

The budget constraints leave little room for financing a reduction. Shifting taxation from labour to consumption offers benefits in terms of resource allocation and certainty of coverage, but it has macroeconomic and distributive effects that need careful assessment, in conjunction with the social partners.

Rigidity in the utilization of labour has implicit costs for business. It may be rooted in hiring procedures, in the deployment of human resources within the firm, or in termination procedures; the latter are made onerous, above all, by the length and cost of possible legal proceedings, which are uncertain and frequently very high. Some flexibility has been recovered during recent years with the spread of atypical employment contracts. If the labour market is well-regulated and typical contracts not overly rigid, atypical contracts will offer a useful range of options to firms and workers. However, if they become a surrogate for ordinarily flexible employment, they prevent many young people from planning for the future, reduce the incentives for firms to invest in training and curb macroeconomic productivity.

Efficiency and equity require that market segmentation be lessened by establishing more uniform rules under which employment becomes more stable with the passage of time. In an age in which the economy must rapidly reallocate resources in the changed competitive environment, it is the worker rather than the job that must be protected by ensuring – subject to budget constraints – a decent and non-distorting level of unemployment benefits and real opportunities for training and career change.

This is not enough, however. A return to productivity growth calls for innovation and investment in research and technology, and entrepreneurs with the courage and far-sightedness not to remain passive in the face of difficulties but to seize the opportunity to change the way their businesses operate.

The stagnation in productivity is partly due to the shortage of human capital. The low level of employment among members of the most vital and promising segment of the working population is a serious waste: in Italy the employment rate for people in their twenties is 10 points lower than the average for the European Union.

In the past ten years Italy has narrowed the gap with the other advanced countries as regards young people's educational attainment, but the cumulative deficiencies will be reflected in the average educational level of Italians for a long time to come. In 2003 secondary-school and university graduates made up 34 and 10 per cent respectively of the age group from 25 to 64, compared with averages of 41 and 24 per cent in the OECD countries.

The quality of academic results is also unsatisfactory in several respects. By the age of 15, Italian students are the equivalent of one school year behind in mathematics: according to an OECD survey, Italy ranks 26th out of 29 countries. This lack of educational effectiveness is compounded by a lack of equity: in terms of the variability of achievement levels among 15-year-olds, Italy is in 23rd position among the OECD countries; success in secondary school and at university is closely correlated with the socio-economic status of the student's family.

The seriousness of the problem is a compelling reason to examine the experience of other European countries, such as Sweden, Finland and the United Kingdom, which have experimented with ways of improving the performance of the education and research system by increasing competition among schools and universities; even more than additional expenditure, what is needed are new rules to reward teachers and researchers on merit.

The productivity of the service sector is essential for economic growth. Services account for over 70 per cent of value added in the OECD countries; they are used in production by all the other branches of activity. Monopoly rents that keep prices high, impede innovation and productivity, and depress the economy's competitiveness are more prevalent in the service sector.

Utility companies in Italy were still entirely publicly owned until the middle of the 1990s. The large-scale privatization programme involving them helped to reduce the public debt in relation to GDP. The liberalization of these markets has not progressed to the same extent. The problems of network operation and expansion of the number of suppliers remain largely unresolved. Where local public services are concerned, even privatization has made little progress, and liberalization is practically non-existent;

contracts can be let to public or mixed companies without a call for tenders. Local authorities still control many enterprises supplying public services. Sometimes they attempt to increase the range of services offered, triggering a return to public control.

Obstacles to competition also stem from restrictive regulations, which in several branches of activity harm the majority of consumers and workers.

In the retail sector the average number of employees is about half the euro-area average. The degree of fragmentation impinges on efficiency; it slows the adoption of new technologies, which are an important source of productivity growth in the sector in other countries. The reform law of 1998 liberalizing the establishment of small shops empowered the regional authorities to regulate the opening of larger outlets. Not all of the regions took this opportunity to liberalize. In the regions that applied the most restrictive standards this hindered productive efficiency and the spread of new technologies, to the detriment of consumers and even of employment growth in the sector.

The European services directive currently in the process of being adopted can offer only modest stimulus to competition. The undertaking of more resolute liberalization policies is still left mainly to the discretion of national governments. Italy has everything to gain by moving resolutely in this direction.

The legal and administrative system significantly affects the costs and competitiveness of businesses. In Italy it has long been indifferent to market considerations. In a World Bank classification of the bureaucratic and administrative formalities affecting businesses, Italy comes 70th, last but one among the OECD countries.

From the middle of the 1990s onwards, steps were taken to simplify administrative procedures and improve the system of regulation. They have been only partially successful. The discrepancy between measures as formally drafted and their practical application continues to be a general problem of the Italian system.

The recent reform of bankruptcy law has introduced instruments to promote earlier detection of critical situations and the rapid reorganization of firms in temporary difficulty; it has streamlined and modernized liquidation procedures. However, the new legislation only applies to about half of all businesses; in particular, a large set of firms are not eligible for the cancellation of residual debts at the end of the procedure. The penal provisions, based on a punitive view of bankruptcy, remain unchanged.

Much remains to be done in the general area of the application of the law, although this is not the place to suggest remedies, which can be sought in the experience of other countries. The reforms passed in the last fifteen years to speed up civil proceedings have not yielded the desired results. Civil actions still last far longer than in other European countries; debt recovery proceedings in Italy take five times the OECD average. International studies show that, in relation to the size of the population, the number of judges and officials in Italy and the amount of public spending on the justice system are comparable to the figures for other countries of similar size and legal tradition.

In the tax field, action to improve the clarity of the rules and regulations and the way they are applied reduces litigation and guarantees firms a more certain framework in which to operate. Compliance with tax and social security obligations is discouraged by frequent recourse to amnesties and immunity from prosecution; between 1970 and 2004 only two fiscal years were not covered by provisions of this kind.

The revival of domestic economic growth and the reduction of geographical disparities are complementary objectives. Measures that will have an impact on the structure of the economy, particularly on the growth in the size of firms and changes in their product specialization, serve both purposes. In fact, they bring greater benefits to the economy of the South, which suffers more acutely from the national ills, notably in public services and infrastructure but also in the enforcement of law and order.

Specific policies offering incentives to firms may be helpful, but their usefulness must not be overrated. They involve administrative costs, possible distortions in the allocation of resources, and the risk that they will be abused, especially if they rely on discretionary mechanisms. Even the benefit of stimulating investment, despite being greater for firms in the South, is modest in relation to the resources employed. According to Bank of Italy surveys, one fifth of industrial firms in the South received public incentives in 2005, compared with nearly one quarter of those in the rest of Italy. In the case of firms in the South, the additional investment generated is less than 30 per cent of the funds distributed; in the Centre and North the corresponding figure is about 10 per cent.

A scaling-down of the system of transfers to firms would release resources for other spending priorities and for reducing the tax burden and social security contributions. By contrast, an attempt to force the growth of the South financially by assigning inappropriate tasks to banks could once again lead to situations that have already proved harmful in the past both for the economy of the South and for the stability and efficiency of the banking system.

The financial system in the South has made important strides in the last ten years, especially in the quality and efficiency of banking, thanks in part to the involvement of banks based in the Centre and North. On a risk-adjusted basis, the difference between the cost of credit in the South compared with that in the Centre and North has almost vanished. However, there is still a lag in the spread of more advanced financial instruments among households in the South, and even in the use of banking services. Banks and financial institutions have considerable growth potential in the South.

A financial system serving development

The capital markets

Funds raised directly in the market by firms in the form of listed shares and bonds represent only 17 per cent of their financing in Italy, about a quarter less than in France and Germany; the figure is higher than 40 per cent in the United States and close to 50 per cent in the United Kingdom. In relation to the size of the economy, Italy's stock exchange is much smaller than the average for the advanced countries.

Development of the capital markets is necessary for the growth of firms, and vice versa. The markets play a crucial role in mobilizing financial resources. The total financial wealth of Italian households is large in relation to GDP and also by comparison with the other major European countries. Although the behaviour of savers has changed in the last few years, the diversification of households' portfolios is still limited, to the detriment of the balance between returns on savings and protection from risk. Broader, efficient and well-regulated financial markets will make it possible to encourage current trends, benefiting households, firms and intermediaries themselves.

In the life of a firm, admission to stock exchange listing is the first step towards a more solid financial structure, possibly paving the way for a leap in size, with a higher proportion of bond debt and often with a lower cost of bank credit. But fear of losing control of the firm and the costs connected with the transparency requirements for listed companies, including their tax implications, deter many entrepreneurs from seeking a listing. Regulation must seek to strike a balance between safeguarding investors and minimizing the costs for firms. It is up to the entrepreneur to assess the opportunities offered by stock exchange listing, which detracts nothing from his passion or creativity; on the contrary, in difficult moments of transition, it can represent a compromise between keeping all the capital in his own hands, thereby sacrificing the opportunities for growth, and relinquishing control entirely.

Development of the markets requires rapid and effective protection of minority shareholders from opportunistic or non-transparent behaviour. Prevention must be able to rely not only on primary and secondary legislation and its application by the supervisory authorities, but also on the autonomous initiative of operators in the market: banks, rating agencies, investors. There is ample scope for self-regulation and shareholder activism.

If this is not fully exploited in Italy, it is partly because institutional investors carry little weight. Their voice, which is strong and insistent elsewhere, is faint in Italy. Their presence contributes to the assessment of the quality of corporate management, the protection of minority shareholders and the correct handling of conflicts of interest; it deepens the market and increases its allocative efficiency; it facilitates the placement of equity capital and the spread of long-term financial liabilities. Where institutional investors play a more prominent role, the average size of the companies that seek a listing is smaller.

Pension funds in particular have great potential for growth in Italy. In the most advanced financial systems they are among the main investors in listed shares. In the United States they hold about one fifth of the market capitalization, corresponding to roughly one third of GDP; in Italy the proportion is close to zero. The financial assets managed by Italian pension funds amount to 2.1 per cent of GDP, those of funds created after 1993 to 0.8 per cent.

More rapid expansion is necessary. The income replacement delivered by the public pension system will decline in the decades ahead as a consequence of the reforms introduced in recent years. The rapid growth of supplementary pension schemes is essential to provide adequate incomes for future generations of retirees.

In addition to workers' contributions, it will be necessary to use the flow of resources now set aside for severance pay, which for the private sector amounts to approximately 1.5 per cent of GDP per year. The advantages for workers are likely to be considerable. Greater investment in equities would increase the return on retirement savings. Over the long run the rate of return on equities has been substantially higher than that on bonds and well above the nominal rate of growth in GDP; it has been far higher on average than that on accumulated severance pay.

Hitherto, the accumulation of severance pay has represented a form of precautionary saving for workers, offering a modest but certain return, which in the event of loss of employment supplemented the often scant protection provided by the welfare system. Ways must be found to guarantee workers adequate flexibility in the use of the accumulated resources and an appropriate limitation of risk.

As for firms, contributions relief such as that which has been announced would amply compensate for the loss of a source of finance at less than market rates.

The development of supplementary pension schemes requires that full competition be promoted between all financial institutions and that workers be guaranteed full freedom of choice. Suitable fund size and greater transparency of terms and conditions must contribute to containing costs.

At the same time, it is necessary to give workers clear information about the public pension that they will receive in the future. According to the Bank of Italy's Survey of Household Income and Wealth, one third of the persons in employment are unable to judge whether their pension will be adequate.

The experience of other countries suggests that the expansion of pension funds is also crucial for the development of intermediaries specialized in fostering the growth of small, innovative firms. Between 2000 and 2003 pension funds in the United States accounted for 42 per cent of the financial flows of venture capital firms, compared with 20 per cent in the euro area and 3 per cent in Italy.

A deep and efficient stock market enables private-equity investors to dispose of their shareholdings by means of stock exchange listings, a method of disinvestment that makes the valuation process transparent while also offering entrepreneurs greater protection against the risk of losing control. The growth of specialized intermediaries, the greater involvement of institutional investors and the strengthening of the stock market are mutually reinforcing.

More widespread use of investment funds would permit greater diversification of the risks in households' portfolios and improve the functioning of the financial markets. The competitiveness of Italian funds is affected by tax disadvantages by comparison with foreign operators; it is in the interest of the development of the Italian financial industry that they be eliminated.

The Bank of Italy will simplify the supervisory rules. The timetable for the launch of funds will be shortened by broadening the range of cases in which the approval of fund rules is rapid or automatic. Hedge funds and funds reserved to qualified investors, which have high minimum investment requirements, will be allowed the greatest possible operational autonomy.

The growth of investment funds could also benefit from changes in the sector's structure. The current governance arrangements for asset management companies are based on the integration of the production and distribution of financial products and on the central role of banking and insurance groups. Initially this model enabled the sector to grow rapidly, but today it threatens to segment the market, reduces its efficiency and restrains its further growth in quality and size, preventing full exploitation of the large economies of scale in asset management.

In the past few years the Italian financial marketplace has achieved great progress in terms of trading volumes and transaction costs. The market's liquidity and depth can increase further if implementation of the plans for federation with other European exchanges is accelerated, while safeguarding the informational advantages of the national market.

The European directive on financial markets has created the conditions in which integration can strengthen competition between regulated markets and systems operated by intermediaries. However, the benefits may not materialize if barriers to access to clearing and settlement services persist and legislative and technical disparities remain. Further common rules could be formulated with the aim of preventing discrimination in access and creating a harmonized regulatory and supervisory framework that will ensure competition on an equal footing, investor protection and systemic stability.

The banks

The Italian banking system is sound. In the last few years loan quality has remained high, despite the weakness of the real economy; it has benefited not only from improvements in borrower selection techniques but also from the transfer of part of the credit risk away from banks' balance sheets. The profitability of banking groups has improved: the return on equity has reached 12 per cent, two points higher than in 2004; for the leading groups it has risen by five points to 16.2 per cent.

Further development of the banking sector, including in terms of banks' size, can improve the financial system's competitiveness and strengthen the economy. Small banks continue to play an indispensable role in financing local economies; the presence of sufficiently large intermediaries is necessary to ensure that more advanced services are widely available at low cost. The growth and internationalization of firms are facilitated by the growth and internationalization of banks.

As well as engaging in traditional activities, banks now increasingly distribute a wide range of financial products. This alters the composition of the risks they face. Their good name, which depends on proper conduct and the quality of the products they sell, including those of third parties, becomes crucially important for their competitiveness and even for their stability. In addition to traditional credit and market risks, which have now been partly transferred to other intermediaries, banks now face reputational, legal and operational risks.

In this context strict compliance with regulations, with appropriate operating standards and with deontological and ethical principles is a prerequisite for the sound and prudent management of intermediaries. The measures to foster corporate cultures based on rigorous observance of the rules, the correct handling of conflicts of interest and maintenance of customers' trust must be strengthened. The Bank of Italy will issue instructions requiring banks to establish a compliance function to monitor observance of legal and self-regulatory rules.

The code of ethics that the Board of Directors of the Bank of Italy approved this morning contains a provision to that effect for this institution.

Effective governance arrangements are equally important. Especially where ownership is fragmented, self-referential forms of governance must be prevented from taking hold. The clear allocation of roles, the effective exercise of their powers by governing bodies, the existence of adequate checks and balances, and transparent conduct will ensure proper management with the well-informed assumption of business risks.

Banks' greater efficiency and the increase in competition are not yet sufficiently reflected in the prices or quality of some banking services.

Bank charges for closing accounts are especially significant, because they may restrict customer mobility and thereby hinder competition. At the end of 2004, in consultation with the Antitrust Authority, the Bank of Italy initiated an enquiry into the procedures and charges for terminating the main retail banking and financial services. In the last two years some banks have eliminated their charges for closing accounts. In most European countries banks are not allowed to charge for this; in some, such as the United Kingdom and France, self-regulatory codes also lay down standards to ensure that accounts and the related services can actually be transferred within a given time. The extensive data collected in the course of the enquiry are described in the body of the Annual Report; the follow-up is now the responsibility of the Antitrust Authority.

The new Basel Capital Accord introduces some highly innovative principles into the regulation of banking. Its transposition requires a far-reaching revision of supervisory rules. It will simplify prudential regulations, increase intermediaries' freedom of action and enhance the flexibility of the banking system.

The key criterion is the evaluation of the different forms of risk using common quantitative methods, together with a more accurate correlation between capital requirements and the size of the risks faced. The new rules for assessing the capital and organizational adequacy of banks are based on their own methodologies. The Bank of Italy's task is to verify the reliability and rigour of the methods used and, if necessary, to require corrections and improvements. There will be a more intense interaction between the supervisory authority and the banks, but the regulatory formalities will be reduced.

The widespread dissemination of the methods for calculating capital requirements developed by each of the leading banks has made adequate techniques available to a wide range of intermediaries, in some cases through participation in consortiums. However, the most advanced calculation methods will initially be used only by some of the major groups. The market will comprise banks applying credit assessment methodologies of varying complexity. The Bank of Italy is committed to checking that the use of different methods of customer selection does not lead to regulatory arbitrage or adverse selection.

The risk-weighting system and the special treatment reserved for small loans mean that the new rules will not result in credit rationing or higher costs for smaller firms.

By increasing the role of flexible and market-oriented supervisory instruments and reducing that of detailed administrative prescriptions, the new regulatory system enhances the role and effectiveness of on-site and prudential supervision.

Again with the aim of directing finance toward stimulating renewed economic growth, the Bank of Italy intends to submit a proposal for revising the regulation of banks' equity interests in non-financial corporations to the Interministerial Committee for Credit and Savings. The rules would be fully aligned with Community law by easing the present stringent constraints while introducing rigorous codes of corporate governance in order to safeguard intermediaries' stability and ensure the transparent and correct handling of conflicts of interest.

As regards the authorization of acquisitions of controlling interests in banks, the obligation to notify plans to the Bank of Italy before they have been submitted to the board of directors will be abolished.

Driven by the single currency and progressive regulatory harmonization, the integration of European banking markets derives additional momentum from developments in the competitive environment. The growth of consumer credit and, more generally, of financial products for households contributes in this respect. Such products are becoming increasingly standardized in design and in the technology used, which encourages their large-scale distribution and enhances the value of existing distribution networks. Italy, where households have a low level of debt and still relatively undiversified financial assets, is an attractive market.

In the last ten years the main European banking groups have become highly profitable, partly owing to the restructuring carried out in national markets. They now have the resources to extend their activity abroad significantly. The growth of the main Italian banks has narrowed the gap between them and their leading European counterparts, but has not eliminated it; the process must continue.

It is well known that last year saw important acquisitions of two Italian banks by foreign banking groups and of foreign banks by an Italian group. This greatly increased the degree of internationalization of Italy's banking system, bringing it into line with that of the other leading euro-area countries. Foreign-owned banks' share of the assets of banks established in Italy rose from 8 to 14 per cent; in France, Germany and Spain the corresponding figure is between 10 and 11 per cent, and in the Netherlands it is 14 per cent. The foreign assets of the largest five Italian banking groups rose from 11 to 41 per cent of their combined assets, a figure comparable to that in the other countries I have just mentioned. The increase was entirely due to a single acquisition.

The spread of multinational banking groups in Europe requires supervision performed jointly by authorities from different countries, in accordance with principles established at European level, under which the supervisory authority of the parent company is responsible for coordination. Permanent structures, known as supervisory colleges, have been established to coordinate the supervision of multinational groups. The Bank of Italy has signed agreements with the German authorities and made contact with those of many other European countries with a view to establishing cooperation arrangements for Italian groups with a presence of systemic significance in other countries and vice versa. Cooperation also relates to the convergence of supervisory practices, to ensure that units of groups located in different countries receive uniform treatment.

The law on the protection of savings passed in December 2005 is intended to strengthen the safeguards for savers and increase market transparency, with provisions that affect the regulation of market participants, relations between intermediaries and their customers and the arrangements for supervisory authorities.

As regards the latter aspect, the reform is based on the principle of the purpose-based allocation of responsibilities. In accordance with this approach, antitrust activity in the banking sector has been transferred to the Antitrust Authority and new duties concerning the regulation and control of the supply of financial products by banks and insurance companies have been entrusted to Consob. The purpose-based model of supervision offers advantages in terms of the specialization of controls, the speed of decision-making and the transparent identification of the authorities' responsibilities in relation to the purposes they are assigned and the exercise of the powers they are granted.

The Bank of Italy had already concluded agreements with Isvap and Consob on the supervision of financial conglomerates and is now ready for any additional agreements that the new legal framework may require. For matters that fall under the jurisdiction of more than one authority, it is to be hoped that some of the technical solutions envisaged by the law will be simplified, especially as regards the artificial combination of the various authorizations involved in banking mergers into a single act. Cooperation among the authorities is essential for the more effective exercise of administrative discretion and to curb the costs borne by the entities subject to supervision.

* * *

I began my remarks with the words "returning to growth". This is Italy's absolute priority for economic policy today, as was entering the monetary union ten years ago. While preserving the stability we acquired at so great a cost, we must find our way back to the path of growth. The actions to be undertaken, including the measures to redress the public finances that have now become imperative, must be evaluated first and foremost from this point of view.

Such an objective can only be achieved if there is consensus on the goals for the future and agreement on action in the present. Let us draw encouragement from the knowledge that in the course of its history this country has successfully overcome far more dramatic challenges.

THE BANK OF ITALY’S ANNUAL ACCOUNTS

THE BANK OF ITALY'S ANNUAL ACCOUNTS [1]

Foreign exchange reserves. – In managing its foreign exchange reserves, the Bank continued with the policy aimed at diversifying the potential sources of income and reducing the volatility of yields.

At 31 December 2005 Italy's foreign exchange reserves amounted to €24.4 billion, an increase of 12 per cent on the year-earlier figure of €21.8 billion. At the same date the foreign reserves managed on behalf of the ECB amounted to approximately €6 billion, with an increase of 17 per cent. In both cases the increase was primarily due to the appreciation of the dollar against the euro.

Monetary policy operations and operations on behalf of the Treasury. – The implementation of monetary policy required 74 open-market transactions, of which 52 were main refinancing operations, 13 were longer-term refinancing operations and 9 were fine-tuning operations. The latter were carried out on the last day of a maintenance period and included 6 cases of deposit-taking and 3 of refinancing.

Turning to the public debt, as the Treasury's agent, the Bank carried out the placement of issues on the primary market, the settlement of special transactions undertaken directly by the Ministry for the Economy and Finance, and transactions on the secondary market. The agreement whereby the Bank acts as agent for the Ministry for the Economy and Finance for Republic of Italy foreign currency loans was renewed for the period 2005-06.

Management of the Bank's investment portfolio. – The investment activity of the Bank is based on the principle of long-term prudence, with account taken of the need for appropriate combinations of risk and return in relation to its institutional functions.

At the end of 2005 investments of the Bank's own funds in securities amounted to approximately €76 billion at market prices. The part invested

[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.

in listed securities amounted to approximately €74 billion and was divided between bonds (91 per cent) and equities (9 per cent).

The total net assets of the supplementary pension fund for employees hired from 28 April 1993 onwards amounted to €67 million.

Human, organizational and IT resources. – At 31 December 2005 the Bank's staff numbered 7,957, down by 139 on 31 December 2004; compared with the end of 1995 the reduction was 1,466 or 15.6 per cent.

The Bank participated actively in the numerous working groups set up at European level to analyze problems of special interest.

On 27 April 2006 the Bank signed agreements with the trade unions on the economic and other conditions of employment, bringing to an end the negotiations for the four-year period 2002-05. The agreements also covered workplace access to the Internet (pursuant to Article 4 of Law 300/1970).

The organizational measures have been completed for the unification of the "Cashier" and "Accounting and Control" functions throughout the branch network, where the new units called "Inpayments, Outpayments and Control" have been set up. In addition, the Milan and Naples local branches, charged with payment services and accounting for the Treasury, have been merged with their respective main branches.

