BANCA D'ITALIA
EUROSISTEMA

# Annual Report
## Abridged Version

Ordinary General Meeting
of Shareholders
Rome, 31 May 2007

113[th] FINANCIAL YEAR

year 2006

financial year CXIII

BANCA D'ITALIA
EUROSISTEMA

# Annual Report
## Abridged Version

## Ordinary Meeting of Shareholders

2006 - 113th Financial Year

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## THE ITALIAN ECONOMY

## SYMBOLS AND CONVENTIONS

In the following tables:

| | |
|---|---|
| – | the phenomenon in question does not occur |
| .... | the phenomenon occurs but the value is not known |
| .. | the value is known but is nil or less than half the final digit shown |

# THE INTERNATIONAL ECONOMY

# 1. ECONOMIC DEVELOPMENTS AND POLICIES IN THE MAIN COUNTRIES AND AREAS

In 2006 the world economy expanded by 5.4 per cent. Growth became more balanced in the main industrial countries and continued to accelerate in the emerging economies; in China and India the rate of expansion was around 10 per cent.

In the United States output increased by 3.3 per cent. Since the middle of last year economic activity has reflected the sharper than expected slowdown in the residential property market and the consequent decline in residential investment. House prices, which had been climbing rapidly since the beginning of the decade, slowed brusquely and now do not appear to be exaggeratedly overvalued with respect to equilibrium values. In the summer the cyclical slowdown and low inflation expectations prompted the Federal Reserve to end the policy of monetary tightening it had followed since the middle of 2004. The federal deficit contracted from 2.6 per cent in 2005 to 1.9 per cent last year, thanks to a substantial increase in revenues.

In Japan growth accelerated to 2.2 per cent, driven by investment and export demand. As economic activity gained strength, the Bank of Japan gradually ended the expansionary monetary policy of previous years. Thanks to the curbing of investment spending and the strong performance of revenues, the public deficit decreased to 5.3 per cent of GDP, against 6.8 per cent in 2005.

Bulgaria and Romania joined the EU on 1 January 2007, bringing the number of members to 27 and completing stage one of enlargement. In recent years the new member states have generally recorded strong economic growth, rising inflation, huge capital inflows and large external deficits. A return to more balanced growth is essential if they are to achieve the convergence necessary for the adoption of the euro.

In the emerging economies output expanded by close to 8 per cent. The Chinese monetary authorities took measures to curb the expansion in investment, but monetary policy was of limited effectiveness, partly owing to the magnitude of firms' self-financing. In India, after four years of strong growth there were signs of overheating, which the central bank countered by repeatedly raising interest rates. The other emerging economies expanded at a less rapid but nonetheless robust pace, benefiting from high raw material prices and favourable financial market conditions. In Russia output accelerated to 6.7 per cent and in Latin America to 5.5 per cent, while in Africa the rate of economic growth was unchanged from the previous year at 5.5 per cent.

## *The United States*

In 2006, the fifth year of the current expansion, GDP grew by 3.3 per cent, compared with 3.2 per cent in 2005 (Table 1.1). Growth was extremely rapid in the first quarter and slackened during the rest of the year as a consequence of the housing market crisis. In the second quarter residential investment began to decline, falling by 4.2 per cent over the year. The four previous years of expansion had pushed up residential investment by around 1 percentage point of GDP, to about 5.5 per cent.

Table 1.1

**Gross domestic product and components of demand in the leading industrial countries**
*(volumes at chain-linked prices; except as indicated, annualized percentage changes on previous period)*

| | 2005 | 2006 | 2006 | | | | 2007 |
|---|---|---|---|---|---|---|---|
| | | | Q1 | Q2 | Q3 | Q4 | Q1 |
| **United States** | | | | | | | |
| GDP | 3.2 | 3.3 | 5.6 | 2.6 | 2.0 | 2.5 | 0.6 |
| Household consumption (1) | 3.5 | 3.2 | 4.8 | 2.6 | 2.8 | 4.2 | 4.4 |
| General government expenditure (2) | 0.9 | 2.1 | 4.9 | 0.8 | 1.7 | 3.4 | 1.0 |
| Gross fixed private investment | 7.5 | 2.9 | 8.2 | -1.6 | -1.2 | -9.1 | -3.5 |
| Change in stocks (3) | -0.3 | 0.2 | .. | 0.4 | 0.1 | -1.2 | -1.0 |
| Net exports (3) | -0.3 | .. | .. | 0.4 | -0.2 | 1.6 | -1.0 |
| **Japan** | | | | | | | |
| GDP | 1.9 | 2.2 | 3.1 | 1.2 | 0.3 | 5.0 | 2.4 |
| Household consumption (1) | 1.6 | 0.8 | -0.6 | 2.4 | -4.0 | 4.3 | 3.5 |
| General government expenditure | 1.7 | 0.3 | -0.1 | 2.7 | 2.5 | 0.3 | -0.3 |
| Gross fixed private investment | 2.4 | 3.4 | 11.2 | 0.6 | -1.2 | 10.6 | -2.8 |
| Change in stocks (3) | -0.1 | 0.1 | 0.6 | -0.5 | 0.8 | -0.5 | -0.4 |
| Net exports (3) | 0.3 | 0.8 | 0.5 | -0.1 | 1.5 | 0.6 | 1.5 |
| **EU-25** | | | | | | | |
| GDP | 1.7 | 2.9 | 3.6 | 4.0 | 2.7 | 3.6 | 2.4 |
| Household consumption (1) | 1.6 | 2.0 | 2.1 | 2.4 | 2.5 | 2.3 | .... |
| General government expenditure | 1.7 | 2.1 | 4.2 | 0.5 | 2.6 | 1.8 | .... |
| Gross fixed private investment | 3.0 | 5.4 | 5.7 | 8.1 | 4.9 | 7.6 | .... |
| Change in stocks (3) (4) | -0.1 | 0.1 | -0.1 | 0.2 | 0.5 | -0.4 | .... |
| Net exports (3) | -0.1 | 0.2 | 0.1 | 0.1 | -0.1 | 0.7 | .... |
| **United Kingdom** | | | | | | | |
| GDP | 1.9 | 2.8 | 3.3 | 3.1 | 2.7 | 2.7 | 2.9 |
| Household consumption (1) | 1.4 | 2.0 | 0.5 | 4.6 | 1.3 | 4.3 | 2.3 |
| General government expenditure | 3.0 | 2.4 | 1.7 | 2.6 | 2.5 | 2.8 | 1.7 |
| Gross fixed private investment | 3.0 | 6.5 | 9.0 | 4.8 | 8.6 | 10.6 | 7.0 |
| Change in stocks (3) (4) | -0.1 | 0.2 | 2.3 | 0.8 | -1.8 | -2.2 | -0.1 |
| Net exports (3) | .. | -0.4 | -1.4 | -2.0 | 1.7 | -0.2 | 0.0 |

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.

In the first quarter of 2007 economic activity increased at an annual rate of 0.6 per cent, against 2.5 per cent in the fourth quarter of 2006. The further slowdown can be attributed to the sharp reduction in the foreign sector's contribution to growth. Investment in residential building continued to decline rapidly; non-residential investment, which had fallen by 3.1 per cent in the fourth quarter of 2006, picked up slightly thanks to an upturn in ICT investment. Consumption was sustained by the robust increase in real disposable personal income and continued to expand at a rapid pace.

Although the rate of increase in output in 2006 was above the average for 2002-05, estimates of the growth in potential output in the United States have been revised downwards. The Congressional Budget Office, which in 2002 had estimated a growth rate of potential output over ten years of 3.1 per cent, revised this to 2.9 per cent in 2005 and to 2.6 per cent in 2007 (Table 1.2). The new figures mainly adjust for a reduction in the increase in potential hours worked; the medium-term rate of increase in potential labour productivity is virtually unchanged at around 2.3 per cent. The estimated growth rate of potential hours worked, including expected migratory flows, which the CBO set at 1.2 per cent in 2002, has been revised down to 0.7 per cent this year (Table 1.2). The adjustment takes account of the unexpected fall in the participation rate in the course of the decade, from 67.1 per cent in 2000 to 66.2 per cent in 2006. This is chiefly due to the decision of many 16-24 year-olds not to enter the job market, often in order to prolong their education, and to the end of the long-term rising trend in the participation of women aged 25 to 54. In addition, from 2009 onwards the participation rate will be affected by the progressive shift in the working-age population towards groups with lower age-specific rates, in particular the over-54 year-olds.

Table 1.2

**Estimated potential economic growth in the United States**

| PUBLICATION DATE | Time horizon | Potential GDP | Non-farm business sector | | | |
|---|---|---|---|---|---|---|
| | | | potential output | potential hours worked | potential labour productivity | potential total factor productivity |
| 2002 – Jan. | 2002-2012 | 3.1 | 3.4 | 1.2 | 2.2 | 1.3 |
| 2003 – Jan. | 2003-2013 | 2.9 | 3.3 | 1.1 | 2.2 | 1.2 |
| 2004 – Jan. | 2004-2014 | 2.8 | 3.1 | 0.9 | 2.2 | 1.3 |
| 2005 – Jan. | 2005-2015 | 2.9 | 3.3 | 0.9 | 2.4 | 1.4 |
| 2006 – Jan. | 2006-2016 | 2.8 | 3.2 | 0.8 | 2.4 | 1.4 |
| 2007 – Jan. | 2007-2017 | 2.6 | 3.0 | 0.7 | 2.3 | 1.4 |

Source: Congressional Budget Office.

The rate of increase in labour productivity in the non-farm business sector, which had peaked in 2002 and 2003 at 4.1 and 3.7 per cent respectively, fell to 1.6 per cent in 2006. The average increase of 2.8 per cent in 2001-06 is still above that recorded in the second half of the 1990s (2.5 per cent).

Household consumption increased by 3.2 per cent in 2006, outpacing the growth in real disposable income for the fourth year running. The personal saving rate, already negative in 2005 (-0.4 per cent), fell to -1 per cent. From the end of 2005 to the end of 2006 households' net worth rose from 573 to 584 per cent of personal disposable income, as larger holding gains on financial assets more than offset the decrease in holding gains on real estate.

Non-residential investment increased by 7.2 per cent. The substantial growth in non-financial corporate profits – up by 17.6 per cent measured according to national accounts criteria –further strengthened firms' balance-sheet situation. The debt of non-farm corporate business continued to decrease, reaching 40.3 per cent of net worth at market prices at the end of 2006.

Consumer prices increased on average by 3.2 per cent in 2006. Excluding food and energy prices, inflation rose progressively from 2.1 per cent in January to 2.9 per cent in September before dropping to 2.3 per cent in April this year. This trend can be put down to the steep rise in rents, presumably reflecting households' move away from home purchase. Core inflation, measured by the consumption deflator excluding food and energy, followed a similar but less marked trend, staying below 2.4 per cent and settling at 2.1 per cent in March this year.

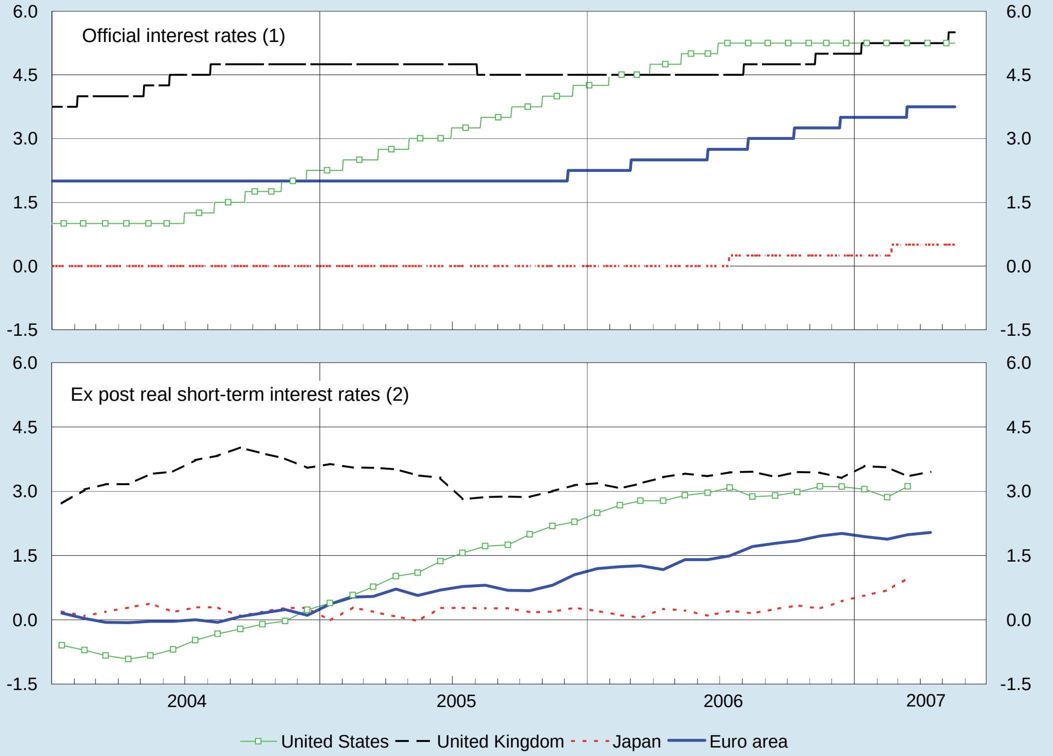
Although the unemployment rate remained low, reaching a minimum of 4.4 per cent in October 2006 and March 2007, there are still no clear signs of an acceleration in labour costs. The Employment Cost Index for the private sector increased by 2.9 per cent in 2006, compared with 3.1 per cent in 2005. Hourly compensation in the non-farm business sector, which, unlike the Employment Cost Index, reflects shifts in employment between jobs with different salary levels, increased by 4.8 per cent, against 4.1 per cent the year before. Large profit margins – in the fourth quarter of 2006 profits in the corporate sector represented 17.1 per cent of gross value added, 7 percentage points more than at the start of the expansion – may enable firms to postpone passing a substantial rise in costs onto prices.

In the first half of 2006 the Federal Reserve raised the federal funds target rate by 0.25 percentage points on four separate occasions, bringing it to 5.25 per cent at the end of June (Figure 1.2). Between mid-May and end-June, as the risk of inflation heightened, expectations of a further rise in official rates in the second half of 2006 spread through the markets. However, at the end of the 30 June meeting of the FOMC the Fed signalled that concern about the pressure on prices had diminished owing to the slowdown in economic activity. As a result expectations regarding the trend of monetary policy changed brusquely, and the markets have since correctly anticipated that there would be no change in interest rates. More recently, on 9 May this year the Fed signalled a risk that inflationary pressure might not abate as expected. Futures prices indicate that dealers foresee no change in official rates at the next FOMC meeting on 27 and 28 June, but do not rule out a reduction of 25 basis points before the end of the year.

The gradual process of adjusting the federal deficit that was set in motion in 2005 carried on throughout last year. The deficit, which had been reduced to 2.6 per cent of GDP in 2005 (from 3.6 per cent the year before), decreased to 1.9 per cent. The increase in individual income taxes, equal to 14.6 per cent in 2005 and to 12.6 per cent in 2006, was a major contributory factor. The rapid and somewhat unexpected growth in this source of revenue – from 7 to 8 per cent of GDP between 2004 and 2006 – was partly due to the large rise in capital gains and possibly also to the substantial increase in the highest incomes, which carry higher tax rates. The CBO estimates that the Administration's budget presented in February this year could cut the federal deficit slightly, to 1.6 per cent in both 2007 and 2008.

Figure 1.2

**Official interest rates and real short-term interest rates**
*(percentages)*




Sources: ECB and national statistics.
(1) Daily data. For the United States, federal funds target rate; for Japan, target rate on overnight money market funds; for the euro area, interest rate on the main refinancing operations; for the United Kingdom, interest rate on commercial banks' reserves with the Bank of England and before 18 May 2006, repo rate. – (2) Monthly averages. Real interest rates are obtained by deflating nominal rates with the changes in the previous 12 months in the following indexes: for the United States, deflator of consumption excluding food and energy; for the United Kingdom and the euro area, harmonized consumer price index excluding fresh food and energy; for Japan, consumer price index excluding fresh food.

## *Japan*

Growth rose from 1.9 to 2.2 per cent in 2006, owing to the acceleration of private investment and exports, particularly to China. Non-residential fixed private investment rose by 7.5 per cent (6.6 per cent in 2005), while investment in residential building, which had declined the year before, increased by 1 per cent.

During the year households' disposable income and consumption showed an erratic pattern. On average, consumption slowed from 1.6 per cent in the previous two years to 0.8 per cent, while the disposable income of working households declined by 0.8 per cent in real terms compared with 2005.

The growth in consumption, although low, was sustained by an increase of 260,000, or 0.4 per cent, in the total number of employed persons in 2006. This was accompanied by a decline in the unemployment rate, from 4.4 per cent in 2005 to 4.1 per cent, but it did not lead to an acceleration in wages and salaries. In fact, firms continued to keep labour costs down regardless of large profits, taking advantage of the opportunity to replace older workers, who earn higher salaries towards the end of their career, with a young labour force given increasingly less advantageous labour contracts.

In the first quarter of this year GDP grew at an annualized rate of 2.4 per cent, thanks to the strengthening of household consumption and the sharp upturn in exports.

After a lengthy period of deflation lasting since 1999, the trend in Japan's general consumer price index turned positive in 2006. The increase in prices was sustained by energy products: after peaking in August inflation decreased, averaging 0.2 per cent on an annual basis, compared with disinflation of 0.3 per cent in 2005. At the beginning of this year core inflation, which does not include fresh food prices, turned negative once more and was -0.1 per cent in April.

In March 2006 the Bank of Japan abandoned its strategy of increasing liquidity and adopted a new framework for monetary policy, setting a target for the overnight rate. This was initially set at zero but was then raised to 0.25 per cent in July and to 0.50 per cent in February this year. The three-month interest rates on yen eurodeposit futures indicate that dealers think a further 25 basis-point increase in reference rates likely before the end of 2007.

The government continued to take measures to redress the public finances. The aim is to achieve a primary surplus by 2011. The latest official figures indicate that in the fiscal year that ended in March 2007 the deficit came down 1.5 percentage points, to 5.3 per cent of GDP, partly thanks to a larger-than-expected increase in tax revenues. The budget for the current year is based on a further increase in revenues and tight control of public spending; new issues of government bonds should decrease to ¥25.4 trillion, equal to 4.9 per cent of GDP, and the primary deficit to 0.8 per cent of GDP. The central bank estimates that the gross public debt amounted to 163.7 per cent of GDP at the end of March this year, slightly lower than a year earlier.

## *The European Union and the integration of the new member states*

Growth in the EU-25 accelerated from 1.7 per cent in 2005 to 2.9 per cent last year, gaining strength in almost all the member countries. Euro-area GDP increased by 2.7 per cent.

In the United Kingdom economic activity expanded by 2.8 per cent, almost 1 percentage point more than in 2005. Inflation, measured by the harmonized consumer price index, rose from 1.8 per cent in March 2006 to 3.1 per cent a year later. The Bank of England countered the rising inflation by raising the reference rate for monetary policy on four separate occasions from August on, bringing it to 5.5 per cent. In March this year, with inflation running at more than 1 point over the 2 per cent target, the procedure requiring the Governor to write an open letter of explanation to the Chancellor was activated for the first time ever. In the Governor's estimation around half of the increase in inflation was due to the rise in domestic energy prices and in food prices. Corporate pricing policies designed to restore profit margins may have also contributed; this interpretation was supported by data on the share of profits in the non-oil sector, which rose to 23.1 per cent in the third quarter, after having fallen from

25.2 per cent in the fourth quarter of 2004 to 21.6 per cent in the first quarter of 2006. The Bank of England forecast that with wages not accelerating and energy prices stable inflation will begin to slow in the second half of this year, settling at around 2 per cent in December. In fact, in April the rate had already dropped to 2.8 per cent. In the fiscal year ending in March public sector net borrowing decreased to around 2.7 per cent of GDP, compared with 3 per cent the year before.

In the ten countries that joined the EU in May 2004 growth accelerated from 4.8 per cent in 2005 to 6 per cent in 2006, 3 percentage points higher than in the euro area. Economic activity was driven by domestic demand and gained strength in almost all of these countries. Investment continued to benefit from inflows of foreign direct investment, while consumption was sustained by an increase in employment and in real wages, as well as by the rapid expansion in credit. Although exports increased at a faster pace even than in 2005, partly boosted by the recovery in the euro area, the contribution to growth was negative in the majority of the new members because of the acceleration in imports.

Inflation rose in most countries, reflecting the cyclical expansion on the one hand and the changes in regulated prices and indirect taxes on the other. The majority of the central banks tightened monetary conditions. In the countries included in the ERM II Central Bank Agreement, rises in reference rates were generally in line with those decided by the Eurosystem.

Budget policies were pro-cyclical in 2006. Despite strong economic growth and increasing revenues, in most countries the public deficit widened – to 10 per cent of GDP in Hungary and by a substantial amount in Latvia, Lithuania and Slovakia. The Czech Republic, Hungary, Malta, Poland and Slovakia are now in an excessive deficit situation.

Only a few countries expect to tighten budget policy in 2007. Hungary aims to cut its deficit by 3 percentage points, to below 7 per cent of GDP, and Slovakia to less than 3 per cent. Cyprus and Malta have asked the EU to assess their economic convergence with a view to adopting the single currency. In the middle of May the ECB and the Commission released reports on the convergence of the two countries in question, which will form the basis for a final decision by the European Council in June and by the Ecofin Council in July.

On 1 January Bulgaria and Romania joined the EU, thus completing the enlargement begun in May 2004. In 2006 both countries recorded faster growth than in the previous year, mainly led by consumption and investment. Inflation was over 5 per cent but should decline in response to a tightening of monetary policy. The public debt remains small in proportion to GDP and in the case of Bulgaria increased revenues have led to a budget surplus.

### *The main emerging economies*

*China*. – In 2006 the economy grew by 10.7 per cent, up from 10.4 per cent in 2005. The expansion in output was again led by investment and exports.

Despite the restrictive measures introduced by the monetary authorities during the year, fixed investment in urban areas, amounting to 85 per cent of the total, increased by 24.5 per cent in nominal terms (27.2 per cent in 2005) thanks to a 31 per cent rise in corporate profits. In the three years from 2004 to 2006 fixed capital investment in urban areas expanded at an average annual rate of 27 per cent in nominal terms. The largest increases were registered in the sectors with the strongest growth in output, such as extractive industries, construction, hotels and restaurants, export-led manufacturing industries (textiles, clothing and footwear) and investment-related ones (machinery and transport equipment).

In almost all sectors an increasingly large majority of investment spending comes from self-financing. In a quarter of a century the proportion of public financing was drastically reduced, from 28.1 per cent of the total in 1981 to 4.4 per cent in 2005. At the same time, self-financing has increased from 55.4 to 74.1 per cent, while borrowing and foreign investment generally account for a small proportion – respectively, 17.3 and 4.2 per cent in 2005 (Table 1.3).

**Table 1.3**

**Sources of finance of fixed investment in China**

| | State budget | Domestic loans | Foreign investment (1) | Self-financing and other funds |
|---|---|---|---|---|
| | | *percentage of total* | | |
| 1981 | 28.1 | 12.7 | 3.8 | 55.4 |
| 1990 | 8.7 | 19.6 | 6.3 | 65.4 |
| 2000 | 6.4 | 20.3 | 5.1 | 68.2 |
| 2005 | 4.4 | 17.3 | 4.2 | 74.1 |

Source: National Bureau of Statistics of China, *China Statistical Yearbook 2006*.
(1) Includes loans from foreign governments, banks and international financial institutions; issues of bonds and stocks overseas; export credit and foreign direct investment.

In the last three years the People's Bank of China has mopped up liquidity, partly in order to curb the expansion in credit, which accelerated from growth of 13.3 per cent in 2005 to 15.2 per cent in 2006, and by this means that in investment as well. The PBC made substantial use of open-market operations, above all to neutralize the effects of the considerable build-up of foreign currency reserves, while also raising the twelve-month lending rate and increasing the reserve requirement ratio.

In the same period, with M2 expanding at an average annual rate of 16 per cent, the reserve requirement ratio was increased on eight occasions, from 7 per cent at the beginning of 2004 to 11.5 per cent in May 2007; the twelve-month lending rate was raised from 5.31 to 6.57 per cent.

However, the effectiveness of the PBC's measures has been limited by the large volume of commercial banks' reserve deposits. The level of these has always been well in excess of the requirement, reducing the need for financial institutions to raise funds on the money market.

In 2006 household consumption, amounting to about 40 per cent of GDP, continued to grow at a slower pace than output (7.2 per cent in real terms according to IMF estimates). The income gap between rural and urban areas widened: the national bureau of statistics of China estimates that the disposable income of rural households grew by 7.4 per cent in real terms, compared with 10.4 per cent for urban households. The divergence in income trends fuels migration from the countryside to the cities, and the government has calculated that although 11.8 million jobs were created in urban areas during 2006, some 25 million were in fact needed to absorb the new labour force.

Despite the steady expansion of the money supply and bank credit, consumer price inflation averaged just 1.5 per cent in 2006, but at the start of 2007 the rapid rise in food prices pushed inflation up to 3.3 per cent.

Exports continued to provide a major stimulus to growth last year, increasing by 27.2 per cent in nominal terms, compared with 28.5 per cent in 2005. Since imports grew by 19.7 per cent (17.6 per cent in 2005) the trade surplus widened to $218 billion, equal to 8 per cent of GDP, $84 billion more than in 2005. Inflows of foreign direct investment were again substantial, amounting to $78.1 billion. The persistent upward pressure on the renminbi led to a further massive build-up of foreign currency reserves.