The project for the concentration at regional level of branches' contracts for some services is nearing completion. The possibility of acquiring certain goods and services using on-line catalogues was extended to all the Bank's units (the e-procurement project). Other initiatives continue aimed at streamlining administrative procedures.

As regards IT resources, work continued on several projects for the development of applications of national and international importance concerning the payment system, payment services and accounting for the Treasury, and book-keeping.

In particular, work continued on the preparation of the single European platform of the new TARGET2 payment system and for the adoption of the single list of securities eligible as collateral for ESCB credit operations.

The Bank's computing infrastructure was strengthened: the capacity of the central systems grew by about 19 per cent; the scope of the use of intermediate systems was broadened; and a substantial proportion of work stations was renewed.

The technological upgrading of the local networks of the branches was completed; the renewal of the networks of the Head Office is under way.

The Bank adopted additional measures to ensure business continuity in the event of an emergency, whether within the Bank, the Italian financial system or the Eurosystem.

Accounting aspects. – Work continued in 2005 on preparing the Bank's accounting system and procedures for the application, as of 2007 in accordance with the decision of the Governing Council of the ECB, of the so-called economic approach. This method provides for transactions in financial instruments to be entered in the books at the trade date of the contract instead of at the settlement date; provision is also made for accruals on foreign exchange transactions to be recorded daily.

As regards taxation, the Bank's tax return for 2004, the first year of application of the new corporate income tax (Ires), was prepared taking account of the reform of corporate taxation, with special reference to the part concerning equity interests.

An analysis was made of the effects of Decree Law 203/2005, ratified by Law 248/2005, which provided for the tax losses accumulated by the Bank in the period 2002-04 to be carried forward indefinitely and used to offset up to a maximum of 50 per cent of taxable income in each year.

The Bank provided tax assistance directly to 6,835 employees and pensioners, while 3,386 used the services of tax assistance centres.

Expenditure procedures have been simplified at the branches and the related control systems improved, partly by introducing new sampling methods.

New cost accounting tools have been prepared that promote the process of harmonization under way within the Eurosystem.

Participation in the Eurosystem. – The Bank continued to be actively involved in carrying out activities within the Eurosystem and implementing initiatives that originated there.

Summary of the results for 2005. – The Bank's results for the year reflected the appreciation of the US dollar against the euro (by approximately 13 per cent, from \$1.3621 to \$1.1797) and the gradual rise in the interest rates on dollar-denominated assets. In the euro area money market rates remained relatively low, showing an upward trend in the last few months of 2005.

The year-end balance sheet total rose by €25,443 million (from €159,586 million to €185,029 million), largely as a result of the rise in the value of gold and net foreign currency assets and of the revaluation of "instrumental" buildings under Law 266/2005. On the assets side refinancing operations and the portfolio of securities denominated in euros also increased; on the liabilities side banknotes in circulation showed significant growth (rising on average over the year by 15 per cent, in line with the Eurosystem as a whole).

Profit before tax and allocations to provisions for risks benefited from the virtual absence of foreign exchange writedowns, which in 2004 had amounted to €1,699 million and from the €717 million improvement in *net interest income*. The latter result was due to the higher rate of return on assets denominated in foreign currency and the above-mentioned growth in banknotes in circulation.

An allocation of €703 million was made to the provision for general risks, from which withdrawals had been made in the three previous years to cover unrealized losses.

The tax on income for the year and that on productive activities amounted to €935 million. In accordance with Law 248/2005 – which amended Article 65 of Law 289/2002 – the Bank is required to pay tax on €404 million of income (in addition to its payments on account) since tax losses can now be used to offset only 50 per cent of the taxable income for the year.

Net income for the year consequently amounted to €50 million (€25 million in 2004).

On 28 April 2006 the exchange rate of the dollar against the euro was 1.2537, a decline of approximately 6 per cent compared with the end of 2005.

BALANCE SHEET
AND INCOME STATEMENT
for the year ended 31 December 2005

ASSETS	amounts in euros 2005	2004
1 GOLD AND GOLD RECEIVABLES	**34,279,174,572**	**25,348,345,047**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**21,626,458,133**	**20,449,732,089**
2.1 Receivables from the IMF	2,510,117,195	3,633,965,360
2.2 Securities (other than shares)	14,920,468,682	13,482,833,103
2.3 Current accounts and deposits	4,191,899,816	3,330,872,380
2.4 Reverse operations	–	–
2.5 Other claims	3,972,440	2,061,246
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**6,929,534,590**	**5,595,383,242**
3.1 Financial counterparties	6,929,534,590	5,595,383,242
3.1.1 Securities (other than shares)	*3,244,517,458*	*2,704,043,645*
3.1.2 Reverse operations	–	–
3.1.3 Other claims	*3,685,017,132*	*2,891,339,597*
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	**21,276,759,750**	**14,632,036,365**
5.1 Main refinancing operations	21,072,514,723	14,218,340,951
5.2 Longer-term refinancing operations	204,185,386	411,676,704
5.3 Fine-tuning reverse operations	–	–
5.4 Structural reverse operations	–	–
5.5 Marginal lending facility	–	–
5.6 Credits related to margin calls	59,641	2,018,710
6 OTHER CLAIMS ON EURO-AREA BANKS	**115,111,983**	**308,848**
7 SECURITIES ISSUED BY EURO-AREA RESIDENTS (other than shares)	**1,939,412,655**	**1,978,377,877**
8 GENERAL GOVERNMENT DEBT	**18,405,970,514**	**18,560,774,548**
9 INTRA-EUROSYSTEM CLAIMS	**15,541,738,332**	**15,246,998,970**
9.1 Participating interest in the ECB	726,278,371	726,278,371
9.2 Claims deriving from the transfer of foreign reserves to the ECB	7,262,783,715	7,262,783,715
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem	–	–
9.4 Other claims within the Eurosystem (net)	7,552,676,246	7,257,936,884
10 ITEMS TO BE SETTLED	**1,137,334**	**1,916,202**
11 OTHER ASSETS	**64,914,149,535**	**57,771,627,737**
11.1 Euro-area coins	36,418,012	26,161,148
11.2 UIC endowment fund	258,228,450	258,228,450
11.3 Investments of reserves and provisions (including shares)	29,531,670,162	29,112,651,560
11.4 Intangible fixed assets	23,349,329	25,170,761
11.5 Deferred charges	4,516,450	5,729,126
11.6 Tangible fixed assets (net of depreciation)	3,989,568,125	2,452,221,341
11.7 Accrued income and prepaid expenses	758,581,472	714,539,423
11.8 Sundry	30,311,817,535	25,176,925,928
TOTAL	**185,029,447,398**	**159,585,500,925**
13 MEMORANDUM ACCOUNTS	**267,831,272,348**	**254,009,182,041**

Audited and found correct - 27 April 2006

THE AUDITORS: Giuseppe Bruni, Enrico Nuzzo, Angelo Provasoli, Massimo Stipo, Gianfranco Zanda

SHEET

LIABILITIES	amounts in euros 2005	amounts in euros 2004
1 BANKNOTES IN CIRCULATION	**94,933,679,360**	**84,191,125,720**
2 LIABILITIES TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS	**11,452,935,348**	**12,971,530,076**
2.1 Current accounts (covering the minimum reserve system)	11,451,124,748	12,970,082,463
2.2 Deposit facility	1,810,600	1,447,613
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	**14,707,403,877**	**15,968,221,526**
4.1 General government	14,662,533,655	15,859,340,512
4.1.1 Treasury payments account	*14,405,375,705*	*15,770,902,538*
4.1.2 Sinking fund for the redemption of government securities	*166,396,749*	*3,585,994*
4.1.3 Other liabilities	*90,761,201*	*84,851,980*
4.2 Other counterparties	44,870,222	108,881,014
5 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN EUROS	**91,029,853**	**30,501,268**
5.1 Liabilities to non-euro-area EU central banks	49,667,292	150,659
5.2 Other liabilities	41,362,561	30,350,609
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	**1,627,000,102**	**648,188,775**
7.1 Deposits and balances	11,248,769	9,609,089
7.2 Other liabilities	1,615,751,333	638,579,686
8 COUNTERPART OF SDRs ALLOCATED BY THE IMF	**849,833,760**	**800,455,040**
9 INTRA-EUROSYSTEM LIABILITIES	**8,100,701,800**	**6,077,311,530**
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	8,100,701,800	6,077,311,530
9.3 Other liabilities within the Eurosystem (net)	–	–
10 ITEMS TO BE SETTLED	**29,975,193**	**23,640,110**
11 OTHER LIABILITIES	**2,062,697,836**	**2,290,976,932**
11.1 Bank of Italy drafts	614,082,157	524,323,203
11.2 Cashier's department services	–	2,382
11.3 Accrued expenses and deferred income	36,653,594	27,161,553
11.4 Sundry	1,411,962,085	1,739,489,794
12 PROVISIONS	**6,753,370,840**	**6,259,616,599**
12.1 Provisions for specific risks	1,088,394,839	619,813,508
12.2 Sundry staff-related provisions	5,664,976,001	5,639,803,091
13 REVALUATION ACCOUNTS	**20,600,378,145**	**9,549,667,970**
14 PROVISION FOR GENERAL RISKS	**7,535,281,997**	**6,832,281,998**
15 CAPITAL AND RESERVES	**16,234,874,914**	**13,916,528,881**
15.1 Capital	156,000	156,000
15.2 Ordinary and extraordinary reserves	10,693,306,382	9,893,879,958
15.3 Other reserves	5,541,412,532	4,022,492,923
16 NET PROFITS FOR DISTRIBUTION	**50,284,373**	**25,454,500**
TOTAL	**185,029,447,398**	**159,585,500,925**
18 MEMORANDUM ACCOUNTS	**267,831,272,348**	**254,009,182,041**

THE ACCOUNTANT GENERAL
Anna Maria Tarantola

THE GOVERNOR
Mario Draghi

INCOME STATEMENT

	amounts in euros 2005	2004
a) Net income from institutional operations		
Interest income	*3,386,258,870*	*2,492,644,809*
Interest expense	*-1,424,121,629*	*-1,248,021,911*
Net interest income	**1,962,137,241**	**1,244,622,898**
Profits and losses on financial operations	*471,821,309*	*177,471,731*
Writedowns of financial assets and positions	*-118,681,241*	*-1,720,953,526*
Transfers to/from provisions for exchange rate and price risks	*-702,995,593*	*755,264,050*
Net result of financial operations, writedowns and risk provisions	**-349,855,525**	**-788,217,745**
Fee and commission income	*19,371,992*	*18,240,714*
Fee and commission expense	*-24,024,245*	*-19,919,206*
Net income from fees and commissions	**-4,652,253**	**-1,678,492**
Income from equity shares and participating interests	798,161	27,063,147
Net result of the pooling of monetary income	6,350,235	-238,819,062
b) Other income		
– income from the investment of reserves and provisions	1,743,093,860	1,296,057,125
– prior-year income	59,280,441	181,517,089
– sundry	85,516,749	94,789,113
Total net income (a+b)	**3,502,668,909**	**1,815,334,073**
Sundry expenses and charges		
Staff wages and salaries and related costs (1)	-604,835,746	-612,415,741
Emoluments paid to head and branch office collegial bodies	-2,635,975	-2,697,194
Transfers to provisions for accrued expenses and staff severance pay and pensions	-97,295,981	-94,568,046
Other staff costs	-42,604,292	-41,341,203
Pensions and severance payments	-264,102,724	-280,769,310
Administrative costs	-378,148,321	-374,045,629
Depreciation of tangible and intangible fixed assets	-254,242,306	-186,390,736
Banknote production services	–	–
Other costs:		
– losses on investments of reserves and provisions	-13,181,336	-9,638,221
– other transfers to provisions	–	–
– prior-year expense	-3,767,677	-2,709,017
– appropriation of investment income to reserves (2)	-836,722,624	-422,324,280
– other taxes and duties	-14,249,761	-14,997,525
– sundry	-6,094,821	-6,044,347
Taxes on income for the year and productive activities (3)	-934,502,972	258,061,676
Net profit for the year	**50,284,373**	**25,454,500**

(1) The Bank's staff averaged 8,027 in 2005, against 8,166 in 2004. – (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	**10,056,875**
TO THE EXTRAORDINARY RESERVE	**10,056,875**
TO SHAREHOLDERS: 6% OF THE CAPITAL	**9,360**
AN ADDITIONAL 4% OF THE CAPITAL	**6,240**
TO THE STATE	**30,155,023**
TOTAL	**50,284,373**

Audited and found correct
27 April 2006.

THE AUDITORS

Giuseppe Bruni
Enrico Nuzzo
Angelo Provasoli
Massimo Stipo
Gianfranco Zanda

THE ACCOUNTANT GENERAL

Anna Maria Tarantola

THE GOVERNOR

Mario Draghi

NOTES TO THE ACCOUNTS

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 no. 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 and non-binding recommendations for the other items of their annual accounts. In addition, on 8 April 1999 the Governing Council of the ECB issued Recommendation no. 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"), as amended;

– Legislative Decree 87/1992 ("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") , as amended;

– Article 65 (transactions involving government bonds) of Law 289/2002, as amended by Decree Law 203/2005, ratified by Law 248/2005.

1.2 *Accounting policies*. – The accounting policies applied in preparing the annual accounts for 2005 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 2000 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, including those consisting of securities denominated in foreign currency, 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 part in national currency and at the euro/SDR exchange rate communicated by the ECB for the remaining part.*

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 "instrumental" 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 no. 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 no. 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 on the second working day of the year following the reference year in the form of an interim distribution of profit (ECB Decision no. 11 of 17 November 2005, in

OJ L311 of 26 November 2005, pp. 41-42). 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 Governing Council of the ECB may also decide to transfer part or all of the ECB's seigniorage income to a provision for foreign exchange rate, interest rate and gold price risks. The interim distribution 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 2005 the Governing Council decided 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 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 mathematical reserves for the disbursements to pensioners and those corresponding to the situation of staff having entitlement. The provisions for pensions show a small excess for 2005, which has been left allocated to the account in preparation for the effects on such benefits of the renewal of labour contracts;*
- *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 2003. The provision also includes a*

prudential allocation to the account in preparation for the effects on staff costs of the renewal of labour contracts;

- *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, as amended by Decree Law 203/2005, ratified by Law 248/2005, 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, net of the payments on account made to the tax authorities under Article 87 of Law 289/2002.

INTEREST RATE FUTURES DENOMINATED IN FOREIGN EXCHANGE

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*. – The balance sheet total at 31 December 2005 was equal to €185,029 million, an increase of €25,443 million compared with the figure of €159,586 million at the end of 2004.

Assets:

Gold and gold receivables (Item 1) increased by €8,931 million (from €25,348 million to €34,279 million) exclusively as a result of their valuation at the year-end market price communicated by the ECB; the positive difference was recorded in the corresponding revaluation account. The quantity of gold remained unchanged at 79 million ounces or 2,452 tons.

Claims on non-euro-area residents denominated in foreign currency (Item 2) rose by €1,176 million (from €20,450 million to €21,626 million) as a result both of the valuations at year-end exchange rates and market prices and of the larger holdings of securities and deposits, offset only in part by the decrease in net assets in SDRs vis-à-vis the IMF.

Within this item:

– *receivables from the IMF* (Subitem 2.1) comprised (Table 1):
  - a) Italy's reserve tranche position, which fell as a result of reimbursements by debtor countries, offset only in part by the valuation at the year-end exchange rate;

Table 1

ACCOUNTS WITH THE IMF

(thousands of euros)

	Amounts at end 2005	Amounts at end 2004	Changes
ASSETS			
2.1 Receivables from the IMF	**2,510,117**	**3,633,965**	**-1,123,848**
a) Italy's reserve tranche position	**1,489,391**	**2,716,103**	**-1,226,712**
Quota in the IMF:	8,525,187	8,029,735	495,452
– gold quota	266,212	250,744	15,468
– SDR quota	1,795,285	1,690,971	104,314
– national currency quota	6,463,690	6,088,020	375,670
IMF holdings	-7,035,796	-5,313,632	-1,722,164
b) Italy's share of the loans to support debt-reduction initiatives for the poorest countries (PRGF)	**827,287**	**811,720**	**15,567**
c) SDRs	**193,439**	**106,142**	**87,297**
LIABILITIES			
8. Counterpart of SDRs allocated by the IMF	**849,834**	**800,455**	**49,379**

b) Italy's share of the loans to support debt-reduction initiatives for the poorest countries (PRGF), which increased as a result of the valuation at the year-end exchange rate, although repayments caused the amount outstanding to decline from SDR712 million to SDR684 million;

c) the Bank's SDRs, which rose as a consequence of the larger foreign currency amounts (from 93 to 160 million SDRs) and to a lesser extent owing to the valuation at the year-end exchange rate.

– *securities (other than shares)* (Subitem 2.2) increased by €1,437 million and included €10,548 million of securities denominated in US dollars (71 per cent of the total) and €3,625 million of securities denominated in pounds sterling (24 per cent); the remaining securities were denominated in yen and Swiss francs. For the most part the securities were issued by the US Treasury and international organizations (the BIS and the EIB);

– *current accounts and deposits* (Subitem 2.3) showed an increase of €861 million; denominated mostly in US dollars and yen, they were held at the BIS and with residents of the United Kingdom and Japan. Time deposits increased from €1,314 million to €1,601 million) and sight deposits from €952 million to €2,201 million), while overnight deposits fell from €1,065 million to €390 million;

– *other claims* (Subitem 2.5) consisted almost exclusively of foreign banknotes.

Claims on euro-area residents denominated in foreign currency (Item 3) increased by €1,334 million (from €5,595 million to €6,929 million) as a result both of the growth in the amounts denominated in foreign exchange and of the valuation gains deriving from the application of year-end exchange rates, offset only in part by the writedowns deriving from the application of year-end prices to investments in securities.

Within Subitem 3.1, which consists exclusively of positions with financial counterparties:

– *securities (other than shares)* increased by €540 million; denominated in US dollars and pounds sterling, they amounted respectively to €2,308 million (71 per cent of the total) and €840 million (26 per cent); the remainder, consisting of securities denominated in Swiss francs, amounted to €96 million. Most of the securities were issued by counterparties resident in Germany, France and the Netherlands.

– *other claims* rose from €2,891 million to €3,685 million and consisted of deposits with correspondents, mostly in the form of time deposits in US dollars and pounds sterling.

Lending to euro-area banks related to monetary policy operations (Item 5) increased by €6,645 million (from €14,632 million to €21,277 million) and showed the following movements:

– an increase in *main refinancing operations*, which also rose on an annual average basis (from €14,175 million to €19,527 million);
– a reduction in *longer-term refinancing operations* despite a rise in their annual average value (from €470 million to €844 million);
– a fall to almost zero in *credits related to margin calls*, although their annual average value remained stable (€1 million).

Other claims on euro-area banks (Item 6) increased by €115 million (from €0.3 million to €115 million). They included:

– €109 million of claims on financial counterparties in respect of repos involving securities denominated in euros unrelated to monetary policy, recorded for the first time in 2005;
– €5 million of overnight deposits in connection with the Eurosystem Reserve Management Services (ERMS), also recorded for the first time in 2005.

Securities issued by euro-area residents (other than shares) (Item 7) decreased slightly, from €1,978 million to €1,939 million) as a consequence of net disposals and writedowns deriving from the application of year-end prices.

General government debt (Item 8) declined slightly. In particular:

– the securities received following the bond conversion provided for by Law 289/2002 decreased from €17,515 million to €17,410 million; the reduction of €105 million corresponded to the annual accrued amount of the related discounts;
– the overall position in respect of the past management of stockpiling bills decreased by €50 million (from €1,046 million to €996 million) as a result of the repayment of part of the securitized credits.

The increase of €295 million (from €15,247 million to €15,542 million) in *Intra-Eurosystem claims* (Item 9) was due to that in the credit position vis-à-vis the Eurosystem, primarily in connection with the operation of the TARGET system. The item included:

– the *participating interest in the ECB* (Subitem 9.1), equal to €726 million;

Pursuant to Article 28 of the Statute of the ESCB, the ESCB national central banks are the sole subscribers to the capital of the ECB. Subscriptions depend on the shares which are determined on the basis of the key for the subscription of the ECB's capital established in Article 29 of the Statute and adjusted every five years. The first five-year change since the establishment of the ECB took effect on 1 January 2004; a second change was made on 1 May 2004, pursuant to Article 49.3 of the Statute of the ESCB, in response to the accession of 10 new EU member states and the participation of their central banks in the ESCB.

The Bank of Italy's share of the ECB's capital is equal to 13.0516 per cent; if only the Eurosystem countries are considered, its share is equal to 18.2563 per cent.

– the *claims deriving from the transfer of foreign reserves to the ECB* (Subitem 9.2), equal to €7,263 million;

At the start of the third stage of EMU gold, foreign securities and foreign exchange were transferred to the ECB in proportion to the share of the ECB's capital subscribed for by each central bank; in exchange each NCB recorded a claim denominated in euros and earning interest at a rate based on the latest available marginal rate applied to the Eurosystem's main refinancing operations reduced by 15 per cent to take account of the non-earning component consisting of gold.

– the *other claims within the Eurosystem (net)* (Subitem 9.4) amounted to €7,553 million, with a small increase of €295 million on 2004, arose mainly in connection with the operation of the TARGET system, in respect of which the credit position increased overall by €316 million (from €7,347 million to €7,663 million), including €50 million for Narodowy Bank Polski which accessed TARGET via the BI-Rel gross settlement system as of March 2005. The subitem also included: a) a debt of €116 million towards the ECB for the repayment of seignorage; and b) a claim of €6 million in relation to the net result of the redistribution of the monetary income for 2005.

Other assets (Item 11) included:

– *euro-area coins* (Subitem 11.1), which comprises lira and euro coins, rose by €10 million (from €26 million to €36 million);
– the *UIC endowment fund* (Subitem 11.2), provided entirely by the Bank of Italy and unchanged at €258 million;
– *tangible fixed assets (net of depreciation)* (Subitem 11.6), which increased, primarily as a consequence of the revaluation of "instrumental" buildings under Law 266/2005; in total the revaluation amounted to €1,726 million as detailed below:
  a) €1,595 million in respect of buildings used by the Bank for its institutional activities;
  b) €131 million in respect of buildings in which part of the staff severance pay and pension provisions are invested;

– other assets - *sundry* (Subitem 11.8) rose in total by €5,135 million (from €25,177 million to €30,312 million) and also included:

  a) euro-denominated Italian government securities held as fixed assets, which increased from €14,937 million to €20,362 million as the result of net purchases;

  b) €7,961 million of deferred tax assets (€8,333 million at the end of 2004), as the algebraic sum of the following:

    – €7,937 million of deferred corporate income tax assets deriving from the carry forward of the tax losses for 2002, 2003 and 2004, a decrease of €405 million compared with the previous year;

Law 248/2005 ratifying Decree Law 203/2005 amended Article 65 of Law 289/2002, the legal basis for the conversion of the bonds issued under Law 483/1993 into other government securities at market conditions; the consequent tax loss, offsettable up to 2022, led to the recording of deferred tax assets.

The legislative amendment introduced in 2005 altered the rules on the carryforward of Bank of Italy tax losses by restricting the taxable income that can be offset to 50 per cent of the total, both for the 2002 tax loss referred to above and for the tax losses incurred in the two following years as a result of unrealized losses. At the same time the 20-year limit granted – by way of derogation from the ordinary 5-year limit – for the tax loss deriving from the bond conversion was removed, thereby allowing the Bank to use that loss *sine die*. The removal of the time limit also applied to the tax losses for the years 2003 and 2004, which had previously been subject to the ordinary regime.

Accordingly, only 50 per cent of the taxable income for the year was offset, with a reduction of €404 million in the related deferred tax asset; on the other 50 per cent the Bank will have to pay income tax (the related tax provision is included on the liabilities side under Subitem 12.1 – *provisions for specific risks*).

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 the full amount of the above-mentioned tax losses. This reasonable expectation was reinforced both by the confirmation of the expected improvement in the profitability of the Bank's ordinary operations and by the change in the law referred to above, which, while it lengthened the recovery period, eliminated the earlier limits on the time the tax losses can be carried forward.

    – €68 million of deferred tax assets (in relation to both income tax and the tax on productive activities) deriving from other items; in particular the allocations to the provision for staff costs (€32 million) and the depreciation not yet deducted for tax purposes (€35 million, of which €26 million with reference to the depreciation for the year of the revaluation of "instrumental" buildings under Law 266/2005);

– €44 million of deferred tax liabilities in relation almost exclusively to accelerated depreciation;

c) the balance-sheet total of the supplementary pension fund, which is matched on the liabilities side by an equal amount included on the liabilities side under Subitem 11.4 – *other liabilities – sundry*).

Liabilities:

Banknotes in circulation (Item 1), which represent the Bank of Italy's share of the total Eurosystem note issue (see the section on *Banknotes in circulation* under *Accounting policies*), increased by €10,743 million (from €84,191 million to €94,934 million).

Within *Liabilities to euro-area banks related to monetary policy operations* (Item 2), which contracted by €1,519 million (from €12,972 million to €11,453 millions):

– there was a decrease of €1,519 million *in current accounts (covering the minimum reserve system)* (Subitem 2.1), which consisted entirely of banks' deposits under the minimum reserve system; by contrast the annual average value rose, from €15,095 million to €15,902 million;
– there was a small increase in the *deposit facility* (Subitem 2.2), which consisted of overnight deposits on the initiative of banks, while the annual average value declined from €7 million to €6 million.

Within liabilities to *general government* (Subitem 4.1):

– there was a decrease (from €15,771 million to €14,405 million) in the year-end balance on the *Treasury payments account*, while the average balance on the account rose from €28,559 million to €32,277 million;
– the *sinking fund for the redemption of government securities* showed an increase at the end of the year (from €4 million to €166 million) and the annual average value rose from €2,654 million to €3,788 million as a result of the deposit of the proceeds of the sale of Enel shares, which were subsequently used in the manner provided for in the law establishing the fund.

The fall in liabilities to *other counterparties* (Subitem 4.2) was mainly due to that in the balance on the UIC's current account (from €109 million to €34 million); the annual average value of this account also declined (from €104 million to €88 million).

Liabilities to non-euro-area residents denominated in euros (Item 5) comprised:

– *liabilities to non-euro-area EU central banks* (Subitem 5.1) increased by €50 million, primarily as a result of the opening (in March 2005) of a correspondent account in the name of Narodowy Bank Polski for its participation in the TARGET system (the year-end balance on the account was €50 million);
– *other liabilities* (Subitem 5.2) increased by €11 million and referred mainly to the accounts held by international organizations and central banks of non-euro-area countries that use the Eurosystem Reserve Management Services (ERMS) (see Item 6 on the assets side).

Liabilities to non-euro-area residents denominated in foreign currency (Item 7) amounted to €1,627 million; they were denominated exclusively in US dollars and consisted mainly of repos involving dollar-denominated securities shown under *other liabilities* (Subitem 7.2).

The *Counterpart of SDRs allocated by the IMF* (Item 8) rose by €49 million (from €801 million to €850 million), owing to the valuation at the year-end SDR exchange rate (see Table 1).

Intra-Eurosystem liabilities (Item 9) rose from €6,077 million to €8,101 million and referred entirely to the subitem *Net liabilities related to the allocation of euro banknotes within the Eurosystem* (Subitem 9.2; see the section on *Banknotes in circulation under Accounting policies*).

Among *Other liabilities*, Subitem 11.4 – *sundry* amounted to €1,412 million and consisted mainly of:

– €874 million (€1,201 million at the end of 2004) of lira banknotes not yet presented for conversion, excluding the two payments on account, for a total of €758 million, 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;
– €69 million, the balance-sheet total of the defined-contribution supplementary pension fund for staff hired since 28 April 1993. This liability is matched on the assets side by an equal amount entered under *Other assets – sundry*.

Provisions (Item 12) increased from €6,260 million to €6,753 million.

More specifically, among the *provisions for specific risks* (Subitem 12.1):

a) the provision created last year to cover the Bank of Italy's share of the loss incurred by the ECB in 2004 was used in full (€248 million);

b) the tax provision increased by €717 million as a result of the allocation of €770 million (of which €563 million in respect of income tax and tax on productive activities for the year and €207 million in respect of the tax on the revaluation of buildings) and the taking of €53 million to profit and loss account following the reduction in the risk inherent in tax disputes.

Sundry staff-related provisions (Subitem 12.2) amounted to €5,665 million. In particular:

a) the provisions for staff severance pay and pensions remained unchanged at €5,541 million (the provision for severance pay rose from €1,045 million to €1,053 million, while that for pensions fell from €4,496 million to €4,477 million). The small difference of €11 million was prudentially left allocated to the account in preparation for the effects on pension entitlements of the renewal of labour contracts;

b) the provision for staff costs rose by €25 million as a result of a precautionary allocation in connection with the revision of wages and salaries for 2005 following the renewal of labour contracts; the provision for amounts accrued but not paid at the end of the year was virtually unchanged.

The *revaluation accounts* (Item 13), which comprised the differences arising from the valuation of gold, foreign exchange and securities at year-end market prices, rose from €9,550 million to €20,600 million.

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 €57 million (of which €55 million in respect of pounds sterling and €2 million in respect of Swiss francs), to:

– unrealized gains included in the revaluation accounts amounting to €11,061 million, of which €8,931 on gold, €1,990 on dollars, €127 million on SDRs, €13 million on yen and negligible amounts on other currencies;

– unrealized losses amounting to €4 million on Swiss francs; these were covered by prior-year unrealized gains included in the corresponding revaluation account.

Following the allocation of €703 million by the Board of Directors, the *provision for general risks* (Item 14) rose from €6,832 million to €7,535 million.

2.2. *Income statement*. – The net profit for the year amounted to €50 million, compared with €25 million in 2004.

Among the items included under *net income from institutional operations*, *net interest income* rose by €717 million (from €1,245 million to €1,962 million).

Interest income rose as a result of both a larger average stock of interest-bearing assets denominated in euros and a higher average rate of return on foreign currency securities; interest expense also rose, but to a lesser extent; the rise was primarily due to the growth in the average stock of liabilities.

Interest income (included in Net income from institutional operations)
(thousands of euros)

	2005	2004	Changes
on positions in euros	2,563,769	2,042,930	520,839
securities (including premiums and discounts)	*1,470,370*	*1,302,817*	*167,553*
refinancing operations	*429,950*	*300,213*	*129,737*
intra-Eurosystem balances	*662,195*	*439,897*	*222,298*
other	*1,254*	*3*	*1,251*
on positions in foreign currency	822,490	449,715	372,775
on securities and other assets denominated in foreign currency (including premiums and discounts)	*746,308*	*381,451*	*364,857*
accounts with the IMF	*76,182*	*68,264*	*7,918*
Total	**3,386,259**	**2,492,645**	**893,614**

In particular, interest income on positions in euros showed:

– an increase in that earned on securities (including premiums and discounts), as detailed below:
  a) €824 million from the government securities received in the conversion under Law 289/2002;
  b) €646 million (€479 million in 2004) from other government securities (excluding those in which the reserves and provisions are invested), partly held as fixed assets and partly not held as fixed assets); the increase was due to the expansion in the average size of the portfolio (from €14,565 million to €20,244 million);

– an increase in income from refinancing operations, with special reference to main refinancing operations (from €290 million to €412 million) and longer-term refinancing operations (from €10 million to €18 million) owing to the growth in the average amount of the reference aggregates (see Item 5 on the assets side, *Lending to euro-area banks* *related to monetary policy operations*) and marginally to the higher average level of the applicable interest rates;

– an increase in income from intra-Eurosystem claims as a result of the rise in interest income on the Bank's positive TARGET balances (from €313 million to €532 million) and a marginal rise in interest income earned on the claims deriving from the transfer of foreign reserves to the ECB (from €127 million to €130 million); the average amount of the TARGET balances in relation to the Bank's transactions was €25,409 million;
– sundry interest income comprised €1 million of income on repos denominated in euros, first used in June 2005.

The following items of interest income on foreign currency assets increased:

– income earned on foreign currency securities (including premiums and discounts) and other foreign currency assets; the increase was primarily due to the higher rates of return on dollar securities, which more than offset the effects of the reduction in the average amount of the reference aggregate (from €25,686 million to €23,819 million);
– income from the position with the IMF, primarily as a result of the increase in interest payments on Italy's share of the loans to support debt-reduction initiatives for the poorest countries (PRGF) and on SDR balances.

All the components of *interest expense* increased, as shown below:

Interest expense (included in Net income from institutional operations)
(thousands of euros)

	2005	2004	Changes
on positions in euros	1,382,137	1,225,042	157,095
Treasury payments account	*895,384*	*803,574*	*91,810*
sinking fund for the redemption of government securities	*79,194*	*53,941*	*25,253*
current accounts (covering the minimum reserve system)	*333,181*	*308,236*	*24,945*
intra-Eurosystem balances	*72,670*	*57,652*	*15,018*
other	*1,708*	*1,639*	*69*
on positions in foreign currency	41,985	22,980	19,005
counterpart of SDRs allocated by the IMF	*21,813*	*15,332*	*6,481*
other	*20,172*	*7,648*	*12,524*
Total	**1,424,122**	**1,248,022**	**176,100**

In particular, interest expense increased for the following positions denominated in euros:

– the Treasury payment account, owing to the increase in the annual average balance (from €28,559 million to €32,277 million); the average rate of return declined slightly;

– the sinking fund for the redemption of government securities, owing to the increase in the average amount outstanding (from €2,654 million to €3,788 million) and the small rise in the average rate of return;

– current accounts *(covering the minimum reserve system)*, owing to the increase in the annual average amount of required reserves (from €15,095 million to €15,902 million) and the rise in the average rate of return (from 2.04 to 2.10 per cent);

– intra-Eurosystem balances, exclusively in connection with the balances related to the allocation of euro banknotes within the Eurosystem.

Among the interest paid on positions denominated in foreign currency there were increases in respect of the *counterpart of SDRs allocated by the IMF* and *other*, which was mainly for repos involving securities denominated in dollars; in both cases the increase was primarily due to the higher average rate of return.

Net result of financial operations, writedowns and risk provision transfers
(thousands of euros)

	2005	2004	Changes
Profits and losses on financial operations	471,821	177,472	294,349
profits/losses on securities trading	*-4,838*	*25,079*	*-29,917*
profits/losses on foreign exchange trading	*481,210*	*159,446*	*321,764*
profits/losses on derivatives contracts denominated in foreign currency	*-4,551*	*-7,053*	*2,502*
Writedowns of financial assets and positions	-118,681	-1,720,954	1,602,273
foreign securities	*-56,751*	*-21,867*	*-34,884*
foreign currencies	*-57,288*	*-1,698,989*	*1,641,701*
euro securities	*-4,642*	*-98*	*-4,544*
Transfers to/from provisions for losses of foreign exchange and securities	-702,996	755,264	-1,458,260
transfers from the pre-system revaluation accounts	*4*	*764*	*-760*
transfers to/from provision for general risks	*-703,000*	*754,500*	*-1,457,500*
Total	**-349,856**	**-788,218**	**438,362**

The *net result of financial operations, writedowns and risk provision transfers*, which in 2004 had reflected substantial unrealized losses and withdrawals transfers from the provision for general risks, is detailed below:

– net profits on financial transactions, comprising:

a) a profit on foreign exchange trading, primarily sales of dollars, which benefited from the strengthening of the US currency during the year;

b) a loss on securities trading – with reference almost exclusively to sales of dollar-denominated securities – and losses on interest rate futures denominated in foreign exchange;

– writedowns of financial assets and positions, as a result of:
  a) the valuation at year-end exchange rates of assets denominated in pounds sterling (€55 million) and Swiss francs (€2 million);
  b) the valuation at market prices of foreign currency securities denominated primarily in dollars (€57 million) and of securities denominated in euros (€5 million);
– the transfer of €703 million to the provision for general risks.

Net income from fees and commissions continued negative, deteriorating from minus €2 million to minus €5 million as a result of the increase in the commissions paid to the UIC for the management of the foreign exchange reserves (from €13 million to €16 million). Overall, fee and commission income rose from €18 million to €19 million and the corresponding expense from €20 million to €24 million.

Income from equity shares and participating interests referred in 2005 exclusively to the profits allocated to the Bank in respect of its interest in the UIC's endowment fund; these profits fell from €23 million to €0.8 million, in line with the fall in the UIC's net income for the year. As in the previous year the ECB did not pay a dividend.

In 2005 the ECB's income on euro banknotes in circulation amounting to €868 million, of which the Bank of Italy's share was €158 million (€134 million in 2004), was fully retained by the ECB in accordance with a decision of the Governing Council with respect to the establishment of a provision for foreign exchange rate, interest rate and gold price risks (see the item *Banknotes in circulation* in Section 1: Legal basis, methods of preparation and layout of the annual accounts).

The *net result of the pooling of monetary income* amounted to €6 million, compared with minus €239 million in 2004.

The above-mentioned result was the difference between the monetary income pooled, €1,783 million, and that redistributed, €1,789 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; 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.

Among the components of *other income*:

– *income from the investment of reserves and provisions* rose as a result of the increased profits on disposals of equity securities not held as fixed assets and higher dividends; income from interest-bearing securities, including premiums and discounts, fell, primarily owing to the lower rates of return;

Other income: income from the investment of reserves and provisions
(thousands of euros)

	2005	2004	Changes
interest income (including premiums and discounts)	757,309	826,939	-69,630
dividends	309,165	263,665	45,500
profits from trading and disposals	676,620	205,453	471,167
Total	**1,743,094**	**1,296,057**	**447,037**

– *prior-year income* fell by €123 million (from €182 million to €59 million); the amount for the year referred mainly to the decrease in the tax provision (€53 million) following the reduction in the risk inherent in tax disputes;

– *sundry* income is detailed below:

Other income: sundry
(thousands of euros)

	2005	2004	Changes
rental income from buildings	20,901	20,385	516
interest on tax credits	27,760	21,093	6,667
other interest income	1,738	1,994	-256
procedures, studies and designs completed during the year	9,856	10,170	-314
other	25,262	41,147	-15,885
Total	**85,517**	**94,789**	**-9,272**

Among *sundry expenses and charges*:

– *staff wages and salaries and related costs* declined by €8 million (from €613 million to €605 million); *pensions and severance payments* fell from €281 million to €264 million), primarily as a result of the decrease in severance payments;

– *transfers to provisions for accrued expenses and staff severance pay and pensions* amounted overall to €97 million (€94 million in 2004 and referred to staff costs that had accrued but not been paid at the end of the year and the provision for staff costs arising from the wage agreement for 2005 in the latest labour contract renewal.

– *other staff costs* and *emoluments paid to head and branch office collegial bodies* amounted respectively to €43 million and €3 million.

The breakdown of the Bank's staff by type of employment is shown in Table 2.

Table 2

THE BANK'S STAFF

	Average number of persons in service		Percentage composition	
	2005	2004	2005	2004
Managerial	1,980	1,994	24.8	24.5
Clerical	4,810	4,874	60.2	60.0
General services and security	706	750	8.8	9.2
Blue-collar	497	514	6.2	6.3
TOTAL PAYROLL WORKERS	**7,993**	**8,132**	**100.0**	**100.0**
Contract workers	34	34		

Administrative costs remained basically stable (up from €374 million to €378 million).

Depreciation of tangible and intangible fixed assets increased from €186 million to €254 million, owing to the higher value of its portfolio of "instrumental" buildings following their revaluation under Law 266/2005.

Other costs comprised:

– *losses on investments of reserves and provisions*, which amounted to €13 million (€10 million in 2004) and referred to writedowns of equity investments denominated in euros;

– *prior-year expense*, which rose from €3 million to €4 million;

– *appropriation of investment income to reserves*, which amounted to €837 million, up by €414 million on 2004, primarily owing to larger profits on equities.
– *other taxes and duties* (i.e. excluding income tax for the year and the regional tax on productive activities), which amounted to €14 million (€15 million in 2004) and consisted primarily of the municipal tax on buildings (€10 million);
– other costs – *sundry*, which amounted to €6 million.

Taxes on income for the year and productive activities amounted to €935 million. More specifically, corporate income tax for the year amounted to €779 million (compared with a €258 million positive result in 2004) and comprised €404 million of taxes for the current year, recorded in the tax provision and to be paid, and €404 million of deferred tax assets in respect of the part of the tax losses offset against 50 per cent of the taxable income for the year; the effect of the net change in the remaining deferred tax components was positive (€29 million).

The regional tax on productive activities (Irap) amounted to €156 million, the result of €159 million of tax for the year, recorded in the tax provision and to be paid, and a positive net change of €3 million in the deferred component.

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 2005 of €50,284,373:

– 20 per cent to the ordinary reserve	€	10,056,875
– an amount equal to 6 per cent of the share capital to shareholders	€	9,360
– 20 per cent to the extraordinary reserve........................	€	10,056,875
– an additional amount equal to 4 per cent of the share capital to shareholders	€	6,240
– the remaining amount to the State	€	30,155,023
TOTAL	€	50,284,373

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 €49,470,000, equal to 0.50 per cent (as in 2004) of the total reserves at 31 December 2004.

If these proposals are approved, the total dividend will be equal to €49,485,600 corresponding to €164,952 per share.

THE GOVERNOR
MARIO DRAGHI

REPORT OF THE BOARD OF AUDITORS ON THE 112th FINANCIAL YEAR OF THE BANK OF ITALY AND THE ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2005

To the shareholders,

The accounts for the year ended 31 December 2005 submitted for your approval show the following results:

Assets	€	185,029,447,398
Liabilities	€	168,744,288,111
Capital and reserves	€	16,234,874,914
Net profit for the year (as shown in the vertical income statement)	€	50,284,373

The memorandum accounts, shown on both sides of the balance sheet for an amount of €267,831,272,348, 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 external auditors, were compared with the accounting records and found to conform with them.

The accounting policies have been updated compared with the previous year as a consequence of the decision taken by the Governing Council of the ECB on 17 November 2005 concerning the possibility to transfer part or all of the ECB's income on euro banknotes in circulation, due to the NCBs, to a provision for foreign exchange rate, interest rate and gold price risks. For 2005 the Governing Council decided that the full amount of such income should be retained by the ECB.

The criteria for preparing the annual accounts for 2005 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 €50,284,373, were affected by two legislative measures enacted in December 2005. Pursuant to Law 248/2005, which amended Article 65 of Law 289/2002, the Bank is required to pay €404 million of corporate income tax (in addition to its payments on account) since only 50 per cent of its taxable income for the year may now be used to offset previous tax losses, which are the source of the deferred tax assets shown in the accounts. In 2005 this item decreased by €404 million, used to offset income tax for the year.

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 the full amount of the above-mentioned tax losses. This reasonable expectation was reinforced both by the confirmation of the expected improvement in the profitability of the Bank's ordinary operations and by the change in the law referred to above, which, although it lengthened the recovery period, eliminated the earlier limits on the time the tax losses can be carried forward.

Law 266/2005 reset the time limits for revaluing certain types of buildings; the Bank decided to take the opportunity for its "instrumental" buildings as defined in the first and second sentences of the second paragraph of Article 43 of the Income Tax Code. The amount of the revaluation (€1,726 million), net of the related tax (€207 million), was included in the Revaluation reserve under Law 266/2005 (€1,519 million). The transaction was carried out with reference to the buildings' current market value, after establishing that a market existed capable of providing meaningful indications. The new values were determined taking account of professional appraisals made using the summary comparative method with a prudential reduction of 5 per cent, as for earlier revaluations, compared with the net book value of each building. The value adjustment was made by increasing exclusively the historical cost of the buildings. We can therefore declare that the net book value of the revalued assets, with the depreciation charge relative to the increase in value added back in, did not exceed the current market value of the buildings in question at 31 December 2005.

The Board of Directors approved the transfer of €703 million to the provision for general risks, which had been used on a major scale in the three previous years. The allocation is intended to strengthen the Bank's financial buffers against the risks involved in its activity as a whole.

In our opinion the total amount of the Bank's general and specific risk provisions is prudent. 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. The above-mentioned provision shows an excess of €11 million, left allocated to the account in preparation for the effects on such benefits of the renewal of labour contracts.

Pursuant to Article 54 of the Statute, the Board of Directors proposes the following allocation of the net profit for 2005:

– 20 per cent to the ordinary reserve	€	10,056,875
– an amount equal to 6 per cent of the share capital to shareholders	"	9,360
– 20 per cent to the extraordinary reserve	"	10,056,875
– an additional amount equal to 4 per cent of the share capital to shareholders	"	6,240
– the remaining amount to the State	"	30,155,023
Total	€	50,284,373

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 €49,470,000, equal to 0.50 per cent of such reserves at 31 December 2004 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, including checks on 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 and local branches, whom we thank warmly.

We recommend that you approve the accounts for 2005 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

Table a1

SOURCES AND USES OF INCOME IN FRANCE (1)
(chain-linked volumes; billions of euros; reference year 2000)

	Sources			Uses							
				Domestic demand							Exports of good and services
	Gross domestic product	Imports of goods and services	Total	Gross fixed investment			National consumption		Total (4)		
				Construction	Other (2)	Total	Households (3)	General government			
2001	1,468.1	407.4	1,875.5	130.7	156.7	287.3	823.8	333.9	1,453.4		422.1
2002	1,483.2	414.4	1,897.5	128.7	153.8	282.5	843.2	340.1	1,469.2		428.3
2003	1,499.3	419.1	1,918.3	131.6	157.3	288.9	860.2	346.9	1,494.6		423.2
2004	1,534.1	446.9	1,979.2	135.7	161.9	297.7	879.9	354.8	1,539.2		439.7
2005	1,552.3	474.0	2,022.2	139.0	169.5	308.2	897.4	358.6	1,569.1		453.2
2002 – I	369.0	103.0	472.0	....	....	71.0	208.6	84.3	366.5		105.4
II	371.3	103.6	474.9	....	....	70.5	210.2	84.9	366.9		108.0
III	372.5	104.2	476.8	....	....	70.6	212.3	85.3	368.8		108.0
IV	372.2	103.9	476.2	....	....	70.7	212.9	85.8	368.5		107.6
2003 – I	373.6	104.2	477.9	....	....	71.3	213.7	85.9	372.0		105.7
II	373.3	104.5	477.8	....	....	71.9	214.7	86.5	372.9		104.8
II	376.8	105.3	482.1	....	....	72.8	216.6	87.0	376.1		105.8
IV	378.1	106.9	485.0	....	....	73.1	217.5	87.6	376.9		108.0
2004 – I	380.1	107.8	487.8	....	....	73.0	219.0	88.1	379.5		108.1
II	383.1	111.2	493.9	....	....	74.2	220.7	88.7	384.4		109.4
II	383.4	113.0	496.0	....	....	74.2	220.8	88.9	386.1		109.7
IV	385.7	114.1	499.2	....	....	75.0	223.3	89.1	388.0		111.1
2005 – I	386.0	115.5	500.8	....	....	75.6	224.5	89.3	390.1		110.6
II	386.2	117.1	502.5	....	....	76.2	224.5	89.3	391.0		111.4
II	388.7	120.0	507.5	....	....	77.4	226.2	89.9	393.0		114.6
IV	389.8	122.6	511.0	....	....	78.2	227.1	90.0	395.4		115.7

Source: National statistics.
(1) The quarterly data are adjusted for seasonal factors 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. – (4) Includes changes in stocks and valuables.