In the first quarter of 2007 output growth picked up further, to 11.1 per cent on a year earlier. The trade surplus doubled in the same period, to $46 billion.

*India*. – The Indian economy, which has been expanding rapidly since 2003, grew by 9.2 per cent in 2006. While the main stimulus to economic activity continued to come from the service sector, with growth of 9.3 per cent, manufacturing also contributed, accelerating from 8.8 per cent in 2005 to 10.7 per cent in 2006.

Export demand continued to further stimulate economic activity, particularly in business services and ICT. According to IMF estimates, last year the growth in total exports of services in volume terms was 19 per cent, compared with 6.5 per cent for goods exports.

The rapid expansion of economic activity and even faster increase in domestic demand brought upward pressure on prices, and in February this year inflation reached 7.6 per cent. The monetary authorities tried to stop the overheating and curb the growth in credit by raising the repo rate on several occasions, to 7.5 per cent in March, 100 basis points higher than a year earlier.

Rapid growth produced a considerable increase in tax revenues, helping to improve the public finances and bringing the government's targets within reach. According to official estimates, in the 2006 fiscal year ending in March 2007 the deficit was reduced to 6.6 per cent of GDP, compared with 7.5 per cent the year before, and the primary deficit from 1.6 to 0.9 per cent. The public debt is estimated to have decreased to 78.6 per cent of GDP, about 1 percentage point less than in 2005.

## 2. WORLD TRADE, BALANCES OF PAYMENTS AND FOREIGN EXCHANGE AND FINANCIAL MARKETS

World trade in goods and services continued to expand at a rapid pace in 2006. The dynamic performance of the Asian economies provided a strong impetus to the growth in trade and, given the slim margin of spare capacity, contributed to pushing up the prices of oil and other raw materials.

The balance-of-payments disequilibria increased again, despite the curbing effect of the slowdown in domestic demand in the United States and its acceleration in Japan and the euro area. The terms of trade continued to favour exporters of oil and raw materials. Compared with previous years, a larger proportion of the additional revenues went to sustain domestic demand. However, flows of funds from these countries into international markets remained large, helping to make it easy to finance the US current deficit, which amounted to almost 2 per cent of world GDP.

In China and the oil-exporting countries the authorities countered the pressures on their currencies to appreciate against the dollar with a huge build-up of official reserves. Between January 2006 and 20 May 2007, the dollar depreciated by 6 per cent in nominal effective terms, the result of widely varying performances against the main currencies; it lost 12 per cent against the euro while remaining virtually unchanged against the yen.

In the financial markets volatility remained low and prices continued to rise. However, uncertainties arose about the future course of monetary policy, particularly in the United States, causing bouts of turbulence above all in the equity markets, mainly of the emerging countries. Although short-lived, they indicated that the markets may react brusquely to even small shocks as monetary conditions become less accommodating.

### *International trade and direct investment*

World trade in goods and services at constant prices grew by around 9 per cent in 2006, compared with 7.4 per cent in the previous year. The acceleration outpaced that in world output, partly owing to the upturn in export-fuelling investments.

The main impetus came from the emerging and developing countries, whose imports grew by 15 per cent, compared with 12.1 per cent in 2005, led by strong demand in the Asian economies. The rate of growth also rose in the industrial countries as a whole, from 6.1 to 7.4 per cent, sustained by the acceleration in the euro area (from 5.2 to 7.8 per cent), which more than compensated for the slight slowdown in the United States (from 6.1 to 5.8 per cent).

Exports from the emerging Asian economies, and from China in particular, continued to rise at a much faster pace than those from other regions. Exports were also very dynamic in the leading industrial countries thanks to the recovery in world demand for capital goods; those from the United States and Japan (up by 8.9 and 9.6 per cent respectively) benefited from the depreciation of their currencies.

The international integration of markets for goods and services has progressed further in the last four years and the average annual growth in world trade – which had reached 6.5 per cent in the 1990s, twice that of output – since 2003 has been equal to 9.1 per cent. Between 1990 and 2006 the value of international trade in relation to world output on a PPP basis rose from 32 to 44 per cent.

A major stimulus to the expansion in trade has come from the entry of the emerging countries, which have benefited from far-reaching liberalization measures. In the course of this decade the imports of these countries have accounted for over a third of the growth in world trade, double their contribution in the 1990s. These trends are likely to strengthen in the future, considering that some important countries, notably India, continue to be relatively closed.

The emerging countries' newly found opportunities for growth, along with the availability of low-cost skilled labour, have prompted a brusque increase in foreign direct investment flows to those economies. While world flows of FDI have risen from an annual average of $100 billion in the 1980s to almost $1 trillion this decade, flows to the emerging countries have increased fourteen times over and in 2006 accounted for almost half the world total. Central and Eastern Europe have experienced a particularly large increase in FDI, thanks to the enhanced prospect of commercial and financial integration with the EU, as has China, which has seen annual inflows of $70 billion in the last two years.

### *Raw material prices*

Strong tensions in the oil market persisted in 2006. The price of crude oil (average of the prices for the three main grades) rose by 20 per cent on average, from $53.4 a barrel in 2005 to $64.3 last year. Since this trend began in 2003 prices have increased by around 140 per cent in nominal terms and 130 per cent in real terms.

The rise in oil prices and their marked volatility in the first half of 2006 were due, as in 2005, to the persistent rigidity of supply, which caused them to react sharply to small shocks. After the large increases of April and July, on 7 August oil prices reached a record high of $75.6 a barrel. During the rest of 2006 and until January this year, as international tensions abated and demand weakened in the main industrial countries, mainly owing to the exceptionally mild winter in the northern hemisphere, prices were brought down temporarily to around $50 a barrel.

In February, however, oil prices began to climb again. Initially, this was due to stronger demand in the main industrial countries and to the effects of production cuts decided earlier by the OPEC cartel and totalling 1.7 million barrels a day, or 2 per cent of world demand. Later, heightened tensions in Iran and Nigeria also contributed. WTI grade futures traded on NYMEX on 22 May this year indicate that prices are likely to increase from $64.9 on that date to $68.9 a barrel in December.

The extremely low level of unused production capacity in the OPEC countries compared with the past is the main cause of the short-term rigidity of oil supply. The small increase in 2006 does not appear to have been sufficient to ease price strains, partly because it was mainly due to OPEC's production cuts and not to an expansion of capacity. Even in the medium term there is little likelihood of a substantial improvement in market fundamentals.

The prices of non-fuel raw materials continued to rise sharply in 2006 (28.4 per cent), to almost 70 per cent over the level in 2003. The increase mainly reflected the metals component (which makes up about 30 per cent of the overall index), whose prices are highly sensitive to the business cycle. Metals prices rose by 56.5 per cent in 2006 in response to a surge in demand, mainly from China.

The prices of food products and non-food farm products, which had been virtually stationary in 2005, increased by 9.9 and 10.1 per cent respectively owing to temporary supply shortages (bad harvests brought grain stocks to the lowest level of the last twenty-six years) as demand boomed for crops such as maize and soy that can be used as biomass for fuel production.

### *Global imbalances and exchange rates*

The current account imbalances increased further in 2006 despite the narrowing of gaps in domestic demand growth among the main industrial countries. The rise in oil prices boosted the surpluses of the energy-exporting countries and caused a further deterioration in the US deficit. China recorded an exceptionally large increase in its current account surplus.

The current account deficit of the United States rose from $792 billion in 2005 to $857 billion, equivalent to 6.5 per cent of GDP. The worsening of the trade deficit from $783 billion to $836 billion is almost entirely due to the higher cost of oil imports. When these are excluded, the deficit is shown to have declined slightly in proportion to GDP as the positive growth differential between export and import volumes widened. The balance on investment income, which had been positive until 2005 despite the country's large net debtor position, turned slightly negative.

The United States again financed its current account deficit principally with inflows of private capital, which rose, net of disinvestments, from $1,013 billion in 2005 to $1,464 billion last year. Since 2001 these inflows have gone largely into bonds; the net increase recorded last year in investment in high yielding and riskier corporate bonds may imply greater vulnerability to sudden shifts in confidence. Net inflows from foreign official bodies, which had fallen by almost half in 2005, rose to $300 billion.

The current account surplus of the Asian economies as a whole increased to $541 billion, mainly owing to a rise in China's surplus to $250 billion, equivalent to 9.5 per cent of GDP. The surpluses of the ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand) tripled to $43 billion, while that of Japan remained virtually stationary at $170 billion.

The current account surplus of the oil-exporting countries increased from $368 billion in 2005 to $437 billion last year. These countries used their additional oil revenues for re-spending to a much greater extent than in previous years, and in fact the ratio between the change in goods imports only and the change in oil revenues rose from 54 per cent in 2005 to 120 per cent overall, with especially large increases in Mexico, Norway and Russia.

The dollar's performance against the renminbi, the currencies of the main oil-exporting countries and the yen did not help absorb the current account imbalances. In nominal effective terms the dollar depreciated by 5 per cent. However, it lost only 3 per cent against the renminbi and the depreciation against the currencies of the main oil-exporting countries was similarly small.

China continued to counter the upward pressure on the renminbi by accumulating foreign exchange reserves at an ever faster pace. In 2006 they increased by $247 billion, around $40 billion more than the average of the two previous years (Table 2.1); at the end of the year they reached a total of $1,069 billion. The oil-exporting countries also stepped up their accumulation of foreign exchange reserves, which rose to $752 billion last year.

## *The financial markets*

In the United States, yields on ten-year Treasury notes, which had fluctuated just below 4.5 per cent since the middle of 2004, started to rise at the beginning of 2006, reaching 5.2 per cent in June. This increase reflected much higher premia demanded by investors in view of the increasingly uncertain outlook for the US economy, but was probably also due to a decline in non-residents' purchases of US long-term securities. From the middle of May to the end of June, expectations that official rates would be raised in the second half of the year as well caused a sudden accentuation of bond price volatility. The tensions, which also hit the international stock markets, eased in June when the Federal Reserve signalled that the economic slowdown would curb the pressures on prices, suggesting that the phase of official rate rises was about to end. Subsequently, long-term interest rates fell and from the end of August resumed fluctuating between 4.5 and 4.8 per cent.

Real yields on ten-year index-linked government paper, which stood at 2 per cent at the beginning of 2006, rose to 2.6 per cent at the end of June before gradually slipping back to around 2.3 per cent by 20 May this year. Adjusted for long-term inflation expectations based on Consensus Economics data, yields on ten-year securities followed a similar pattern rising from 2 to 2.5 per cent between October 2005 and April 2006 and then edging down in the months that followed.

The strong growth in profits boosted share prices. From the beginning of 2006 to 20 May this year, in the United States the Standard & Poor's 500 index gained 20 per cent, while in the euro area and the United Kingdom the Dow Jones Euro Stoxx and the FTSE All Share indexes rose by 30 and 20 per cent respectively. In Japan the Nikkei 225, which had jumped by 40 per cent in 2005, recorded a more modest increase of 9 per cent from the beginning of 2006 on. In the United States and the euro area price/earnings ratios remained virtually unchanged and on 20 May they stood at 18 and 16 respectively, close to the average for the last twenty years.

Table 2.1

**Current account of the balance of payments and foreign exchange reserves**

| | Current account balance | | | | Foreign exchange reserves | |
|---|---|---|---|---|---|---|
| | 2005 | | 2006 | | 2005 | 2006 (1) |
| | billion dollars | % of GDP | billion dollars | % of GDP | billion dollars | billion dollars |
| **Euro area** (2) | **-2.0** | **..** | **-5.9** | **-0.1** | **-27.3** | **12.3** |
| **Japan** | **165.8** | **3.6** | **170.4** | **3.9** | **0.4** | **45.4** |
| **United States** | **-791.5** | **-6.4** | **-856.7** | **-6.5** | **-21.8** | **0.8** |
| **Asia** | **247.5** | **4.8** | **370.3** | **6.2** | **234.8** | **382.7** |
| Newly industrialized Asian economies (NIEs) (3) | 79.8 | 5.6 | 87.0 | 5.6 | 15.6 | 58.0 |
| *Hong Kong* | *20.3* | *11.4* | *19.4* | *10.2* | *0.7* | *8.9* |
| *Singapore* | *28.6* | *24.5* | *36.4* | *27.5* | *3.6* | *20.5* |
| *South Korea* | *15.0* | *1.9* | *6.1* | *0.7* | *11.3* | *28.6* |
| *Taiwan* | *16.0* | *4.6* | *25.2* | *7.1* | *....* | *....* |
| ASEAN-4 | 14.8 | 2.1 | 43.4 | 4.8 | 6.8 | 38.9 |
| *Indonesia* | *0.3* | *0.1* | *9.6* | *2.6* | *-2.0* | *7.9* |
| *Malaysia* | *20.0* | *15.2* | *25.5* | *15.8* | *4.0* | *12.3* |
| *Philippines* | *2.4* | *1.8* | *5.0* | *3.1* | *2.8* | *4.1* |
| *Thailand* | *-7.9* | *-4.5* | *3.2* | *1.6* | *2.0* | *14.6* |
| India | -7.9 | -1.0 | -10.1 | -1.1 | 5.3 | 38.8 |
| China | 160.8 | 7.2 | 249.9 | 9.5 | 207.0 | 247.0 |
| **Oil-exporting countries** | **367.9** | **11.3** | **437.0** | **11.3** | **112.9** | **212.9** |
| OPEC (4) | 242.2 | 17.0 | 287.9 | 16.9 | 45.3 | 81.1 |
| *Algeria* | *21.2* | *20.7* | *27.9* | *24.4* | *13.1* | *21.6* |
| *Indonesia* | *0.3* | *0.1* | *9.6* | *2.6* | *-2.0* | *7.9* |
| *Iran* | *14.0* | *7.4* | *14.3* | *6.7* | *....* | *....* |
| *Kuwait* | *32.7* | *40.5* | *41.4* | *43.1* | *0.6* | *3.7* |
| *Libya* | *17.3* | *41.6* | *24.4* | *48.5* | *13.8* | *19.8* |
| *Nigeria* | *9.1* | *9.2* | *14.1* | *12.2* | *11.3* | *14.2* |
| *Qatar* | *10.7* | *25.2* | *6.1* | *11.6* | *1.1* | *0.8* |
| *Saudi Arabia* | *90.8* | *29.3* | *95.5* | *27.4* | *-0.8* | *1.0* |
| *United Arab Emirates* | *20.5* | *15.8* | *27.4* | *16.3* | *2.5* | *6.6* |
| *Venezuela* | *25.5* | *17.8* | *27.2* | *15.0* | *5.5* | *5.5* |
| Mexico | -4.9 | -0.6 | -1.5 | -0.2 | 9.9 | 2.2 |
| Norway | 46.7 | 15.5 | 56.1 | 16.7 | 2.7 | 9.9 |
| Russia | 83.8 | 11.0 | 94.5 | 9.6 | 55.1 | 119.7 |

Sources: IFM and national statistics.
(1) First eleven months for Nigeria. – (2) EU-13. – (3) The flow of foreign exchange reserves does not include Taiwan. – (4) Does not include Iraq. The flow of foreign exchange reserves does not include Iran.

Large, if transitory, decreases in share prices were recorded between the middle of May and the end of June last year in the United States, the euro area, Japan and the United Kingdom, with losses of between 6 and 16 per cent. At the end of February this year, new turbulence was triggered by a sharp fall in the Shanghai stock market and fears of economic slowdown in the US, partly owing to the deterioration in the sub-prime mortgage market.

Conditions on the financial markets of the emerging countries remained generally relaxed in 2006. Risk premia, measured in terms of the yield spread between long-term sovereign securities and US Treasury paper, continued to diminish in these economies as a whole, falling from 2.4 to 1.7 percentage points at the end of the year. This development was most pronounced for the Latin American and Asian countries, with yield spreads narrowing from 2.7 to 1.8 percentage points and from 2.2 to 1.3 points respectively. Share prices recorded gains of over 20 per cent in all the emerging countries. Conditions remained favourable throughout the early months of 2007, and after a brief and relatively small correction at the end of February, risk premia fell to historically low levels while share prices gained more than 9 per cent overall from the beginning of the year.

Between March and June 2006 the stock market indexes recorded losses, especially where they had gained most in 2005 – Argentina, Colombia, Hungary, India, Peru, Russia and Turkey. Many currencies depreciated against the dollar and the euro, particularly those of Latin America and Central and Eastern Europe. In mid-June, share prices began to recover generally, although investors continued to penalize the markets of some countries, such as Hungary and Turkey, with large current account deficits and heavily dependent for financing them on portfolio investment inflows.

In contrast with previous episodes, little of the turbulence was transmitted to the segment of bonds denominated in foreign currencies issued in international markets. This was partly thanks to the strengthening of underlying conditions in the emerging economies as they made significant progress in improving their budget and current account positions and reducing the debt/GDP ratio.

### *Bond issues of emerging countries*

In recent years sovereign bond issues denominated in domestic currency on national markets have increased substantially more than international issues denominated in foreign currencies. At the same time the share of public debt securities indexed to exchange rates has decreased. The emerging countries have thus reduced their exposure to exchange-rate risk.

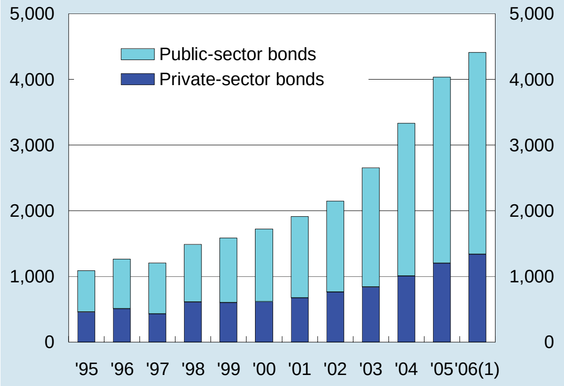
In 2006, gross international issues of sovereign bonds denominated in foreign currencies diminished for the first time in five years. The IMF also estimates that government buy-backs totalled around $23 billion. By contrast, corporate bond issues continued to increase ($125 billion) and in 2006 represented more than 70 per cent of the total issues of emerging countries on international markets, compared with 50 per cent in 2005.

According to the Bank for International Settlements, issues of bonds denominated in domestic currency on national markets amounted to $660 billion in 2005, compared with less than $230 billion ten years earlier, and in the first half of 2006 they totalled $315 billion. In June 2006 over $4,400 billion of these securities were outstanding (compared with $1,100 billion in 1995), about 70 per cent of which consisted of sovereign issues (Figure 2.1). Overall, more than 60 per cent of securities in circulation were issued by Asian countries.

Figure 2.1

**Outstanding local-currency-denominated bonds in national markets**

*(billions of dollars)*




Source: Bank for International Settlements.
(1) Data available as of June 2006.

Available information suggests that non-residents form a small but growing investor base for the emerging countries' issues of bonds denominated in domestic currency: financial institutions and institutional investors in industrial countries have purchased these securities to further diversify their portfolios, particularly in the Central and Eastern European countries. However, it is difficult to set a precise figure on the phenomenon because foreign investors are increasingly using financial derivatives instead of acquiring securities directly. This trend, together with the issue of domestic-currency-denominated bonds on international markets by a few emerging countries, indicates that the latter are overcoming their structural difficulty in raising funds abroad except in foreign currency (their "original sin") and strengthening their financial systems, making them less vulnerable to exchange-rate risk.

Some aspects of the expansion of national bond markets remain fragile. Liquidity is still low: in many markets, trading volumes are low and bid/ask spreads high. This is partly due to the fact that the investor base is poorly diversified, since it consists largely of banks that have buy-and-hold strategies. These factors could heighten the risk of financial instability should investors respond to negative shocks by selling their portfolios at the same time. Finally, the average term to maturity of emerging countries' issues is shorter on national markets than on international markets, entailing a higher risk of refinancing. In the middle of 2006, some 36 per cent of outstanding securities on national markets had a residual maturity of less than one year, compared with 9 per cent for international markets.

# 3. INTERNATIONAL COOPERATION

In 2006 the stock of IMF loans contracted further, reflecting the abundance of international liquidity and continuing favourable economic conditions in the emerging economies. This led to a reduction in the IMF's revenues, and thus in its net income. Discussions are under way on a set of proposals to stabilize the Fund's income in the medium term in the presence of large fluctuations in outstanding loans. The review of the Fund's structure and functions of the Fund continued against a background of slack demand for loans and increasing risks associated with the widening of current account imbalances. Particular emphasis was placed on the economic surveillance of member countries, the prevention of capital account crises and the reform of members' quotas – and hence of their relative voting rights. In the course of special multilateral consultations instituted by the IMF, the authorities of countries and areas of systemic importance agreed on ad hoc measures to redress the present current account imbalances. Despite substantial debt cancellations, the flow of official aid to the poorest countries decreased slightly in real terms with respect to the previous year. If the Millennium Development Goals are to be achieved, particularly those not related to poverty reduction, both donor countries and recipients of aid must immediately intensify their efforts. With the increase in the number of donors, better coordination has become an immediate necessity.

## *The IMF's financial assistance*

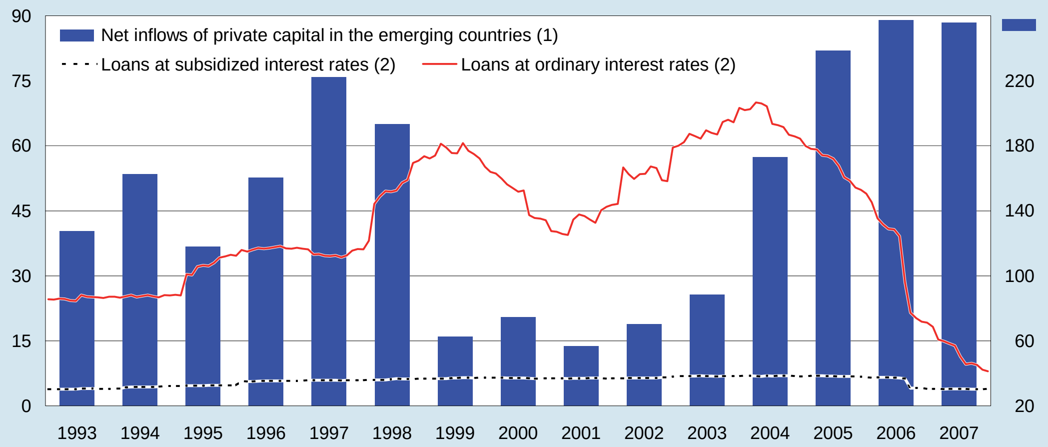
In 2006 the Fund approved twelve new financial assistance programmes for a total of 505 million SDRs, or $757 million, of which 85 per cent at subsidized interest rates as a contribution to poverty reduction. The volume of ordinary loans, at unsubsidized interest rates, continued to decline, reaching the lowest point of the last twenty years (Figure 3.1). At the end of March 2007 the stock of these totalled 7.9 billion SDRs, 62 billion less than the peak amount recorded in September 2003.

The reduction in the stock of loans caused a contraction in the IMF's revenues, which are determined by the amount of ordinary loans and the interest rate on them – the rate of charge on loans is the SDR interest rate plus a spread to cover the Fund's operating expenses. At present the Fund estimates a loss for the 2007 financial year of 108 million SDRs ($165 million); unless adequate corrective measures are introduced, the loss will increase in the following years.

A committee of eminent persons appointed by the IMF Managing Director and chaired by Andrew Crockett has recently issued some recommendations for new and sustainable long-term financing of the IMF's running costs. The main suggestions concern the financing of activities associated with the economic surveillance of member countries, research, distribution of data and statistics, and the drafting of international standards and codes. These costs should be met with revenue from the investment of (a) existing prudential reserves, (b) part of the quotas paid by member countries, and (c) income from the sale of a fraction of the IMF's gold reserves. Discussions are still in the early stages. In April the International Monetary and Financial Committee invited the IMF to submit some concrete proposals before the forthcoming annual meetings, including measures to limit expenditure.

**Figure 3.1**

**Stock of IMF loans and international capital movements**




Source: IMF.
(1) Right-hand scale: annual data in billions of dollars. Data for 2007 are estimated. – (2) Left-hand scale: monthly data in billions of SDRs.

## *Structure and functions of the IMF*

The international community has stepped up its efforts to bring about a far-reaching reform of the Fund's structure and functions. Two main areas are involved: the economic surveillance of member countries and, more generally, the prevention of financial crises and the legitimization of the Fund itself.

*Surveillance*. – The review of the Fund's surveillance activities centres on three aspects: a clearer definition of the member countries' obligations under Article IV of the Articles of Agreement; the institution of a new formal process to define the medium-term priorities and objectives of surveillance; and the introduction of a multilateral consultation procedure with the countries of greatest systemic importance.

The new multilateral consultations will supplement the IMF's existing consultations with individual member countries in order to draw up a set of collective economic policy actions for the solution of problems of systemic importance. The first round of consultations, which began in 2006, focused on global current account imbalances and involved the authorities of China, the euro area, Japan, Saudi Arabia and the United States. The preliminary outcome was made known during the meetings in Washington last spring, when the participants undertook to introduce specific measures to redress the payments imbalances.

*New mechanisms for assisting member countries.* – A new credit line, the Reserve Augmentation Line, is now being discussed as a possible method of preventing capital account crises and encouraging suitable economic reforms in the countries concerned. The RAL would provide semi-automatic financing – i.e. the credit line could be drawn upon, within limits, in the event of a crisis without the prior approval of the IMF's Board of Governors – for a substantial amount (300 per cent of the member's quota) to countries with sound institutions and underlying economic conditions but vulnerable to sudden changes in the direction of foreign financial flows. Use of the RAL would be optional and subject to the beneficiary meeting a number of requirements. It would be conditional upon participation in a complete programme, whereby the country concerned would undertake to follow virtuous macroeconomic policies and tackle its remaining vulnerabilities. The IMF would verify compliance every six months. The three main aspects on which current discussions hinge are a) the potentially negative signals the Fund would send to the market in the event of approval or non-renewal; b) the conflict between the system of automatic disbursement and the obligation to safeguard the Fund's financial integrity; and c) harmonization of the new facility with the existing guidelines for the exceptional access policy available in the case of effective, as opposed to potential, requirements.

*Review of quotas*. – At the last annual meetings in Singapore in September 2006 the IMF's Board of Governors approved an increase in the quotas of four seriously under-represented countries in relation to their positions in the world economy (China, Mexico, South Korea and Turkey). It was also decided to introduce other, more far-reaching reforms before the 2008 annual meetings. In particular, there will be a new quota formula for calculating the reference value of quotas that is simpler and more transparent than the present system and that will assign a greater weight to GDP. The IMF's Articles of Agreement will have to be amended to provide for an increase in the basic votes of each member so as to protect the voice of the poorest countries in the Fund's governing bodies; finally, a second increase will be made in the quotas of the most under-represented countries.

## *Poverty reduction initiatives and development finance*

*Poverty reduction.* – With only nine years to 2015, the deadline for achieving the Millennium Development Goals, the international community has acknowledged serious delays on almost all fronts. The prospects of achieving the human development goals are not encouraging; it is estimated that none of the areas will reach the targets for reducing infant mortality. The regions furthest behind schedule are southern Asia and, above all, sub-Saharan Africa.

By contrast the continuing favourable international economic conditions have left the estimates of per capita income growth generally positive. With the exception of sub-Saharan Africa, all the other areas should succeed in halving the percentage of the population living on less than a dollar a day – the first of the Millennium Development Goals.

In view of the unsatisfactory results to date, it will only be possible to achieve the Goals by the deadline if the donor countries and the emerging economies intensify their efforts. First, the donor countries are called upon to take rapid action to increase the current volume of official aid and to improve its allocation and effectiveness. The developing countries must continue to pursue virtuous economic policies and to improve the quality of their institutions.

*Official development aid*. – Official aid granted by the 22 OECD countries belonging to the Development Assistance Committee amounted to $104 billion in 2006, down 5 per cent in real terms on the previous year. The decrease was the first since 1997 and was mainly the result of the exceptionally large volume of official aid recorded in 2005 with the start of operations to cancel Iraq's and Nigeria's debt. In 2006 too, some 40 per cent of aid was in relation to debt cancellations and was concentrated among a small number of beneficiaries.

It is estimated that the total volume of aid will decline further in 2007 as the effects of cancelling Iraq's and Nigeria's debt fade. A renewed increase in aid is expected in 2008 on the basis of the donor countries' programmes; their goal is to raise aid to 0.36 per cent of GNI by 2010 and to 0.70 per cent by 2015, with a more than proportionate increase in finance to Africa.

*Debt cancellation*. – In 2006 important progress was made in debt reduction in the poorest countries. The International Development Association, the African Development Fund and the IMF approved the cancellation of multilateral credit to 24 heavily indebted poor countries. The operation involved around $38 billion, in nominal terms, of debt maturing over the next 40 years. In the early months of this year, the Inter-American Development Bank cancelled its credits vis-à-vis Bolivia, Guyana, Haiti, Honduras and Nicaragua, for a total of $3.4 billion.

Thanks to these debt cancellation initiatives the beneficiaries will be able to allocate to the Millennium Development Goals the resources freed up by the reduced cost of debt servicing and those obtained through easier access to international markets as their credit ratings improve. However, it is important to prevent their debt from re-expanding too rapidly. The World Bank and the IMF have recently reviewed the tools for assessing debt sustainability in the low-income countries. The G8 is currently working on a list of principles for what is termed responsible financing, which envisage, among other things, that all donor countries should make use of sustainability analyses by the two leading multilateral institutions and ensure greater transparency and sharing of information.

# MACROECONOMIC DEVELOPMENTS, BUDGETARY POLICIES AND MONETARY POLICY IN THE EURO AREA

# 4. MACROECONOMIC DEVELOPMENTS

In the first half of 2005 the economic cycle in the euro area entered an expansionary phase, ending a period of stagnation that had lasted for almost five years. The corporate sector's drive to improve efficiency in order to counter competition from emerging countries helped the area's economy to take advantage of the continuing expansion in world trade. Exports have accelerated markedly in the last two years, stimulating production and the demand for plant and equipment. Investment has also been boosted by the rise in the property market, which is still benefiting from the prolonged period of expansionary monetary policy. Part of the contribution of exports to growth has been offset by a sharp increase in imports due to the recovery in economic activity.

As in the past, household expenditure was less sensitive to cyclical developments owing to continued caution among consumers, especially in Germany, and the smallness of the growth in disposable income.

The gradual removal of monetary policy stimulus and the slow rise in domestic costs, which checked the inflationary pressures deriving from imported costs, meant that the recovery took place against the background of considerable price stability. In 2006 consumer price inflation remained stable at 2.2 per cent.

The area's current account was broadly in balance; the small deterioration with respect to the previous year, due to the rise in world commodity prices, was only partly offset by an improvement in the surplus on services and in the net position in respect of income. After declining in 2005, the net external debtor position deteriorated again, amounting to 11.5 per cent of GDP at the end of the year.

The latest data paint a favourable picture of the area's economy, indicating a rate of growth in the first half of 2007 only marginally below that of last year, with inflation held down by an easing of pressures in commodity markets and continued wage restraint.

## *Economic developments in the euro area*

Stimulus from the strong expansion in world demand enabled the economy of the euro area to return to a sustained rate of growth in 2006 (2.7 per cent; Table 4.1). The growth gap in relation to the United States, which had averaged 1 percentage point over the previous five years, was almost halved.

The scale of the recovery surprised the leading international institutions and the majority of private analysts; at the end of 2005 they had forecast GDP growth of less than 2 per cent. The underestimation is explained mainly by the results for Germany, which were far better than expected (2.7 per cent, compared with forecasts of less than 1.5 per cent) and are significant because of the stimulatory effect that German domestic demand has on the output of the other euro-area economies, and Italy in particular.

Table 4.1

**GDP, imports and the main components of demand in the major euro-area countries**
*(chain-linked volumes; seasonally adjusted data; percentage changes on previous period unless otherwise indicated)*

| | 2004 | 2005 | 2006 | 2006 | | | | 2007 |
|---|---|---|---|---|---|---|---|---|
| | Year | Year | Year | Q1 | Q2 | Q3 | Q4 | Q1 |
| | | | | **GDP** | | | | |
| Germany | 1.2 | 0.9 | 2.8 | 0.8 | 1.2 | 0.8 | 1.0 | 0.5 |
| France | 2.5 | 1.7 | 2.0 | 0.7 | 0.9 | 0.1 | 0.5 | 0.5 |
| Italy (1) | 1.2 | 0.1 | 1.9 | 0.8 | 0.6 | 0.3 | 1.1 | 0.2 |
| Spain | 3.2 | 3.5 | 3.9 | 1.1 | 0.9 | 0.9 | 1.2 | 1.1 |
| Euro area (1) (2) | 2.0 | 1.4 | 2.7 | 0.8 | 1.0 | 0.6 | 0.9 | 0.6 |
| | | | | **Imports** | | | | |
| Germany | 6.9 | 6.5 | 11.6 | 5.8 | -0.6 | 4.0 | 1.1 | 3.7 |
| France | 7.1 | 5.0 | 6.8 | 1.3 | 2.9 | -0.8 | 0.6 | 0.6 |
| Italy | 2.7 | 0.5 | 4.3 | 1.0 | 0.3 | 2.2 | 2.0 | …. |
| Spain | 9.6 | 7.0 | 8.4 | 3.4 | -0.6 | 2.2 | 3.6 | 0.4 |
| Euro area (2) | 6.7 | 5.2 | 7.8 | 2.4 | 1.0 | 2.2 | 1.8 | …. |
| | | | | **Exports** | | | | |
| Germany | 9.6 | 6.9 | 13.0 | 5.2 | 0.7 | 4.3 | 6.0 | -1.2 |
| France | 4.0 | 2.8 | 5.5 | 3.2 | 1.0 | -1.3 | 0.6 | 1.5 |
| Italy | 3.3 | -0.5 | 5.3 | 2.2 | 1.4 | -1.8 | 4.5 | …. |
| Spain | 4.1 | 1.5 | 6.2 | 5.8 | -1.7 | 0.6 | 2.5 | 2.7 |
| Euro area (2) | 6.9 | 4.2 | 8.3 | 3.2 | 1.0 | 1.9 | 3.6 | …. |
| | | | | **Household consumption** (3) | | | | |
| Germany | 0.1 | 0.1 | 0.8 | 0.8 | -0.1 | 0.8 | 0.3 | -1.4 |
| France | 2.5 | 2.2 | 2.0 | 0.7 | 0.5 | 0.5 | 0.2 | 0.3 |
| Italy | 0.7 | 0.6 | 1.5 | 0.5 | 0.4 | 0.6 | 0.2 | …. |
| Spain | 4.2 | 4.2 | 3.7 | 0.4 | 0.8 | 1.2 | 1.3 | 0.3 |
| Euro area (2) | 1.5 | 1.5 | 1.7 | 0.5 | 0.4 | 0.7 | 0.4 | …. |
| | | | | **Gross fixed investment** | | | | |
| Germany | -0.4 | 0.8 | 5.6 | 0.1 | 4.3 | 1.2 | 1.2 | 4.2 |
| France | 3.6 | 4.0 | 3.7 | 0.5 | 1.8 | 0.6 | 1.3 | 1.2 |
| Italy | 1.6 | -0.5 | 2.3 | 1.7 | 0.4 | -0.3 | 1.8 | …. |
| Spain | 5.0 | 7.0 | 6.3 | 1.3 | 1.5 | 1.4 | 2.0 | 1.6 |
| Euro area (2) | 2.2 | 2.5 | 4.7 | 1.1 | 2.2 | 0.9 | 1.5 | …. |
| | | | | **National demand** (4) | | | | |
| Germany | .. | 0.5 | 1.7 | 0.9 | 0.7 | 0.5 | -1.5 | 2.8 |
| France | 3.3 | 2.3 | 2.4 | 0.1 | 1.5 | 0.2 | 0.5 | 0.2 |
| Italy | 1.0 | 0.3 | 1.6 | 0.4 | 0.3 | 1.4 | 0.5 | …. |
| Spain | 4.8 | 5.0 | 4.6 | 0.6 | 1.1 | 1.4 | 1.7 | 0.4 |
| Euro area (2) | 1.9 | 1.7 | 2.4 | 0.5 | 1.0 | 0.7 | 0.1 | …. |
| | | | | **Net exports** (5) | | | | |
| Germany | 1.2 | 0.5 | 1.2 | .. | 0.5 | 0.3 | 2.1 | -2.0 |
| France | -0.7 | -0.6 | -0.4 | 0.5 | -0.5 | -0.1 | .. | 0.3 |
| Italy | 0.2 | -0.3 | 0.3 | 0.3 | 0.3 | -1.1 | 0.7 | …. |
| Spain | -1.7 | -1.7 | -1.0 | 0.4 | -0.3 | -0.5 | -0.5 | 0.6 |
| Euro area (2) | 0.2 | -0.2 | 0.3 | 0.3 | .. | -0.1 | 0.7 | …. |

Sources: Based on national statistics and Eurostat data.
(1) Preliminary estimates for the first quarter of 2007. – (2) The aggregate for the euro area relates to 13 countries. – (3) Consumption of resident households and of non-profit institutions serving households. – (4) Includes changes in stocks and valuables. – (5) Contribution to growth in relation to the previous period in percentage points.

Exports of goods and services, including trade flows within the area itself, increased by 8.3 per cent in real terms, in line with the results for other developed economies and the growth in world trade.

Activity quickened in all the major euro-area countries, although for differing reasons. In Germany the growth of 2.7 per cent was generated primarily by an exceptional rise of 12.5 per cent in exports, which strongly boosted investment, while in France and Spain the main stimulus came from domestic demand.

The growth in the area's exports benefited from the real depreciation of the euro in 2005, even though competitiveness was steadily eroded in 2006 and the early months of this year in parallel with the trend in the nominal exchange rate of the euro against the other leading currencies. Data on trade with countries outside the area show an increase of 7.7 per cent in merchandise exports, which was in line with the growth in demand in those markets and compared with a rise of 4.8 per cent in 2005.

The growth in imports of goods and services also accelerated, from 5.2 per cent in 2005 to 7.8 per cent, thanks to the recovery in intermediate and final demand; world trade made a net contribution of 0.3 percentage points to GDP growth.

Investment grew by 4.7 per cent, compared with 2.5 per cent in 2005, fuelled by a more rapid increase in spending on machinery, equipment and transport equipment and a substantial rise in construction. Despite the steady shift towards a neutral monetary policy stance, the continued high level of earnings and lending and the fall in spare capacity favoured capital formation. Demand for housing remained strong, sustaining property prices and the profits of construction firms. The propensity to invest, approximated by the ratio of total investment to GDP, rose for the third consecutive year to rival the peak reached during the last expansion.

The pick-up in investment was vigorous in Germany, where it had more or less stagnated for the preceding three years, and only modest in France; in Spain investment slowed down. In Germany the increase in spending on machinery and equipment was accompanied by a strong rebound in residential and non-residential construction. In France, by contrast, the acceleration in investment in construction contrasted with a slowdown in spending on plant and equipment, which was affected by the relatively high level at which the propensity to invest had remained during the preceding cyclical downturn.

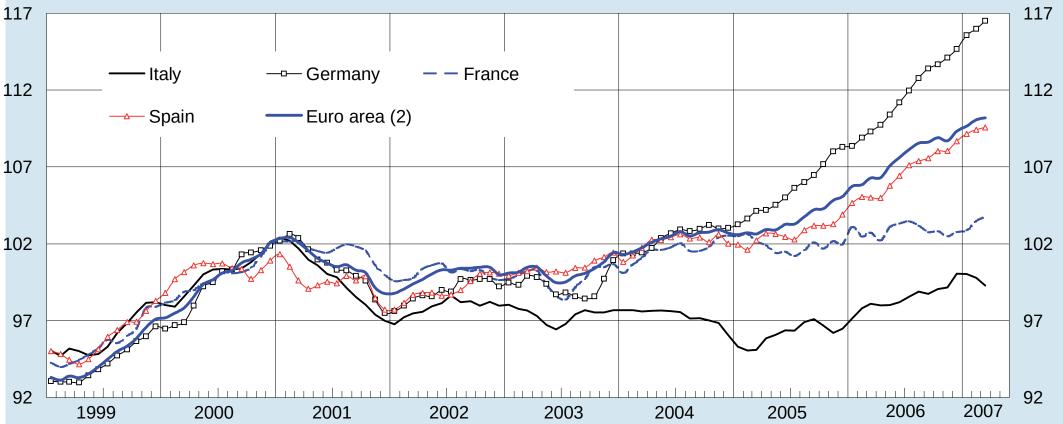
Consumption made only a small contribution to the growth in GDP, rising at an almost unchanged rate (1.7 per cent, compared with 1.5 per cent in the preceding two years; Table 4.1), as household confidence recovered only slowly and the rise in disposable income remained modest.

The growth in household expenditure in Germany, which has been feeble for the past five years, accelerated but remained weak (0.8 per cent), reflecting a modest increase in disposable income (around 0.5 per cent at constant prices) and an abrupt halt in the revival of consumer confidence around mid-year. In France and Spain, by contrast, consumption increased by 2 and 3.7 per cent respectively. Disposable income rose substantially in both countries, by around 3 per cent in real terms; in France the growth was accompanied by a sharp improvement in households' confidence in the course of the year.

Industrial production in the area continued on the rising trend that began in early 2005, increasing to well above the peak of the previous cycle (Figure 4.1). The expansion began to

Figure 4.1

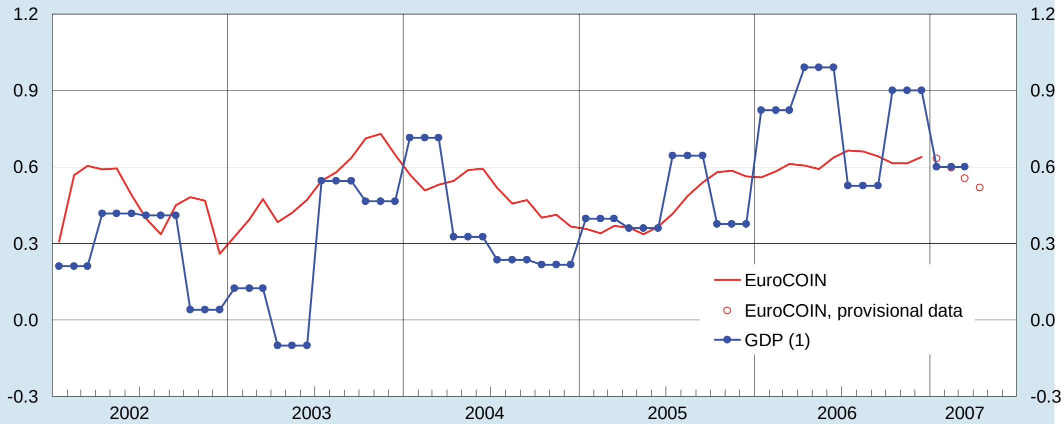
**Industrial production in the major euro-area countries** (1)
*(moving averages for the three months ending in the reference month)*




Sources: Based on Istat and Eurostat data.
(1) Indices, 2000=100; seasonally adjusted data. – (2) The aggregate for the euro area relates to 13 countries.

Figure 4.2

**EuroCOIN indicator of the euro-area business cycle and GDP**
*(three-month percentage changes)*




Source: Centre for Economic Policy Research (www.cepr.org).
(1) The aggregate for the euro area relates to 13 countries.

falter in the first few months of this year, however. The EuroCOIN cyclical indicator, which provides an estimate of the growth in the area's GDP adjusted for short-term fluctuations, has been declining since February, although it continues to indicate that the expansion is close to its potential (Figure 4.2). The improvement in business confidence slackened, and halted temporarily in January; export orders ceased to grow, but remained at a high level. Overall, the latest data point to continuing sustained growth in the economy of the area in the early part of 2007, although at a lower rate than last year.

## *The balance of payments*

As in 2005, the current account of the euro area vis-à-vis the rest of the world was broadly in balance; there was a deficit of around €6 billion, equal to 0.1 per cent of GDP (Table 4.2). Since the overall surplus on the current and capital accounts amounted to just over €5 billion and net inflows on the financial account came to €134 billion, errors and omissions were very large, amounting to an outflow of around €140 billion. When final data for the two previous years were published, more than a third of the statistical discrepancy was reallocated to the financial account, and in particular to direct and portfolio investment.

Table 4.2

**The balance of payments of the euro area** (1)
*(billions of euros)*

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| **Current account** | **57.1** | **32.1** | **60.7** | **-1.9** | **-6.1** |
| Goods | 127.6 | 104.4 | 100.5 | 45.4 | 30.5 |
| Services | 17.8 | 22.5 | 32.6 | 34.8 | 36.6 |
| Income | -39.8 | -38.5 | -13.7 | -11.6 | 1.8 |
| Transfer | -48.5 | -56.3 | -58.6 | -70.5 | -75.0 |
| **Capital account** | **10.1** | **12.2** | **16.6** | **12.1** | **11.3** |
| **Financial account** | **-15.2** | **-0.5** | **-18.7** | **25.5** | **134.0** |
| Direct investment | 22.6 | -11.6 | -68.6 | -210.0 | -156.7 |
| Portfolio investment | 138.0 | 72.3 | 72.9 | 146.1 | 273.1 |
| Financial derivatives | -12.3 | -14.4 | -8.3 | -13.9 | -2.6 |
| Other investment | -160.9 | -74.7 | -27.2 | 85.3 | 21.7 |
| *of which: banks (2)* | *-141.5* | *-16.7* | *-14.4* | *88.0* | *-33.0* |
| Change in official reserves (3) | -2.6 | 27.8 | 12.5 | 18.0 | -1.5 |
| **Errors and omissions** | **-52.0** | **-43.8** | **-58.6** | **-35.8** | **-139.3** |

Source: ECB.
(1) The aggregate for the euro area relates to 13 countries. – (2) Monetary financial institutions, excluding the Eurosystem. – (3) A minus sign indicates an increase in reserves.

In 2006 the area's trade surplus declined from 0.6 to 0.4 per cent of GDP. The difference in the rates of increase in imports and exports in value terms (15.3 per cent and 13.5 per cent respectively) reflected the deterioration in the terms of trade, which was due largely to the rise in the prices of oil and other raw materials.

Net outflows of direct investment came to almost €157 billion, compared with €210 billion in 2005.

Net inflows of portfolio investment almost doubled to €273 billion, consolidating the growth that has been under way since 2003.

The net external debtor position of the euro area had improved slightly in 2005, but it increased again last year, amounting to the equivalent of 11.5 per cent of GDP at the end of December, compared with 10.2 per cent a year earlier. The overall deterioration of almost €153 billion was caused mainly by net inflows on the financial account (€134 billion), as price and exchange rate adjustments were minor. Because of the size of the errors and omissions item, the change in the external position differed sharply from the balance to be financed, as determined by the real components (the sum of the balances on the current and capital accounts). The official reserves of the Eurosystem increased from €320 billion in 2005 to almost €326 billion, benefiting from the revaluation of gold reserves.

## *Prices and costs*

*Consumer prices*. – In 2006 consumer price inflation in the euro area remained unchanged at 2.2 per cent, as it did in Italy.

The slowdown in energy prices offset the rise in those of unprocessed food: core inflation (measured by the change in the index excluding these two components) remained stable at 1.5 per cent (Table 4.3). Energy prices increased by 7.7 per cent, compared with 10.1 per cent in 2005, contributing 0.7 percentage points to general inflation in the area (0.9 per cent in 2005).

Table 4.3

**Inflation indicators in the major euro-area countries**
*(percentage changes on year-earlier period)*

| | Italy | | | Germany | | | France | | | Spain | | | Euro area (1) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 Q1 | 2005 | 2006 | 2007 Q1 | 2005 | 2006 | 2007 Q1 | 2005 | 2006 | 2007 Q1 | 2005 | 2006 | 2007 Q1 |
| **Consumer prices** (2) | | | | | | | | | | | | | | | |
| General index | 2.2 | 2.2 | 2.0 | 1.9 | 1.8 | 1.9 | 1.9 | 1.9 | 1.3 | 3.4 | 3.6 | 2.5 | 2.2 | 2.2 | 1.9 |
| Core inflation (3) | 2.0 | 1.8 | 1.9 | 1.0 | 0.8 | 1.7 | 1.2 | 1.3 | 1.4 | 2.7 | 3.0 | 2.7 | 1.5 | 1.5 | 1.9 |
| Processed food | 2.2 | 2.7 | 2.6 | 3.6 | 2.1 | 2.4 | -0.4 | 0.6 | 0.3 | 3.5 | 3.9 | 2.9 | 2.0 | 2.1 | 2.1 |
| Non-food and non-energy products | 1.4 | 1.2 | 1.5 | -0.4 | 0.2 | 1.2 | -0.2 | 0.2 | 0.4 | 1.0 | 1.5 | 1.1 | 0.3 | 0.6 | 1.1 |
| Services | 2.4 | 2.0 | 1.9 | 1.3 | 1.0 | 1.8 | 2.8 | 2.4 | 2.5 | 3.8 | 3.9 | 3.8 | 2.3 | 2.0 | 2.4 |
| Unprocessed food | -0.7 | 1.6 | 3.3 | 0.8 | 3.2 | 3.4 | 1.0 | 2.6 | 1.7 | 3.3 | 3.9 | 3.8 | 0.8 | 2.8 | 3.1 |
| Energy products | 8.7 | 8.0 | 2.1 | 10.3 | 8.4 | 2.4 | 9.8 | 6.4 | 0.0 | 9.7 | 8.0 | -1.1 | 10.1 | 7.7 | 1.1 |
| **Producer prices** (4) | **4.0** | **5.6** | **3.9** | **4.6** | **5.5** | **2.8** | **3.0** | **3.4** | **2.0** | **4.9** | **5.3** | **2.6** | **4.1** | **5.1** | **2.9** |
| **GDP price deflator** | **2.2** | **1.8** | | **0.6** | **0.3** | | **1.8** | **2.1** | | **4.1** | **3.8** | | **1.9** | **1.7** | |

Source: Based on Eurostat data.
(1) Weighted average of the indices for the countries belonging to the euro area at the date indicated. – (2) Harmonized index of consumer prices. – (3) Excluding unprocessed food and energy products. – (4) Producer price index for industrial products sold in the domestic market.

Price pressures generated by the cyclical upswing were attenuated by the moderation of domestic costs, which benefited from the strong recovery in industrial productivity, only part of which was assimilated into increases in unit wages. The pricing strategies of firms in the euro area were also constrained by the appreciation of the euro and the gradual move away from a stimulatory monetary policy.

Consumer price inflation remained almost stable between 2005 and 2006 in all the major countries of the area.

Since the end of the 1990s oil prices in world markets have risen considerably and have been highly volatile; the increase has been only partly offset by the appreciation of the euro against the dollar. The adjustment of petrol prices has differed between the major countries of the area; measured in terms of the harmonized index, between 1999 and

2006 prices at the pump rose by less in Italy (34 per cent) than in France (43 per cent) and Germany (53 per cent). A recent study by the Bank of Italy analysed the relationship between the behaviour of world crude prices and that of pre-tax petrol prices in the three countries on the basis of weekly data. The adjustment of petrol prices to fluctuations in oil prices over a two-month period appears to be greater in Germany and France (62 and 78 per cent respectively) than in Italy (55 per cent), where the reaction is also slower; however, such differences should be assessed in the light of the overall structure of firms' costs. In all of the countries the price of petrol reacts more strongly and rapidly to events that cause a significant change in the supply of oil (OPEC decisions, sudden reductions in supply from producing countries due to natural disasters or a heightening of geopolitical tensions). In connection with events of this kind, fuel prices in Italy are more responsive to increases than to decreases in the price of crude oil.