SOURCES AND USES OF INCOME IN GERMANY (1)
(chain-linked volumes; billions of euros; reference year 2000)

	Sources			Uses							
				Domestic demand							
				Gross fixed investment			National consumption				
	Gross domestic product	Imports of goods and services	Total	Construction	Other (2)	Total	Households (3)	General government	Total (4)	Exports of good and services
2001	2,088.1	689.5	2,777.6	230.7	195.6	426.3	1,236.9	394.0	2,044.9	732.7
2002	2,089.3	680.2	2,769.5	217.2	183.1	400.4	1,230.4	399.6	2,006.0	763.8
2003	2,085.4	714.6	2,798.9	213.7	183.7	397.3	1,231.9	400.0	2,017.1	782.3
2004	2,119.4	764.6	2,880.7	208.7	188.3	396.6	1,238.7	393.7	2,028.2	855.0
2005	2,138.2	805.4	2,938.0	201.6	195.3	395.9	1,238.6	394.1	2,033.8	908.7
2002 – I	521.4	166.4	687.8	56.8	46.2	103.1	306.3	99.3	501.2	186.7
II	522.1	169.7	691.8	54.1	46.1	100.2	307.2	99.8	502.4	189.5
III	524.8	172.1	696.9	53.9	45.5	99.5	309.5	99.8	502.9	194.1
IV	524.2	174.2	698.4	53.3	46.0	99.4	308.2	100.7	502.0	196.6
2003 – I	521.1	179.9	700.6	53.5	46.3	99.8	307.8	99.8	506.3	194.4
II	520.3	177.3	697.4	53.9	46.0	99.9	309.3	100.0	507.4	190.0
II	522.0	177.4	699.2	53.6	45.8	99.5	308.5	100.2	500.3	199.0
IV	525.2	182.0	706.7	53.9	46.2	100.1	307.2	100.0	505.9	201.0
2004 – I	527.5	184.9	711.9	52.8	45.4	98.2	308.7	99.0	504.7	207.7
II	528.4	188.5	716.2	51.8	46.1	97.9	308.0	98.6	502.5	214.4
II	528.0	193.0	720.0	51.0	47.9	98.8	308.1	99.0	507.3	213.3
IV	527.5	194.0	720.4	51.1	47.4	98.4	310.5	97.1	506.8	214.3
2005 – I	530.6	191.8	721.6	49.5	48.0	97.2	309.2	97.6	503.6	218.9
II	532.9	196.0	727.7	49.5	48.3	97.6	309.3	99.1	507.5	221.2
II	536.2	206.2	740.8	50.6	49.0	99.3	310.3	99.5	509.9	232.1
IV	536.3	208.5	743.0	51.2	49.0	100.1	308.4	97.9	511.1	233.2

Source: National statistics.
(1) The quarterly data are adjusted for seasonal factors 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. – (4) Includes changes in stocks and valuables.

SOURCES AND USES OF INCOME IN SPAIN (1)
(chain-linked volumes; billions of euros; reference year 2000)

	Sources			Uses							
				Domestic demand							Exports of good and services
	Gross domestic product	Imports of goods and services	Total	Gross fixed investment			National consumption		Total (4)		
				Construction	Other (2)	Total	Households (3)	General government			
2001	652.6	211.1	863.7	89.6	80.6	170.2	388.1	112.6	673.3		190.4
2002	670.1	219.3	889.3	95.2	80.6	175.9	399.2	117.7	695.5		193.7
2003	690.2	232.4	922.0	101.2	84.3	185.7	409.5	123.3	721.2		200.8
2004	711.5	254.0	963.3	106.8	87.6	194.7	427.4	130.8	755.6		207.4
2005	735.9	272.1	1,004.4	113.3	95.3	208.6	446.1	136.6	794.1		209.5
2002 – I	165.9	53.0	218.9	23.1	20.0	43.1	99.2	28.5	171.4		47.5
II	166.7	54.3	221.1	23.8	19.8	43.6	99.1	29.3	172.7		48.4
III	168.0	54.9	222.8	23.8	20.2	44.0	99.8	29.7	174.3		48.5
IV	169.5	57.1	226.5	24.5	20.6	45.1	101.0	30.1	177.1		49.4
2003 – I	170.7	57.1	227.7	24.7	21.0	45.7	101.6	30.1	178.1		49.6
II	172.0	56.9	228.8	25.3	20.9	46.2	101.1	30.6	178.7		50.1
II	173.0	58.4	231.3	25.2	21.1	46.4	102.6	31.0	180.7		50.5
IV	174.5	60.0	234.2	25.9	21.3	47.3	104.1	31.6	183.7		50.5
2004 – I	175.8	61.4	236.8	26.2	21.4	47.6	105.0	31.8	185.1		51.6
II	177.1	62.4	239.0	26.7	21.4	48.2	106.0	32.5	187.4		51.6
II	178.5	64.5	242.3	26.5	22.3	48.8	107.4	33.0	189.9		52.4
IV	180.1	65.8	245.2	27.3	22.7	50.1	109.0	33.5	193.2		51.8
2005 – I	181.6	65.1	246.1	27.8	23.2	51.0	109.8	33.4	195.0		50.9
II	183.1	67.3	249.6	28.3	23.4	51.8	110.8	33.8	197.1		52.3
II	184.7	69.5	253.2	28.2	24.2	52.4	112.1	34.4	199.6		53.4
IV	186.5	70.1	255.5	28.8	24.6	53.5	113.4	35.0	202.5		52.8

Source: National statistics.
(1) The quarterly data are adjusted for seasonal factors 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. – (4) Includes changes in stocks and valuables.

ITALY: VALUE ADDED PER STANDARD LABOUR UNIT AND UNIT LABOUR COSTS, BY BRANCH

	1998	1999	2000	2001	2002	2003	2004	2005
	Value added at factor cost per standard labour unit (1) *(chain-linked volumes, euros, reference year 2000)*							
Agriculture, forestry and fishing	**19,084**	**21,192**	**20,917**	**20,205**	**20,236**	**20,190**	**23,209**	**24,662**
Industry excluding construction	**45,696**	**46,247**	**47,394**	**47,300**	**46,598**	**45,530**	**46,691**	**46,329**
of which: manufacturing	*42,444*	*42,613*	*44,030*	*43,811*	*42,973*	*41,872*	*42,685*	*42,454*
Construction	**32,574**	**31,888**	**32,122**	**32,588**	**32,684**	**32,705**	**33,102**	**32,563**
Services (2)	**38,501**	**38,805**	**39,134**	**39,305**	**38,859**	**38,387**	**38,622**	**38,830**
Wholesale and retail trade, repair of household goods	*37,521*	*37,002*	*38,411*	*38,599*	*37,479*	*36,013*	*36,336*	*36,631*
Hotels and restaurants	*31,365*	*31,514*	*31,647*	*30,778*	*28,363*	*26,704*	*26,466*	*26,844*
Transport, storage and communication	*45,702*	*46,258*	*48,760*	*51,035*	*52,416*	*52,890*	*54,220*	*55,649*
Financial intermediation	*89,870*	*92,441*	*80,942*	*80,938*	*77,591*	*78,422*	*79,961*	*80,541*
Sundry business and household services (2) (3)	*40,126*	*41,052*	*41,354*	*41,081*	*40,900*	*40,279*	*39,529*	*38,106*
Public administration (4)	*39,886*	*40,716*	*41,420*	*42,413*	*43,286*	*45,313*	*45,423*	*45,935*
Education	*32,666*	*32,534*	*32,552*	*32,383*	*33,101*	*33,169*	*33,269*	*34,637*
Health and social work services	*36,876*	*37,166*	*38,326*	*39,213*	*39,306*	*39,015*	*39,490*	*40,079*
Other public, social and personal services	*35,030*	*35,366*	*33,724*	*32,072*	*30,573*	*29,228*	*31,500*	*30,597*
Private households with employed persons	*12,676*	*12,684*	*12,695*	*12,731*	*12,723*	*12,719*	*12,729*	*12,799*
Total excluding renting of buildings	**38,390**	**38,837**	**39,286**	**39,313**	**38,920**	**38,426**	**39,013**	**39,157**
Total (2)	**43,072**	**43,566**	**43,964**	**43,956**	**43,611**	**43,199**	**43,761**	**43,964**
	Unit labour costs based on value added at factor cost (1) (5) *(current euros for chain-linked volumes expressed in euros, reference year 2000)*							
Agriculture, forestry and fishing	**0.811**	**0.751**	**0.768**	**0.805**	**0.816**	**0.868**	**0.763**	**0.750**
Industry excluding construction	**0.625**	**0.632**	**0.630**	**0.652**	**0.678**	**0.714**	**0.724**	**0.747**
of which: manufacturing	*0.659*	*0.673*	*0.668*	*0.693*	*0.724*	*0.764*	*0.782*	*0.805*
Construction	**0.692**	**0.727**	**0.733**	**0.736**	**0.755**	**0.784**	**0.808**	**0.844**
Services (2)	**0.723**	**0.736**	**0.748**	**0.771**	**0.801**	**0.842**	**0.864**	**0.886**
Wholesale and retail trade, repair of household goods	*0.648*	*0.685*	*0.680*	*0.698*	*0.738*	*0.789*	*0.813*	*0.832*
Hotels and restaurants	*0.626*	*0.657*	*0.672*	*0.718*	*0.785*	*0.849*	*0.890*	*0.897*
Transport, storage and communication	*0.673*	*0.671*	*0.635*	*0.616*	*0.608*	*0.621*	*0.624*	*0.620*
Financial intermediation	*0.598*	*0.589*	*0.686*	*0.691*	*0.726*	*0.738*	*0.744*	*0.746*
Sundry business and household services (2) (3)	*0.657*	*0.678*	*0.703*	*0.740*	*0.770*	*0.797*	*0.842*	*0.900*
Public administration (4)	*0.762*	*0.765*	*0.774*	*0.810*	*0.833*	*0.885*	*0.939*	*0.958*
Education	*0.924*	*0.963*	*0.984*	*1.025*	*1.047*	*1.087*	*1.066*	*1.108*
Health and social work services	*0.831*	*0.833*	*0.860*	*0.878*	*0.898*	*0.916*	*0.966*	*0.983*
Other public, social and personal services	*0.666*	*0.652*	*0.695*	*0.738*	*0.796*	*0.864*	*0.829*	*0.871*
Private households with employed persons	*0.954*	*0.975*	*1.000*	*1.008*	*1.058*	*1.094*	*1.115*	*1.143*
Total excluding renting of buildings	**0.712**	**0.723**	**0.731**	**0.753**	**0.782**	**0.821**	**0.837**	**0.858**
Total (2)	**0.635**	**0.644**	**0.653**	**0.674**	**0.698**	**0.731**	**0.746**	**0.764**

Source: Istat, national accounts.

(1) Includes indirectly measured financial intermediation services. – (2) Excludes renting of buildings. – (3) 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

(chain-linked volumes; millions of euros; reference year 2000)

	SOURCES AND USES							
	Uses							TOTAL SOURCES/ USES
	Agriculture, forestry and fishing (1)	Industry (1)	Services (1) (2)	Other services (1) (3)	VAT and indirect taxes on imports	Gross domestic product	Imports of goods and services (*fob*) (4)	
1999	27,680	336,570	493,307	215,619	76,743	1,149,870	294,035	1,444,498
2000	27,049	343,463	521,959	219,402	79,183	1,191,057	311,107	1,502,164
2001	26,381	346,261	536,693	223,482	79,627	1,212,442	310,617	1,523,060
2002	25,552	344,100	541,285	225,614	80,038	1,216,589	309,145	1,525,726
2003	24,314	342,290	543,404	226,366	80,665	1,217,041	311,589	1,528,574
2004	27,642	346,033	545,008	230,334	80,883	1,230,006	319,426	1,549,148
2005	27,037	340,830	549,596	231,131	80,626	1,229,568	323,776	1,552,877
2003 – I	6,422	85,877	135,549	56,467	20,157	304,469	78,239	382,689
II	5,909	85,081	136,102	56,603	20,115	303,817	77,533	381,342
III	5,841	85,814	136,462	56,288	20,230	304,639	77,588	382,221
IV	6,141	86,348	135,347	57,007	20,163	304,999	78,985	383,953
2004 – I	6,652	86,755	135,588	57,198	20,308	306,494	78,744	385,215
II	6,814	86,567	135,993	57,590	20,287	307,264	79,292	386,514
III	6,881	86,214	137,040	57,743	20,147	308,077	79,467	387,505
IV	7,296	85,261	136,295	57,803	20,142	306,867	80,722	387,470
2005 – I	6,715	84,728	136,215	57,807	20,006	305,560	79,817	385,294
II	6,616	85,545	137,454	57,629	20,179	307,517	81,218	388,615
III	6,862	85,587	137,836	57,828	20,259	308,449	81,301	389,637
IV	6,845	85,394	138,111	57,866	20,182	308,492	81,754	390,113

Sources: Istat, national accounts.
(1) Value added at producer prices. – (2) Wholesale and retail trade, repair services, hotel and restaurant services, transport and communication services; monetary and financial institutions; 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		Export of goods and services (*fob*) (6)	Non-durable goods	Semi-durable goods	Durable goods	Services	Food products, beverages and tobacco products	Non-food products
		Domestic household expenditure	Public expenditure (5)							
96,517	131,047	693,447	218,686	295,663	224,177	87,983	75,778	320,083	124,059	583,942
102,726	139,303	709,830	223,597	322,248	226,089	89,375	79,971	331,770	127,777	599,427
106,933	141,149	714,701	231,710	323,816	225,295	89,289	79,431	336,803	126,570	604,249
112,048	145,921	715,871	236,795	310,783	226,568	88,334	78,685	336,449	126,941	603,092
113,632	139,944	722,865	241,662	303,219	230,176	87,044	78,800	338,490	127,706	606,783
114,636	144,493	726,805	243,100	312,373	229,104	85,703	82,877	341,911	126,640	612,874
115,260	142,165	727,228	245,988	313,178	230,698	82,493	83,387	342,438	128,145	610,746
28,847	35,370	180,232	59,983	75,744	57,255	21,794	20,029	84,229	32,087	151,198
28,415	34,556	180,681	60,304	74,756	57,833	21,674	19,306	84,517	32,031	151,300
28,291	35,052	181,264	60,697	76,297	57,717	21,898	19,786	84,764	31,940	152,220
28,221	35,186	180,947	60,678	77,092	57,576	21,657	19,806	84,959	31,809	152,191
28,600	36,024	182,119	60,849	76,486	57,697	21,670	20,494	85,428	31,789	153,482
28,464	36,720	181,704	60,713	78,547	57,115	21,762	20,885	85,471	31,681	153,526
28,797	35,852	181,301	60,652	78,521	56,965	21,268	20,743	85,462	31,579	152,847
28,620	35,641	181,795	60,885	77,871	57,455	21,019	20,628	85,597	31,764	152,925
28,325	35,148	180,818	61,284	77,086	57,595	20,526	20,292	85,306	31,853	151,881
28,986	35,718	181,913	61,419	78,912	58,216	20,489	20,728	85,290	32,281	152,396
29,052	36,244	182,574	61,567	78,559	57,846	20,648	21,293	85,781	32,127	153,373
28,983	35,164	182,102	61,718	78,917	57,279	20,797	21,138	85,995	32,087	153,086

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					
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	108.3	95.3	96.8
2004	92.7	99.3	97.9	93.4	95.3	111.0	95.6	97.4
2005	89.1	96.0	94.6	91.1	93.3	114.9	93.1	95.7
1999 – I	88.9	99.0	97.1	96.0	93.1	97.7	94.8	95.2
II	90.4	97.5	96.1	95.6	93.3	95.2	94.8	94.8
III	94.3	101.1	99.4	96.5	94.4	97.5	96.7	96.8
IV	97.9	99.6	99.3	98.0	97.0	98.3	98.1	98.2
2000 – I	98.4	97.5	97.9	99.5	98.4	99.5	98.4	98.6
II	101.0	100.4	100.6	101.1	100.2	100.5	100.5	100.3
III	99.8	100.8	100.2	100.7	100.2	100.4	100.3	100.4
IV	103.5	103.6	103.6	101.2	102.7	99.4	102.6	102.2
2001 – I	102.9	103.9	104.1	103.3	100.9	97.7	102.5	101.9
II	100.1	100.9	100.7	100.6	99.6	98.4	100.3	100.2
III	96.5	100.2	99.1	98.5	98.0	99.1	98.6	98.6
IV	96.9	98.4	98.1	96.6	94.9	103.3	96.4	97.2
2002 – I	96.7	99.5	99.3	96.9	95.0	103.0	96.7	97.4
II	96.5	99.2	98.6	97.1	95.8	104.3	97.1	98.0
III	95.3	98.7	97.7	97.5	96.2	105.2	97.2	98.1
IV	95.3	99.5	98.6	97.7	95.6	103.0	97.3	98.0
2003 – I	90.8	99.7	98.1	94.4	96.4	108.1	96.3	97.6
II	89.4	99.0	96.9	92.8	94.4	107.8	94.8	96.3
III	93.7	100.0	98.6	94.7	94.6	109.3	95.9	97.5
IV	95.5	100.1	99.2	95.7	94.4	108.9	96.2	97.7
2004 – I	96.5	100.4	99.6	94.2	94.0	109.0	95.8	97.3
II	93.0	98.9	97.6	94.0	94.9	110.1	95.5	97.2
III	90.5	98.0	96.4	91.8	94.8	112.1	94.7	96.8
IV	88.7	97.0	95.3	90.4	94.8	111.1	93.8	95.8
2005 – I	87.1	95.2	93.6	89.5	93.6	113.6	92.4	94.8
II	89.8	98.0	96.3	90.9	93.2	113.7	93.5	95.9
III	90.7	97.1	95.8	92.7	94.0	114.9	94.3	96.7
IV	89.7	95.2	94.0	92.7	93.4	118.1	93.3	96.2

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					
1996	95.4	96.5	95.8	95.1	92.8	96.0	95.6	95.9
1997	93.6	98.7	97.3	97.3	96.0	97.9	98.1	98.0
1998	94.3	98.1	96.9	95.6	96.5	98.0	97.8	97.8
1999	95.1	97.8	96.8	94.9	93.2	97.4	95.7	96.1
2000	99.3	97.6	97.6	97.9	98.1	97.9	98.5	98.7
2001	96.3	97.1	96.5	96.6	95.6	95.4	97.0	97.3
2002	93.2	95.5	94.6	94.3	93.1	97.3	94.6	95.7
2003	89.8	96.0	94.3	91.4	92.4	99.7	93.4	95.2
2004	89.5	94.9	93.3	89.8	92.0	99.9	92.6	94.7
2005	86.8	92.8	91.1	88.4	91.1	100.0	91.0	93.8
1999 – I	92.2	97.9	96.6	94.7	92.3	98.8	94.9	95.5
II	92.9	96.2	95.1	94.1	92.3	95.7	94.6	94.8
III	96.2	99.4	98.0	94.8	93.0	97.5	96.0	96.4
IV	99.1	97.6	97.5	96.1	95.4	97.7	97.1	97.5
2000 – I	98.7	95.1	95.6	97.0	96.5	98.3	97.1	97.5
II	100.0	97.7	97.8	98.5	98.1	98.7	98.7	98.8
III	98.5	97.7	97.0	97.9	97.7	98.1	98.2	98.6
IV	100.0	100.0	99.9	98.2	100.0	96.6	100.0	100.0
2001 – I	100.0	100.0	100.0	100.0	98.1	94.3	99.9	99.7
II	97.2	97.1	96.7	97.5	96.8	94.5	97.8	98.0
III	93.8	96.5	95.1	95.5	95.2	94.6	96.1	96.5
IV	94.2	94.8	94.2	93.5	92.4	98.1	94.0	95.1
2002 – I	94.0	95.8	95.3	93.8	92.5	97.3	94.3	95.2
II	93.7	95.5	94.6	94.1	93.0	98.0	94.7	95.8
III	92.6	95.0	93.8	94.4	93.7	98.3	94.7	96.0
IV	92.5	95.8	94.7	94.7	92.9	95.8	94.8	95.8
2003 – I	88.2	95.9	94.2	91.7	93.8	100.0	93.9	95.5
II	86.9	95.3	93.0	90.0	91.7	99.2	92.4	94.2
III	91.1	96.3	94.7	91.6	92.1	100.0	93.5	95.4
IV	92.8	96.4	95.2	92.4	91.8	99.6	93.8	95.6
2004 – I	93.8	96.7	95.6	91.3	91.4	99.7	93.4	95.1
II	90.3	95.2	93.7	91.0	92.4	100.0	93.1	95.1
III	87.9	94.3	92.5	89.2	92.1	100.0	92.3	94.7
IV	86.1	93.4	91.5	87.7	92.1	100.0	91.4	93.7
2005 – I	84.6	91.6	89.8	86.7	90.9	100.0	90.1	92.7
II	87.3	94.3	92.4	88.0	90.7	100.0	91.1	93.8
III	88.1	93.5	92.0	89.5	91.6	100.0	91.9	94.6
IV	87.0	91.7	90.3	89.5	90.9	100.0	90.9	94.1

Source: Based on Istat data.

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 (6)	Total net of food and energy products and those with regulated prices	Overall index (6)
	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*
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
2005	0.9	3.0	0.7	-0.8	0.1	11.0	1.9	6.1	1.1	2.0	2.4	1.9	2.0	1.7
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
Sept.	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
Sept.	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	0.0	12.2	2.0	-0.5	1.2	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
Apr.	0.9	3.1	0.8	-1.3	-0.1	13.4	2.0	5.1	0.4	1.2	2.2	1.9	2.0	1.7
May	1.0	3.2	0.6	-1.0	-0.1	10.4	2.0	5.5	0.5	1.4	2.2	1.9	2.1	1.7
June	1.0	3.1	0.5	-1.1	-0.1	8.2	1.8	5.6	0.4	1.4	2.2	1.8	2.0	1.6
July	0.9	3.1	0.5	-0.8	0.0	11.9	2.0	7.4	0.9	2.1	2.4	2.1	2.1	1.8
Aug.	1.0	2.8	0.4	-0.7	0.0	11.8	1.9	7.4	0.9	2.1	2.4	2.0	1.9	1.8
Sept.	0.9	2.7	0.4	-0.3	0.1	14.7	2.0	7.4	0.8	2.0	2.4	2.0	1.8	1.9
Oct.	0.8	2.7	0.5	0.2	0.4	14.8	2.0	9.4	1.6	3.0	2.4	2.2	1.8	2.0
Nov.	1.0	2.6	0.7	0.5	0.6	9.6	1.9	9.6	2.5	3.9	2.4	2.2	1.8	1.8
Dec.	1.1	2.3	0.9	0.8	0.8	8.9	1.8	9.4	1.4	2.9	2.4	2.0	1.7	1.9
2006 – Jan.	1.1	2.4	1.1	0.9	1.0	12.6	2.0	8.8	1.5	2.9	2.6	2.2	1.7	2.2
Feb.	1.2	2.4	1.3	0.5	1.0	12.0	2.1	9.5	1.9	3.4	2.6	2.1	1.8	2.1
Mar.	1.2	2.3	1.5	0.1	1.0	9.3	1.9	9.9	1.8	3.4	2.6	2.1	1.8	2.1

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 2006. – (4) The sub-indices are based on the 205-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. – (6) Changes communicated by Istat, calculated on the basis of the index rounded to the first decimal place.