Despite rising more slowly of late, pre-tax petrol prices in Italy are still higher than in France and Germany, by around 12 per cent on average in 2006; the fragmentation of the fuel distribution network may be a factor in this.

The prices of goods other than food and energy accelerated in the course of the year, as past rises in raw materials prices were partly passed on to final prices at a time of strong growth in demand. In 2006 on average, however, the increase remained modest (0.6 per cent), thanks to the slowdown in domestic costs. Inflation in the services sector declined further, to 2 per cent, benefiting primarily from the fall in telephone charges and smaller increases in the cost of air transport than in 2005.

*Producer prices, costs and profit margins.* – The acceleration in producer price inflation from 4.1 per cent in 2005 to 5.1 per cent in 2006 (Table 4.4) reflected a quickening of the rise in the prices of non-energy intermediate products; the rate of increase in energy prices remained around 13.3 per cent.

The imported component of firms' costs, measured by the implicit price deflator for merchandise imports, rose by 4.4 per cent, against 3.6 per cent in 2005, reflecting mainly the more rapid increase in the prices of non-energy commodities, which in dollar terms rose on average by 30 per cent, while the price of Brent crude went up by about 20 per cent.

Despite these pressures, the rise in the producer prices of non-food and non-energy goods for final consumption declined to 0.9 per cent, thanks to the moderation of domestic costs and to the appreciation of the euro. Unit labour costs in industry fell by 1.5 per cent in the four largest countries (Table 4.4) owing to productivity gains of more than 4 per cent. In services, the slowdown in value added per employee caused the rate of increase in unit labour costs to accelerate from 1.4 per cent in 2005 to 1.7 per cent last year. In the economy as a whole the rise in unit labour costs was broadly unchanged, at around 1 per cent, as higher productivity gains offset the acceleration in labour costs per employee after the slowdown of the previous three years.

Wage restraint and productivity gains gave industrial firms in the euro area scope to increase their profit margins. According to national accounts data, profits as a share of value added in industry excluding construction rose by more than 1 percentage point to 31 per cent.

The appreciation of the euro led producers to hold down export prices despite the expansion in world demand. The increase in export prices, as measured by the rise

Table 4.4

**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) | | | |
| | 2005 | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 | 2006 |
| | | | | | **Industry excluding construction** (3) | | | | | |
| Germany | 0.6 | 2.2 | 4.7 | 6.1 | 2.9 | 5.0 | -1.7 | -1.0 | -4.0 | -3.7 |
| France | 2.0 | 3.7 | 4.4 | 4.4 | 2.0 | 2.3 | -2.3 | -1.9 | -2.4 | -0.6 |
| Italy | 2.8 | 2.7 | 0.3 | 1.2 | -1.8 | 2.5 | -2.1 | 1.3 | 2.4 | 1.4 |
| Spain | 2.8 | 3.0 | 0.4 | 3.1 | 0.7 | 3.1 | 0.3 | 0.0 | 2.4 | -0.1 |
| Euro 4 (4) | 1.3 | 2.5 | 2.8 | 4.1 | 1.4 | 3.7 | -1.4 | -0.4 | -1.5 | -1.5 |
| | | | | | **Services** (5) | | | | | |
| Germany | -0.2 | 0.2 | 0.1 | 0.4 | 0.8 | 1.8 | 0.7 | 1.3 | -0.3 | -0.2 |
| France | 2.8 | 3.2 | 0.5 | 0.9 | 1.5 | 2.1 | 1.0 | 1.1 | 2.3 | 2.3 |
| Italy | 3.5 | 2.5 | 0.5 | -0.3 | 1.0 | 1.6 | 0.5 | 1.9 | 3.0 | 2.9 |
| Spain | 2.1 | 3.5 | 0.8 | 0.1 | 4.4 | 3.6 | 3.5 | 3.4 | 1.3 | 3.3 |
| Euro 4 (4) | 1.5 | 1.9 | 0.1 | 0.2 | 1.5 | 2.1 | 1.3 | 1.8 | 1.4 | 1.7 |
| | | | | | **Total economy** | | | | | |
| Germany | -0.1 | 0.6 | 1.2 | 1.9 | 1.1 | 2.7 | -0.1 | 0.7 | -1.3 | -1.2 |
| France | 2.6 | 3.3 | 0.6 | 1.3 | 1.1 | 2.1 | 0.5 | 0.8 | 2.0 | 2.0 |
| Italy | 3.1 | 2.5 | 0.4 | 0.1 | 0.2 | 1.7 | -0.2 | 1.6 | 2.7 | 2.5 |
| Spain | 2.6 | 3.4 | 0.1 | 0.5 | 3.3 | 3.6 | 3.1 | 3.1 | 2.5 | 2.9 |
| Euro 4 (4) | 1.4 | 2.0 | 0.4 | 1.0 | 1.2 | 2.4 | 0.8 | 1.4 | 1.0 | 1.0 |

Source: Based on Eurostat data.
(1) For France, Italy and Spain, standard labour units. – (2) Chain-linked volumes. – (3) Manufacturing, mining and quarrying, and electricity generation and distribution. – (4) France, Germany, Italy and Spain. – (5) Comprises "wholesale and retail trade, transport and communications", "financial services and real-estate property" and "other services".

in their implicit price deflator, came to 2.7 per cent, practically the same as that in the domestic producer prices of non-energy goods, whereas in 2005 there had been a difference of about 0.7 percentage points.

In the services sector the more rapid rise in unit labour costs led to a slight narrowing of profit margins.

*Inflation expectations.* – The expectations of the professional forecasters surveyed by Consensus Economics with regard to inflation in the euro area in 2007, which had been revised upwards slightly in the course of 2006, settled back to just under 2 per cent in the last few months of the year. They are broadly in line with the forecasts of the major international organizations, which expect an easing of oil prices and a persistent moderation of domestic costs.

Over the longer term, inflation in the area is expected to remain stable at around 2 per cent, the same as inflation expectations implied by prices in the financial markets.

## *Employment*

Driven by the pick-up in economic activity, the growth in employment in the euro area accelerated from 0.6 per cent in 2005 to 1.4 per cent last year, equal to almost 2 million jobs.

On the basis of Eurostat data, the employment rate for the working-age population rose to 64.4 per cent, 1 percentage point higher than in the previous year; the proportion of part-time and fixed-term positions increased further. The rise in the employment rate was greatest for women (from 55.2 per cent in 2005 to 56.4 per cent) and persons aged between 55 and 64 (from 40.2 to 41.7 per cent). Despite the progress made, the labour market indicators for the euro-area countries still fall well short of the targets for 2010 set in the Lisbon Agenda, which lays down an overall employment rate of 70 per cent, a female rate of 60 per cent and one of 50 per cent for the population aged between 55 and 64.

The unemployment rate continued to fall, declining by 0.7 percentage points to 7.9 per cent, and the participation rate rose further, from 69.8 per cent in 2005 to 70.4 per cent last year.

In Germany employment began to grow again, rising by 0.7 per cent after stagnating in 2005; one factor was the increase in traditional salaried employment, which was encouraged by the cyclical upturn and the expiry of subsidies for business start-ups and part of the contribution rebates for forms of flexible employment (so-called "mini jobs"). The unemployment rate fell appreciably, from 9.5 per cent in 2005 to 8.4 per cent; the comparison with 2005 may be distorted, however, by changes in the methodology of the labour force survey that took effect in that year.

In France employment rose by 0.8 per cent in terms of standard labour units, a slightly faster increase than in the previous year. The unemployment rate fell slightly, from 9.7 to 9.4 per cent.

In Spain employment continued to grow strongly, rising by an annual average of 3.1 per cent, the same as in 2005. As in previous years, the growth was mainly in fixed-term positions, which account for about one third of total employment, despite the introduction of tax incentives last year to foster the creation of permanent jobs. The unemployment rate fell to 8.6 per cent, 0.6 points less than in 2005.

# 5. BUDGETARY POLICIES

*Budgetary policies in 2006*. – General government net borrowing in the euro area decreased for the third consecutive year, falling from 2.5 per cent of GDP in 2005 to 1.6 per cent in 2006. The improvement involved all the euro-area countries except Italy. It should be noted, however, that the two extraordinary charges on the public finances in Italy in 2006 (caused by the judgment of the European Court of Justice concerning VAT and the cancellation of the State's claims on the high-speed railway company TAV S.p.A.) contributed 0.3 percentage points to the euro-area deficit.

According to the national stability programme updates submitted in late 2005 and early 2006, the area's deficit was set to decrease by 0.2 percentage points of GDP. The public finances benefited from cyclical conditions that were more favourable than expected; above all the rate of economic growth was 2.7 per cent, compared with the 2.1 per cent indicated in the national programmes.

In Germany and Greece the deficit was brought below the 3 per cent threshold, to 1.7 and 2.6 per cent respectively; in Portugal and Italy net borrowing remained above the limit set by the Maastricht Treaty and equal to respectively 3.9 and 4.4 per cent of GDP (excluding the two extraordinary charges referred to above, the figure for Italy was 2.5 per cent).

The primary surplus of the euro area increased from 0.5 per cent of GDP in 2005 to 1.3 per cent in 2006. Interest payments were basically unchanged at 2.9 per cent. The improvement in the balance was primarily due to the increase in revenue, which rose from 45.1 to 45.8 per cent of GDP. Primary expenditure declined by 0.2 percentage points to 44.5 per cent of GDP.

For the first time since 2002 the euro-area debt declined in relation to GDP, falling from 70.5 per cent in 2005 to 69 per cent in 2006. This was the outcome of mixed results: the debt ratio remained stable in Germany, rose in Italy, Luxembourg and Portugal and declined in the other euro-area countries.

*Stability programmes*. – According to the latest stability programme updates, submitted starting from end-October 2006, net borrowing in the euro area in 2007 should decline further, from the 2.1 per cent of GDP estimated at the time for 2006 to 1.4 per cent (Table 5.1). In 2009, the last year covered by forecasts in most of the programmes, the budgetary position of the euro area should be close to balance.

On 20 April 2007 the Eurogroup finance ministers undertook to pursue more ambitious budgetary targets than those indicated in the programmes and to allocate any larger-than-expected revenues to improving the public finances. In addition, the countries that have not yet achieved the medium-term objective undertook to implement policies in 2008 that would accelerate its achievement.

*Outlook for 2007-08*. – The European Commission's recent projections indicate a fall in euro-area net borrowing from 1.6 per cent of GDP in 2006 to 1 per cent in 2007 (Table 5.1), mainly as a result of the improvement expected in the public finances of Germany and Italy. In Germany net borrowing is projected to fall by 1.1 percentage points to 0.6 per cent of GDP; in Italy it should fall from 4.4 to 2.1 per cent of GDP, chiefly owing to the disappearance of the extraordinary charges that weighed on the result for 2006. Net borrowing in France is expected to remain basically unchanged at 2.4 per cent of GDP.

**Table 5.1**

**General government net borrowing and debt: objectives and forecasts** (1)
*(as a percentage of GDP)*

| | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|
| **Net borrowing** | | | | |
| National stability programme objectives | 2.1 | 1.4 | 1.1 | 0.5 |
| Outturn and forecasts: | | | | |
| IMF | 1.6 | 1.2 | 1.1 | – |
| European Commission | 1.6 | 1.0 | 0.8 | – |
| **Debt** | | | | |
| National stability programme objectives | 69.3 | 67.7 | 66.2 | 64.3 |
| Outturn and forecasts: | | | | |
| IMF | 69.3 | 67.9 | 66.7 | – |
| European Commission | 69.0 | 66.9 | 65.0 | – |

Sources: Based on the updates to national stability programmes submitted between late 2006 and early 2007 and data published by the IMF (*World Economic Outlook*, April 2007) and the European Commission (*Spring Forecasts*, May 2007).
(1) The variables refer to the 13-country euro area.

On the assumption of unchanged policies, the Commission estimates that the deficit of the euro area for 2008 will be 0.8 per cent of GDP. In Germany the deficit would fall to 0.3 per cent, in France to 1.9 per cent, while in Italy it would remain basically unchanged. In the absence of further adjustment measures, Portugal would not meet the deadline of 2008 set by the EU Council for bringing its deficit below 3 per cent of GDP; in fact it would be 3.2 per cent.

On 16 May 2007, in light of the 2006 budget outturns and the recent forecasts for 2007 and 2008, the European Commission expressed a favourable opinion on the abrogation of the excessive deficit procedures against Germany and Greece. In January 2007 the EU Council had abrogated the procedure initiated against France in April 2003, deeming that its net borrowing had been brought below the 3 per cent threshold in a credible and lasting manner.

In the period 2006-08 Germany is expected to improve its budgetary position considerably, with a swing from deficits of more than 3 per cent of GDP (3.2 per cent in 2005) to close to balance in 2008. The adjustment would be the result of a reduction in primary current expenditure of about one percentage point per year; the revenue ratio would remain basically unchanged over the period. The Netherlands achieved a similar improvement in its budgetary position, with a swing from net borrowing equal to 3.1 per cent of GDP in 2003 to a surplus of 0.6 per cent in 2006.

Under agreements entered into at European level, the euro-area countries that have not yet achieved their medium-term budgetary objective should improve their budgetary position on a cyclically adjusted basis and excluding the effects of one-off measures by at least 0.5 percentage points of GDP per year. According to the European Commission's projections, in each of the two years 2007-08, the improvement would be less than half a percentage point in most of the countries; in 2007 it would be larger in Germany and Italy, where the improvement over the two years would be about 0.8 points.

The public debt ratio in the euro area is expected to fall by about 2 percentage points of GDP per year, from 69 per cent in 2006 to 65 per cent in 2008. In the two years 2007-08 the debt ratio would fall by more than the euro-area average in Greece (by 7.1 percentage points to 97.6 per cent), in Belgium (by 6.5 points to 82.6 per cent), in Spain (by 5.2 points to 34.6 per cent) and in Germany (by 4.3 points to 63.6 per cent). In Italy the debt would be 103.1 per cent of GDP in 2008, compared with 106.8 per cent in 2006.

*Long-term sustainability*. – In October 2006 the European Commission published a report on the "Long-term sustainability of public finances in the European Union". The report is based on estimates presented in February by the Commission and the Economic Policy Committee in the report on the possible effects of population ageing on public expenditure in the EU countries. According to these estimates, total spending on pensions, health, long-term care, education and income support for the unemployed would increase by about 4 percentage points of GDP between 2006 and 2050. The report shows that, starting from the state of the public finances in 2005 and in the absence of reforms, long-term sustainability of the public finances would require a lasting reduction in expenditure unrelated to the ageing of the population or an equivalent increase in revenue amounting, on average, to about 3.5 percentage points of GDP. In the absence of measures, the public debt in the European Union would remain close to 60 per cent of GDP until 2020 and then rise rapidly to about 200 per cent of GDP in 2050.

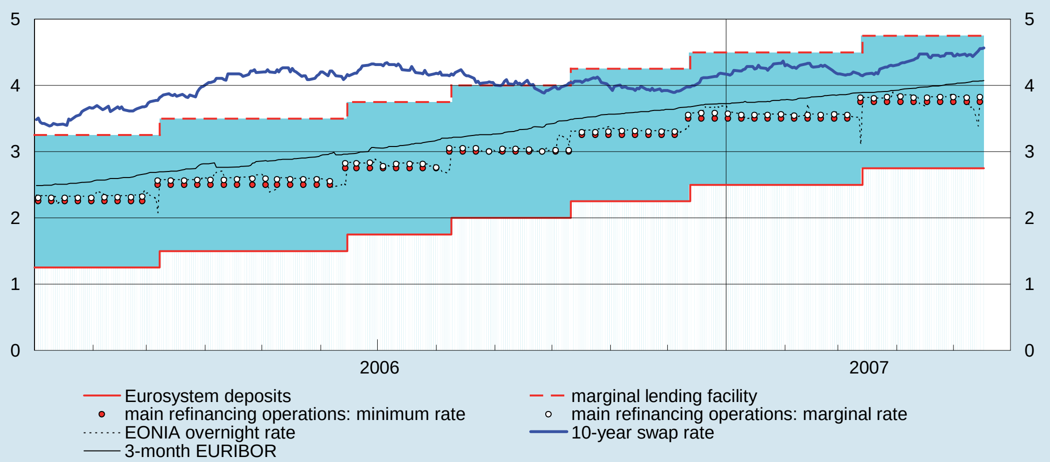
In light of these trends, the report suggests that EU countries should introduce structural reforms. On the assumption that these would allow all the European countries to reach their medium-term objective in 2010, achieving the long-term sustainability of public finances would be much less burdensome. On average it would be necessary to make a lasting adjustment of about 1.5 percentage points of GDP to expenditure or revenue. The debt would remain below 60 per cent of GDP until about 2040 and rise to about 80 per cent in 2050. Greece, Portugal and Slovenia are the euro-area countries where the sustainability of the public finances is most at risk. The Netherlands, Austria and Finland, instead, are those where the risk is least, mainly as a consequence of the pension reforms launched in the last few years.

# 6. THE COMMON MONETARY POLICY

During 2006 the Governing Council of the European Central Bank (ECB) progressively reduced the accommodation of monetary conditions from the extremely expansionary level obtaining at the end of 2005. The minimum bid rate on main refinancing operations was raised five times, by 25 basis points on each occasion; by the end of the year it stood at 3.5 per cent (Figure 6.1).

**Figure 6.1**

**Official interest rates and money and financial market rates in the euro area**
*(daily data; percentages)*




Sources: ECB, Reuters, Telerate.

The adjustment of monetary conditions followed three years in which real short-term interest rates had remained close to zero. The Governing Council's decisions met the need to counter the upside price risks and to keep medium-term inflation expectations stable, given the sharp increase in energy prices in the first half of the year, the gathering pace of the recovery in economic activity, fuelled by a strengthening of domestic demand and by the strong growth in the world economy, and the very rapid expansion of money and credit, which indicated extremely expansionary liquidity conditions.

In March 2007, when signs of a further improvement in growth prospects emerged, the Governing Council again raised the minimum bid rate on main refinancing operations by 25 basis points to 3.75 per cent.

## *Interest rates and the exchange rate of the euro*

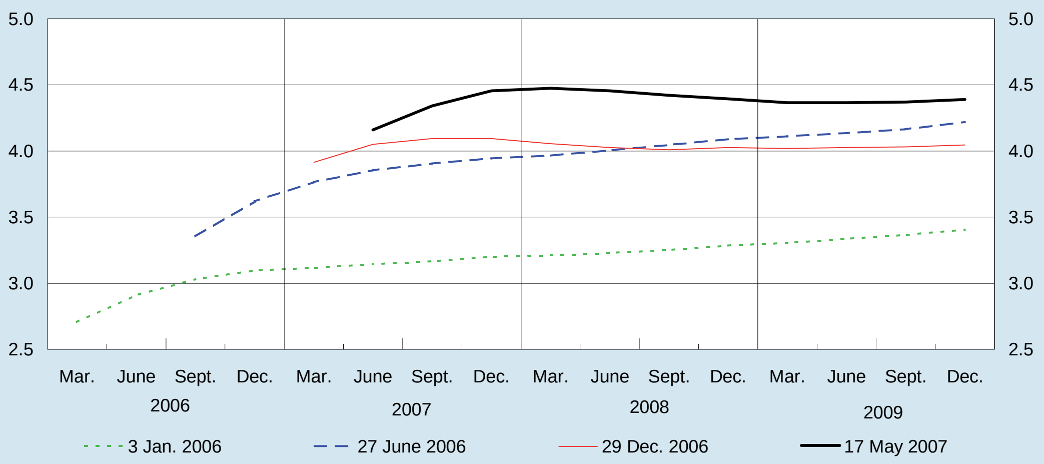
*Short-term interest rates*. – In the course of the year economic indicators confirmed that the recovery was continuing and endorsed the picture of strengthening economic activity. The macroeconomic projections by the staff of both the Eurosystem and the ECB were revised upwards. The inflation rate remained above 2 per cent until August, reflecting the increase in oil prices; there remained a danger that consumer prices would accelerate further if the rise in crude oil prices had repercussions on wages and other prices at a time of rising employment.

From the autumn onwards, the appreciation of the euro and the decline in oil prices helped bring inflation below 2 per cent.

The short-term yield curve reflected changes in expectations about official rates. It became positively sloped at the beginning of the year and shifted markedly upwards as time progressed, embodying the prospect of a gradual adjustment of monetary conditions to the improving economic climate and price pressures (Figure 6.2). Between January and December three-month interest rates rose by 1.2 percentage points to 3.7 per cent.

Figure 6.2

**Rates on 3-month EURIBOR futures contracts** (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.

In the course of the year the Governing Council of the ECB repeatedly indicated that monetary policy remained expansionary and that further withdrawal of monetary accommodation would be necessary if the economic data confirmed the outlook for growth and inflation.

The yield curve shifted upwards again in the early months of 2007, in connection with a further upward revision of expectations for growth in the area. Three-month money market rates continued to rise, reaching 4.1 per cent in mid-May.

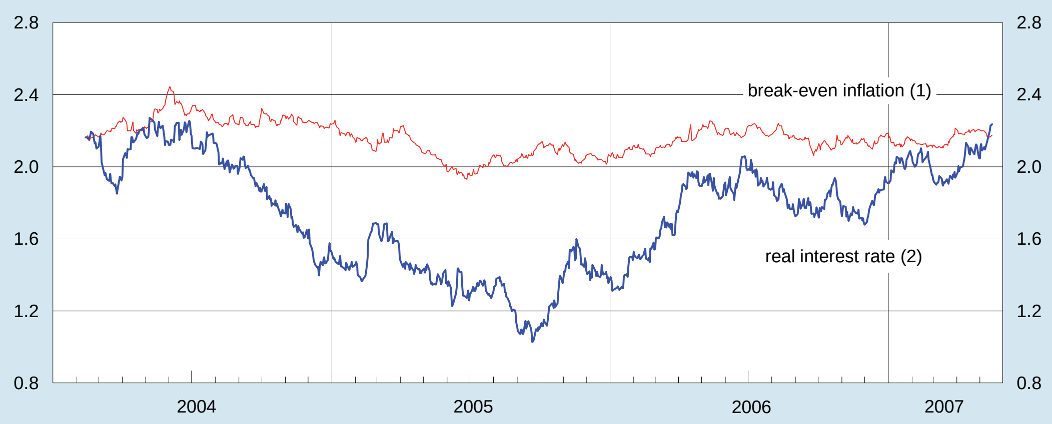
In 2006 the increase in nominal short-term interest rates was almost entirely matched by a rise in real rates, against the background of stable expectations of short-term inflation. Real interest rates, which had been virtually zero at the end of 2005, reached 1.5 per cent in December and 2 per cent in mid-May of this year. According to market expectations, they should remain just above 2 per cent for the remainder of 2007. At this level they are below the average for the last three decades in Germany.

*Long-term interest rates*. – Long-term rates gradually rose, reflecting the change in the economic climate. In the first half of 2006 the yields implied by 10-year interest rate swaps increased by 0.9 percentage points to 4.3 per cent as growth forecasts for the area improved; they then fluctuated around the 4 per cent level from the summer onwards following the publication of conflicting data on the outlook for the world economy. In December they rose again to 4.2 per cent.

The rise in nominal long-term rates was triggered by an increase in real rates, whereas inflation expectations remained broadly unchanged. The yield implied by the prices of Italian government securities indexed to consumer prices in the euro area and maturing in 2014 rose by 0.6 percentage points during the year to 1.9 per cent (Figure 6.3). Long-term inflation expectations implied by the same prices (break-even inflation) rose by only 0.1 point to 2.2 per cent, a rate slightly above the definition of price stability adopted by the ECB but one that probably incorporates a risk premium.

**Figure 6.3**

**Break-even inflation and the real long-term 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.

Nominal and real long-term interest rates continued to rise in the first part of 2007 in conjunction with a further improvement in the area's growth prospects.

*The exchange rate of the euro*. – In 2006 the euro appreciated by 4.5 per cent in nominal effective terms, reflecting mainly the strengthening of the currency against the US dollar (11.6 per cent) and the yen (13 per cent) and a slight depreciation against sterling (1.9 per cent). The appreciation against the dollar took place at a time when the US currency was generally weak, although it was also due partly to the steady improvement in the area's growth prospects and the change in market expectations about the monetary policy stance in the two economies.

The euro continued to strengthen in early 2007. Between the beginning of the year and mid-May it appreciated against the dollar, the yen and sterling by 2.7, 3.8 and 1.4 per cent respectively and by 1.5 per cent in nominal effective terms. At the end of April its exchange rate against the dollar reached a peak of \$1.36. The reduction in the interest rate differential between the euro area and the United States contributed to the strengthening of the single currency against the dollar.

## *Money and credit*

In 2006 the behaviour of the monetary and credit aggregates continued to signal expansionary liquidity conditions. The M3 money supply expanded very rapidly; at the end of the year the twelve-month rate of increase was 9.8 per cent, the highest rate since the launch of the common monetary policy. The acceleration continued in the first few months of 2007.

Although the raising of official rates did not affect the rate of growth of M3, it did have a significant effect on its composition. The expansion in the more liquid instruments, which are held for transaction purposes, slowed down sharply: the annual growth rate in M1, which includes notes and coin in circulation and overnight deposits, was 7.4 per cent, some 4 percentage points less than a year earlier. The acceleration in M3 is attributable entirely to those components for which demand responds to portfolio considerations; M2 grew by 9.3 per cent, and marketable instruments (such as units in money market funds, short-term bank bonds and repos) increased by 12.9 per cent, around 12 points more than in the previous year. The adjustment in the composition of the money supply towards less liquid components reflected changes in rates of return, especially the rise in short-term rates, which made overnight deposits less attractive, and the narrowing of the differential in relation to long-term yields due to the continuing low level of the latter, which made it more attractive to hold short-term market instruments than long-term ones.

A Divisia monetary index, calculated by weighting the components of M3 according to their degree of liquidity (measured in inverse ratio to yield), indicates that money continued to expand strongly in the first quarter of 2007, by around 8 per cent, albeit less rapidly than in 2006, whereas the growth in M3 accelerated rapidly.

Lending to the private sector accelerated last year, to a 12-month rate of growth of 10.8 per cent in December. A strong acceleration in lending to firms, which increased by 13 per cent, contrasted with a slowdown in lending to households; loans to finance house purchases slowed the most, but still recorded a robust increase of 8.2 per cent.

The results of the Eurosystem's quarterly Bank Lending Survey indicate that in a context of continuing easy financing conditions the strengthening of economic activity was reflected in growing demand for corporate loans to finance fixed investment and working capital. A not inconsiderable part of corporate demand for credit stemmed from special financial operations, in particular mergers and acquisitions. In the household sector, the increase in mortgage interest rates and the slowdown in the property markets of some euro-area countries led to a pronounced softening of demand for loans to finance house purchases.

## *Monetary policy operations*

The average daily liquidity provided by the Eurosystem via main refinancing operations increased to €307 billion in 2006 owing to strong demand for notes and coin in circulation. The number of banks participating in the auctions rose from an average of 351 in 2005 to 377 in 2006, while the ratio between bid amounts and allotments declined slightly to an average of 1.22. The proportion of the total funds allotted to Italian banks fell from 6.7 per cent in 2005 to 5.7 per cent; on average, 18 Italian banks participated in the auctions. The daily average of excess bank reserves remained very low (0.43 per cent of minimum reserve requirements), indicating efficient liquidity management by banks and the absence of significant segmentation of the money market.

The differential between the EONIA interest rate and the minimum bid rate for main refinancing operations set by the Governing Council of the ECB was small, around 8 basis points, thus contributing to the appropriate transmission of monetary policy signals to the market.

In accordance with a decision taken on 16 December 2005, the ECB increased the amounts offered in each longer-term refinancing operation from €30 billion to €40 billion. The average volume of liquidity injected into the market by means of these operations rose appreciably, from €88 billion in 2005 to €116 billion; so too did the number of banks participating in the auctions, which increased from 151 in 2005 to 162. Last December the ECB decided to increase the amount offered in such operations further to €50 billion to meet the greater demand for liquidity in connection with the strong growth in the volume of banknotes and coin held by the public.

# THE ITALIAN ECONOMY

# 7. DEMAND, SUPPLY AND PRICES

Strong world demand, and in particular the cyclical upturn in the euro area, generated a resumption in growth in the Italian economy in 2006 that was more rapid than expected (1.9 per cent; Table 7.1) and higher than the economy's potential, which the leading international institutions estimate to be around 1.5 per cent.

The easing of pressures in the oil market, the moderation of domestic unit costs owing to an improvement in labour productivity in industry, and the gradual return towards a neutral monetary policy stance made it possible to hold inflation down to little more than 2 per cent.

Table 7.1

**Resources and uses of income**

| | As a percentage of GDP in 2006 (volumes at previous-year prices) | 2005 | | | 2006 | | |
|---|---|---|---|---|---|---|---|
| | | Percentage changes | | Contribution to GDP growth (chain-linked volumes) | Percentage changes | | Contribution to GDP growth (chain-linked volumes) |
| | | Chain-linked volumes | Deflators | | Chain-linked volumes | Deflators | |
| **Resources** | | | | | | | |
| GDP | – | 0.1 | 2.3 | – | 1.9 | 1.8 | – |
| Imports of goods *fob* and services (1) | 26.7 | 0.5 | 7.9 | -0.1 | 4.3 | 9.1 | -1.1 |
| *of which: goods* | *21.3* | *-0.7* | *9.0* | *0.1* | *3.4* | *10.5* | *-0.7* |
| **Uses** | | | | | | | |
| National demand | – | 0.3 | 2.8 | 0.3 | 1.6 | 2.8 | 1.6 |
| Consumption of resident households | 58.4 | 0.6 | 2.4 | 0.4 | 1.5 | 2.7 | 0.9 |
| Consumption of general government and non-profit institutions serving households | 20.4 | 1.5 | 3.6 | 0.3 | -0.3 | 3.4 | -0.1 |
| Gross fixed capital formation | 20.7 | -0.5 | 3.1 | -0.1 | 2.3 | 2.4 | 0.5 |
| *machinery, equipment and transport equipment* | *10.1* | *-1.0* | *2.3* | *-0.1* | *2.2* | *2.2* | *0.2* |
| *intangible assets* | *0.9* | *-2.9* | *3.6* | *..* | *7.0* | *- 2.5* | *0.1* |
| *construction* | *9.7* | *0.3* | *3.9* | *..* | *2.1* | *3.1* | *0.2* |
| Change in stocks and valuables (2) | – | – | – | -0.2 | – | – | 0.3 |
| Exports of goods *fob* and services (3) | 26.9 | -0.5 | 5.6 | -0.1 | 5.3 | 5.3 | 1.4 |
| *of which: goods* | *21.5* | *-1.2* | *6.3* | *-0.2* | *4.4* | *6.1* | *0.9* |
| Net exports | – | – | – | -0.3 | – | – | 0.3 |

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

The expansion that began in the second half of 2005 was driven by exports and investment, which in turn were helped by continuing favourable credit conditions and rising business confidence. Exports were stimulated by the quickening of demand in our main export markets, first and foremost Germany. This had a knock-on effect on investment. The strong growth in exports merely attenuated the long crisis for Italian exporters, which is reflected in a substantial and enduring erosion of market share. The adjustments that are beginning to occur in the structure of industry to cope with changed competitive conditions in the world economy may have played some part in the recovery in exports.

Despite real disposable income remaining static, consumption grew rapidly, thanks to the increase in households' wealth and presumably a weakening of the precautionary saving motive. Spending may have been boosted by the closing of the gap between actual inflation and consumers' perception of inflation, which had widened considerably after the changeover from the lira to the euro in 2002.

The present situation is similar in nature to that of the preceding expansion from 1998 to 2000, although then the acceleration in activity was more vigorous thanks to the improvement in price competitiveness, greater budgetary stimulus and a reduction in interest rates in the run-up to Italy's entry to the euro area.

### *Household consumption*

Having increased very little in the previous four years, the consumption of resident households rose by 1.5 per cent in real terms in 2006 (Table 7.1); this was nevertheless below the average rate of growth recorded in the upswing of 1998-2000.

The pick-up in consumer spending owed nothing to the behaviour of consumer households' gross disposable income, which appears to have stagnated in real terms for the second year in succession (Table 7.2). In view of the substantial revisions to the official statistics on income for 2004 and 2005, it would be unwise to consider the figure for 2006 as final. After adjustment for the smaller monetary erosion of net financial assets due to the reduction in expected inflation, purchasing power probably increased by half a percentage point in 2006.

General government measures cut the growth in consumer households' nominal disposable income by 1.1 percentage points, almost twice as much as in 2005. The increase of 4.8 per cent in expenditure on social benefits offset only part of the surge of 4.4 per cent in social security contributions and, above all, that of 8.9 per cent in current taxation on income and capital, which had risen by an average of 1.9 per cent over the preceding five years.

Income from self-employment stagnated, after having fallen sharply in 2005. The slight recovery in the number of standard self-employed labour units (0.7 per cent, compared with a fall of 4.1 per cent the previous year) was almost completely wiped out by a fall of 0.5 per cent in per capita incomes. By contrast, total employee compensation rose by 5 per cent, contributing 2 percentage points to the growth in nominal disposable income, thanks to a simultaneous increase in the number of standard employee labour units and in unit wages.

Table 7.2

**Gross disposable income and propensity to save in Italy**
*(at current prices, unless otherwise indicated)*

| | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|
| | *Percentage changes* | | | |
| Earnings net of social contributions charged to workers | 3.5 | 4.1 | 4.7 | 5.0 |
| *Income from salaried employment per standard labour unit* | *3.7* | *3.5* | *3.0* | *2.6* |
| *Total social contributions* (1) | *-0.3* | *0.3* | *0.1* | *0.4* |
| *Standard employee labour units* | *0.2* | *0.3* | *1.5* | *2.0* |
| Income from self-employment net of social contributions (2) | 3.1 | 2.1 | -3.7 | -0.8 |
| *Income from self-employment per standard labour unit* | *1.5* | *2.3* | *1.5* | *-0.5* |
| *Total social contributions* (1) | *..* | *-0.8* | *-1.1* | *-1.0* |
| *Standard self-employed labour units* | *1.6* | *0.5* | *-4.1* | *0.7* |
| Net property income (3) | -2.0 | 3.8 | 3.9 | 4.5 |
| Social benefits and other net transfers | 5.4 | 3.1 | 3.1 | 4.0 |
| *of which: net social benefits* | *5.6* | *3.6* | *3.2* | *4.8* |
| Current taxes on income and wealth (–) | 1.2 | 3.1 | 2.9 | 8.9 |
| **Households' gross disposable income** (4) | **2.9** | **3.4** | **2.3** | **2.7** |
| at chain-linked prices (5) | 0.1 | 0.8 | .. | .. |
| at chain-linked prices, adjusted for expected inflation (6) | 0.6 | 0.9 | -0.3 | 0.5 |
| at chain-linked prices, adjusted for past inflation (7) | 0.5 | 1.3 | -0.1 | 0.3 |
| **Private sector gross disposable income** | **3.8** | **3.7** | **1.9** | **1.4** |
| at chain-linked prices (5) | 1.0 | 1.0 | -0.5 | -1.2 |
| at chain-linked prices, adjusted for expected inflation (6) | 1.4 | 0.9 | -0.8 | -0.9 |
| at chain-linked prices, adjusted for past inflation (7) | 1.3 | 1.2 | -0.6 | -1.2 |
| | *Percentages* | | | |
| **Households' average propensity to save** (4) (8) | **12.8** | **12.9** | **12.3** | **11.0** |
| calculated on income adjusted for expected inflation | 10.5 | 10.7 | 9.9 | 9.1 |
| calculated on income adjusted for past inflation | 9.9 | 10.4 | 9.8 | 8.8 |
| **Private sector average propensity to save** (8) | **25.9** | **26.1** | **25.3** | **23.2** |
| calculated on income adjusted for expected inflation | 26.4 | 26.6 | 25.9 | 23.7 |
| calculated on income adjusted for past inflation | 26.5 | 26.7 | 25.9 | 23.8 |

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

The growth in net property income accelerated to 4.5 per cent, to which a number of factors contributed, including a further rise in the rate of growth of gross operating profit to 5.4 per cent, boosted by an increase in lease rentals, and an increase of 6.5 per cent in households' net interest receipts. The latter reflects an increase in interest income, as the growth in the stock of households' financial wealth and the rise in interest rates during the year halted the fall that had begun in 2002. At the same time, interest expenses increased further owing to the costs associated with the continuing expansion in debt for the purchase of houses and consumer goods and the appreciable rise in interest rates. Italian households' recourse to consumer credit is growing, encouraged by financial innovation, but it is still lower than in other developed countries. Households' receipts of dividends and other profits distributed by companies increased overall by 1.8 per cent, markedly less than in 2005.

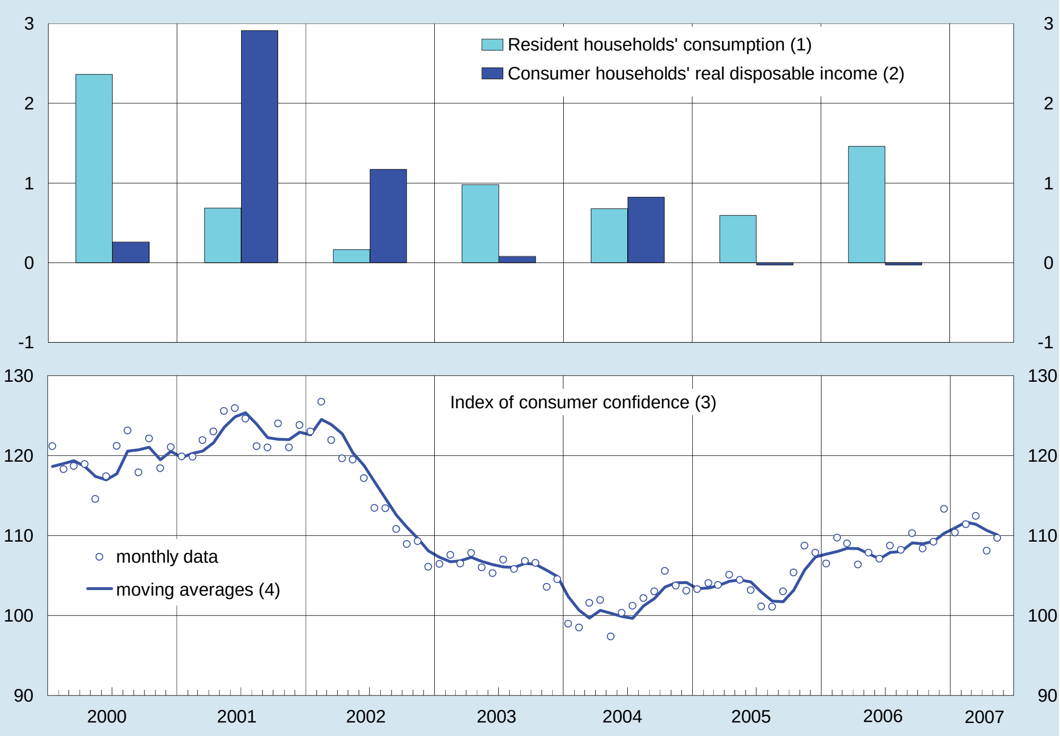
Households' propensity to save fell by 1.3 percentage points to 11 per cent, the lowest level since 2000 but still high by comparison with the other advanced economies; measured in relation to income adjusted for expected monetary erosion, the propensity to save was 9.1 per cent, compared with 9.9 per cent in 2005. Additions to the stock of savings, net of the change in pension fund reserves, amounted to €108 billion at current prices, 8.2 per cent less than in 2005; together with the revaluation of financial and real assets, net new saving continued to boost the accumulation of household wealth.

Consumption may have benefited from this, and also from the gradual reduction in uncertainty that weighed upon household behaviour in the recent past, indicated by the slow but steady improvement in confidence (Figure 7.1).

In 2006 the gross disposable income of the private sector (households and firms) increased by 1.4 per cent in nominal terms but fell by 1.2 per cent in real terms, compared with a decline of 0.5 per cent the previous year (Table 7.2). The propensity to save of the sector as a whole was 23.2 per cent, more than two percentage points less than in 2005.

Figure 7.1

**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, divided by the deflator of resident households' consumption. – (3) Indices, 1980=100; seasonally adjusted data. – (4) For the three months ending in the reference month.

Savings formation for the entire economy, measured in relation to national income, nevertheless remained essentially on a par with the results for the previous year, thanks to an improvement in the current account of general government.

## *Investment*

Gross fixed investment increased by 2.3 per cent in 2006, after having declined slightly the previous year. The recovery occurred both in construction and in plant and equipment, especially the latter; it was particularly strong in transport equipment and intangible assets, where it made up for the contraction of 2005, and in residential building (Table 7.3). The ratio of investment to GDP remained virtually unchanged.

Table 7.3

**Fixed investment in Italy**

*(chain-linked volumes, unless otherwise indicated; percentage changes and percentages)*

| | % composition in 2006 (volumes at previous-year prices) | Percentage change | | | As a percentage of GDP (1) (volumes at previous-year prices) | |
|---|---|---|---|---|---|---|
| | | 2004 | 2005 | 2006 | 2003 | 2006 |
| Construction | 47.2 | 1.5 | 0.3 | 2.1 | 9.3 | 9.7 |
| *residential* | *21.1* | *2.3* | *5.3* | *4.0* | *3.9* | *4.4* |
| *other* | *26.1* | *0.9* | *-3.2* | *0.5* | *5.4* | *5.4* |
| Machinery and equipment | 39.3 | 2.7 | -0.4 | 1.8 | 8.3 | 8.1 |
| Transport equipment | 9.3 | 2.1 | -3.5 | 3.7 | 2.0 | 1.9 |
| Intangible assets | 4.2 | -6.7 | -2.9 | 7.0 | 0.9 | 0.9 |
| **Total gross fixed investment** | **100** | **1.6** | **-0.5** | **2.3** | **20.6** | **20.7** |
| Total excluding residential buildings | – | 1.5 | -1.9 | 2.0 | 16.7 | 16.3 |
| Total excluding construction | – | 1.8 | -1.2 | 2.7 | 11.2 | 10.9 |
| **Total net fixed investment** (2) | **–** | **..** | **-7.4** | **3.6** | **5.3** | **5.0** |

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

In keeping with the cyclical recovery, the plant utilization rate rose, but without reaching the levels recorded at the peak of previous cycles. The rise boosted expenditure on plant and equipment, which is now directed mainly towards expanding installed capacity, as suggested by indications from the survey coordinated by the European Commission.

Investment in construction grew by 2.1 per cent, a far more rapid increase than in 2005 (0.3 per cent). Investment in housing, which had shown exceptional strength in 2005, was again more vigorous, posting an increase of 4 per cent, almost twice as large as that for the sector as a whole. By contrast, non-residential construction remained weak, rising by 0.5 per cent after having contracted by more than 3 per cent the previous year. Property sales continued to rise, as in the previous two years, but at only a modest rate of 1.3 per cent. However, the annual figure masks a substantial slowdown in the second half of the year, with all sectors recording a fall in relation to the corresponding period of 2005, albeit a less marked one in the case of residential construction. The deterioration in lending conditions during 2006, after three years in which they had remained favourable, points to a fall in sales in 2007.

According to a survey carried out at the beginning of this year by the branches of the Bank of Italy, in which 4,252 firms with 20 or more employees in industry excluding construction and in the private non-financial services sector were interviewed, investment by such firms increased by 1.1 per cent in real terms in 2006 (Tables 7.4 and 7.5). The outturn is better than the plans made at the beginning of the year. Expenditure on plant and equipment increased more than expected in the service sector and decreased less than initially forecast by industrial firms.

Table 7.4

**Gross fixed investment of the firms in the Bank of Italy sample according to size, capacity utilization and change in turnover**
*(percentage changes at 2006 prices, unless otherwise indicated)* (1)

| | Total | Number of employees | | | | Capacity utilization (2) (3) | | Change in turnover (2) | |
|---|---|---|---|---|---|---|---|---|---|
| | | 20 to 49 | 50 to 199 | 200 to 499 | 500 or more | High | Low | High | Low |
| **Industry excluding construction** | | | | | | | | | |
| *of which: Manufacturing* | | | | | | | | | |
| *realized investment in 2006* | *-1.4* | *-3.5* | *1.4* | *-2.7* | *-1.3* | *2.4* | *-3.9* | *3.1* | *-6.3* |
| *realization rate* (4) | *103.9* | *110.7* | *105.5* | *100.8* | *99.1* | *102.2* | *101.1* | *106.8* | *100.5* |
| *plans for 2007* | *-0.5* | *-1.6* | *-3.0* | *2.3* | *1.2* | *-2.3* | *2.5* | *0.8* | *-2.1* |
| Realized investment in 2006 | -2.5 | -2.9 | 1.4 | -2.8 | -4.2 | 2.7 | -7.0 | -0.6 | -5.1 |
| Realization rate (4) | 102.8 | 109.6 | 104.9 | 99.9 | 99.4 | 101.2 | 100.9 | 105.0 | 99.8 |
| Plans for 2007 | 7.2 | -1.8 | -1.9 | 3.2 | 18.4 | 4.8 | 14.7 | 11.5 | 1.0 |
| **Services** (5) | | | | | | | | | |
| Realized investment in 2006 | 5.4 | 4.6 | 5.3 | 1.0 | 7.0 | …. | …. | 9.4 | 2.7 |
| Plans for 2007 | -2.3 | -10.1 | -11.8 | -2.0 | 4.6 | …. | …. | -3.7 | -1.4 |
| **Total** | | | | | | | | | |
| Realized investment in 2006 | 1.1 | 0.6 | 3.1 | -1.3 | 1.2 | 2.7 | -7.0 | 3.1 | -0.8 |
| Plans for 2007 | 2.5 | -6.0 | -6.1 | 1.1 | 11.1 | 4.8 | 14.7 | 5.4 | -0.4 |

Source: Banca d'Italia, *Indagini sulle imprese industriali e dei servizi*.
(1) Robust (Winsorized) means obtained by adjusting both positive and negative extreme values of the distribution of annual changes in investment according to the 5th and 95th percentiles; the method takes account of the sampling fractions in each stratum of the sample (Winsorized Type II Estimator). The investment deflator was estimated by the firms interviewed. – (2) The firms are distributed according to whether they are above (high) or below (low) the median value calculated separately for industry and services with reference to 2006. – (3) With reference only to industrial firms with 50 employees or more. – (4) Realized investment as a percentage of investment planned at the end of 2005 for 2006, both at current prices. – (5) Private sector non-financial services.

The investment plans of the firms surveyed suggest a real increase of 2.5 per cent in expenditure in 2007, attributable essentially to the energy sector and mining and quarrying, with spending broadly unchanged in manufacturing and falling in the service sector.

Table 7.5

**Gross fixed investment of the firms in the Bank of Italy sample according to proportion of turnover exported and administrative headquarters**
*(percentage changes at 2006 prices, unless otherwise indicated)* (1)

| | Total | Proportion of turnover exported | | | | Administrative headquarters (2) | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | 0 | 0 - 1/3 | 1/3 - 2/3 | More than 2/3 | North-West | North-East | Centre | South and Islands |
| **Industry excluding construction** | | | | | | | | | |
| *of which: Manufacturing* | | | | | | | | | |
| *realized investment in 2006* | *-1.4* | *-2.2* | *-4.2* | *-0.1* | *3.6* | *-1.2* (*-0.4)* | *-1.8* *(-1.7)* | *-0.9* *(-0.9)* | *-1.7* *(-4.9)* |
| *realization rate* (3) | *103.9* | *108.1* | *103.9* | *103.0* | *103.2* | *102.3* | *104.5* | *106.6* | *106.9* |
| *plans for 2007* | *-0.5* | *-6.2* | *-0.5* | *-1.2* | *3.2* | *0.3* *(3.5)* | *0.2* *(3.9)* | *-3.9* *(-4.0)* | *-2.4* *(-9.1)* |
| Realized investment in 2006 | -2.5 | -5.6 | -4.4 | -0.1 | 3.6 | -2.4 (-2.8) | -2.0 (-2.9) | -4.0 (-1.2) | -0.6 (-3.3) |
| Realization rate (3) | 102.8 | 102.7 | 103.1 | 102.2 | 103.3 | 101.0 | 103.8 | 104.2 | 106.0 |
| Plans for 2007 | 7.2 | 23.8 | 0.0 | 3.2 | 3.1 | 3.5 (8.9) | 2.9 (9.3) | 22.8 (13.8) | -1.5 (1.0) |
| **Services** (4) | | | | | | | | | |
| Realized investment in 2006 (5) | 5.4 | 2.7 | 3.5 | | | 16.4 (20.9) | -1.7 (-0.8) | 0.7 (0.9) | 1.8 (0.6) |
| Plans for 2007 (5) | -2.3 | -2.7 | -0.7 | | | -2.9 (-6.9) | -3.9 (-1.3) | 0.9 (2.4) | -6.0 (-4.8) |
| **Total** | | | | | | | | | |
| Realized investment in 2006 | 1.1 | -0.3 | -1.2 | 7.9 | 1.3 | 4.6 (7.5) | -1.9 (-2.1) | -1.3 (-0.1) | 0.9 (-1.3) |
| Plans for 2007 | 2.5 | 6.4 | -0.3 | 1.2 | 0.3 | 0.5 (0.6) | 0.4 (5.3) | 10.4 (7.6) | -4.3 (-2.0) |

Source: Banca d'Italia, *Indagini sulle imprese industriali e dei servizi*.
(1) Robust (Winsorized) means obtained by adjusting both positive and negative extreme values of the distribution of annual changes in investment according to the 5th and 95th percentiles; the method takes account of the sampling fractions in each stratum of the sample (Winsorized Type II Estimator). The investment deflator was estimated by the firms interviewed. – (2) Data in brackets relate to actual location. – (3) Realized investment as a percentage of investment planned at the end of 2005 for 2006, both at current prices. – (4) Private sector non-financial services. – (5) For firms exporting more than one third of their turnover the size of the sample does not permit significant estimates to be made.

## *Exports and imports*

*Exports*. – According to the national accounts, exports of goods and services increased by 5.3 per cent in real terms last year (Table 7.1), the best result since the peak of the cycle in 2000.

Foreign trade data show that merchandise exports grew again, by 3.6 per cent after having contracted by 0.9 per cent in 2005. Italian goods benefited mainly from the recovery in the euro area, which takes about 45 per cent of Italian exports, and in Germany, our main export market (Table 7.6).