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*	*40.3*	*74.3*	*11.3*	*7.8*	*19.1*	*6.6*	*85.6*	*100.0*
2002	2.4	3.4	2.9	2.2	4.9	3.4	-2.6	2.8	2.6
2003	1.8	3.2	2.6	3.4	3.9	3.6	3.2	2.7	2.8
2004	1.6	2.6	2.1	3.6	2.0	2.9	2.4	2.3	2.3
2005	1.4	2.4	1.9	2.2	-0.7	1.0	8.7	2.0	2.2
2003 – Jan.	1.8	3.5	2.7	2.3	2.8	2.5	4.3	2.6	2.8
Feb.	1.1	3.4	2.3	2.3	2.4	2.5	5.4	2.4	2.6
Mar.	2.0	3.5	2.8	2.5	2.7	2.6	6.4	2.7	2.9
Apr.	2.1	3.5	2.7	3.9	2.0	3.0	4.5	2.9	3.0
May	2.3	3.4	2.9	3.9	2.3	3.1	2.8	2.9	2.9
June	2.2	3.3	2.8	3.6	3.7	3.6	2.3	2.9	2.9
July	1.9	3.2	2.6	3.6	4.3	3.9	2.1	2.7	2.9
Aug.	1.4	3.3	2.5	3.5	4.9	4.1	2.9	2.6	2.7
Sept.	1.7	3.1	2.4	3.5	5.6	4.5	3.1	2.6	2.9
Oct.	2.0	2.8	2.4	3.6	5.9	4.6	1.1	2.7	2.8
Nov.	2.0	2.7	2.4	3.9	5.8	4.7	1.7	2.5	2.8
Dec.	1.8	2.6	2.2	4.0	5.1	4.5	1.8	2.4	2.5
2004 – Jan.	1.1	2.5	1.8	3.9	5.2	4.5	0.0	2.1	2.1
Feb.	2.0	2.3	2.3	4.0	5.3	4.5	-1.0	2.5	2.5
Mar.	1.5	2.3	2.0	5.1	4.7	4.9	-1.5	2.4	2.3
Apr.	1.7	2.4	2.2	3.6	4.2	3.9	-0.8	2.4	2.3
May	1.5	2.3	2.0	3.7	3.7	3.7	1.9	2.3	2.3
June	1.6	2.6	2.2	3.6	2.9	3.3	3.5	2.4	2.4
July	1.3	2.5	2.1	3.7	2.1	3.0	3.5	2.3	2.3
Aug.	1.5	2.7	2.2	3.4	1.4	2.6	3.5	2.3	2.4
Sept.	1.6	2.8	2.3	3.3	-0.1	1.8	3.0	2.4	2.2
Oct.	1.7	2.6	2.2	3.0	-1.5	1.0	5.8	2.3	2.1
Nov.	1.6	2.6	2.2	2.5	-2.1	0.6	6.1	2.2	2.1
Dec.	1.7	2.8	2.3	3.5	-1.9	1.2	5.5	2.5	2.4
2005 – Jan.	1.2	2.7	2.0	3.4	-2.3	1.0	5.0	2.2	2.0
Feb.	1.2	2.6	1.9	3.2	-1.9	1.1	5.9	2.1	2.0
Mar.	1.4	2.8	2.1	2.0	-1.4	0.6	6.9	2.1	2.2
Apr.	1.7	2.5	2.1	1.8	-1.2	0.6	9.5	2.0	2.2
May	1.8	2.6	2.2	1.8	-1.0	0.6	8.1	2.1	2.4
June	1.6	2.4	2.0	1.7	-0.8	0.7	7.1	2.0	2.1
July	1.1	2.6	1.8	1.9	-0.8	0.8	9.8	1.8	2.1
Aug.	1.1	2.3	1.8	2.2	-0.7	1.0	9.8	1.9	2.2
Sept.	1.0	2.2	1.7	2.1	-0.2	1.1	11.4	1.8	2.2
Oct.	1.3	2.2	1.8	2.1	0.3	1.4	12.3	1.8	2.6
Nov.	1.4	2.1	1.7	2.4	0.4	1.5	9.6	1.9	2.4
Dec.	1.4	1.9	1.7	1.3	0.7	1.0	9.1	1.6	2.1
2006 – Jan.	1.2	1.9	1.6	1.6	0.8	1.2	10.9	1.6	2.2
Feb.	0.8	2.0	1.5	2.3	0.6	1.6	10.6	1.6	2.2
Mar.	1.2	1.9	1.6	2.6	0.2	1.6	9.6	1.8	2.2

Source: Eurostat.
(1) Chain indices, 2005=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 2006. – (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 a10

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	*30.7*	*40.8*	*71.5*	*11.9*	*7.4*	*19.3*	*9.2*	*83.4*	*100.0*
2002	1.5	3.1	2.4	3.1	3.1	3.1	-0.6	2.5	2.2
2003	0.8	2.5	1.8	3.3	2.1	2.8	3.0	2.0	2.1
2004	0.8	2.6	1.8	3.4	0.6	2.3	4.5	2.1	2.1
2005	0.3	2.3	1.4	2.0	0.8	1.6	10.1	1.5	2.2
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	3.3	0.8	2.2	7.5	2.0	2.5
Apr.	0.8	2.9	2.0	3.3	0.9	2.3	2.2	2.1	2.1
May	0.9	2.5	1.8	3.3	1.1	2.4	0.6	2.0	1.8
June	0.8	2.5	1.8	3.2	2.5	2.9	1.6	2.0	1.9
July	0.7	2.3	1.6	3.1	2.7	3.0	2.0	1.8	1.9
Aug.	0.6	2.5	1.7	3.1	3.3	3.1	2.7	1.9	2.1
Sept.	0.8	2.5	1.8	3.1	4.2	3.6	1.6	2.0	2.2
Oct.	0.8	2.5	1.7	3.5	3.8	3.6	0.7	2.0	2.0
Nov.	0.7	2.4	1.7	4.0	3.8	3.9	2.2	2.0	2.2
Dec.	0.7	2.3	1.6	3.8	3.2	3.6	1.8	1.9	2.0
2004 – Jan.	0.6	2.5	1.7	3.3	2.9	3.2	-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.	0.7	2.5	1.8	4.1	1.7	3.1	-2.0	2.1	1.7
Apr.	1.0	2.5	1.8	3.9	1.6	2.9	2.0	2.1	2.0
May	0.9	2.6	1.8	3.9	1.7	3.1	6.7	2.1	2.5
June	0.9	2.6	1.9	3.8	1.2	2.8	5.9	2.2	2.4
July	0.7	2.7	1.9	3.8	0.7	2.6	6.0	2.1	2.3
Aug.	0.9	2.7	1.9	3.6	-0.2	2.1	6.5	2.2	2.3
Sept.	0.8	2.6	1.8	3.3	-1.5	1.4	6.4	2.0	2.1
Oct.	0.8	2.6	1.8	2.8	-1.2	1.2	9.8	2.0	2.4
Nov.	0.8	2.7	1.9	2.3	-1.0	1.0	8.7	1.9	2.2
Dec.	0.8	2.7	1.9	3.2	0.0	2.0	6.9	2.1	2.4
2005 – Jan.	0.5	2.4	1.6	2.8	-0.6	1.5	6.2	1.8	1.9
Feb.	0.2	2.4	1.4	2.7	0.7	1.9	7.7	1.6	2.1
Mar.	0.4	2.5	1.6	1.6	1.3	1.5	8.8	1.6	2.1
Apr.	0.3	2.2	1.4	1.7	0.8	1.3	10.1	1.4	2.1
May	0.3	2.5	1.6	1.5	1.0	1.3	6.8	1.6	2.0
June	0.2	2.2	1.4	1.5	0.5	1.1	9.4	1.4	2.1
July	0.0	2.3	1.3	1.6	0.3	1.1	11.7	1.3	2.2
Aug.	0.0	2.2	1.3	1.7	1.0	1.4	11.5	1.3	2.2
Sept.	0.2	2.2	1.3	2.3	1.0	1.8	15.0	1.4	2.6
Oct.	0.3	2.2	1.4	2.4	1.1	1.9	12.1	1.5	2.5
Nov.	0.4	2.1	1.4	2.6	1.5	2.2	10.0	1.5	2.3
Dec.	0.4	2.1	1.4	1.8	1.5	1.7	11.2	1.4	2.2
2006 – Jan.	0.2	2.0	1.2	1.9	2.0	1.9	13.6	1.3	2.4
Feb.	0.3	2.0	1.2	1.9	1.7	1.8	12.5	1.3	2.3
Mar.	0.5	1.9	1.3	2.3	0.6	1.6	10.5	1.4	2.2

Source: Eurostat.

(1) Weighted average of the indices of the euro-area countries. The weights shown in the table are those for January 2006. – (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.

INDEX OF INDUSTRIAL PRODUCER PRICES: ITALY (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*
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
2005	1.8	-0.9	1.7	2.5	15.5	2.1	4.0
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.	0.0	3.1	1.3	2.8	-5.6	1.7	0.7
Apr.	0.0	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	2.2	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.	2.3	-1.0	2.1	4.8	14.7	3.5	4.8
Apr.	2.3	-1.5	1.8	3.5	15.6	2.8	4.4
May	2.3	-1.5	1.6	2.7	10.4	2.3	3.2
June	2.1	-1.5	1.5	1.8	15.3	1.8	3.7
July	1.9	-1.2	1.5	1.4	16.0	1.5	3.6
Aug.	1.7	-0.7	1.5	0.9	17.1	1.3	3.7
Sept.	1.5	-0.5	1.6	0.7	18.2	1.1	3.8
Oct.	1.3	-0.4	1.5	0.5	19.6	0.9	4.0
Nov.	1.6	-0.1	1.4	0.6	17.1	1.1	3.6
Dec.	1.3	0.2	1.3	0.7	19.8	1.0	4.2
2006 – Jan.	1.3	0.9	1.3	0.9	22.1	1.1	4.8
Feb.	1.3	1.1	1.4	1.7	20.9	1.5	4.9
Mar.	1.5	1.0	1.5	2.2	17.5	1.9	4.5

Source: Based on Istat data.
(1) Classification of goods by main industrial groupings, 2000=100. – (2) The item does not include motor vehicles, which are included under investment goods.

INDEX OF INDUSTRIAL PRODUCER PRICES: MAJOR EURO-AREA COUNTRIES

(percentage changes on corresponding period)

	GERMANY					FRANCE				
	Consumer goods net of food products	Intermediate goods		Overall index net of food and energy products	Overall index	Consumer goods net of food products	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*
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	-0.8	2.7	5.1	1.1	2.0
2005	1.0	3.2	14.0	2.0	4.6	1.0	2.5	11.5	1.8	3.0
2004 – 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	0.0	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	3.9	10.2	2.5	3.1
Mar.	1.3	5.0	10.0	3.0	4.2	1.2	3.7	11.2	2.5	3.2
Apr.	1.2	4.2	13.2	2.5	4.6	1.6	3.3	11.5	2.5	3.3
May	1.4	3.5	11.0	2.2	4.1	1.6	2.9	7.6	2.3	2.5
June	1.3	3.4	14.4	2.1	4.6	1.5	2.3	11.5	1.8	2.9
July	1.0	2.3	16.4	1.5	4.6	0.8	1.7	13.2	1.4	3.0
Aug.	1.0	2.0	16.5	1.4	4.6	0.8	1.3	12.7	1.1	2.8
Sept.	1.0	1.9	17.1	1.3	4.9	0.6	1.3	15.0	1.1	3.3
Oct.	1.2	1.6	16.0	1.3	4.6	0.7	1.7	12.3	1.3	3.0
Nov.	1.1	1.8	17.5	1.2	5.0	0.5	2.0	11.0	1.3	2.9
Dec.	0.9	1.9	19.5	1.3	5.2	0.6	2.1	12.6	1.3	3.2
2006 – Jan.	0.9	1.7	21.4	1.1	5.6	0.2	2.5	14.9	1.4	3.8
Feb.	1.0	1.7	22.8	1.1	5.9	-0.5	2.4	13.7	1.3	3.6
Mar.	0.6	1.9	22.0	1.1	5.9	-0.5	2.3	11.2	1.3	3.3
	SPAIN					EURO (2)				
Weights (1)	*16.8*	*31.6*	*18.0*	*66.7*	*100.0*	*14.0*	*31.7*	*16.8*	*66.8*	*100.0*
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
2005	3.2	3.8	14.0	3.1	4.9	1.6	2.9	13.4	2.1	4.1
2004 – 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	4.3	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	5.2	10.0	3.3	4.2
Mar.	3.5	4.9	13.1	3.8	5.1	1.8	4.5	11.7	3.1	4.2
Apr.	3.7	3.7	14.5	3.2	5.0	1.9	3.7	13.2	2.6	4.3
May	3.8	3.3	11.0	3.1	4.2	2.0	3.0	9.7	2.3	3.5
June	3.6	3.1	13.5	3.0	4.4	1.9	2.6	13.4	2.1	4.0
July	3.2	3.0	15.7	2.7	4.6	1.6	1.9	15.1	1.6	4.1
Aug.	3.2	2.9	16.4	2.7	4.9	1.5	1.7	15.2	1.5	4.0
Sept.	2.9	3.2	17.9	2.8	5.4	1.3	1.6	16.6	1.4	4.4
Oct.	3.0	3.1	15.2	2.7	5.0	1.3	1.6	15.3	1.4	4.2
Nov.	2.8	3.2	14.7	2.8	4.9	1.3	1.8	14.7	1.4	4.2
Dec.	2.7	3.2	15.6	2.8	5.2	1.2	1.9	17.0	1.5	4.7
2006 – Jan.	2.8	3.6	20.6	3.0	6.3	1.1	2.0	19.8	1.5	5.3
Feb.	2.8	3.9	20.1	3.2	6.3	1.0	2.2	19.7	1.6	5.4
Mar.	2.6	4.5	16.4	3.4	5.8	1.0	2.5	17.4	1.7	5.1

Source: Based on Eurostat data.
(1) 1995=100 for Germany; 2000=100 for France, Spain and euro area. – (2) GDP-weighted average for the 12 euro-area countries.

ITALY: BALANCE OF PAYMENTS
(millions of euros)

	2000	2001	2002	2003	2004	2005
Current account	**-6,305**	**-740**	**-10,014**	**-17,352**	**-12,471**	**-22,056**
Goods	10,368	17,405	14,049	9,922	8,850	72
Credits	260,906	273,596	267,582	263,599	283,345	299,580
Debits	250,538	256,191	253,533	253,677	274,495	299,508
Services	1,167	18	-3,043	-2,362	1,179	-359
Credits	61,479	64,614	63,760	63,420	68,204	72,500
Debits	60,312	64,596	66,803	65,781	67,025	72,859
Income	-13,099	-11,635	-15,396	-17,811	-14,817	-13,595
Credits	41,894	43,111	45,782	43,097	42,748	49,544
Debits	54,993	54,746	61,178	60,908	57,564	63,140
Transfers	-4,742	-6,527	-5,624	-7,101	-7,683	-8,173
Credits	16,996	17,962	22,183	18,418	17,527	19,388
EU institutions	*6,275*	*6,121*	*6,183*	*6,531*	*6,917*	*6,599*
Debits	21,738	24,489	27,807	25,519	25,210	27,561
EU institutions	*11,180*	*11,755*	*11,910*	*12,820*	*13,454*	*14,578*
Capital account	**3,195**	**936**	**-67**	**2,251**	**1,822**	**1,779**
Intangible assets	-72	-312	-206	-86	-38	69
Transfers	3,267	1,248	139	2,337	1,859	1,710
EU institutions	*3,625*	*1,748*	*1,626*	*3,635*	*2,816*	*3,236*
Financial account	**4,287**	**-3,294**	**8,532**	**17,319**	**8,228**	**19,041**
Direct investment	1,149	-7,377	-2,739	6,507	-1,971	-17,556
Abroad	-13,368	-23,995	-18,194	-8,037	-15,513	-33,575
In Italy	14,517	16,618	15,455	14,544	13,542	16,019
Portfolio investment	-26,255	-7,640	16,107	3,369	26,447	43,398
Assets	-86,340	-40,070	-16,968	-51,068	-21,065	-87,028
Shares	-82,894	-11,153	-6,039	-13,806	-12,863	-20,014
Debt securities	-3,446	-28,917	-10,929	-37,262	-8,202	-67,014
bonds	*-1,698*	*-27,017*	*-10,301*	*-40,133*	*-8,903*	*-65,217*
Liabilities	60,085	32,430	33,075	54,437	47,512	130,426
Shares	-1,714	-354	-7,155	-2,191	13,381	4,063
Debt securities	61,799	32,784	40,230	56,628	34,131	126,363
bonds	*75,160*	*43,171*	*32,064*	*48,276*	*47,979*	*102,299*
Financial derivatives	2,501	-477	-2,710	-4,827	1,833	2,332
Other investment	29,950	11,716	985	13,676	-20,343	-9,943
Assets	987	3,007	8,296	-19,390	-38,667	-77,983
Liabilities	28,963	8,709	-7,311	33,066	18,324	68,040
Change in official reserves	-3,058	484	-3,111	-1,406	2,262	810
Errors and omissions	**-1,177**	**3,098**	**1,549**	**-2,218**	**2,421**	**1,236**

ITALY: NET INTERNATIONAL INVESTMENT POSITION
(millions of euros)

	2000	2001	2002	2003	2004	2005
ASSETS	**1,220,570**	**1,223,523**	**1,147,737**	**1,241,481**	**1,328,591**	**1,598,567**
Non-bank sectors	**955,517**	**958,264**	**851,961**	**911,935**	**961,674**	**1,175,847**
Direct investment	178,948	191,630	170,155	174,767	191,478	217,146
Real estate	6,682	7,490	7,609	8,067	9,148	10,493
Other	172,266	184,140	162,546	166,700	182,330	206,653
Portfolio investment	597,869	588,912	526,659	563,108	594,690	723,452
Other investment	176,296	174,347	146,977	162,912	164,363	222,665
Financial derivatives	2,404	3,375	8,170	11,148	11,143	12,584
Banks	**203,420**	**188,498**	**229,356**	**265,380**	**300,389**	**343,346**
Direct investment	14,791	15,305	15,306	14,371	14,435	31,623
Portfolio investment	36,298	36,553	38,920	64,964	73,099	74,064
Other investment	150,938	135,106	172,762	179,216	203,082	224,619
Financial derivatives	1,393	1,534	2,368	6,829	9,773	13,040
Central bank	**61,633**	**76,761**	**66,420**	**64,166**	**66,528**	**79,374**
Direct investment	4	5	5	5	5	6
Portfolio investment	715	912	2,673	2,436	3,313	4,840
Other investment	10,548	23,407	10,702	11,637	17,409	18,621
Reserves	50,366	52,437	53,040	50,088	45,801	55,907
of which: gold	*23,098*	*24,732*	*25,764*	*26,042*	*25,348*	*34,279*
LIABILITIES	**1,178,412**	**1,197,590**	**1,216,343**	**1,310,705**	**1,418,919**	**1,676,449**
Non-bank sectors	**845,666**	**869,566**	**901,365**	**964,514**	**1,045,351**	**1,185,874**
Direct investment	120,967	121,701	119,706	136,522	154,496	176,411
Real estate	2,961	3,249	3,566	4,835	5,013	5,894
Other	118,006	118,452	116,140	131,687	149,483	170,517
Portfolio investment	599,693	621,083	656,944	707,165	760,566	848,096
Government securities (1)	*470,349*	*485,224*	*515,343*	*568,043*	*590,940*	*688,636*
BOTs	*61,369*	*55,799*	*43,533*	*57,582*	*42,842*	*67,335*
BTPs	*257,994*	*283,700*	*326,404*	*371,266*	*407,624*	*476,482*
Other	*82,749*	*65,333*	*62,596*	*54,045*	*64,047*	*69,758*
Republic of Italy	*68,237*	*80,392*	*82,810*	*85,150*	*76,427*	*75,061*
Other investment	123,108	123,191	119,185	113,289	118,254	140,038
Financial derivatives	1,898	3,591	5,530	7,538	12,035	21,329
Banks	**314,728**	**325,531**	**309,870**	**343,747**	**372,801**	**488,747**
Direct investment	9,253	7,012	5,038	6,701	7,547	9,965
Portfolio investment	19,697	21,005	18,957	25,601	33,316	89,927
Other investment	284,838	295,942	282,900	306,396	324,631	378,198
Financial derivatives	940	1,572	2,975	5,048	7,307	10,657
Central bank	**18,018**	**2,493**	**5,108**	**2,444**	**767**	**1,828**
Direct investment	....	....	....	....	....	....
Portfolio investment	....	....	....	....	....	....
Other investment	18,018	2,493	5,108	2,444	767	1,828
OVERALL NET POSITION	**42,158**	**25,933**	**-68,606**	**-69,224**	**-90,328**	**-77,882**

(1) The breakdown by instrument is estimated and subject to revision.

CONSOLIDATED ACCOUNTS OF GENERAL GOVERNMENT (1)
(millions of euros)

	2000	2001	2002	2003	2004	2005
Revenue						
Direct taxes	171,833	183,998	179,554	178,745	185,400	189,052
Indirect taxes	175,037	176,952	185,174	186,770	195,398	201,859
Actual social security contributions	144,093	149,841	157,530	164,965	173,082	179,059
Imputed social security contributions	3,892	3,982	3,745	3,811	3,468	3,357
Income from capital	6,884	8,142	8,249	8,087	7,477	8,118
Other	33,638	35,957	36,979	37,184	42,476	41,708
Total current revenue	**535,377**	**558,872**	**571,231**	**579,562**	**607,301**	**623,153**
Capital taxes	1,117	1,065	2,986	17,932	7,912	1,808
Other	3,927	2,404	2,681	4,358	3,811	4,156
Total capital revenue	**5,044**	**3,469**	**5,667**	**22,290**	**11,723**	**5,964**
Total revenue	**540,421**	**562,341**	**576,898**	**601,852**	**619,024**	**629,117**
as a % of GDP	*45.4*	*45.0*	*44.5*	*45.1*	*44.6*	*44.4*
Expenditure						
Compensation of employees	124,306	131,647	137,621	144,749	149,609	155,533
Intermediate consumption	59,853	64,289	67,154	70,809	74,660	77,317
Social assistance benefits in kind (market purchases)	27,541	31,757	33,681	34,824	37,975	39,819
Social assistance benefits in cash	195,422	202,332	214,078	224,485	234,627	241,692
Subsidies to firms	14,097	15,156	14,450	14,213	14,533	13,201
Interest payments	75,561	78,764	71,519	68,514	65,753	64,549
Other	22,789	24,820	28,548	33,234	35,023	38,130
Total current expenditure	**519,569**	**548,765**	**567,051**	**590,828**	**612,180**	**630,241**
Gross investment (2)	27,720	29,630	22,468	32,778	33,276	33,499
Investment grants	14,548	16,891	18,440	19,463	17,728	18,909
Other (3)	-11,454	5,556	6,024	4,819	3,492	4,642
Total capital account expenditure (2) (3)	**30,814**	**52,077**	**46,932**	**57,060**	**54,496**	**57,050**
Total expenditure (2) (3)	**550,383**	**600,842**	**613,983**	**647,888**	**666,676**	**687,291**
as a % of GDP	*46.2*	*48.1*	*47.4*	*48.5*	*48.0*	*48.5*
Deficit on current account (surplus –)	**-15,808**	**-10,107**	**-4,180**	**11,266**	**4,879**	**7,088**
Net borrowing (4)	**9,962**	**38,501**	**37,085**	**46,036**	**47,652**	**58,174**
as a % of GDP	*0.8*	*3.1*	*2.9*	*3.4*	*3.4*	*4.1*

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)

	2000	2001	2002	2003	2004	2005
Currency and deposits	**5,063**	**22,351**	**11,043**	**-37,658**	**16,364**	**21,574**
of which: PO funds	4,753	18,735	8,675	-62,686	-1,187	-4,177
savings certificates	*2,375*	*4,132*	*3,863*	*-19,725*	*-4,430*	*-7,144*
savings books	*2,285*	*6,788*	*3,424*	*-48,917*	–	–
current accounts	*92*	*7,816*	*1,387*	*5,956*	*3,243*	*2,967*
Short-terms securities	**-17,830**	**11,775**	**-372**	**6,057**	**-998**	**-924**
of which: issued abroad	-237	202	-333	–	–	–
Medium and long-term securities	**35,630**	**23,147**	**31,702**	**23,068**	**41,622**	**40,254**
of which: variable rate	-7,598	-9,812	-13,476	-15,111	860	1,575
issued abroad	16,003	10,199	8,970	8,006	4,916	4,231
Other liabilities	**-6,474**	**1,604**	**-5,101**	**40,697**	**-5,334**	**6,371**
of which: MFI loans (2)	-6,363	-3,790	-2,469	-5,580	-1,409	5,594
resident banks	*-2,799*	*-2,442*	*-1,450*	*-4,391*	*-1,305*	*5,605*
non-resident banks	*-3,564*	*-1,349*	*-1,019*	*-1,189*	*-104*	*-12*
towards the central bank	-1,403	-52	39	127	-88	-23
Treasury assets held with the Bank of Italy	**9,590**	**-2,024**	**284**	**8,022**	**-2,578**	**1,197**
TOTAL BORROWING REQUIREMENT	**25,980**	**56,854**	**37,556**	**40,185**	**49,075**	**68,473**
as a % of GDP	*2.2*	*4.6*	*2.9*	*3.0*	*3.5*	*4.8*
Settlements of past debts (3)	**4,601**	**9,310**	**5,328**	**8,537**	**533**	**403**
Privatization receipts (3)	**-15,450**	**-4,603**	**-1,929**	**-16,855**	**-7,673**	**-4,318**
Borrowing requirement net of debt settlements and privatization receipts	**36,828**	**52,147**	**34,158**	**48,504**	**56,215**	**72,388**
Memorandum item:						
change in bank deposits	737	-42	1,836	552	664	4,262
Central government borrowing requirement	**18,489**	**52,670**	**35,221**	**18,097**	**45,409**	**58,767**
securities	15,199	33,082	26,662	25,946	35,916	33,076
MFI loans (2)	-9,969	-3,723	-2,613	-4,709	-2,025	3,913
other	13,259	23,310	11,172	-3,140	11,518	21,778
Local government borrowing requirement	**6,223**	**2,272**	**4,826**	**24,825**	**4,971**	**11,109**
securities	2,601	1,840	4,668	3,179	4,708	6,254
MFI loans (2)	3,605	-108	179	-793	653	1,653
other	16	540	-21	22,440	-390	3,201
Borrowing requirement of social security institutions	**1,268**	**1,912**	**-2,491**	**-2,737**	**-1,305**	**-1,403**

(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).