Whereas world demand expanded strongly and the euro appreciated by more than 1 per cent in real effective terms during the year (Figure 4.1), Italy's share of world markets declined further at both current and constant prices. According to preliminary data, it fell from an annual average of 3.7 per cent in 2005 to 3.5 per

Table 7.6

**Exports and imports *cif-fob* by main countries and areas: values and indices of average unit values (AUVs) and volumes** (1)

*(percentage composition in the year and percentage changes on previous years; indices, 2000=100)*

| | Exports | | | | | | Imports | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2005 | | | 2006 | | | 2005 | | | 2006 | | |
| | % comp. of values | % change in AUVs | % change in volumes | % comp. of values | % change in AUVs | % change in volumes (2) | % comp. of values | % change in AUVs | % change in volumes | % comp. of values | % change in AUVs | % change in volumes (2) |
| **EU-25 countries** | **59.3** | **5.1** | **-1.1** | **58.7** | **4.9** | **4.4** | **57.7** | **4.9** | **-1.0** | **55.6** | **6.6** | **2.5** |
| EU-15 countries | 53.3 | 4.8 | -1.1 | 52.4 | 4.7 | 3.7 | 53.4 | 4.8 | -2.1 | 50.9 | 6.4 | 1.5 |
| *France* | *12.3* | *5.4* | *-1.0* | *11.8* | *2.5* | *3.6* | *10.0* | *4.5* | *-5.5* | *9.2* | *4.6* | *0.1* |
| *Germany* | *13.2* | *2.8* | *-0.9* | *13.3* | *4.8* | *6.0* | *17.3* | *3.6* | *0.9* | *16.8* | *5.1* | *4.4* |
| *Spain* | *7.5* | *6.1* | *2.2* | *7.3* | *5.5* | *1.9* | *4.3* | *6.8* | *-7.2* | *4.1* | *7.1* | *3.0* |
| *United Kingdom* | *6.6* | *3.8* | *-6.1* | *6.1* | *6.7* | *-3.9* | *4.0* | *4.6* | *-3.0* | *3.6* | *12.3* | *-10.6* |
| Other EU-25 countries (3) | 5.9 | 8.0 | -0.6 | 6.3 | 6.5 | 10.0 | 4.3 | 5.3 | 14.9 | 4.8 | 10.0 | 14.4 |
| ***Non-EU countries*** | **40.7** | **8.1** | **-0.9** | **41.3** | **9.3** | **2.5** | **42.3** | **14.5** | **1.0** | **44.4** | **15.5** | **3.1** |
| China | *1.5* | *10.1* | *-5.7* | *1.7* | *12.0* | *10.3* | *4.6* | *1.9* | *17.5* | *5.1* | *10.5* | *15.1* |
| *DAEs* (4) | *3.0* | *7.6* | *-6.0* | *3.0* | *9.4* | *-1.3* | *2.7* | *4.0* | *6.3* | *2.5* | *4.5* | *0.5* |
| *Japan* | *1.5* | *7.9* | *-3.0* | *1.4* | *5.4* | *-6.1* | *1.6* | *1.1* | *-10.8* | *1.6* | *1.3* | *8.2* |
| *Russia* | *2.0* | *6.0* | *15.5* | *2.3* | *6.9* | *17.7* | *3.8* | *28.5* | *-6.0* | *3.9* | *30.1* | *-11.2* |
| *United States* | *8.0* | *10.2* | *-3.3* | *7.5* | *9.5* | *-5.8* | *3.5* | *9.2* | *-1.8* | *3.1* | *11.5* | *-9.6* |
| **Total** | **100.0** | **6.3** | **-0.9** | **100.0** | **6.6** | **3.6** | **100.0** | **8.7** | **-0.1** | **100.0** | **10.5** | **2.7** |

Source: Based on Istat data.
(1) The values for EU countries and the total are calculated on the basis of data corrected for the estimate of transactions measured annually and taking account, in view of past experience, of delays in submitting customs returns. – (2) For EU countries and the total, changes in volumes for 2006 are calculated on the basis of data deflated for AUVs. – (3) Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. – (4) Dynamic Asian economies: Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand.

cent last year at current prices and exchange rates, and from 2.7 to 2.5 per cent at constant 1995 prices and exchange rates. As in the past, the main European countries outperformed Italy in terms of market shares at constant prices and exchange rates; in particular, Germany's share increased further to 12 per cent (11.8 per cent in 2005). Market shares at constant prices and exchange rates suffer, especially in the case of Italy, from the difficulty of measuring the average unit values of exports, which are used to deflate current values. On the basis of the Bank of Italy's annual survey of a sample of Italian manufacturing companies with 50 employees or more, in which price variations according to destination market are recorded, it has been estimated that on average over the period from 1996 to 2005 export prices rose by about 2 percentage points per year less than the average unit values calculated by Istat. In the light of this finding, Italy's market share at constant prices and exchange rates fell by 30 per cent between 1996 and 2005, and not by the 40 per cent arrived at on the basis of average unit values. The correction does not negate the conclusions about Italy's loss of competitiveness in relation to France, which lost only 15 per cent of its market share over the same period, and Germany, whose share rose slightly, but it does affect the size of the change.

The most dynamic export sectors were those producing capital goods, in particular mechanical machinery and equipment, and electrical equipment and precision instruments; exports of metal products and transport equipment also increased strongly. By contrast, export performance in the traditional sectors in which a significant share of Italian production is still concentrated was weak. This was accompanied by a large increase in average unit values; as noted above, this may reflect problems of statistical measurement, qualitative shifts towards market segments with higher unit prices or pricing policies aimed at discriminating between export markets and maximizing margins rather than sales volumes. Moreover, these sectors are witnessing intensive international outsourcing of production.

*Imports*. – On the basis of national accounts data, imports of goods and services grew by 4.3 per cent in real terms in 2006 (Table 7.1), driven by the recovery in domestic demand and exports. Foreign trade as a whole contributed 0.3 percentage points to GDP growth.

Merchandise imports alone, measured according to trade statistics, grew less strongly, by 2.7 per cent (Table 7.6). As in previous cyclical recoveries, the largest increases were in imports of intermediate goods for industrial processing. In the textile and clothing sector, and in leather products and footwear, where domestic production stagnated, there were large increases in the volume of imports. Flows of goods from China increased by 15.1 per cent and now account for more than 5 per cent of total imports; in Italy's traditional sectors, products from China already account for 20 per cent of Italian imports.

## *Supply*

The growth of almost 2 per cent in GDP in 2006 was the best result since the peak of the cycle in 2000. In contrast to the previous upswing from 1998 to 2000, Italy still lags behind the other euro-area countries, albeit by only a small margin. The expansion was considerably larger than had been expected by the main forecasting bodies, which had predicted growth of little more than 1 per cent at the beginning of 2006. The disparity is attributable largely to the underestimation of the expansion in the German economy.

Value added at factor cost in the economy as a whole increased by 1.7 per cent, after remaining more or less static in 2005. The improvement was driven mainly by a strong recovery in manufacturing industry, where the increase of 3.8 per cent more than made up for the fall of the previous year. Within that sector, traditional activities continued to decline, although more slowly; value added in textiles and clothing contracted by 3.3 per cent and in hides and leather products by 1.4 per cent, whereas in 2005 they had suffered decreases of 8.7 per cent and 4.7 per cent respectively. On the other hand, value added in branches producing electrical machinery and transport equipment, which had fallen in the previous year, increased at a far higher rate than the average for manufacturing industry.

In the first quarter of this year industrial production fell by an average of almost 1 per cent; according to preliminary estimates from Istat, GDP growth fell back to 0.2 per cent, compared with 1.1 per cent in the fourth quarter of 2006 (Table 4.1). In the light of the recovery in both domestic and foreign orders in more recent months, the weakening of industrial activity should be only temporary.

## *Prices and costs*

*Consumer prices.* – Consumer price inflation in Italy, as measured by the general consumer price index, rose to an average of 2.1 per cent in 2006, compared with 1.9 per cent in 2005 (Table 7.7). For the second year in succession the variation in the harmonized index was the same as that for the euro area as a whole (2.2 per cent).

The slight rise in inflation was due mainly to increases in the food prices, which rose by 1.7 per cent, whereas in 2005 they had remained essentially unchanged. The acceleration in the prices of regulated energy products, which increased by an average of 10.5 per cent compared with 6.1 per cent the previous year, was offset by a fall in unregulated energy prices.

Table 7.7

**Consumer prices** (1)

| | Percentage changes on year-earlier period | | Percentage weights | Contributions to average inflation (percentage points) |
|---|---|---|---|---|
| | 2005 | 2006 | 2006 | 2006 |
| **Overall index** | **1.9** | **2.1** | **100** | |
| **Unregulated goods and services** | **1.9** | **1.9** | **81.6** | **1.55** |
| Unprocessed food | -0.8 | 1.4 | 6.4 | 0.09 |
| Processed food | 0.7 | 1.9 | 9.8 | 0.19 |
| Non-food and non-energy products | 0.9 | 1.2 | 30.0 | 0.36 |
| *of which: computers* | *-10.6* | *-12.9* | *0.2* | *-0.02* |
| *telephones* | *-20.4* | *-14.9* | *0.7* | *-0.10* |
| Services | 3.0 | 2.4 | 32.1 | 0.77 |
| *of which: air transport* | *18.1* | *1.3* | *0.7* | *0.01* |
| *financial services* | *6.6* | *1.7* | *0.9* | *0.02* |
| *professions* | *7.2* | *1.2* | *0.7* | *0.01* |
| *hotels and restaurants* | *2.4* | *2.4* | *10.6* | *0.25* |
| Energy products | 11.0 | 6.0 | 3.3 | 0.20 |
| **Regulated goods and services** | **2.1** | **2.8** | **18.4** | **0.52** |
| Medical products | -5.1 | -3.7 | 2.9 | -0.11 |
| Tobacco products | 8.9 | 6.3 | 2.0 | 0.12 |
| Rents | 2.4 | 2.5 | 3.1 | 0.08 |
| Public services and utilities | 2.6 | 4.1 | 10.4 | 0.43 |
| *of which: gas* | *7.6* | *9.3* | *1.9* | *0.17* |
| *electricity* | *3.9* | *12.6* | *1.1* | *0.14* |

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

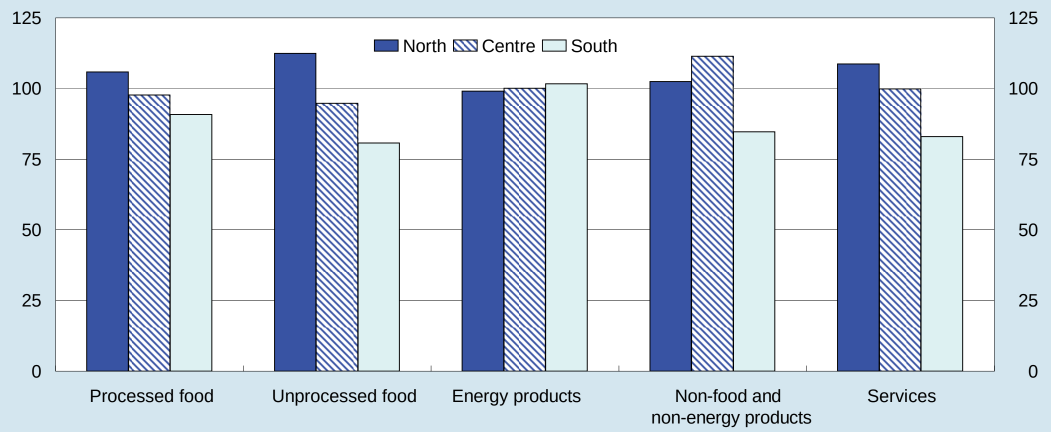
The rise in the prices of unregulated services slowed from 3 to 2.4 per cent, owing partly to smaller increases for air transport in connection with the average reduction over the year in the cost of fuel and the more moderate rise in the prices of financial services (which on the basis of Istat's new definition increased by 1.7 per cent, against 6.6 per cent in 2005) and professional fees (1.2 per cent, after two years in which increases averaged about 7.5 per cent). The rise in the prices of unregulated goods other than food and energy accelerated slightly, from 0.9 per cent in 2005 to 1.2 per cent last year, owing to the growth in demand and external cost pressures, which were only partly offset by the containment of domestic costs.

Consumer price inflation was almost uniform throughout the country last year. A recent study based on average prices recorded by Istat for a set of commonly purchased products representing about 16 per cent of the index basket shows, however, that there is a not insignificant negative price differential between the regions in the South and those in the Centre and more especially in the North. The disparity is greater for services and unprocessed food but almost non-existent for energy products (Figure 7.2).

Figure 7.2

**Average level of prices in 2006 by geographical area and type of product** (1)

*(indices, national average=100)*




Source: Based on data published by the Ministry for Economic Development.
(1) Average level of prices recorded monthly by Istat in 2006 for a basket of widely-consumed products and services in around forty provincial capitals.

*Producer prices, costs and profit margins.* – In 2006 the producer prices of industrial products sold on the domestic market rose by an average of 5.6 per cent, compared with 4 per cent in 2005; this was the highest annual increase since the beginning of the decade. It was due largely to the marked acceleration in the prices of non-energy intermediate products from 2.5 to 5.2 per cent, which followed in the train of raw materials prices. Producer price inflation continued to be underpinned by the increase in energy prices, which rose by an average of around 16 per cent, the same as in 2005.

The producer prices of non-food and non-energy products for final consumption behaved more favourably, rising on average by 1.4 per cent, compared with 1.8 per cent in 2005, held in check by the more moderate rise in domestic costs.

The rise in unit labour costs in industry slowed down sharply, to 1.4 per cent from 2.4 per cent in 2005, benefiting from an appreciable recovery in productivity after five years of virtual stagnation. According to the national accounts, profit margins remained almost unchanged in the industrial sector, as the increase in output prices was in line with that in unit variable costs. In services, however, unit profit margins appear to have narrowed, one factor being the rise of unit labour costs by 2.9 per cent, the same as in 2005, owing to a decline of 0.3 per cent in productivity that offset the slowdown in labour costs per employee.

The short-term inflation picture for Italy remains stable. The inflation expectations recorded in May by Consensus Economics' survey of professional forecasters stand at an average of 1.8 per cent for 2007 and 1.9 per cent for 2008. Firms' pricing policies are likely to remain moderate; according to the survey conducted in March by the Bank of Italy in collaboration with *Il Sole 24 Ore*, firms expect to raise selling prices by 2 per cent during the next twelve months (compared with a rate of 2.4 per cent indicated in the previous survey), in line with their expectations of consumer price inflation over the same period (2.1 per cent).

## *Actual inflation and "perceived inflation"*

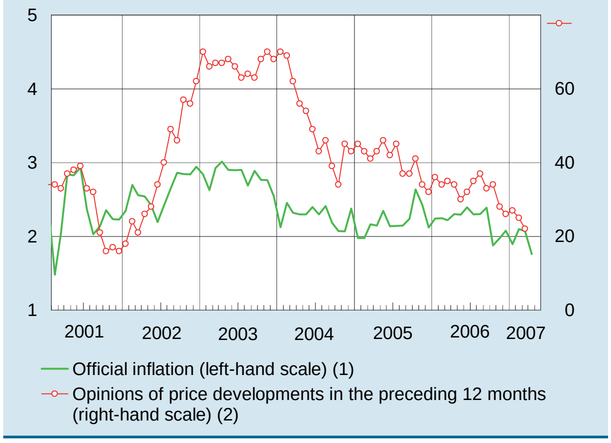
In 2006 the rate of increase in consumer prices perceived by Italian households, as measured by the qualitative indicator derived from the surveys carried out by ISAE, returned to the levels observed before the changeover to the euro (Figure 7.3). However, there is still a widespread belief among consumers that prices are now much higher than before the introduction of the single currency. According to empirical analyses carried out by the Bank of Italy in recent years, the changeover led to price rises in some sectors that are less exposed to competition but their impact on average inflation was generally small. These studies revealed that various factors may have contributed to the widening of the gap between perceived inflation and the rate recorded by official statistics (see the Chapter *Prices and costs* in the Annual Report for 2003). An overall picture of individual perceptions of inflation, expressed in both quantitative and qualitative terms, and of the mechanisms behind them, now emerges from a survey of a representative sample of 1,000 households carried out by the Bank of Italy at the end of last year. This survey shows above all that consumers find it quite difficult to interpret the statistics for measuring inflation and have a distorted recollection of past price levels.

Inflation tends to be associated with the level of prices rather than with their variation over time, and with an expenditure basket that

Figure 7.3

**Inflation and qualitative survey on the behaviour of prices**

*(monthly data)*




Sources: Based on ISAE and Istat data.
(1) Harmonized index of consumer prices; 12-month percentage change. – (2) Percentage difference between positive replies ("increased considerably", "increased somewhat") and negative replies ("roughly stable", "declined") from consumers about prices in Italy in the preceding twelve months.

does not match the one on which the official index is based. The recollection of prices in lire is rather imprecise. Only 16 per cent of interviewees correctly recalled the price of a newspaper in 2001 (1,500 lire), whereas almost half thought it had been 1,000 lire, which broadly corresponds to the price prevailing when the survey was carried out, but applying a conversion rate of 1,000 lire for one euro. This confirms the findings of another recent study, in which the recollection of the price of a cinema ticket at the end of 2001 averaged 9,000 lire, far lower than the actual price of 13,000 lire and corresponding to the price charged at the beginning of the 1990s.

Although the survey shows that there is a widespread perception of high inflation, individual perceptions of the level of inflation appear to be correlated to demographic, social and economic factors. These findings suggest that a complex set of factors influence consumers' assessments of what they describe as "inflation", including some that are not directly linked to the behaviour of prices. In particular, inflation may have been wrongly blamed for the relative impoverishment of some categories of household. This conclusion appears to be consistent with evidence from the studies recently carried out by the Bank of Italy on household budgets and by Istat on inflation for various types of household. They show that significant changes have taken place in recent years in the relative economic conditions of Italian households, owing to income trends rather than to differences in the inflation suffered by different categories in relation to their respective baskets of consumption.

# 8 THE LABOUR MARKET

The growth of employment was significantly faster in 2006 than in the preceding years and involved all parts of Italy, foreigners again making a substantial contribution to the increase. The unemployment rate fell further, to historically low levels. The proportion of residents participating in the labour market continued to rise, owing in part to the progressive entry of foreign workers into official employment. The geographical disparities in employment and participation rates widened further.

Against a backdrop of enduring wage moderation, the acceleration in employment growth essentially reflected the upturn in economic activity. The impulse to job creation deriving from the demand for goods and services counteracted the impact of an increase in unit labour costs that again outpaced that in the value added deflator. In manufacturing, where the value added deflator recorded an unusual decline, for the first time since 1995 the expansion of employment was accompanied by an increase in labour productivity.

## *Total employment and its composition*

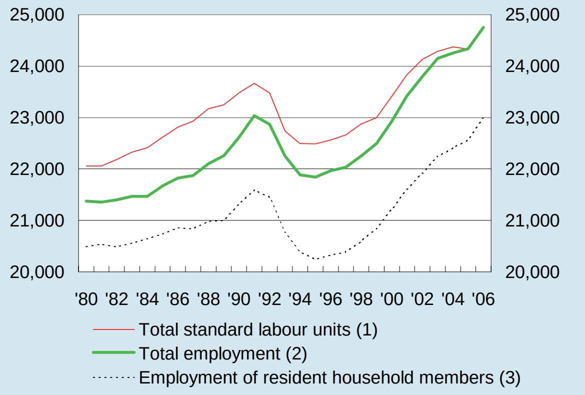
In 2006 the number of persons employed in Italy as recorded in the national accounts, which includes unregistered workers and non-residents, increased by 1.7 per cent, one of the largest rises in the last thirty years (Figure 8.1). The total labour input, measured in terms of full-time equivalent workers, rose at about the same pace (1.6 per cent).

According to Istat's labour force survey, which unlike the national accounts includes only residents, the number of persons employed averaged 23 million for the year, an increase of 425,000 or 1.9 per cent (Table 8.1). After holding broadly steady for three years, the employment rate for the working-age population rose by 0.9 percentage points to 58.4 per cent.

As in preceding years, a substantial share of the additional

Figure 8.1

**Measures of employment in Italy**
*(thousands)*




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

employment in 2006 involved foreigners (more than two fifths, or 178,000 jobs). Between 2005 and 2006, this population group grew by 209,000 and their employment rate rose from 63.9 to 66.1 per cent. Resident foreigners made up 5.9 per cent of total

Table 8.1

**Structure of employment in Italy, 2006**

*(thousands of persons and percentages)*

| | Centre and North | | South | | Italy | |
|---|---|---|---|---|---|---|
| | Thousands of persons (1) | Percentage change 2006-05 (2) | Thousands of persons (1) | Percentage change 2006-05 (2) | Thousands of persons (1) | Percentage change 2006-05 (2) |
| Employees | 12,138 | 2.6 | 4,777 | 1.5 | 16,915 | 2.3 |
| Permanent | 10,771 | 1.6 | 3,922 | 0.4 | 14,693 | 1.3 |
| full-time | 9,318 | 1.0 | 3,560 | .. | 12,878 | 0.7 |
| part-time | 1,452 | 5.3 | 362 | 5.1 | 1,815 | 5.3 |
| Fixed-term and temporary | 1,367 | 11.5 | 855 | 6.9 | 2,222 | 9.7 |
| full-time | 1,066 | 10.8 | 681 | 7.1 | 1,747 | 9.4 |
| part-time | 301 | 13.8 | 174 | 5.9 | 475 | 10.8 |
| Self-employed | 4,334 | 0.2 | 1,739 | 2.0 | 6,073 | 0.7 |
| Entrepreneurs, professionals, self-employed workers | 3,606 | -0.2 | 1,506 | 0.7 | 5,113 | 0.1 |
| Family workers | 311 | -0.3 | 113 | 4.5 | 425 | 1.0 |
| Cooperative members | 26 | -22.1 | 14 | 31.2 | 39 | -9.2 |
| Coordinated collaborators | 319 | 4.4 | 86 | 18.9 | 404 | 7.2 |
| Occasional workers | 72 | 18.2 | 20 | 6.7 | 93 | 15.5 |
| Full-time | 3,771 | -0.2 | 1,538 | 2.1 | 5,309 | 0.5 |
| Part-time | 563 | 3.2 | 201 | 1.3 | 764 | 2.7 |
| Total employment | 16,472 | 2.0 | 6,516 | 1.6 | 22,988 | 1.9 |
| women | 6,862 | 2.2 | 2,187 | 3.5 | 9,049 | 2.5 |
| men | 9,610 | 1.8 | 4,330 | 0.7 | 13,939 | 1.5 |
| Unemployed | 764 | -6.9 | 909 | -14.8 | 1,673 | -11.4 |
| women | 441 | -6.4 | 432 | -16.2 | 873 | -11.5 |
| men | 324 | -7.6 | 477 | -13.6 | 801 | -11.3 |
| Labour force | 17,236 | 1.6 | 7,425 | -0.7 | 24,662 | 0.9 |
| women | 7,303 | 1.7 | 2,618 | -0.4 | 9,921 | 1.1 |
| men | 9,933 | 1.5 | 4,807 | -0.9 | 14,740 | 0.7 |
| Participation rate (ages 15-64) | 68.0 | 0.8 | 53.2 | -0.4 | 62.7 | 0.4 |
| women | 58.4 | 0.8 | 37.3 | -0.2 | 50.8 | 0.4 |
| men | 77.6 | 0.7 | 69.3 | -0.6 | 74.6 | 0.3 |
| Employment rate (ages 15-64) | 65.0 | 1.0 | 46.6 | 0.8 | 58.4 | 0.9 |
| women | 54.9 | 1.0 | 31.1 | 1.0 | 46.3 | 1.0 |
| men | 75.0 | 1.0 | 62.3 | 0.4 | 70.5 | 0.8 |
| Unemployment rate | 4.4 | -0.4 | 12.2 | -2.0 | 6.8 | -0.9 |
| women | 6.0 | -0.5 | 16.5 | -3.1 | 8.8 | -1.3 |
| men | 3.3 | -0.3 | 9.9 | -1.5 | 5.4 | -0.7 |
| Youth unemployment rate (ages 15-24) | 14.4 | -1.0 | 34.3 | -4.4 | 21.6 | -2.4 |
| women | 17.3 | -1.2 | 40.5 | -4.1 | 25.3 | -2.2 |
| men | 12.3 | -0.5 | 30.4 | -4.5 | 19.1 | -2.3 |

Source: Based on Istat, labour force survey.
(1) Participation, employment and unemployment rates are percentages. The unemployment rate is the number of job seekers aged 15-74 as a percentage of the labour force aged 15 and over. The youth unemployment rate refers to 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.

average employment in 2006, 0.7 points more than in 2005. They now constitute more than a tenth of all persons employed in the hotel and restaurant sector, 13 per cent of men employed in construction, and more than a quarter of women employed in services to households and other social services.

Geographical disparities continued to widen, though more slowly than in the past. Between 2003 and 2005 the number of persons employed in the South had fallen by 70,000, against an increase of 718,000 in the rest of the country. Last year it rose by 105,000, more slowly than in the Centre and North (1.6 as against 2 per cent). The employment rate for the working-age population rose by 0.8 points to 46.6 per cent in the South and by a full point, from 64 to 65 per cent, in the Centre and North.

The number of persons aged 15-34 in work declined by 0.8 per cent, less than the fall in the total population in that age-group (1.5 per cent). The employment rate for the group thus rose by 0.4 points to 51.4 per cent, which is still about 6 percentage points below the EU average. In the South employment in this age-group increased by 0.3 per cent, raising its employment rate from 35.8 to 36.5 per cent.

Internal migration from South to North, which in the past decade has once again been increasing steadily, continued in 2006. Istat estimates a net domestic migratory outflow from the South of 2.4 per 1,000 residents. In addition to this migration, which tends to involve young people and the better educated, there are significant numbers of persons who move for job-related reasons but do not change their official residence. According to the labour force survey, last year about 8 per cent of employed persons of working age resident in the South worked in the Centre or North (while just 0.1 per cent of those resident in the latter area worked in the South); the share was higher (10 per cent) for workers under 35. A year earlier, about a quarter of the latter had not been employed. University graduates made up 15 per cent of young Southerners working in the Centre or North, compared with 10 per cent of those employed in the South and 8 per cent of the southern population between the ages of 15 and 34.

Nationwide, women's employment returned to rapid growth (2.5 per cent) after slowing down from an annual increase of 3 per cent between 1997 and 2001 to one of 1.5 per cent in the following four years. The southern component contributed more than in the past (3.5 per cent; 2.2 per cent in the Centre and North), more than making up for the decline of the last few years.

Most of the employment gain was again accounted for by payroll positions, which increased by 2.3 per cent, or 381,000. However, the number of self-employed workers also showed an increase (0.7 per cent) after several years of stagnation, led by the South with growth of 2 per cent against 0.2 per cent in the rest of the country. Their share of total employment fell further to 26.4 per cent, but it remains fully 10 percentage points above the euro-area average. The number of self-employed workers on collaboration and occasional employment contracts remained stable nationwide at some 500,000 between 2004 (the first year for which data are available) and 2006, resulting from an increase of 12.7 per cent in the South and a decline of 3 per cent in the rest of the country. Their share of total self-employment rose by 0.3 points to 8.2 per cent. About half of the employment relationships governed by these types of contract are exclusive, require that the work be performed at the employer's premises, and have predetermined working hours – all typical characteristics of wage or salaried work.

Not even half of the additional payroll employment in 2006 consisted in permanent jobs, almost all of which (169,000) where in the Centre and North, whereas more than a quarter of the additional fixed-term employees (55,000) were resident in the South. Fixed-term positions, whose share of total payroll jobs rose from 12.2 to 13.1 per cent, were mostly held by women, who held just 41.3 per cent of permanent positions. Residents in the South accounted for two fifths of fixed-term employment and just 22.7 per cent of permanent positions.

The number of part-time employees increased by 6.4 per cent to 2,290,000, or 13.5 per cent of total payroll jobs; 80 per cent of them were women. More than a quarter of all Italian working women had part-time jobs (compared with a third in the euro area).

In the decade between 1996 and 2006 the number of women working part-time increased by 46 per cent, while women's full-time employment gained 15.5 per cent; over the same period, among men part-time employment declined by 14.7 per cent and full-time employment increased by 9.3 per cent. A survey by Istat in 2002 and 2003 (Indagine multiscopo sull'uso del tempo) found that Italian women devoted an average of 5 hours a day to housework and family care. This falls to 4 hours for women employed outside the home, regardless of type of work, and rises to nearly 7 hours for women who engaged chiefly in domestic activities and did not participate in the labour market (about a third of the resident female population). Overall, employed Italian women work an average of 9 hours a day, barely half of it remunerated and thus included in the national accounts. The unpaid half nevertheless includes activities that could be performed by others for pay, such as cleaning, or care for children and the elderly. The development of a market context in which this happens more readily would be a significant stimulus for women's employment and would increase the portion of the value added actually produced that is picked up in the national accounts.

### *Unemployment and the labour supply*

Year on year, the number of job-seekers diminished by 216,000 (11.4 per cent) in 2006 to 1,673,000. The number of those who had been jobless for more than 12 months fell at about the same rate. These long-term unemployed account for a slightly higher share of the total in Italy than in the EU as a whole (48.4 as against 44.9 per cent).

Based on the data from the continuous labour force survey, about a fifth of job-seekers can be expected to find work within three months; for those unemployed for less than six months, the share is around 30 per cent. About a third of the persons who have found jobs in the three previous months report that they are looking for a new job, which highlights the difficulty the unemployed have in finding a position that matches their characteristics. Social shock absorbers help make the transition process more efficient, alleviating the costs of lack of income during spells of unemployment. If poorly designed, however, they can result in excessively long periods of non-employment. Italy's system is fragmented and lacking in controls, it covers only some workers, and its benefits are generally lower than in the rest of Europe. In 2005 social benefits in connection with joblessness totaled 0.6 per cent of the Italian GDP, compared with 1.3 per cent for the EU as a whole; ordinary unemployment benefits are equal to 50 per cent of the worker's last monthly pay check, compared with an EU average of 70 per cent.

The unemployment rate fell further in Italy in 2006, from 7.7 to 6.8 per cent. This was the sharpest decline since 2001. The reduction involved all parts of the country and both men and women, albeit in varying measure. The unemployment rate for young people aged 15-24, after rising in 2005, turned downward again (Table 8.1).

The labour force expanded by 210,000 persons in 2006, three times as fast as in the previous two years (by 0.9 as against 0.3 per cent), when the rise in the participation rate that had begun in 1996 was interrupted. The expansion reflects both the increase in the resident population and, in contrast to the previous two years, a rise in the participation rate for the population aged 15-64, which increased by 0.4 percentage points to 62.7 per cent, after falling by 0.5 points between 2003 and 2005.

According to the labour force survey, resident foreigners accounted for 80 per cent of the growth in the labour force, with an increase of 173,000 economically active persons out of an increase of 209,000 in the foreign population aged 15 or more. The labour market participation rates of these foreigners are significantly higher than those of Italians (89 and 73.9 per cent respectively for men and 58.6 and 50.4 per cent for women). The difference, which is only partly accounted for by demographics, is greatest among men aged 15-24 and 55-64 with no more than a high school education and among women aged 55-64 (Table 8.2).

**Table 8.2**

**Composition of the population, participation and employment rates in 2006**

| AGE | EDUCATION | Population | | Participation rate | | Employment rate | |
|---|---|---|---|---|---|---|---|
| | | Italian | Foreign (1) | Italian | Foreign (1) | Italian | Foreign (1) |
| | | | | **Men** | | | |
| 15-24 | | | | 36,7 | 57,8 | 29,5 | 50,8 |
| | Lower secondary or less | 9.0 | 12.9 | 26.9 | 50.3 | 21.0 | 43.7 |
| | Upper secondary | 6.6 | 3.2 | 50.6 | 86.9 | 41.5 | 77.6 |
| | University or higher | 0.4 | 0.1 | 26.9 | 84.0 | 20.8 | 84.0 |
| 25-54 | | | | 91.0 | 95.8 | 86.9 | 91.4 |
| | Lower secondary or less | 29.7 | 42.6 | 89.4 | 95.0 | 84.4 | 90.7 |
| | Upper secondary | 27.7 | 30.5 | 92.4 | 97.1 | 89.1 | 92.9 |
| | University or higher | 8.2 | 7.5 | 92.5 | 95.2 | 88.6 | 89.3 |
| 55-64 | | | | 44.7 | 74.4 | 43.5 | 71.3 |
| | Lower secondary or less | 11.7 | 1.6 | 36.9 | 77.2 | 35.3 | 73.5 |
| | Upper secondary | 4.9 | 0.9 | 52.4 | 82.7 | 51.6 | 78.1 |
| | University or higher | 1.8 | 0.7 | 75.3 | 58.4 | 74.9 | 58.4 |
| **Total** | | **100.0** | **100.0** | **73.9** | **89.0** | **69.8** | **84.2** |
| | | | | **Women** | | | |
| 15-24 | | | | 26.7 | 31.9 | 20.0 | 22.3 |
| | Lower secondary or less | 7.6 | 11.4 | 14.4 | 26.8 | 9.9 | 18.3 |
| | Upper secondary | 6.9 | 4.8 | 38.5 | 44.6 | 29.9 | 32.8 |
| | University or higher | 0.7 | 0.2 | 43.9 | 19.0 | 33.1 | 0.0 |
| 25-54 | | | | 64.3 | 64.4 | 59.4 | 56.6 |
| | Lower secondary or less | 27.4 | 35.2 | 47.5 | 56.1 | 42.4 | 48.0 |
| | Upper secondary | 28.1 | 32.8 | 73.5 | 70.9 | 69.1 | 63.3 |
| | University or higher | 9.8 | 11.5 | 84.7 | 71.5 | 79.6 | 63.9 |
| 55-64 | | | | 22.2 | 52.1 | 21.5 | 50.0 |
| | Lower secondary or less | 14.1 | 2.3 | 15.1 | 51.6 | 14.4 | 49.3 |
| | Upper secondary | 3.9 | 1.1 | 35.9 | 55.9 | 35.4 | 55.6 |
| | University or higher | 1.4 | 0.7 | 56.4 | 47.5 | 55.9 | 43.4 |
| **Total** | | **100.0** | **100.0** | **50.4** | **58.6** | **46.1** | **50.7** |

Source: Based on Istat, labour force survey.
(1) Legally present in Italy and resident in households.

On 1 January 2006 there were 2,671,000 foreign citizens resident in Italy, an increase of 268,000 (11.2 per cent) from a year earlier. They made up 4.5 per cent of the total population, compared with 2.7 per cent at the end of 2002. Counting another 100,000 foreigners who are non-residents but legally present in the country, the incidence rises to 4.7 per cent. The labour force survey found that about four fifths of these foreign citizens were between the ages of 25 and 54, compared with 65 per cent of Italians. The educational disparity in this age-group is relatively modest. Just under half of foreign men have at least a high school diploma, as against 55 per cent of Italian citizens. Among women the share is roughly the same, a little more than half.

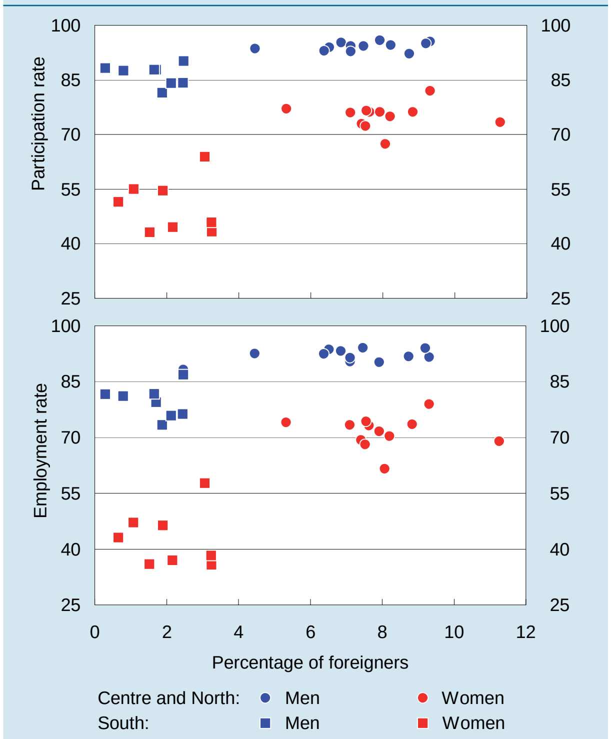
Even though educational levels are comparable, the evidence does not suggest a negative relationship between the presence of foreigners and the job opportunities of Italians. The correlation between the participation and employment rates of Italian citizens aged 25-54 and the population share of foreigners in the same age-group, on a regional basis, is not statistically significant (Figure 8.2). This is confirmed by the Bank of Italy's own econometric analysis covering the period from 1993 to 2003, taking account of individual characteristics and those of the provincial labour markets. Among both men and women there is a positive correlation between the foreign presence and participation and employment rates (stronger for the participation rate); and the correlation is stronger for women than for men in both respects. For men, the correlation with the employment rate is not statistically significant.

The labour market participation rate of women aged 15-64 rose by 0.4 percentage points to 50.8 per cent in 2006, making good two thirds of the decline registered in the previous two years. The female labour force thus grew by 1.1 per cent. Unlike that among men, the rise was due not only to the foreign component but also, albeit only 0.2 points, to Italians.

The participation of Italian women in the labour market may benefit from the growing presence of foreigners, especially foreign women, which enables the former to reconcile work with family responsibilities. Our analysis for the decade from 1993 to 2003 shows that the probability of an Italian woman's participating in the labour market and being employed is positively correlated with the share of foreign women in the province, even allowing for local factors that could affect both Italian women's decision to work

**Figure 8.2**

**Employment and participation rates and presence of foreigners** (1)




Source: Based on Istat, labour force survey, 2006.
(1) The points in the graph correspond to the regions of Italy. The employment and participation rates are for the Italian population aged 25-54 resident in the region. The foreign presence is defined as the percentage of foreign citizens aged 25-54 legally resident in the region in the total population of the same sex and age-group.

outside the home and the presence of foreign women. This positive correlation can be traced essentially to that for women with pre-school children and at most a high school education.

The participation rate among the older age-groups continued to rise. The number of 55-64-year-olds in the labour force increased by 71,000, bringing their participation rate to 33.4 per cent, up by 0.9 points on 2005.

### *Young people's work and education*

The number of labour market participants under 25 declined again, by 78,000, owing both to the smaller size of the younger cohorts (down by 54,000) and to a fall in the participation rate (to 32.5 per cent) due in part to more protracted schooling. Among persons aged 25-34 there was a decline of 126,000, half of it in the South; for this age-group the participation rate held steady at 77.2 per cent nationwide but fell by 1 point to 63.5 per cent in the South.

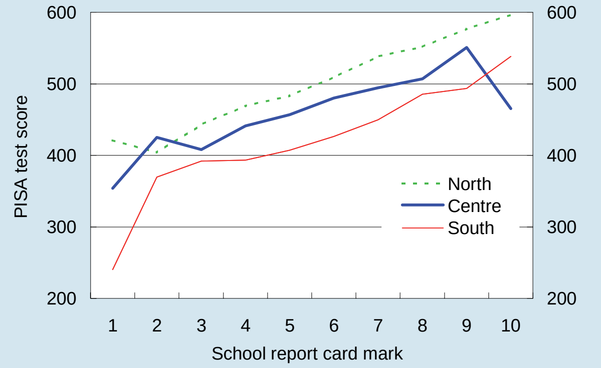
A considerable portion of the human capital formed in universities is not utilized in the production process. Last year about 30 per cent of university graduates aged 25-34 were not employed, twice the average for the EU. Just over a quarter of these were pursuing advanced degrees, while more than three quarters were willing to work immediately although they were not actively seeking employment. The non-employment rate among graduates in this age-group varies significantly according to academic discipline. In 2005, with an overall non-employment rate of 25 per cent, the rate was 15 per cent for graduates in engineering and 45 per cent in the humanities. Despite these disparities, the labour supply does not appear to adapt quickly to demand. In the last fifty years, the population share of university graduates has increased tenfold but their distribution by discipline has remained virtually unchanged: a quarter in the humanities, just under a third in economics, business and law, and a quarter in science and engineering.

The geographical disparities in employment, participation and unemployment depend largely on differences in the endowment of knowledge in the various parts of Italy. The OECD's PISA survey found that the test scores of 15-year-olds in the South were lower than those of their peers in the Centre and North by about 10 per cent of the average Italian score. Significant gaps are found already among primary school pupils, and they tend to widen among lower and upper secondary school students, despite higher drop-out rates in the South, even before finishing compulsory schooling. The share of 15-year-olds with very low achievement levels ranges from 14 to 22 per cent in the South, depending on the subject, while it is 8 per cent in the Centre and no more than 5 per cent in the North. Lack of achievement in different subjects tends to be found in the same students, especially in the South; one in three Southerners is knowledge-poor (i.e. below the lowest PISA level of competence) in at least one subject, one in five in at least two, and one in eight in three or more. The corresponding figures in the rest of the country are much lower.

Schools and students do not appear to be fully aware of their relative standing. The evaluation derived from school report cards and the national school-leaving examination after high school is only weakly correlated with learning levels as measured by external, international tests. The PISA test found that the learning gap between 15-year-olds in the Centre and North and those in the South is very wide even when their school marks are the same. In mathematics, among students whose marks are between 4 and 8 (out of 10), a range that embraces over 90 per cent of all students, the PISA score differential between North and South is about 70 points, or 16 per cent of the average Italian score in mathematics. A Northern student with a mark of 4 has the same mathematical knowledge, on the average, as one in the Centre getting a 6 and better than a Southerner getting a 7 (Figure 8.3). At the same time, however, 15 per cent of the students who are getting a mark of 4 in the South score better than 15 per cent of those getting a 7 in the North. In short, report card marks are most uninformative on skill levels as measured by PISA.

Figure 8.3

**PISA test scores and Italian school marks in mathematics** (1)




Source: Based on OECD, PISA survey.
(1) Italian report card marks are on a scale of 1-10. The PISA test results are normalized to get an average score of 500 for the entire international sample and a standard deviation of 100 points.

## *Labour input by sector*

Thanks to the economic recovery, labour input to the economy as gauged in standard labour units by the national accounts returned to growth in 2006 after the slowdown of the previous four years, culminating in the decline of 2005. The increase involved all sectors, albeit at different rates.

In construction, despite a pick-up in investment and value added, the growth in labour input slowed down sharply from 3.7 to 0.6 per cent, after the phase of strong expansion of 3 per cent per year since 1999.

Industry excluding construction scored the fastest growth in labour input since 1998 (1.3 per cent), recouping about half of the decline recorded from 2003 through 2005. The entire gain was accounted for by the 1.4 per cent increase in manufacturing.

In the private service sector too an increment of nearly 2 per cent reversed a protracted slowdown (from growth of 2.6 per cent in 2002 to 0.5 per cent in 2005). The sector of banking, insurance, and real estate and professional services, which comprises more than a third of the overall private service sector, accounted for about half of the overall increase with growth of 2.8 per cent. In wholesale and retail trade and the hotel industry, which generates about half the sector's total labour demand, labour input returned to growth of 1.4 per cent after the 0.4 per cent decline of 2005.

In the sector of public or prevalently publicly managed services, which accounts for just over two fifths of total employment in the service sector, labour input rose by 2 per cent. The growth was fueled by continuing expansion in health care, whose share of total employment in this sector has risen since the early 1990s from 23 to over 27 per cent, and by increased employment in education, which has recovered to the levels of the early 1990s.

Table 8.3

**Labour costs and productivity in Italy**
*(annual percentage changes, except as indicated)*

| | Value added at base prices, chain-linked volumes (1) | Total standard labour units | Output per standard labour unit (2) | Compensa-tion 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* | | | | |
| 1996-2000 | 0.6 | -0.3 | 0.8 | 3.5 | 2.5 | 1.7 | 62.6 | -0.1 | 1.0 |
| 2001-2005 | -1.3 | -0.6 | -0.7 | 3.0 | 3.1 | 3.8 | 63.2 | 0.6 | 0.6 |
| 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 | 0.0 | -2.2 | 2.6 | 2.8 | 5.2 | 64.1 | 1.5 | -0.1 |
| 2004 | -0.8 | -1.0 | 0.2 | 3.9 | 4.0 | 3.9 | 64.3 | 0.5 | 1.7 |
| 2005 | -1.8 | -2.2 | 0.4 | 2.8 | 2.8 | 2.4 | 65.0 | 1.6 | 0.8 |
| 2006 | 2.5 | 1.3 | 1.2 | 3.2 | 2.7 | 1.4 | 66.0 | 2.7 | 1.0 |
| | | | | | *Construction* | | | | |
| 1996-2000 | 0.9 | 1.0 | -0.2 | 3.3 | 2.1 | 2.3 | 71.8 | -0.2 | 0.9 |
| 2001-2005 | 2.9 | 3.3 | -0.4 | 2.6 | 2.9 | 3.3 | 67.8 | -1.7 | 0.2 |
| 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 | 0.0 | 2.5 | 3.9 | 3.8 | 67.9 | -0.7 | -0.2 |
| 2004 | 0.9 | 1.6 | -0.7 | 3.8 | 3.9 | 4.6 | 66.7 | -2.5 | 1.5 |
| 2005 | 0.7 | 3.7 | -2.8 | 2.0 | 1.8 | 4.8 | 66.8 | -2.6 | 0.0 |
| 2006 | 1.6 | 0.6 | 1.0 | 2.9 | 2.3 | 1.3 | 66.1 | -0.1 | 0.8 |
| | | | | | *Private services* (8) (9) | | | | |
| 1996-2000 | 3.2 | 2.2 | 1.0 | 3.2 | 2.0 | 0.9 | 69.7 | -0.1 | 0.7 |
| 2001-2005 | 1.1 | 1.6 | -0.5 | 2.5 | 2.6 | 3.1 | 68.2 | 0.0 | 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 | 1.5 | 0.7 | 0.8 | 2.9 | 3.1 | 2.3 | 68.5 | 1.3 | 0.7 |
| 2005 | 0.8 | 0.5 | 0.3 | 3.1 | 3.1 | 2.8 | 69.5 | 1.7 | 1.1 |
| 2006 | 2.1 | 1.9 | 0.2 | 2.6 | 2.3 | 2.1 | 70.9 | 2.3 | 0.5 |
| | | | | | *Private sector* (9) | | | | |
| 1996-2000 | 2.1 | 0.9 | 1.2 | 3.4 | 2.3 | 1.1 | 69.5 | 0.2 | 0.9 |
| 2001-2005 | 0.4 | 0.8 | -0.4 | 2.7 | 2.8 | 3.2 | 68.4 | 0.2 | 0.3 |
| 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 | 1.1 | 0.3 | 0.9 | 3.2 | 3.3 | 2.4 | 68.8 | 1.0 | 1.0 |
| 2005 | -0.2 | -0.4 | 0.2 | 2.8 | 2.7 | 2.5 | 69.6 | 1.4 | 0.8 |
| 2006 | 2.0 | 1.5 | 0.5 | 2.8 | 2.4 | 1.9 | 70.8 | 2.2 | 0.7 |
| | | | | | *Total economy* (9) | | | | |
| 1996-2000 | 2.0 | 0.8 | 1.1 | 3.5 | 2.7 | 1.5 | 72.5 | 0.3 | 1.0 |
| 2001-2005 | 0.6 | 0.8 | -0.2 | 3.2 | 3.2 | 3.4 | 71.8 | 0.4 | 0.8 |
| 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 | 0.0 | 0.1 |
| 2003 | -0.6 | 0.6 | -1.2 | 3.2 | 3.7 | 5.0 | 72.2 | 0.2 | 0.5 |
| 2004 | 1.2 | 0.4 | 0.8 | 3.4 | 3.3 | 2.4 | 72.2 | 0.9 | 1.2 |
| 2005 | 0.1 | -0.2 | 0.3 | 3.3 | 3.1 | 2.8 | 72.9 | 1.3 | 1.3 |
| 2006 | 1.8 | 1.6 | 0.2 | 2.8 | 2.5 | 2.3 | 74.0 | 1.6 | 0.7 |

Source: Based on 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 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.

### *Earnings and labour costs*

The growth of actual compensation per full-time equivalent worker for the entire economy, as measured in the national accounts, slowed from 3.3 to 2.8 per cent last year (Table 8.3). This reflected the deceleration in the public sector to 2.8 per cent from an average of over 4 per cent in the three previous years, partly a statistical effect of the accounting methods applied to payments in connection with some contract renewals made during the year but relating to the two previous years. In the private sector, actual per capita compensation continued to rise at about the same pace as in recent years, less than 3 per cent, and just 0.1 point more than the resident household consumption deflator.

Real value added per labour unit in the private sector, net of building rentals, picked up slightly from growth of 0.2 per cent to 0.5 per cent. Given a faster increase in labour costs per full-time equivalent worker, unit labour costs increased by 1.9 per cent (compared with 2.5 per cent in 2005). There was a consequent further rise in labour's share of value added, to 70.8 per cent.

In industry excluding construction unit labour costs continued to decelerate, reflecting the upturn in productivity and the steady rate of increase in labour costs. However, there was a further widening of the gap with respect to the euro area, where unit labour costs turned downwards, declining by 1.4 per cent. For manufacturing alone, the acceleration to 2.3 per cent in the increase in value added per worker at constant prices halted the downtrend under way since 2000 and helped to curb the growth in unit labour costs, which slowed to 0.5 per cent after rising at an average annual rate of over 4 per cent for five years.

# 9. THE PRODUCTIVE STRUCTURE AND STRUCTURAL AND TERRITORIAL POLICIES

For at least a decade the Italian economy has been experiencing structural difficulties, evident in its loss of competitiveness and the protracted stagnation of productivity. The good performance of the labour market has not been accompanied by rapid economic growth: over the last five years GDP has expanded at half the pace of the previous five years. The problems lie above all in the productive system's capacity to innovate, regulation of the economy, competition in the markets for services, the efficiency of public services, the quality of human capital and the education system.

The stagnation of productivity is only partly explained by the slowdown in capital intensity following the wage moderation policies and the reforms that have made the use of labour less costly. The preponderant factor was the fall in the overall efficiency of production processes, weighed down by the difficulties of firms in adapting to the altered technological and market environment and the weaknesses of the economic system as a whole.

In the manufacturing sector, where the slackening of productivity growth had been most pronounced, the negative trend appears to have been halted. A survey carried out by the Bank of Italy found evidence that firms are engaged in a process of transformation and market repositioning, with strategies aimed at strengthening competitive advantages, relying increasingly on service activities such as research, marketing and customer assistance. In this process businessmen complain of the scant efficiency of services sheltered from international competition and of the public administration, the judicial system in particular.

Progress has been made in the regulation of services, with the removal of some barriers to access and some restrictions on the conduct of operators not justified by the protection of the public interest. The measures concerning retailing and the professions deserve special mention. In public services, the institutional changes have not yet produced visible benefits for firms and consumers, especially in the energy sector, where the former public monopolies continue to enjoy a dominant position. In local services, partly because of the uncertainty of the national legislative framework, the transformation initiated in the mid-1990s has not produced incisive modernization. Especially glaring lags are found in the regions of the South in terms of both the management and quality of the services supplied.

The working of the civil justice system is still deficient, despite repeated corrective measures. The excessive length of proceedings hinders the effective resolution of disputes, with serious harm for the efficient functioning of the markets. The problems stem primarily from shortcomings in the management of resources, the amount of which is not less than in the other European countries.