GENERAL GOVERNMENT DEBT BY INSTRUMENT AND SUBSECTOR (1)
(millions of euros)

	2000	2001	2002	2003	2004	2005
Currency and deposits	**115,463**	**137,814**	**148,857**	**111,198**	**127,562**	**149,137**
of which: PO funds	111,218	129,954	138,628	75,942	74,755	70,578
savings certificates	*69,255*	*73,387*	*77,250*	*57,525*	*53,094*	*45,950*
memorandum item: redemption value (2)	120,108	129,644	138,367	127,301	126,037	115,075
savings books	*38,705*	*45,493*	*48,917*	–	–	–
current accounts	*3,258*	*11,074*	*12,461*	*18,417*	*21,661*	*24,628*
Short-term securities	**101,923**	**113,699**	**113,325**	**119,382**	**118,384**	**117,460**
of which: in foreign currencies	–	–	–	–	–	–
issued abroad	132	335	–	–	–	–
Medium and long-term securities	**1,008,816**	**1,030,050**	**1,034,158**	**1,050,249**	**1,090,501**	**1,129,288**
of which: in foreign currencies	43,954	36,904	37,046	26,710	26,363	27,070
variable rate	235,515	225,491	211,588	195,976	196,406	197,694
issued abroad	77,150	87,561	93,180	98,081	101,979	107,270
Other liabilities	**73,903**	**75,813**	**70,661**	**111,283**	**105,945**	**112,292**
of which: MFI loans (3)	67,569	64,084	61,564	55,909	54,496	60,066
in foreign currencies	*1,891*	*1,408*	*1,064*	*569*	*267*	*153*
resident MFIs	*59,863*	*57,422*	*55,972*	*51,580*	*50,276*	*55,881*
non-resident MFIs	*7,706*	*6,662*	*5,592*	*4,329*	*4,220*	*4,185*
towards the central bank	95	42	82	209	120	98
GENERAL GOVERNMENT DEBT (4)	**1,300,106**	**1,357,376**	**1,367,001**	**1,392,112**	**1,442,392**	**1,508,176**
as a % of GDP	*109.2*	*108.7*	*105.5*	*104.3*	*103.9*	*106.4*
Central government debt	**1,254,797**	**1,307,869**	**1,315,192**	**1,318,237**	**1,364,909**	**1,421,037**
securities	1,103,614	1,134,777	1,133,876	1,152,867	1,187,472	1,219,129
MFI loans (3)	35,605	32,180	29,517	24,733	22,704	26,593
other	115,578	140,911	151,799	140,637	154,733	175,315
Local government debt	**39,229**	**41,515**	**46,309**	**71,112**	**76,025**	**87,084**
securities	7,125	8,972	13,608	16,764	21,413	27,618
MFI loans (3)	31,828	31,728	31,906	31,113	31,766	33,420
other	276	815	795	23,235	22,845	26,046
Debt of social security institutions	**6,079**	**7,992**	**5,500**	**2,763**	**1,458**	**55**
Treasury assets held with the Bank of Italy	**19,535**	**21,559**	**21,275**	**13,253**	**15,831**	**14,634**
DEBT NET OF THE TREASURY ASSETS HELD WITH THE BANK OF ITALY	**1,280,570**	**1,335,817**	**1,345,727**	**1,378,859**	**1,426,561**	**1,493,542**
of which: in foreign currencies	45,845	38,312	38,110	27,279	26,630	27,222
Memorandum item:						
bank deposits	22,053	22,012	23,847	24,399	25,063	29,326

(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.

Table a18

GENERAL GOVERNMENT DEBT BY HOLDING SECTOR (1)

(millions of euros)

	2000	2001	2002	2003	2004	2005
Currency and deposits	**115,463**	**137,814**	**148,857**	**111,198**	**127,562**	**149,137**
Short-term securities	**101,923**	**113,699**	**113,325**	**119,382**	**118,384**	**117,460**
held by:						
Bank of Italy	78	–	180	–	–	–
MFIs	9,312	21,172	26,930	44,647	46,564	37,768
other financial institutions	3,097	5,271	6,197	6,037	6,311	12,371
other residents	26,847	30,489	36,090	10,692	22,343	-619
non-residents	62,590	56,767	43,928	58,006	43,165	67,940
Medium and long-term securities	**1,008,816**	**1,030,050**	**1,034,158**	**1,050,249**	**1,090,501**	**1,129,288**
held by:						
Bank of Italy	62,320	64,283	40,920	49,072	53,937	59,012
MFIs	126,709	117,426	100,774	116,258	108,862	121,215
other financial institutions	142,554	173,566	158,476	135,744	150,735	149,317
other residents	274,375	255,332	284,913	259,961	262,990	223,389
non-residents	402,858	419,443	449,076	489,213	513,978	576,354
Other liabilities	**73,903**	**75,813**	**70,661**	**111,283**	**105,945**	**112,292**
of which: MFI loans (2)	67,569	64,084	61,564	55,909	54,496	60,066
resident MFIs	*59,863*	*57,422*	*55,972*	*51,580*	*50,276*	*55,881*
non-resident MFIs	*7,706*	*6,662*	*5,592*	*4,329*	*4,220*	*4,185*
towards the central bank	95	42	82	209	120	98
GENERAL GOVERNMENT DEBT (3)	**1,300,106**	**1,357,376**	**1,367,001**	**1,392,112**	**1,442,392**	**1,508,176**
as a % of GDP	*109.2*	*108.7*	*105.5*	*104.3*	*103.9*	*106.4*
held by:						
Bank of Italy	62,493	64,326	41,181	49,281	54,058	59,110
MFIs	195,885	196,020	183,676	212,485	205,702	214,864
other financial institutions	151,772	190,404	173,688	216,475	247,155	275,531
other residents	416,803	423,753	469,860	362,323	374,115	310,193
non-residents	473,154	482,873	498,597	551,548	561,363	648,479
Memorandum item:						
Debt issued abroad	84,987	94,558	98,772	102,409	106,199	111,454

(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.

Table a19

LOCAL GOVERNMENT DEBT BY INSTRUMENT AND SUBSECTOR (1)
(millions of euros)

	2000	2001	2002	2003	2004	2005
Securities	**7,125**	**8,972**	**13,608**	**16,764**	**21,413**	**27,618**
issued in Italy	2,106	2,599	3,228	3,961	6,174	9,695
issued abroad	5,019	6,373	10,380	12,803	15,239	17,924
MFI loans (2)	**31,828**	**31,728**	**31,906**	**31,113**	**31,766**	**33,420**
resident MFIs	30,822	30,716	30,764	29,737	30,384	32,049
non-resident MFIs	1,006	1,012	1,142	1,376	1,383	1,371
Other (3)	**276**	**815**	**795**	**23,235**	**22,845**	**26,046**
LOCAL GOVERNMENT DEBT	**39,229**	**41,515**	**46,309**	**71,112**	**76,025**	**87,084**
as a % of GDP	*3.3*	*3.3*	*3.6*	*5.3*	*5.5*	*6.1*
Debt of the regions	**17,703**	**19,212**	**21,915**	**27,161**	**29,149**	**30,697**
Securities	4,763	6,072	9,831	11,610	13,337	13,836
issued in Italy	*84*	*99*	*314*	*442*	*826*	*937*
issued abroad	*4,679*	*5,974*	*9,517*	*11,167*	*12,511*	*12,899*
MFI and Cassa Depositi e Prestiti S.p.A. loans (2)	12,815	12,493	11,703	13,273	13,730	14,974
resident	*11,908*	*11,687*	*10,991*	*12,475*	*12,949*	*14,123*
non-resident	*906*	*807*	*713*	*798*	*782*	*851*
Debt of provinces and municipalities (4)	**16,999**	**17,432**	**18,834**	**38,280**	**41,245**	**48,550**
Securities	2,334	2,866	3,736	5,106	8,021	13,631
issued in Italy	*1,994*	*2,466*	*2,874*	*3,470*	*5,293*	*8,606*
issued abroad	*340*	*400*	*863*	*1,635*	*2,728*	*5,024*
MFI and loans (2)	14,546	14,434	14,985	32,483	32,586	34,212
resident	*14,447*	*14,229*	*14,556*	*31,905*	*31,985*	*33,692*
non-resident	*100*	*205*	*429*	*578*	*601*	*520*
Debt of other entities	**4,527**	**4,871**	**5,560**	**5,671**	**5,631**	**7,837**

(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) Mostly loans disbursed by Cassa Depositi e Prestiti S.p.A., the proceeds of securitizations classified as loans in accordance with the rules laid down by Eurostat, and some minor items. – (4) Including metropolitan areas and municipal unions.

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
2002 – Dec.	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	56,924	167,108	19,075
2004 – ”	9,083	339,741	52,506	1,107,883	93,689	89	13,440	65,046	62,335	162,810	25,076
2005 – Jan.	7,508	327,624	53,414	1,124,432	86,065	89	12,836	60,824	62,023	164,729	24,687
Feb.	7,465	322,950	54,210	1,120,156	88,373	89	13,791	58,058	63,218	170,139	24,418
Mar.	8,045	331,823	53,325	1,128,154	89,422	89	12,622	61,964	63,590	169,638	25,430
Apr.	7,414	336,348	54,748	1,128,031	94,798	84	12,774	65,638	63,874	168,983	26,748
May	7,601	354,851	55,048	1,135,881	100,200	84	11,620	68,484	65,075	167,430	26,820
June	7,593	359,233	55,403	1,155,789	98,918	84	12,231	70,097	69,476	172,312	27,700
July	7,657	348,936	54,864	1,159,100	97,367	84	12,654	70,157	70,624	168,329	27,344
Aug.	7,602	356,978	53,665	1,153,772	99,912	84	15,957	64,635	70,152	167,694	26,928
Sept.	7,410	362,820	55,530	1,159,964	96,332	84	16,081	74,400	73,258	168,594	27,631
Oct.	7,912	372,284	55,846	1,168,447	95,777	84	15,899	71,420	72,347	173,304	27,883
Nov.	8,279	363,869	54,788	1,185,415	99,939	84	16,573	72,190	73,550	174,458	28,014
Dec.	9,291	366,406	57,069	1,193,141	103,559	84	16,553	66,858	78,053	163,300	28,184
2006 – Jan. (2)	7,871	371,653	57,137	1,202,804	104,256	84	17,385	70,275	78,642	167,979	28,008
Feb. (2)	8,003	353,608	57,474	1,207,038	96,032	84	19,160	61,830	80,008	165,009	28,268
Mar (2)	7,726	363,011	58,288	1,218,081	114,492	84	18,875	67,168	80,666	154,937	27,324

(1) ESCB harmonized statistics. Rounding may cause discrepancies in totals. – (2) Provisional.

Table a20

ASSETS

shares, at market value – Residents of other euro-area countries – MFIs	shares, at market value – Residents of other euro-area countries – General government	shares, at market value – Residents of other euro-area countries – Other sectors	shares, at market value – Rest of the world	Shares and other equity – Residents of Italy – MFIs	Shares and other equity – Residents of Italy – Other sectors	Shares and other equity – Residents of other euro-area countries – MFIs	Shares and other equity – Residents of other euro-area countries – Other sectors	Shares and other equity – Rest of the world	Fixed assets	Remaining assets	Total assets	
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	...... Dec. – 2002
7,438	17,475	9,492	15,730	51,004	43,420	5,232	12,052	7,631	46,545	190,587	2,246,094	.... ” – 2003
9,665	25,996	8,752	16,332	52,573	45,944	5,442	12,399	8,368	47,076	214,821	2,379,067	.... ” – 2004
10,217	26,741	8,838	20,086	52,955	48,482	5,236	12,222	10,009	46,544	227,233	2,392,794	.... Jan. – 2005
11,436	27,179	8,711	19,855	53,083	49,947	5,272	12,830	10,111	46,981	225,286	2,393,558	.... Feb.
12,511	25,878	9,204	20,973	55,456	52,587	5,086	12,881	10,273	46,990	233,660	2,429,602	.... Mar.
12,888	25,695	9,451	20,288	59,795	57,564	5,125	12,896	10,336	46,668	235,523	2,455,669	.... Apr.
12,762	26,555	9,321	20,561	60,915	63,169	5,252	13,614	10,736	46,786	252,119	2,514,884	.... May
13,204	24,942	9,285	20,995	57,126	58,853	5,374	13,870	9,037	46,643	253,096	2,541,261	.... June
13,535	23,410	9,294	22,915	60,824	48,626	5,134	12,536	9,335	47,278	243,552	2,513,554	.... July
13,731	22,287	8,741	22,867	60,551	48,603	5,304	12,317	9,324	47,330	237,591	2,506,025	.... Aug.
13,681	21,584	8,910	22,351	60,537	53,030	5,101	12,987	9,302	47,267	245,493	2,542,348	.... Sept.
13,244	21,246	9,449	22,212	60,101	62,929	5,347	13,146	9,505	47,991	244,026	2,570,398	.... Oct.
12,963	24,203	9,242	22,088	61,131	56,669	21,432	13,904	9,504	48,337	254,923	2,611,552	.... Nov.
12,561	21,595	9,918	16,781	58,903	50,204	21,417	13,876	9,521	48,463	253,402	2,599,139	.... Dec.
12,866	23,609	10,165	20,602	60,141	50,528	21,540	14,106	9,563	48,635	248,650	2,626,499	... (2) Jan. – 2006
13,070	22,204	10,456	20,490	60,760	52,490	21,546	14,891	9,676	48,664	249,314	2,600,073	... (2) Feb.
12,000	20,639	11,026	18,989	62,481	55,168	21,657	15,494	9,275	48,902	240,959	2,627,241	... (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
2002 – Dec.	285,275	7,109	689,068	111,654	8	9,279
2003 – ”	313,742	7,730	691,960	118,928	17	9,268
2004 – ”	343,492	7,218	724,848	126,294	13	13,214
2005 – Jan.	335,004	7,588	716,222	137,623	19	10,978
Feb.	332,067	7,293	711,462	147,243	99	11,364
Mar.	344,496	7,437	716,441	143,892	94	11,551
Apr.	344,284	7,655	729,069	146,361	93	12,277
May	368,025	7,931	736,160	153,120	89	12,489
June	367,579	8,591	744,750	153,908	367	14,428
July	354,979	7,678	750,374	154,345	101	13,400
Aug.	362,130	7,819	733,540	154,610	90	13,383
Sept.	370,251	8,380	740,524	153,153	577	13,841
Oct.	374,061	8,199	752,570	161,490	1,008	15,684
Nov.	373,555	8,069	743,395	156,307	940	13,311
Dec.	378,792	8,214	775,985	146,229	921	14,279
2006 – Jan. (2)	378,933	7,593	766,052	165,081	2,563	14,461
Feb. (2)	361,331	7,667	763,673	163,772	344	14,215
Mar. (2)	367,882	7,607	772,438	169,976	110	15,713

(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	
146,026	41,966	367,969	146,172	261,595	2,066,123	................Dec. – 2002
159,227	107,031	399,958	156,726	281,508	2,246,095	.... ” – 2003
157,033	101,079	442,994	163,181	299,700	2,379,067	.... ” – 2004
163,627	99,645	442,682	165,154	314,254	2,392,794	.... Jan. – 2005
157,396	99,086	451,423	165,142	310,983	2,393,558	.... Feb.
161,458	98,125	458,198	166,903	321,007	2,429,602	.... Mar.
170,619	97,430	460,337	168,749	318,793	2,455,667	.... Apr.
171,619	95,827	464,569	170,436	334,618	2,514,883	.... May
169,951	94,087	471,047	171,244	345,307	2,541,259	.... June
163,577	92,787	470,169	175,412	330,732	2,513,554	.... July
172,628	92,483	467,899	174,943	326,502	2,506,026	.... Aug.
178,354	91,083	470,644	175,071	340,469	2,542,347	.... Sept.
182,721	89,481	474,025	175,699	335,461	2,570,398	.... Oct.
185,113	88,535	476,526	190,921	374,880	2,611,552	.... Nov.
179,641	88,548	484,416	191,407	330,708	2,599,139	.... Dec.
185,810	85,489	483,651	193,765	343,101	2,626,499	.... (2) Jan. – 2006
181,783	83,011	495,698	193,851	334,729	2,600,073	.... (2) Feb.
184,168	77,644	504,489	195,905	331,311	2,627,241	.... (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:					
			from 1 to 5 years	*more than 5 years*	up to 1 year (2)	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 – Dec.	5.57	4.37	4.49	4.37	8.04	7.66	5.22	8.39
2005 – Jan.	5.58	4.35	4.47	4.35	8.22	7.66	5.21	8.64
Feb.	5.54	4.34	4.46	4.33	8.14	7.63	5.20	8.55
Mar.	5.50	4.31	4.48	4.30	7.99	7.58	5.19	8.38
Apr.	5.48	4.29	4.46	4.29	8.11	7.53	5.21	8.53
May	5.44	4.27	4.44	4.26	8.05	7.52	5.20	8.48
June	5.40	4.24	4.38	4.24	7.89	7.46	5.19	8.40
July	5.34	4.19	4.37	4.18	7.85	7.43	5.16	8.36
Aug.	5.32	4.18	4.35	4.18	7.85	7.42	5.16	8.35
Sept.	5.31	4.17	4.34	4.17	7.80	7.39	5.15	8.28
Oct.	5.29	4.16	4.33	4.16	7.82	7.37	5.15	8.25
Nov.	5.28	4.17	4.33	4.17	7.78	7.33	5.15	8.19
Dec.	5.29	4.21	4.39	4.21	7.75	7.42	5.17	8.16
2006 – Jan. (3)	5.39	4.31	4.52	4.31	7.93	7.42	5.28	8.34
Feb. (3)..........	5.38	4.33	4.51	4.33	7.87	7.38	5.30	8.27
Mar. (3)...........	5.40	4.36	4.54	4.36	7.94	7.39	5.33	8.35

(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*
	up to 1 year (2)	from 1 to 5 years	more than 5 years			
4.44	4.98	3.92	4.05	5.62	5.45	6.12
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	5.00	3.77	3.88	5.62	5.47	6.13
4.29	4.91	3.80	3.87	5.51	5.38	6.01
4.30	4.95	3.80	3.86	5.54	5.42	6.05
4.27	4.90	3.80	3.86	5.46	5.37	5.97
4.21	4.78	3.75	3.84	5.36	5.24	5.88
4.18	4.75	3.75	3.80	5.33	5.21	5.84
4.20	4.78	3.76	3.83	5.36	5.24	5.88
4.18	4.76	3.74	3.80	5.34	5.22	5.86
4.17	4.75	3.73	3.81	5.31	5.21	5.82
4.18	4.73	3.76	3.82	5.25	5.19	5.75
4.26	4.83	3.84	3.89	5.35	5.26	5.82
4.38	4.96	3.91	4.00	5.48	5.39	5.96
4.39	4.96	3.95	4.03	5.48	5.38	5.95
4.44	5.01	4.01	4.08	5.54	5.44	6.01

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: households	up to 2 years	more than 2 years					
2003 – Dec.	0.88	0.71	0.61	1.62	3.67	0.89	1.95	1.49	1.47	1.96
2004 – Dec.	0.89	0.71	0.59	1.47	3.54	1.01	1.97	1.49	1.48	1.97
2005 – Jan.	0.87	0.70	0.59	1.47	3.52	0.96	1.97	1.51	1.50	1.95
Feb.	0.87	0.68	0.58	1.46	3.51	0.98	1.97	1.52	1.51	1.93
Mar.	0.89	0.70	0.59	1.46	3.49	1.05	1.96	1.51	1.50	1.93
Apr.	0.88	0.70	0.59	1.46	3.47	1.06	1.96	1.49	1.47	1.93
May	0.89	0.71	0.59	1.45	3.45	1.07	1.97	1.51	1.49	1.92
June	0.89	0.70	0.59	1.44	3.45	1.11	1.97	1.51	1.50	1.92
July	0.88	0.69	0.59	1.44	3.43	1.07	1.97	1.52	1.51	1.95
Aug.	0.90	0.71	0.59	1.45	3.43	1.06	1.99	1.50	1.48	1.97
Sept.	0.90	0.72	0.60	1.45	3.41	1.07	1.99	1.52	1.51	1.96
Oct.	0.90	0.72	0.61	1.44	3.39	1.04	2.01	1.51	1.50	2.01
Nov.	0.92	0.74	0.62	1.45	3.38	1.05	2.05	1.53	1.52	2.06
Dec.	0.95	0.77	0.64	1.46	3.36	1.09	2.14	1.58	1.57	2.19
2006 – Jan. (2).........	0.98	0.79	0.67	1.48	3.33	1.08	2.21	1.63	1.61	2.23
Feb. (2).........	0.99	0.80	0.68	1.49	3.31	1.10	2.27	1.63	1.62	2.27
Mar. (2).........	1.05	0.86	0.71	1.52	3.26	1.19	2.35	1.69	1.66	2.38

(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: month	day	Liquidity-providing factors: Net assets in gold and foreign currency	Net claims on the Eurosystem	Monetary policy operations: Main refinancing operations	Longer-term refinancing operations	Marginal lending facility	Other liquidity-providing operations
2003	23	53,520	12,524	10,895	..	1	..
2004	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
June	7	45,773	21,859	15,950	1,108	..	1
July	12	47,043	32,024	20,177	983	..	1
Aug.	9	49,744	35,932	21,676	844	..	1
Sept.	6	49,532	32,302	22,667	896	..	5
Oct.	11	50,166	17,530	20,064	904	1	1
Nov.	8	52,020	17,899	20,354	747	..	1
Dec.	5	52,750	15,302	22,330	498	..	1
2006 – Jan.	17	52,405	19,769	21,662	248	10	..
Feb.	7	54,532	29,263	20,422	555	..	19
Mar.	7	54,834	20,641	20,743	903	..	..
Apr.	11	55,314	22,308	18,911	1,756	..	9
May	9	57,352	23,120	16,157	2,645	..	..

Maintenance period ending in: month	day	Liquidity-absorbing factors: Monetary policy operations: Other liquidity-absorbing operations	Deposit facility (a)	Currency in circulation (b)	Central government deposits	Other factors (net)	Credit institutions' current accounts with the central bank (c)	Italian contribution to base money (a+b+c)
2003	23	..	2	80,669	33,368	-51,706	14,606	95,277
2004	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
June	7	21	6	96,309	30,791	-58,022	15,585	111,900
July	12	..	7	98,246	43,479	-57,571	16,067	114,319
Aug.	9	..	13	100,616	47,253	-55,801	16,117	116,746
Sept.	6	..	3	100,308	44,503	-55,686	16,275	116,585
Oct.	11	2	12	100,466	27,836	-55,806	16,157	116,635
Nov.	8	..	5	101,084	28,140	-54,115	15,905	116,995
Dec.	5	39	5	102,158	25,986	-53,631	16,323	118,485
2006 – Jan.	17	..	1	106,907	22,899	-52,409	16,695	123,603
Feb.	7	..	13	102,730	34,581	-48,857	16,325	119,067
Mar.	7	..	4	103,676	26,705	-50,319	17,055	120,735
Apr.	11	..	3	105,061	26,674	-50,362	16,922	121,986
May	9	91	2	107,290	25,999	-50,825	16,718	124,010

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
2003	616,242	43,955	165,920	826,117	68,468
2004	663,072	45,664	184,358	893,094	71,318
2005 – Jan.	658,927	44,256	186,054	889,237	65,853
Feb.	655,659	43,027	188,268	886,954	67,383
Mar.	658,569	45,496	189,757	893,822	67,025
Apr.	678,907	43,082	191,649	913,638	64,125
May	681,155	42,406	192,448	916,009	70,941
June	689,714	45,278	193,494	928,486	73,106
July	692,094	45,095	194,971	932,160	78,564
Aug.	671,951	44,630	197,348	913,929	79,813
Sept.	685,577	45,542	198,356	929,475	73,763
Oct.	696,561	44,899	199,049	940,509	77,937
Nov.	689,071	44,849	200,510	934,430	78,562
Dec.	722,617	48,860	203,883	975,360	75,190
2006 – Jan.	710,221	46,501	205,811	962,533	78,780
Feb.	707,939	47,675	207,537	963,151	78,961
Mar.	715,571	50,721	208,170	974,462	79,990

(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".

Table a24

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	
105,463	7,195	1,007,243	542,936	752,811	933,937	 2003
98,789	3,480	1,066,681	577,763	807,785	981,372	 2004
97,521	3,024	1,055,635	574,734	805,044	971,442	.... Jan. – 2005
96,794	3,079	1,054,210	570,928	802,223	969,479	.... Feb.
95,941	3,093	1,059,881	572,318	807,571	973,630	.... Mar.
95,295	3,058	1,076,116	590,748	825,479	987,957	.... Apr.
93,766	2,883	1,083,599	592,104	826,958	994,548	.... May
92,001	2,873	1,096,466	598,490	837,262	1,005,242	.... June
90,704	3,269	1,104,697	599,131	839,197	1,011,734	.... July
90,517	2,688	1,086,947	580,100	822,078	995,096	.... Aug.
89,106	2,956	1,095,300	592,437	836,335	1,002,160	.... Sept.
87,605	3,337	1,109,388	603,105	847,053	1,015,932	.... Oct.
86,615	3,877	1,103,484	595,199	840,558	1,009,612	.... Nov.
86,638	3,495	1,140,683	625,422	878,165	1,043,488	.... Dec.
83,736	5,023	1,130,072	614,948	867,260	1,034,799	.... Jan. – 2006
81,295	5,217	1,128,623	612,010	867,222	1,032,694	.... Feb.
76,123	5,654	1,136,230	618,252	877,143	1,038,911	.... 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						Finance
		Deposits of central government	Medium and long-term liabilities to the money-holding sector				Liabilities to non-residents of the euro area	
			Deposits with agreed maturity over 2 years and deposits redeemable at notice over 3 months	Debt securities over 2 years' agreed maturity (1)	Capital and reserves (1)	Total		Loans
2003	1,007,243	21,042	4,320	327,525	123,938	455,783	160,065	53,011
2004	1,066,681	23,090	3,714	366,318	131,088	501,120	158,369	52,629
2005 – Jan.	1,055,635	54,705	3,715	365,645	135,514	504,874	165,475	53,537
Feb.	1,054,210	67,871	3,708	371,857	135,175	510,740	158,744	54,333
Mar.	1,059,881	57,680	3,453	377,003	135,233	515,689	162,874	53,448
Apr.	1,076,116	56,141	4,401	378,362	133,669	516,432	172,219	54,866
May	1,083,599	43,568	4,346	381,500	136,416	522,262	173,417	55,166
June	1,096,466	73,980	4,328	383,150	143,651	531,129	171,559	55,521
July	1,104,697	65,401	4,341	380,876	143,913	529,130	164,716	54,982
Aug.	1,086,947	54,233	4,200	379,024	144,101	527,325	174,333	53,783
Sept.	1,095,300	45,140	4,271	378,486	147,982	530,739	179,523	55,648
Oct.	1,109,387	46,023	4,283	382,985	147,294	534,562	183,921	55,964
Nov.	1,103,484	42,121	4,127	384,609	148,700	537,436	186,560	54,906
Dec.	1,140,683	23,797	4,596	388,132	152,604	545,332	182,041	57,187
2006 – Jan.	1,130,072	56,772	5,502	385,402	155,256	546,160	188,180	57,255
Feb.	1,128,623	51,684	5,582	396,061	155,611	557,254	184,235	57,592
Mar.	1,136,230	38,627	5,631	404,897	155,257	565,785	186,555	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 shares/other equity	Total				
238,272	291,283	1,064,313	28,631	61,162	1,154,106	1,445,389	113,459	85,285	 2003
249,296	301,925	1,121,323	33,924	65,184	1,220,431	1,522,356	107,124	119,780	 2004
253,526	307,063	1,137,268	33,623	67,092	1,237,983	1,545,046	109,224	126,419	.... Jan. – 2005
259,526	313,859	1,133,947	33,225	69,219	1,236,391	1,550,250	105,734	135,581	.... Feb.
257,933	311,381	1,140,776	34,730	71,963	1,247,469	1,558,850	111,358	125,916	.... Mar.
258,112	312,978	1,140,805	36,254	76,676	1,253,735	1,566,713	114,427	139,768	.... Apr.
258,383	313,549	1,147,501	36,196	83,203	1,266,900	1,580,449	118,831	123,566	.... May
262,277	317,798	1,168,020	37,033	79,290	1,284,343	1,602,141	119,151	151,842	.... June
257,075	312,057	1,171,754	36,689	68,133	1,276,576	1,588,633	121,560	153,751	.... July
256,248	310,031	1,169,729	35,718	67,900	1,273,347	1,583,378	116,407	143,053	.... Aug.
256,722	312,370	1,176,045	36,594	73,448	1,286,087	1,598,457	125,143	127,102	.... Sept.
260,785	316,749	1,184,346	37,380	82,941	1,304,667	1,621,416	122,273	130,204	.... Oct.
265,265	320,171	1,201,988	37,304	77,512	1,316,804	1,636,975	124,491	108,135	.... Nov.
252,212	309,399	1,209,694	38,150	71,361	1,319,205	1,628,604	113,287	149,962	.... Dec.
258,714	315,969	1,120,189	38,221	72,039	1,330,449	1,646,418	121,138	153,628	.... Jan. – 2006
254,951	312,542	1,226,198	38,773	74,952	1,339,923	1,652,465	113,098	156,234	.... Feb.
242,455	300,860	1,236,956	38,397	78,356	1,353,708	1,654,569	115,590	157,038	.... 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)						
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	44,528	4,646	6,440	3,513	6,310	126	6,261	10,789	4,554	-1,415	30,143
2004	397	43,951	4,141	6,162	4,514	5,309	254	6,097	11,219	4,534	-1,101	30,651
2005 (3)	419	45,804	4,217	7,007	6,387	5,885	314	7,116	12,092	5,572	-796	32,058
						Cooperative banks *(banche popolari)*						
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	44	5,270	637	647	489	728	10	803	1,338	281	-142	3,786
2005 (3)	46	5,719	670	561	277	854	10	656	1,542	477	156	3,891
						Mutual banks *(banche di credito cooperativo)*						
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	34	3,968	604	146	38	681	..	21	794	2	84	3,377
2005 (3)	36	4,280	615	146	41	723	..	24	892	2	93	3,570
						Branches of foreign banks						
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	86	2,439	174	399	768	463	162	834	2	1,064	-312	1,029
2005 (3)	97	2,839	183	541	877	558	153	852	1	1,765	-350	858
						Total banks						
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	56,203	6,332	7,484	4,764	8,440	287	7,450	13,105	6,099	-1,655	38,419
2004	562	55,628	5,556	7,355	5,810	7,181	427	7,754	13,353	5,881	-1,472	38,843
2005 (3)	598	58,642	5,685	8,255	7,582	8,020	477	8,649	14,526	7,816	-897	40,377

(1) Rounding may cause discrepancies in totals. – (2) Includes central credit institutions. – (3) Provisional.

Non-interest income			Gross income (c)=(a)+(b)	Operating expenses		Operating profit (e)=(c)-(d)	Value adjustments and re-adjustments and allocations to provisions		Tax (g)	Net profit (e)-(f)-(g)	Total assets	Capital and reserves	Number of banking staff (average)
(b)	*of which: trading*	*of which: services*		(d)	*of which: banking staff costs*		(f)	*of which: for loan losses*					
Limited company banks (2)													
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
25,845	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
25,608	1,248	10,749	56,259	33,610	18,373	22,649	5,310	5,977	4,762	12,577	1,880,152	126,935	269,236
27,627	317	12,064	59,686	35,051	18,789	24,635	5,437	4,497	5,386	13,812	2,038,881	135,660	267,247
Cooperative banks *(banche popolari)*													
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
3,445	92	1,211	7,232	4,594	2,513	2,637	906	675	374	1,357	223,195	20,684	38,125
3,685	177	1,265	7,576	4,889	2,666	2,687	1,530	1,134	255	902	246,394	22,508	38,472
Mutual banks *(banche di credito cooperativo)*													
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	24,798
969	79	400	4,346	2,910	1,541	1,436	292	291	246	898	121,078	11,970	25,743
1,066	65	425	4,636	3,137	1,624	1,498	10	204	266	1,222	132,459	12,784	26,424
Branches of foreign banks													
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
868	405	294	1,897	1,136	453	760	298	314	249	213	106,567	1,565	3,919
1,209	377	322	2,067	1,183	540	884	92	74	278	515	131,050	1,698	4,267
Total banks													
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
30,924	2,734	11,928	69,343	42,275	23,166	27,067	11,235	9,091	4,737	11,095	2,170,483	150,909	338,292
30,890	1,824	12,655	69,734	42,251	22,879	27,482	6,805	7,257	5,631	15,046	2,330,992	161,154	337,023
33,587	937	14,076	73,965	44,261	23,620	29,704	7,069	5,909	6,184	16,451	2,548,784	172,649	336,410

ITALY'S FINANCIAL ASSETS AND LIABILITIES IN 2005 (1)

(stocks in millions of euros)

Institutional sectors / Financial instruments	Non-financial corporations		Financial corporations: Monetary financial institutions		Financial corporations: Other financial intermediaries		Financial corporations: Financial auxiliaries		Financial corporations: Insurance corporations and pension funds	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Monetary gold and SDRs	**–**	**–**	**34,473**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Currency and transferable deposits, with	**172,892**	**–**	**121,041**	**890,986**	**92,757**	**–**	**31,450**	**–**	**30,988**	**–**
MFIs	149,602	–	94,035	890,986	18,150	–	15,557	–	13,716	–
other residents	2,334	–	307	–	74,606	–	–	–	87	–
rest of the world	20,956	–	26,699	–	..	–	15,893	–	17,185	–
Other deposits, with	**10,680**	**–**	**356,521**	**608,170**	**11,166**	**123,422**	**9,653**	**–**	**4,941**	**–**
MFIs	10,680	–	298,467	608,170	11,166	–	9,653	–	4,873	–
other residents	..	–	1,250	–	–	123,422	–	–	–	–
rest of the world	..	–	56,804	–	..	–	..	–	68	–
Short-term securities, issued by	**2,718**	**11,649**	**59,988**	**29**	**9,493**	**134**	**11**	**–**	**5,835**	**–**
general government	26	–	37,465	–	4,215	–	11	–	5,684	–
other residents	1	11,649	11,567	29	167	134	–	–	–	–
rest of the world	2,691	–	10,956	–	5,110	–	–	–	151	–
Bonds, issued by	**62,509**	**49,510**	**312,877**	**492,987**	**253,363**	**158,164**	**14,223**	**–**	**252,821**	**4,325**
MFIs	12,160	–	68,041	492,987	13,027	–	288	–	32,495	–
central government: CCTs	1,314	–	76,706	–	17,665	–	1,362	–	32,553	–
central government: other	6,203	–	92,171	–	43,268	–	6,666	–	100,012	–
local government	3,229	–	9,839	–	3,137	–	1,562	–	1,721	–
other residents	21,259	49,510	19,126	–	23,913	158,164	4,346	–	19,036	4,325
rest of the world	18,344	–	46,995	–	152,354	–	–	–	67,004	–
Derivatives	**3,050**	**4,168**	**111,985**	**108,158**	**1,967**	**2,149**	**–**	**–**	**3,050**	**4,168**
Short-term loans, of	**77,841**	**388,513**	**579,692**	**89,755**	**48,206**	**123,954**	**..**	**10,289**	**11,274**	**2,124**
MFIs	–	284,004	579,692	16,395	–	99,096	–	10,289	–	2,124
other financial corporations	–	32,376	–	294	48,206	–	..	–	11,274	..
general government	–	–	–	–	–	–	–	–	–	–
other residents	77,841	–	–	–	–	–	–	–	–	–
rest of the world	–	72,133	–	73,067	–	24,858	–	–	–	–
Medium and long-term loans, of	**–**	**457,727**	**818,944**	**58,977**	**137,419**	**44,909**	**..**	**2,402**	**9,669**	**13,672**
MFIs	–	356,178	818,944	5,222	–	36,376	–	2,376	–	10,540
other financial corporations	–	48,007	–	733	137,419	–	..	–	9,669	27
general government	–	45,897	–	3,202	–	–	–	25	–	956
other residents	–	–	–	–	–	–	–	–	–	–
rest of the world	–	7,645	–	49,820	–	8,533	–	–	–	2,149
Shares and other equity, issued by	**696,863**	**1,319,460**	**198,158**	**424,562**	**225,933**	**34,969**	**..**	**2,465**	**107,239**	**144,186**
residents	534,206	1,319,460	162,633	424,562	72,223	34,969	..	2,465	71,425	144,186
of which: listed shares	*252,368*	*371,986*	*39,848*	*219,972*	*51,827*	*1,783*	–	–	*32,495*	*82,865*
rest of the world	162,657	–	35,525	–	153,710	–	–	–	35,813	–
Mutual fund shares, issued by	**14,186**	**–**	**14,978**	**88,548**	**27,569**	**264,227**	**339**	**–**	**72,330**	**–**
residents	3,764	–	6,623	88,548	–	264,227	339	–	66,476	–
rest of the world	10,422	–	8,356	–	27,569	–	–	–	5,854	–
Insurance technical reserves	**19,564**	**103,687**	**1,112**	**17,552**	**–**	**–**	**–**	**–**	**–**	**457,928**
net equity of households	–	103,687	–	17,552	–	–	–	–	–	391,206
prepayments and other claims	19,564	–	1,112	–	–	–	–	–	–	66,722
Other accounts receivable/payable	**382,210**	**337,277**	**820**	**531**	**777**	**..**	**–**	**–**	**78**	**844**
Trade credits	343,637	317,300	–	–	–	–	–	–	–	–
Other	38,573	19,977	820	531	777	..	–	–	78	844
Total	**1,442,514**	**2,671,992**	**2,610,590**	**2,780,256**	**808,651**	**751,928**	**55,677**	**15,156**	**498,224**	**627,246**

(1) Provisional. Rounding may cause discrepancies in totals.

General government						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
–	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**34,473**	**34,473**	**34,473**	**Monetary gold and SDRs**
24,557	**112,209**	**27,927**	**–**	**11,830**	**–**	**555,196**	**–**	**30,933**	**96,376**	**1,099,572**	**1,099,572**	**Currency and transferable deposits,** with
14,739	–	16,109	–	11,401	–	526,841	–	30,834	–	890,986	890,986	MFIs
–	112,209	8,957	–	..	–	25,819	–	99	–	112,209	112,209	other residents
9,817	–	2,861	–	429	–	2,536	–	–	96,376	96,376	96,376	rest of the world
248	**115,075**	**1,216**	**–**	**1,197**	**–**	**318,438**	**–**	**189,919**	**57,311**	**903,978**	**903,978**	**Other deposits,** with
248	–	1,015	–	1,197	–	80,952	–	189,919	–	608,170	608,170	MFIs
–	115,075	–	–	–	–	237,247	–	–	–	238,498	238,498	other residents
..	–	201	–	..	–	238	–	–	57,311	57,311	57,311	rest of the world
1	**116,757**	**27**	**..**	**65**	**–**	**2,711**	**–**	**67,335**	**19,616**	**148,185**	**148,185**	**Short-term securities,** issued by
1	116,757	27	..	65	–	1,926	–	67,335	–	116,757	116,757	general government
–	–	–	–	–	–	77	–	–	–	11,813	11,813	other residents
–	–	–	–	–	–	708	–	–	19,616	19,616	19,616	rest of the world
780	**1,194,367**	**5,751**	**27,701**	**10,727**	**–**	**659,785**	**–**	**761,529**	**407,312**	**2,334,365**	**2,334,365**	**Bonds,** issued by
215	–	613	–	1,078	–	315,051	–	50,018	–	492,987	492,987	MFIs
44	202,392	215	–	3,120	–	10,313	–	59,102	–	202,392	202,392	central government: CCTs
271	991,975	702	–	3,256	–	166,894	–	572,532	–	991,975	991,975	central government: other
50	–	1,608	27,701	..	–	3,169	–	3,387	–	27,701	27,701	local government
201	–	199	–	1,926	–	45,505	–	76,489	–	211,999	211,999	other residents
–	–	2,415	–	1,347	–	118,853	–	–	407,312	407,312	407,312	rest of the world
–	**6,866**	**–**	**–**	**–**	**–**	**–**	**–**	**71,568**	**66,111**	**191,620**	**191,620**	**Derivatives**
..	**2,527**	**–**	**5,195**	**–**	**36**	**..**	**53,173**	**170,057**	**211,506**	**887,071**	**887,071**	**Short-term loans,** of
–	2,527	–	5,195	–	36	–	51,303	–	108,724	579,692	579,692	MFIs
–	–	–	..	–	–	–	1,870	–	24,940	59,480	59,480	other financial corporations
..	–	–	–	–	..	–	–	–	..	..	..	general government
–	–	–	–	–	–	..	–	–	77,841	77,841	77,841	other residents
–	–	–	–	–	–	–	–	170,057	–	170,057	170,057	rest of the world
72,217	**56,141**	**7,022**	**73,988**	**5,953**	**20**	**–**	**380,192**	**72,373**	**35,570**	**1,123,598**	**1,123,598**	**Medium and long-term loans,** of
–	21,284	–	26,854	–	17	–	340,932	–	19,164	818,944	818,944	MFIs
–	26,080	–	26,045	–	3	–	33,291	–	12,903	147,089	147,089	other financial corporations
72,217	5,963	7,022	19,677	5,953	–	–	5,969	–	3,503	85,192	85,192	general government
–	–	–	–	–	–	–	–	–	–	–	–	other residents
–	2,814	–	1,413	–	–	–	–	72,373	–	72,373	72,373	rest of the world
109,532	**–**	**11,975**	**..**	**711**	**–**	**803,795**	**–**	**259,578**	**488,141**	**2,413,783**	**2,413,783**	**Shares and other equity,** issued by
102,497	–	10,168	..	301	–	712,610	–	259,578	–	1,925,642	1,925,642	residents
30,819	–	*5,524*	–	*269*	–	*175,787*	–	*87,670*	–	*676,606*	*676,606*	*of which: listed shares*
7,035	–	1,807	–	410	–	91,185	–	–	488,141	488,141	488,141	rest of the world
62	**–**	**2,860**	**–**	**1,121**	**–**	**335,187**	**–**	**4,118**	**119,975**	**472,750**	**472,750**	**Mutual fund shares,** issued by
58	–	54	–	1,095	–	270,248	–	4,118	–	352,775	352,775	residents
4	–	2,806	–	25	–	64,939	–	–	119,975	119,975	119,975	rest of the world
141	**–**	**1,402**	**–**	**32**	**–**	**571,879**	**32,414**	**17,450**	**–**	**611,581**	**611,581**	**Insurance technical reserves**
–	–	–	–	–	–	537,130	32,414	7,729	–	544,859	544,859	net equity of households
141	–	1,402	–	32	–	34,749	–	9,721	–	66,722	66,722	prepayments and other claims
55,359	**28,272**	**22,832**	**34,837**	**29,942**	**3,757**	**21,611**	**80,179**	**32,592**	**60,525**	**546,222**	**546,222**	**Other accounts receivable/payable**
–	–	–	–	–	–	5,782	–	28,197	60,317	377,617	377,617	Trade credits
55,359	28,272	22,832	34,837	29,942	3,757	15,829	80,179	4,395	208	168,605	168,605	Other
262,898	**1,632,214**	**81,011**	**141,721**	**61,579**	**3,813**	**3,268,602**	**545,959**	**1,677,454**	**1,596,914**	**10,767,199**	**10,767,198**	**Total**

ITALY'S FINANCIAL ASSETS AND LIABILITIES IN 2005 (1)
(flows in millions of euros)

Institutional sectors / Financial instruments	Non-financial corporations		Financial corporations: Monetary financial institutions		Financial corporations: Other financial intermediaries		Financial corporations: Financial auxiliaries		Financial corporations: Insurance corporations and pension funds	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Monetary gold and SDRs	–	–	**79**	–	–	–	–	–	–	–
Currency and transferable deposits, with	**30,002**	–	**-1,299**	**57,835**	**32,924**	–	**3,183**	–	**3,862**	–
MFIs	15,464	–	1,503	57,835	2,421	–	2,512	–	4,033	–
other residents	326	–	-5,219	–	30,503	–	–	–	-13	–
rest of the world	14,211	–	2,417	–	..	–	671	–	-158	–
Other deposits, with	**235**	–	**46,265**	**79,112**	**-133**	**23,625**	**1,252**	–	**1,988**	–
MFIs	100	–	35,474	79,112	-133	–	1,252	–	1,988	–
other residents	135	–	50	–	–	23,625	–	–	–	–
rest of the world	..	–	10,740	–	..	–	..	–	..	–
Short-term securities, issued by	**1,110**	**2,291**	**-7,247**	**24**	**2,313**	**81**	**-210**	–	**-947**	–
general government	-299	–	-9,282	–	700	–	-210	–	46	–
other residents	-3	2,291	2,408	24	102	81	–	–	–	–
rest of the world	1,412	–	-373	–	1,510	–	–	–	-993	–
Bonds, issued by	**3,288**	**430**	**39,383**	**41,277**	**16,771**	**35,322**	**1,911**	–	**19,162**	**10**
MFIs	-468	–	15,505	41,277	806	–	-137	–	428	–
central government: CCTs	-410	–	6,531	–	857	–	259	–	-9,054	–
central government: other	-3,098	–	7,401	–	-9,943	–	-72	–	3,059	–
local government	529	–	3,639	–	589	–	223	–	267	–
other residents	5,508	430	2,089	–	7,762	35,322	1,638	–	4,218	10
rest of the world	1,227	–	4,218	–	16,699	–	–	–	20,244	–
Derivatives	–	**-399**	**6,692**	–	–	**8,954**	–	–	–	**468**
Short-term loans, of	**28,441**	**18,311**	**-2,350**	**126**	**13,480**	**2,375**	**..**	**1,538**	**4,819**	**281**
MFIs	–	3,227	-2,350	-4,036	–	456	–	1,538	–	281
other financial corporations	–	350	–	-107	13,480	–	..	–	4,819	..
general government	–	–	–	–	–	–	–	–	–	–
other residents	28,441	–	–	–	–	–	–	–	–	–
rest of the world	–	14,734	–	4,269	–	1,919	–	–	–	–
Medium and long-term loans, of	–	**47,714**	**103,526**	**-1,679**	**9,907**	**9,009**	..	**703**	**162**	**2,562**
MFIs	–	35,088	103,526	198	–	8,208	–	703	–	2,345
other financial corporations	–	3,828	–	-12	9,907	–	..	–	162	10
general government	–	7,087	–	-107	–	–	–	..	–	..
other residents	–	–	–	–	–	–	–	–	–	–
rest of the world	–	1,712	–	-1,759	–	801	–	–	–	207
Shares and other equity, issued by	**4,508**	**25,422**	**7,321**	**12,035**	**-88**	**431**	..	**-166**	**7,745**	**7,476**
residents	1,415	25,422	-8,371	12,035	4,062	431	..	-166	6,367	7,476
of which: listed shares	….	….	….	….	….	….	–	–	….	….
rest of the world	3,093	–	15,691	–	-4,150	–	–	–	1,379	–
Mutual fund shares, issued by	**750**	–	**1,754**	**-4,848**	**624**	**-187**	**-5**	–	**396**	–
residents	-56	–	-98	-4,848	–	-187	-5	–	-808	–
rest of the world	806	–	1,851	–	624	–	–	–	1,205	–
Insurance technical reserves	**90**	**6,596**	**5**	**155**	–	–	–	–	–	**41,449**
net equity of households	–	6,596	–	155	–	–	–	–	–	40,713
prepayments and other claims	90	–	5	–	–	–	–	–	–	738
Other accounts receivable/payable	**860**	**-3,526**	**228**	**175**	..	..	–	–	..	..
Trade credits	-4,916	-4,322	–	–	–	–	–	–	–	–
Other	5,777	795	228	175	..	..	–	–	..	..
Total ...	**69,283**	**96,839**	**194,357**	**184,214**	**75,799**	**79,610**	**6,130**	**2,075**	**37,189**	**52,248**

(1) Provisional. Rounding may cause discrepancies in totals.

General government						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
–	–	–	–	–	–	–	–	–	**79**	**79**	**79**	**Monetary gold and SDRs**
4,259	**28,780**	**3,585**	–	**-936**	–	**37,469**	–	**-4,866**	**21,567**	**108,183**	**108,183**	**Currency and transferable deposits,** with
339	–	3,736	–	-868	–	33,574	–	-4,879	–	57,835	57,835	MFIs
–	28,780	75	–	..	–	3,096	–	13	–	28,780	28,780	other residents
3,920	–	-226	–	-67	–	799	–	–	21,567	21,567	21,567	rest of the world
-544	**-10,826**	**224**	–	**181**	–	**10,047**	–	**43,147**	**10,748**	**102,661**	**102,661**	**Other deposits,** with
-544	–	224	–	181	–	-2,574	–	43,147	–	79,112	79,112	MFIs
–	-10,826	–	–	–	–	12,613	–	–	–	12,798	12,798	other residents
..	–	..	–	..	–	8	–	–	10,748	10,748	10,748	rest of the world
-27	**-962**	..	..	..	–	**-15,029**	–	**23,322**	**1,850**	**3,285**	**3,285**	**Short-term securities,** issued by
-27	-962	..	..	..	–	-15,212	–	23,322	–	-962	-962	general government
–	–	–	–	–	–	-112	–	–	–	2,396	2,396	other residents
–	–	–	–	–	–	294	–	–	1,850	1,850	1,850	rest of the world
-45	**33,662**	**296**	**6,223**	**2,538**	–	**1,833**	–	**101,902**	**70,115**	**187,039**	**187,039**	**Bonds,** issued by
..	–	..	–	..	–	-3,289	–	28,432	–	41,277	41,277	MFIs
24	1,211	..	–	663	–	-6,447	–	8,787	–	1,211	1,211	central government: CCTs
-65	32,451	..	–	..	–	-23,767	–	58,936	–	32,451	32,451	central government: other
..	–	267	6,223	..	–	497	–	211	–	6,223	6,223	local government
-4	–	29	–	1,875	–	7,111	–	5,535	–	35,763	35,763	other residents
–	–	..	–	..	–	27,728	–	–	70,115	70,115	70,115	rest of the world
–	**117**	–	–	–	–	–	–	**2,449**	–	**9,141**	**9,141**	**Derivatives**
..	**847**	**–**	**964**	**–**	**17**	**..**	**-10**	**20,922**	**40,865**	**65,313**	**65,313**	**Short-term loans,** of
–	847	–	964	–	17	–	-222	–	-5,421	-2,350	-2,350	MFIs
–	–	–	..	–	–	–	212	–	17,844	18,299	18,299	other financial corporations
..	–	–	–	–	..	–	–	–	..	..	..	general government
–	–	–	–	–	–	..	–	–	28,441	28,441	28,441	other residents
–	–	–	–	–	–	–	–	20,922	–	20,922	20,922	rest of the world
3,260	**1,178**	**1,671**	**2,851**	**2,520**	**-1,420**	–	**54,116**	**991**	**7,002**	**122,036**	**122,036**	**Medium and long-term loans,** of
–	3,043	–	607	–	10	–	46,030	–	7,295	103,526	103,526	MFIs
–	-1,194	–	3,200	–	-1,430	–	5,566	–	100	10,069	10,069	other financial corporations
3,260	-671	1,671	-986	2,520	–	–	2,520	–	-393	7,451	7,451	general government
–	–	–	–	–	–	–	–	–	–	–	–	other residents
–	..	–	29	–	–	–	–	991	–	991	991	rest of the world
-3,899	–	**977**	..	..	–	**32,550**	–	**11,440**	**15,357**	**60,556**	**60,556**	**Shares and other equity,** issued by
-3,899	–	977	..	..	–	33,206	–	11,440	–	45,199	45,199	residents
….	–	….	–	….	–	….	–	….	–	….	….	*of which: listed shares*
..	–	..	–	..	–	-656	–	–	15,357	15,357	15,357	rest of the world
..	–	..	–	..	–	**9,726**	–	**4**	**18,283**	**13,248**	**13,248**	**Mutual fund shares,** issued by
..	–	..	–	..	–	-4,072	–	4	–	-5,035	-5,035	residents
..	–	..	–	..	–	13,797	–	–	18,283	18,283	18,283	rest of the world
1	–	**6**	–	..	–	**49,277**	**2,402**	**1,224**	–	**50,604**	**50,604**	**Insurance technical reserves**
–	–	–	–	–	–	48,687	2,402	1,179	–	49,866	49,866	net equity of households
1	–	6	–	..	–	590	–	45	–	738	738	prepayments and other claims
2,048	**5,272**	**-288**	**5,354**	**1,103**	**449**	**3,594**	**1,893**	**3,404**	**1,334**	**10,949**	**10,949**	**Other accounts receivable/payable**
–	–	–	–	–	–	-128	–	2,056	1,334	-2,988	-2,988	Trade credits
2,048	5,272	-288	5,354	1,103	449	3,722	1,893	1,348	..	13,938	13,938	Other
5,052	**58,069**	**6,472**	**15,392**	**5,406**	**-954**	**129,468**	**58,402**	**203,938**	**187,201**	**733,094**	**733,096**	**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)	€i BTPs (2)	Republic of Italy issues	Other (3)	Total
				Gross issues				
2001	188,677	35,528	28,330	119,929	–	22,529	55	395,047
2002	208,761	32,556	44,535	133,646	–	16,186	–	435,684
2003	214,093	31,185	38,313	134,732	10,150	21,998	..	450,471
2004	221,300	27,128	34,527	117,053	17,750	14,000	–	431,758
2005	212,666	23,206	26,011	112,866	18,199	12,264	–	405,211
				Redemptions				
2001	176,960	49,367	38,357	83,562	–	14,025	1,547	363,818
2002	208,831	21,940	57,279	93,797	–	11,520	39,406	432,773
2003	208,188	37,742	56,245	114,843	–	15,771	49	432,838
2004	222,195	34,161	34,632	100,745	–	10,808	50	402,591
2005	213,610	25,625	24,782	103,997	–	9,976	50	378,040
				Issue discounts				
2001	–	2,637	-213	-1,670	–	-59	474	1,170
2002	–	2,282	-447	-2,387	–	71	-22,213	-22,693
2003	–	1,349	-484	-1,688	17	51	-730	-1,484
2004	–	1,164	-430	569	-69	35	-2,973	-1,703
2005	–	919	-286	-2,322	-557	27	-367	-2,586
				Net issues (7)				
2001	11,717	-16,476	-9,814	38,037	–	9,049	-1,494	31,019
2002	-70	8,335	-12,296	42,236	–	4,388	-17,570	25,023
2003	5,905	-7,907	-17,448	21,577	10,133	5,589	-50	17,800
2004	-895	-8,198	325	15,739	17,819	2,469	-50	27,210
2005	-944	-3,338	1,515	11,191	18,756	1,620	-50	28,750
				Coupons (8)				
2001	4,817	3,111	12,677	38,027	–	5,201	-7,439	56,393
2002	4,256	1,906	9,209	37,324	–	5,435	-5,768	52,361
2003	2,990	2,855	7,084	37,921	–	3,693	-5,845	48,699
2004	2,921	2,383	4,836	37,049	361	3,460	-5,304	45,706
2005	2,891	1,225	5,040	36,441	728	3,321	-4,116	45,530

(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. – 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. – (4) Includes of the individual components by the amount of the bonds issued by Crediop on behalf of the Treasury. – (6) Issues for cash. Redemptions refer to the market value of shares bought back and cancelled.

SECTOR SECURITIES								
			Other sectors			Total bonds and public sector securities	Listed shares of Italian companies (6)	
Autonomous government agencies, State Railways etc. (4)	Local governments	Total (5)	Banks	Firms	Total			
Gross issues								
–	2,408	397,454	95,777	53,048	148,825	546,279	6,171	 2001
–	5,995	441,679	92,346	44,528	136,874	578,553	3,894	 2002
–	4,033	454,504	116,815	42,809	159,624	614,128	8,710	 2003
6,500	5,867	444,125	120,462	51,154	171,617	615,742	3,197	 2004
2,950	7,299	415,460	125,280	56,798	182,078	597,538	12,600	 2005
Redemptions								
1,937	412	366,167	63,586	6,687	70,273	436,440	767	 2001
1,653	523	434,948	59,049	11,623	70,672	505,620	40	 2002
–	622	433,460	84,826	18,640	103,466	536,926	983	 2003
516	793	403,900	77,426	26,902	104,328	508,228	17	 2004
–	939	378,979	83,858	20,020	103,878	482,857	444	 2005
Issue discounts								
–	..	209	357	655	1,011	1,220	–	 2001
–	-8	-22,119	356	82	438	-21,681	–	 2002
–	..	-167	429	-9	421	253	–	 2003
–	-2	1,997	461	39	501	2,497	–	 2004
–	-78	-1,750	478	74	551	-1,199	–	 2005
Net issues (7)								
-1,937	1,996	31,078	31,834	45,706	77,541	108,619	6,171	 2001
-1,653	5,481	28,850	32,941	32,823	65,764	94,614	3,894	 2002
–	3,412	21,211	31,560	24,178	55,737	76,949	8,710	 2003
5,942	5,076	38,228	42,575	24,213	66,788	105,017	3,197	 2004
3,043	6,438	38,231	40,944	36,704	77,649	115,880	12,600	 2005
Coupons (8)								
46	389	56,828	13,274	....	13,274	70,102	15,889	 2001
46	481	52,888	12,178	....	12,178	65,066	18,650	 2002
46	633	49,378	11,020	....	11,020	60,398	17,030	 2003
148	742	46,595	11,226	....	11,226	57,821	22,517	 2004
157	881	46,568	12,400	....	12,400	58,968	23,708	 2005

(2) The redemptions of €i BTPs (BTPs indexed to the euro-area inflation rate) are calculated on the basis of the unrevalued nominal capital. – (3) Includes the 76,206 billion lire of the securities issued in 2004 by Infrastrutture S.p.A. to finance the construction of high-speed railway infrastructure. – (5) The total for the public sector differs from the sum Share cancellations following mergers are not included. – (7) The net issues of Republic of Italy loans include accounting lags. – (8) The figures refer only to fixed rate securities, except for CCTs.

Table a30

INTEREST RATES ON SECURITIES LISTED ON THE ITALIAN STOCK EXCHANGE
(average values before tax)

	CCTs	CTEs	CTOs	€i BTPs	CTZs	Fixed-rate bank bonds
1996	9.01	6.33	–	9.06	8.49	9.20
1997	6.81	5.42	–	6.76	6.45	7.41
1998	4.89	4.87	–	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	–	1.67	4.28	2.30	3.87
2004	2.14	–	1.64	4.28	2.25	3.59
2005	2.26	–	1.44	3.65	2.27	–
2004 – Jan.	2.13	–	1.44	4.38	2.18	3.80
Feb.	2.08	–	1.53	4.34	2.11	3.69
Mar.	2.04	–	1.57	4.18	1.99	3.48
Apr.	1.93	–	1.67	4.35	2.15	3.65
May	2.10	–	1.81	4.49	2.32	3.73
June	2.19	–	1.82	4.54	2.43	3.90
July	2.22	–	1.79	4.45	2.37	3.74
Aug.	2.23	–	1.68	4.31	2.30	3.60
Sept.	2.18	–	1.62	4.27	2.38	3.53
Oct.	2.22	–	1.53	4.16	2.29	3.45
Nov.	2.19	–	1.70	4.05	2.27	3.33
Dec.	2.20	–	1.54	3.87	2.21	3.16
2005 – Jan.	2.22	–	1.49	3.80	2.23	–
Feb.	2.20	–	1.46	3.74	2.23	–
Mar.	2.22	–	1.62	3.90	2.26	–
Apr.	2.24	–	1.49	3.76	2.20	–
May	2.18	–	1.42	3.62	2.13	–
June	2.18	–	1.38	3.48	2.03	–
July	2.17	–	1.42	3.54	2.11	–
Aug.	2.21	–	1.37	3.54	2.17	–
Sept.	2.21	–	1.20	3.40	2.15	–
Oct.	2.27	–	1.31	3.55	2.36	–
Nov.	2.41	–	1.56	3.74	2.60	–
Dec.	2.64	–	1.50	3.67	2.71	–
2006 – Jan.	2.72	–	1.45	3.64	2.76	–
Feb.	2.78	–	1.58	3.80	2.85	–
Mar.	2.87	–	1.72	3.96	3.04	–
Apr.	3.04	–	1.99	4.25	3.17	–

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 adjusted bad debts (3)	
			Banking system			
2003	1,090,940	6.7	4.7	5.1	1.2	108.5
2004	1,151,173	6.6	4.7	5.0	0.9	106.8
2005	1,238,401	5.3	3.7	4.0	0.8	107.7
			Limited company banks (*società per azioni*)			
2003	922,570	6.8	4.9	5.4	1.2	108.4
2004	962,712	6.8	5.0	5.4	0.9	106.5
2005	1,029,499	5.4	3.8	4.1	0.8	108.0
			Cooperative banks *(banche popolari)*			
2003	101,653	5.4	3.7	4.0	1.2	109.0
2004	112,294	4.9	3.3	3.6	0.7	109.1
2005	124,371	4.9	3.4	3.5	1.1	104.7
			Mutual banks *(banche di credito cooperativo)*			
2003	66,717	6.5	2.9	3.2	0.9	109.9
2004	76,167	6.4	2.9	3.1	0.9	109.4
2005	84,531	6.0	2.8	3.1	0.9	108.6
			Major, large and medium-sized banks *(banche maggiori, grandi e medie)*			
2003	767,605	6.6	4.7	5.1	1.3	108.0
2004	789,306	6.7	4.9	5.2	0.9	106.2
2005	841,245	5.7	4.1	4.4	0.8	106.6
			Other banks			
2003	323,335	6.7	4.7	5.1	1.1	109.6
2004	361,867	6.3	4.3	4.7	0.8	108.4
2005	397,156	4.5	2.7	3.0	0.9	111.6
			Banks based in the Centre or North			
2003	1,030,414	6.3	4.4	4.8	1.2	109.1
2004	1,085,261	6.2	4.4	4.7	0.8	107.4
2005	1,166,046	5.0	3.4	3.6	0.8	108.4
			Banks based in the South			
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
2005	72,355	11.1	8.8	9.1	1.0	103.5

(1) Based on the classifications in force at the end of 2005. For uniformity, 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 adjusted bad debts to performing loans in the previous year net of repo assets, net interest to be debited to customers and adjusted bad debts.

CONSOLIDATED INCOME STATEMENT (1)
(percentages of total assets)

	Banking system – of which: limited company banks	of which: cooperative banks	of which: mutual banks	Banking system	Classification by geographical area – Centre and North	South
			Net interest income			
2003	2.06	2.45	3.18	2.19	2.17	3.05
2004	2.02	2.44	3.06	2.15	2.13	3.07
2005	1.84	2.24	2.96	1.97	1.95	3.04
			Non-interest income			
2003	1.46	1.33	0.91	1.41	1.42	1.08
2004	1.40	1.38	0.86	1.36	1.37	1.15
2005	1.82	1.95	0.89	1.79	1.80	1.38
			Gross income			
2003	3.53	3.78	4.08	3.60	3.59	4.13
2004	3.42	3.82	3.92	3.51	3.50	4.21
2005	3.66	4.19	3.86	3.76	3.75	4.42
			Operating expenses			
2003	2.17	2.39	2.90	2.25	2.23	2.95
2004	2.08	2.33	2.77	2.16	2.15	2.97
2005	2.19	2.60	2.74	2.29	2.27	3.15
			Operating profit			
2003	1.36	1.39	1.18	1.35	1.36	1.18
2004	1.34	1.49	1.15	1.35	1.35	1.24
2005	1.48	1.59	1.12	1.48	1.48	1.27
			Non-recurring items (net) and allocations to provisions			
2003	0.15	0.19	-0.10	0.15	0.15	0.01
2004	-0.03	0.17	-0.16	-0.01	-0.01	-0.04
2005	0.14	0.14	-0.17	0.12	0.12	-0.03
			Loan losses			
2003	0.55	0.51	0.23	0.52	0.53	0.39
2004	0.43	0.40	0.31	0.42	0.42	0.32
2005	0.24	0.52	0.34	0.29	0.29	0.25
			Tax			
2003	0.28	0.32	0.20	0.28	0.28	0.27
2004	0.32	0.36	0.23	0.32	0.32	0.34
2005	0.38	0.41	0.25	0.38	0.38	0.39
			Dividends			
2003	0.22	0.27	0.04	0.22	0.22	0.06
2004	0.26	0.23	0.04	0.24	0.25	0.07
2005	0.42	0.32	0.05	0.38	0.39	0.20
			Allocations to supervisory capital			
2003	0.15	0.11	0.83	0.18	0.17	0.46
2004	0.36	0.32	0.72	0.38	0.37	0.56
2005	0.33	0.42	0.65	0.36	0.36	0.46
			Share of non-interest income in gross income *(percentages)*			
2003	41.4	35.2	22.3	39.2	39.5	26.2
2004	40.9	36.1	22.0	38.7	39.0	27.2
2005	49.8	46.5	23.2	47.6	48.0	31.3
			Cost-income ratio *(percentages)* (2)			
2003	61.6	63.2	70.9	62.5	62.3	71.5
2004	60.8	61.1	70.6	61.5	61.3	70.4
2005	59.7	61.9	71.1	60.8	60.6	71.4
			ROE *(percentages)*			
2003	6.9	5.8	6.7	6.7	6.7	5.1
2004	11.4	8.6	7.4	10.5	10.6	6.4
2005	15.4	8.1	8.1	13.3	13.5	6.9
			Memorandum item: **Total assets** *(average values in millions of euros)* (3)			
2003	1,424,061	303,623	99,111	1,826,795	1,793,132	33,663
2004	1,448,788	317,106	110,110	1,876,004	1,840,789	35,216
2005	1,600,285	340,827	120,221	2,061,333	2,023,266	38,067

(1) Consolidated data for banking groups and data on a solo basis for banks not belonging to a group. The figures for 2005 are not comparable with those of the previous years owing to the application of IAS/IFRS in preparing the 2005 consolidated accounts. – (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)

	Tier 1 capital	Tier 2 capital		Supervisory capital	Capital ratio (percentages)	Excess capital	Capital shortfalls	
			of which: subordinated liabilities (2)				Number of banks	Amount
Banking system								
2003	104,356	41,558	37,151	139,829	11.4	42,454	–	–
2004	112,490	42,270	38,397	148,650	11.6	46,929	3	145
2005	132,871	54,181	46,023	174,651	10.6	44,012	3	16
Main banking groups (3)								
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	–	–
2005	71,145	35,301	32,288	97,752	10.0	19,763	–	–
Banks and banking groups based in the Centre or North								
2003	101,211	41,217	36,916	136,344	11.3	40,513	–	–
2004	109,087	41,918	38,119	144,896	11.5	44,899	3	145
2005	129,112	53,694	45,691	170,408	10.5	41,699	3	16
Banks and banking groups based in the South								
2003	3,145	341	235	3,485	18.1	1,941	–	–
2004	3,403	352	278	3,754	17.4	2,030	–	–
2005	3,759	487	332	4,243	17.6	2,313	–	–
Limited company banks *(società per azioni)*								
2003	75,239	33,314	30,002	103,813	11.2	30,789	–	–
2004	80,631	34,431	31,376	110,418	11.6	34,887	2	14
2005	98,213	44,081	37,958	132,117	10.3	30,397	1	1
Cooperative banks *(banche popolari)*								
2003	17,133	7,476	6,965	23,298	10.0	4,679	–	–
2004	19,001	7,100	6,796	24,678	9.9	4,918	1	131
2005	20,815	9,421	7,825	28,087	10.3	6,330	1	14
Mutual banks *(banche di credito cooperativo)*								
2003	11,984	768	184	12,718	17.8	6,986	–	–
2004	12,858	739	225	13,554	16.9	7,124	–	–
2005	13,843	679	240	14,447	16.1	7,285	1	1

(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 Banking 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

BOTs – *Buoni ordinari del Tesoro*
Treasury bills

BTPs – *Buoni del Tesoro poliennali*
Treasury bonds

CCTs – *Certificati di credito del Tesoro*
Treasury credit certificates

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

Covip – *Commissione di vigilanza sui fondi pensione*
Pension fund supervisory authority

CTOs – *Certificati del Tesoro con opzione*
Treasury option certificates

CTZs – *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*
Italian 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 2005

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Mario DRAGHI - Governor*
Vincenzo DESARIO - Director general
Pierluigi CIOCCA - Deputy director general
Antonio FINOCCHIARO - Deputy director general

* Appointed with a presidential decree issued on 29 December 2005, took office on 16 January 2006

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