The regions of the South continue to show a significant development lag. In a context of general difficulty for the country, territorial development policies do not appear to have significantly sped the South's convergence.

## *Productivity*

The new national accounts data and new measurements of capital employed in production processes, which are incorporated into our estimates, only confirm the productivity crisis already documented in the past. After the sharp cutback in growth in the second half of the 1990s, labour productivity in the whole economy diminished by more than half a percentage point between 2000 and 2006. In France and Germany, where the growth in employment was smaller, labour productivity rose in the same period by 0.8 and 1.2 per cent per year respectively.

A factor in the performance of labour productivity in the last five years no doubt has been the long cyclical stagnation of the economy, which, in contrast with the recession of the early 1990s, has not resulted in a reduction in employment. The differences between the two periods are connected with the intervening changes in the labour market.

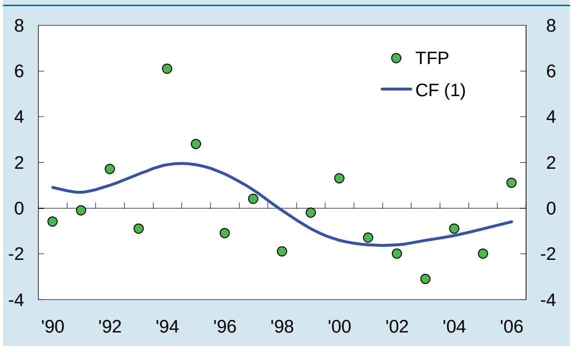
The increase in flexibility in the use of labour, prolonged wage moderation and the rapid increase in migration have made the use of labour less costly relative to capital, sustaining the expansion of employment even in periods of slow output growth. A consequence has been a slowdown in the capital intensity of production (the ratio of capital to labour employed), which in turn explains part of the negative productivity trend. Controlling for changes in the quality of productive factors, in the private sector the contribution to productivity growth of increases in capital intensity fell from 0.8 percentage points per year in the period 1985-95 to about 0.4 points per year in the subsequent ten years.

The deceleration in capital intensity was accompanied by a deterioration in total factor productivity, which approximates the changes in total efficiency in production that are not attributable to the individual factors. Its rate of growth fell from about 1 per cent per year between 1985 and 1995 to negative values in the subsequent decade. Between 2000 and 2005 the contribution of total factor productivity to the growth in labour productivity was negative by about one percentage point.

Total factor productivity declined in all the main sectors of the economy, but most sharply in industry excluding construction, where its average annual growth of about 2 per cent per year in the period 1985-95 – twice the average rate for the private sector – gave way to slightly negative figures in the second half of the 1990s and then a contraction of 1.4 per cent per year between 2000 and 2005. The decline remains significant even after adjusting for the cyclical component (Figure 9.1). The persistence of the downward trend shows that the manufacturing system has encountered severe difficulties in adapting to the altered market conditions characterized by the new information technologies and the success of the emerging economies.

**Figure 9.1**

**Total factor productivity in industry**
*(annual percentage rates of change)*




(1) Christiano-Fitzgerald filter.

However, in the last three years labour productivity in industry excluding construction has returned to growth. The progress was feeble at first but gathered pace in 2006 (0.1 per cent in 2004, 0.3 per cent in 2005 and 1.2 per cent in 2006). These signs of improvement, together with the recovery in production and exports, suggest that restructuring and market repositioning by Italian firms may be under way.

### *The restructuring under way among firms: demographics and structural changes in the light of a Bank of Italy survey*

The data on the demographics of firms capture what are presumably the signs of a slow restructuring that began in the years of stagnation. According to the registers of the Chambers of Commerce, the number of firms that went out of business increased in 2006 notwithstanding the recovery in production, thereby lowering the annual increase in the number of firms to 1.2 per cent (from 1.6 per cent in 2005 and 1.8 per cent in 2004). In manufacturing alone, the balance between start-ups and closures was again negative and the exit rate remained high for the third consecutive year (5.4 per cent). These developments in a period of recovering production could indicate, as some theoretical approaches suggest, that the productive system is going through a process of creative destruction, with a portion of output reallocated from the firms that are expelled from the market to those that are able to withstand the new competitive challenges; with the strengthening of the recovery, there is likely to be an acceleration in entries and an increase in the new firms' contribution to production.

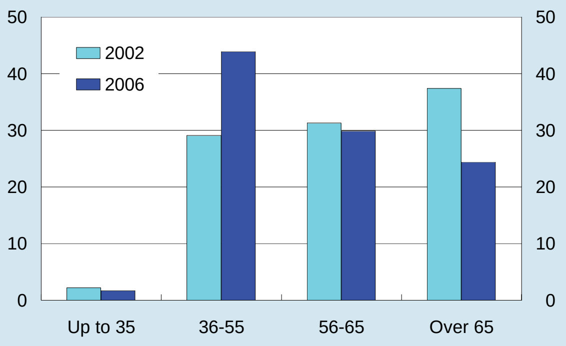
A special section of the customary Survey of Industrial and Service Firms carried out by the Bank of Italy on more than 4,000 businesses shows that this winnowing has been accompanied by qualitative alteration of the productive fabric. Between 2000 and 2006 more than half of the industrial firms surveyed introduced important changes in strategy; many, especially among the largest firms, expanded their presence on international markets through direct investment or cooperation agreements. In most cases these changes were accompanied by improved earnings.

The factors that determine internationalization vary greatly with firm size. Small enterprises are impelled mainly by the need to limit labour costs (especially in traditional sectors), large companies by the need for proximity to outlet markets. Although it is not large, the presence of Italian firms has expanded strongly in China and, to a lesser extent, in Europe.

These signs of renewal have been accompanied by a generational changeover that has reduced the average age and raised the level of educational attainment of the heads of the firms surveyed (Figure 9.2). Among industrial firms with at least 50 workers, the proportion of businessmen aged 65 or more fell from 37.4 per cent in 2002 to 24.4 per cent in 2006, while the proportion

**Figure 9.2**

**Distribution of industrial firms with 50 or more workers by age of firm's owner**




Source: Banca d'Italia, *Survey of Industrial and Service Firms.*

between the ages of 35 and 55 rose from 29.1 to 43.9 per cent. For the same set of firms, the percentage of entrepreneurs with a university degree rose from 23 to 37.4 per cent, and for post-graduate degrees from 2.8 to 4.2 per cent. The percentage of businessmen with no more than a lower-middle-school education declined form 22.4 to 9.5 per cent. As a rule, there is a positive correlation between generational handover and the likelihood of introducing strategic changes.

A field survey based on in-depth interviews with a small number of businessmen offers additional useful information of a qualitative nature for evaluating the transformation under way in the world of enterprise. The findings clearly point up the growing role played by auxiliary activities (R&D, design, marketing, customer services) in determining firms' competitive advantage, by maintaining high margins in an open and competitive market. Given the success of the emerging countries, competition exclusively in terms of production costs would be unsustainable.

The proportion of university graduates has also risen among staff; in industrial firms with 50 or more workers, it rose from 6.9 per cent in 2000 to 9.5 per cent in 2006. According to Istat's labour force survey, there has been a constant rise in the percentage of skilled workers employed throughout the economy. In particular, the percentage of technicians increased from under 12 per cent in 1993 to over 17 per cent in 2006.

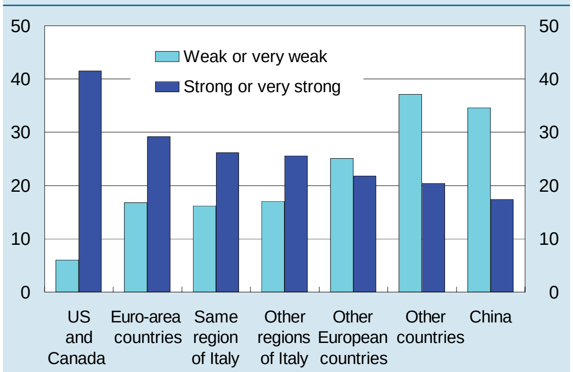
Changes are also evident on the organizational plane. In particular, there has been a rapid spread of enterprise resource planning (ERP) and similar systems to rationalize the management of production inputs, process organization and dealings with suppliers and customers. The proportion of industrial firms with 50 or more workers that have an ERP system rose from 20.1 per cent in 2000 to 36.4 per cent in 2006. Since service activities are becoming more important, so too are the economies of scale not strictly connected with the phase of production – where the flexibility of numerically controlled machines has for some time now reduced the importance of size – but determined by the fixed costs in intangible assets: high sales volumes are needed to recoup investments in research, marketing and the development of a sales network. Combination among firms would seem desirable in this respect, but the Bank of Italy survey indicates that such a process has yet to begin.

The growing importance of these service activities requires an improvement in the quality of the resources that society as a whole makes available to firms, for example through universities, with which a small but increasing number of companies are establishing relationships of cooperation both to recruit qualified personnel and to develop new products and technologies.

The numerous firms that still see their competitive advantages threatened by competition on international markets will have to set

**Figure 9.3**

**Industrial firms' perception of the strength of their market position according to the location of their main competitors**




Source: Banca d'Italia, *Survey of Industrial and Service Firms.*

their sights on organizational and product innovation. A substantial share of industrial firms deem their competitive position weak, above all among the roughly 35 per cent of firms that indicate the low-wage countries as their main competitors (Figure 9.3). The perception of weakness is especially common among firms in traditional sectors and those with medium-low technology products.

### *Incentives policies*

In their capacity for innovation, Italian firms appear to be trailing those of the more advanced countries in every sector and every class of technology.

Total public and private spending on research and development is still around 1 per cent of GDP (1.1 per cent in 2004, the latest available figure), compared with the ambitious objective of 2.5 per cent by 2010 set by the Government as part of the Lisbon Agenda.

The goal of increasing innovation requires policies that can reorient incentives to the benefit of private research and partnership between firms and research institutions. If public intervention is needed to remedy market failures, as in the case of R&D investment, the private returns to which are lower than the social returns, generating a suboptimal level of expenditure, the disbursement of public incentives must follow procedures that limit their distortionary effects. Both our econometric analyses of the efficacy of investment incentives and the opinions expressed by businessmen in the above-mentioned survey suggest that in this respect automatic incentives are preferable to those based on selection procedures. On the whole, the current approach to policies for firms is moving in this direction.

The Ministry for Economic Development has formulated a reform of industrial policy with a bill that the Council of Ministers approved on 22 September and already partly incorporated into the Finance Law for 2007. The bill envisages two main lines of reform. One is broad-based support for the productive system through automatic tax measures to lower production costs and promote investment, the expansion of firms and the reduction of geographical disparities. The relevant actions include two measures contained in the Finance Law for 2007: the reduction of Irap rates to contain labour costs, designed in such a way as to promote permanent employment contracts; and the tax credit for research and development spending within the limit of 10 per cent of the costs incurred (15 per cent if the costs refer to contracts with universities and public research entities).

The second line of reform action sets objectives intended to reposition the Italian industrial system towards higher-value-added products. According to the bill, these interventions would make use of Industrial Innovation Projects targeted to particular fields of technology and production. The Finance Law for 2007 provides funding for five Projects: energy efficiency, sustainable mobility, the new biotechnologies, the cultural heritage and typical "made in Italy" goods.

The bill provides for monitoring and evaluation systems, an important innovation to foster greater transparency. The automatic nature of the incentives under the first line of action is a positive factor, although the resources needed to honour commitments to beneficiaries will have to be carefully gauged so that firms can know with certainty that the funds will actually be available when they plan their investments. The sectoral incentives envisaged under the second line of action are characterized by complex implementation procedures and presuppose that the public entities have good capacities for strategic evaluation in the selection of projects. The risks of a suboptimal allocation of resources and of bureaucratization are considerable.

### *The regulation of productive activities*

A sector sheltered from competition suffers from an inefficient allocation of resources, limits its growth potential and harms the sectors that use its outputs as production inputs. Recent research by the Bank of Italy shows that there is a negative correlation between the obstacles to competition in business services and the growth of value added and productivity in manufacturing industry in the OECD countries, especially in the case of the professions (for example, notaries, lawyers, engineers and accountants) and energy supply (gas and electricity). For the professions the main impediments to competition take the form of restrictions on conduct (e.g. bans on advertising, or fee schedules established by professional associations), while in energy supply barriers to the entry of new firms are more important.

These results are particularly important for a country like Italy, which, according to OECD indicators, had one of the highest levels of regulation of business services at the beginning of the 1990s. In 2003 its regulatory intensity was still above the OECD average, despite significant reductions in all sectors except the professions.

The measures contained in Laws 248/2006 and 40/2007 go in the direction of reducing the obstacles to competition in these markets, removing regulatory access barriers and restrictions on conduct that are not justified by protection of the public interest. Among the sectors affected are retailing, professional services, pharmaceuticals distribution, insurance and local public transport. Especially significant are the measures concerning retailing and professional services, in the light of these sectors' economic impact.

For retailing, a set of general principles and provisions was introduced to prevent the adoption at local level of measures restrictive of competition in the sector. In addition, national legislation deemed incompatible with those principles was repealed. Not all of the regional governments had modified their own regulations accordingly by 1 January 2007, the deadline set by the law.

In professional services, measures significantly liberalizing the rules governing conduct with respect to fee-setting, advertising and the organization of professional activity were introduced to increase the degree of competition and foster more efficient forms of organization.

The changes bring Italian regulation into line with the prevailing standard in the other industrial countries. According to our estimates, the OECD index of regulation of professional services, which before the reform showed Italy to be among the most stringently regulated, would now put it very close to the mean.

## *Public services: energy, telecommunications and local public services*

*Energy*. – A decade on, the liberalization of the energy sector is still incomplete in the electricity market and far behind schedule in the gas market.

In the electric power sector, the far-reaching changes in institutional arrangements, with the separation of the grid from the former monopolist and the start-up of the electric power exchange, have been accompanied by a progressive reduction in concentration in power generation. According to Eurostat's indices, the market share held by the former monopolist fell more in Italy than in the other main EU countries, from 71 per cent in 1999 to less than 40 per cent in 2005. However, this indicator fails to capture the actual competitive conditions of the market. The fact-finding inquiry carried out by Italy's Antitrust Authority and Electricity and Gas Authority shows that in 2004, despite the decline in its share of generation, Enel's market power remained strong. The dominant operator was in a position to influence prices in nearly every geographical segment of the electricity market, thanks to its control of the marginal power plants needed to meet intraday demand peaks. The Italian authorities' analysis, confirmed for 2005 by the survey conducted by the European Commission, concluded that only the entry of new operators and the expansion of the grid would permit a competitive market to be established. As is shown by the experience in the United Kingdom, the first major European country to have begun liberalizing the sector, the decline in prices hinges above all on a drastic reduction in the concentration of marginal generating capacity.

In the gas sector, final prices in Italy have only partially followed the upward path of the price of natural gas and are now lower than the European Union average, whereas two years ago they were in line with it. The liberalization process is seriously behind schedule in most of Europe, hindered by the controlling position of the dominant firms in the supply of natural gas, which is imported from a small number of countries under non-contestable long-term contracts. In Italy, according to the Electricity and Gas Authority, Eni holds a dominant position in all upstream and downstream activities. Given the control it exercises over imports and infrastructure, there appears to be little scope for real competition to develop. In the medium term, the entry of new competitors could be assisted by the opening of regasification facilities, which would make it possible to import gas by sea free of the constraints imposed by the use of the pipelines controlled by Eni. The Authority deems the risks of excess supply to be remote.

Community legislation sets this July as the date for the complete opening up of final markets, which will allow all firms and households to choose their electricity and gas suppliers. This has been possible for gas since 2003, but the Electricity and Gas Authority had established a regulated price for the weakest customers. With complete liberalization, Directive 2003/54/EC sets stringent limits on the scope for price regulation, to be defined by the law transposing the directive into national legislation. As the Authority stated in its report to Parliament and the Government on 15 May 2007, with the markets continuing to be non-competitive and in the absence of the law that should establish new instruments for protecting consumers, the liberalization of final sales could translate into a rise in prices. Bill 691/2006, which would give the Government powers to transpose the directive, has not completed its passage through Parliament.

Some of the measures envisaged by Bill 691/2006 to promote energy efficiency were, however, incorporated into the Finance Law for 2007. They were made necessary by the country's growing dependency on imported energy and the commitments to the EU – not honoured up to now – to reduce greenhouse gas emissions (the emissions index rose from 106 in 2000 to 112 in 2005, compared with an objective of 93.5 for the year 2010). Moreover, the European Union has tightened the targets for emissions reduction further in order to combat global warming, outlining measures that will be binding on all member countries.

*Telecommunications*. – The process of opening up to the market is at a more advanced stage in telecommunications, not least because of the technological innovations that have affected the sector. However, in the report attached to its Resolution 208 of 2 May 2007, the Communications Regulatory Authority notes that Telecom Italia, the dominant operator, maintains monopoly control of the network, essential infrastructure that it is not economically efficient to replicate, giving rise to numerous legal disputes with competitors. Using its new powers under Law 248/2006, the Authority intends to conclude the procedures for the functional and corporate separation of Telecom Italia from the network, although the extent of the infrastructure that will be covered by the measure is still to be defined. In particular, it remains to be decided whether separation will concern the traditional network only or new-generation infrastructure as well.

*Local public services*. – Like most of the other industrial countries, Italy has included the main local public services within the scope of liberalization. From the mid-1990s onwards new regulatory principles have been established to separate service operation from planning and monitoring. Injecting elements of competition into the operation of services and strengthening local government's role of planning and monitoring were expected to foster the growth of operations beyond the municipal dimension and the assimilation of an industrial logic, even in the case of publicly-owned companies. In order to curb operating deficits and to moderate service costs and make them explicit, provision was made for the costs to be progressively covered by tariff increases, which would be limited in any event by the anticipated efficiency gains. According to the initial results of an ad hoc survey carried out by the Bank of Italy, these policy principles have been put into practice only in part and with marked geographical disparities, reflecting the uncertainty of the legislative framework and widespread recourse to transitory regimes. The process of setting up Optimal Territorial Areas and the related Area Authorities that were supposed to manage the award of services at a supra-municipal level has proved cumbersome. And where these new bodies have in fact been instituted, they have tended to become an additional seat of political representation and, for technical expertise, often turn to the service operators, who should be their counterparties instead. The enabling bill on local public services that the Government presented at the start of the current legislature is still in Parliament.

In urban public transport, the first results of the survey conducted in the provincial capitals show that the changes introduced by Legislative Decree 422/1997 have not produced the expected results so far. Fewer than half of the cities, the vast majority of these in the Centre and North, have used competitive procurement procedures for the award of service contracts. Direct and in-house award is prevalent, and even where a tender procedure is used the service contract usually goes to the previous operator. There are almost always very few tenderers (not even three in almost 70 per cent of the cases and just one in 40 per cent) and scant participation by foreign companies; the reduction with respect to the starting price is generally negligible (less than 1 per cent in 65 per cent of tenders). Often, savings have been pursued by differentiating the terms and conditions of contract of new employees and through outsourcing, without altering the overall organization of the service. More in general, central government intervention in providing part of the resources necessary for labour contract renewals and for investments lessens the incentive for local authorities to make an effort to curb costs.

In waste collection and disposal too, the modernization launched by Legislative Decree 22/1997 (the Ronchi Decree) is still far from reaching completion. Service contract awards are only rarely made at the level of Optimal Territorial Areas, and, especially in the South, there are many instances of regional services operating under special administrators. Although one of the objectives of the new legislation was to curb the production of waste, between 2000 and 2006 the amount generated per inhabitant grew at a higher rate than GDP (6 per cent between 2000 and 2005, compared with an EU average of 1 per cent). The objectives for the growth in pre-sorting and separate collection – 35 per cent by 2003, raised by the Finance Law for 2007 to 45 per cent by 2008 and 65 per cent by 2012 – were also only fully achieved in the North but largely unimplemented in the South, where only 10 per cent of waste was pre-sorted in 2005 (compared with 38 per cent in the North). In the South the low incidence of separate collection goes together with the area's limited endowment of disposal facilities other than landfills, in some areas now dramatically insufficient to cope with local needs.

The application of prices in lieu of tax for solid waste removal, which was supposed to bring out the costs of the service and ensure that they were completely covered by revenues, is limited to less than a quarter of the national population (and only 7 per cent in the South).

Likewise, for water services, compliance with the statutory guidelines – laid down by Law 36/1994 (the Galli Law) – has been less than complete. Award of the water supply service at the level of Optimal Territorial Areas has happened in only 59 of the 91 Areas established, which serve about two thirds of the population. And even in the case of integrated award of the service, there remain multiple operators within a single Area (108 operators in 59 Areas). The majority of awards are made in-house and to the previous operator, under the safeguard clause provided for by the law. In the Areas in which the service has not been awarded, some 600 operators are still active.

As to the quality of management, there are doubts as to the correctness of the Area plans in linking prices to costs and to the financing of the investment projects decided at the time the service was awarded. In many cases, with a view to holding prices down and because of the need to cover costs completely, forecast consumption was overestimated so as increase projected revenues.

On the basis of data gathered from 76 operators, evident geographical disparities persist in the efficiency and quality of water-supply service. The difference between the volume of water pumped into aqueducts and the volume billed, which gives an approximate measure of water loss to leakage, is about one quarter of the total of water supplied in the North-West, one third in the North-East and Centre and one half in the South. According to Istat data, 23.8 per cent of families in the South complained of service interruptions in 2005, compared with 9 per cent of those in the Centre and North; the gap was slightly narrower than in 2000, when the figures were 28.3 and 8.3 per cent respectively.

## *The civil justice system*

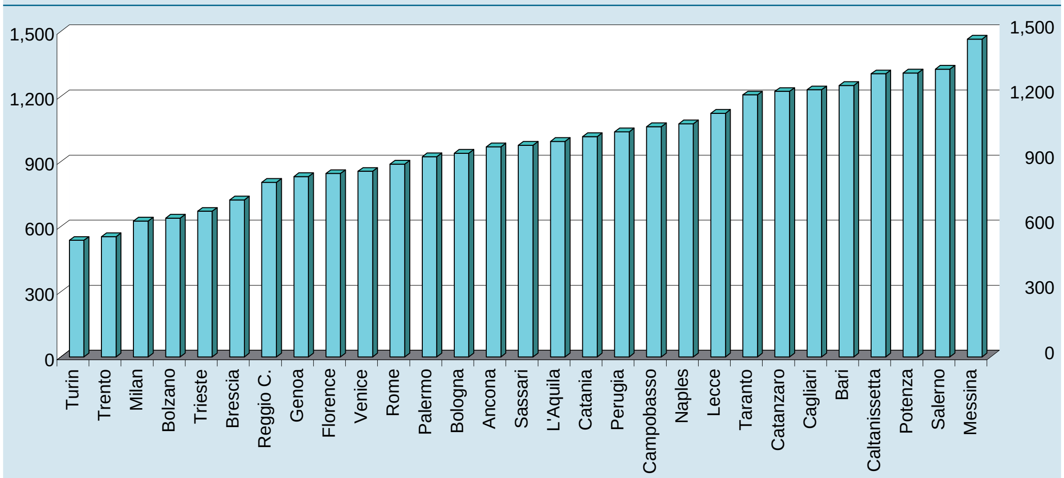
Important legislation affecting the civil justice system was adopted or took effect in 2006. The "mini-reform" of the Code of Civil Procedure (Law 80/2005), aimed at speeding up proceedings by simplifying ordinary civil trials, entered into effect. Legislative Decree 40/2006 concerned trials in the Court of Cassation, Italy's supreme court of appeal. Numerous legislative decrees implemented parts of Law 150/2005 on the reform of the judiciary; the related secondary legislation is still to be issued. The latest innovations are part of the broader reform process launched in the early 1990s with a view to improving the efficiency of civil justice. In the years since then the rules of procedure have undergone multiple amendment: proceedings have been streamlined and concentrated in just a few hearings, special proceedings have been introduced and, except in case of trials held under the new company law, the judge's powers in directing proceedings have been expanded.

A revision of geographical jurisdictions has increased the average size of civil court offices, in order to assist flexibility and the specialization of staff. The number of judges has been increased both directly, through the strengthening of honorary magistrates (justices of the peace, etc.) and indirectly, with the institution of the single presiding judge in place of multiple judges in many trials.

The available statistics do not permit precise evaluation of the effects (in particular, actual data on the length of trials are lacking), but overall the picture of the system's functioning is still negative. The estimated time to resolution is still long, and there are indications that decisions are not of high quality. According to estimates based on Ministry of Justice data, in 2005 ordinary civil proceedings in courts of the first instance lasted an average of 918 days (see the geographical details in Figure 9.4) and the appeals trials took another 1,185 days.

**Figure 9.4**

**Estimated length of ordinary civil proceedings in courts of the first instance by appeals court district in 2005**
*(days)*




Source: Based on Ministry of Justice data.

Although civil justice systems are admittedly not perfectly comparable, the shortcomings of the Italian system are very substantial by international standards and cannot be explained by the volume of resources used, which is greater than the average for the main European countries. The propensity to litigate, however, is relatively high in Italy.

International and domestic comparisons suggest that there is a productivity problem in the administration of justice and, coupled with economic analysis, indicate that the organization of the courts and the system of incentives offered to judges have a significant impact on results. Inadequate IT endowment, poor coordination between administrative personnel and judges and the absence of para-professionals to assist judges in drafting decisions undermine the efficiency of Italian courts. A crucial need is a revision of the promotion system for judges that, while safeguarding the independence of the judiciary guaranteed by the Constitution, gives due weight to individual merit.

### *Regional economic policy*

According to Svimez estimates, in 2006 GDP grew by 2 per cent in the regions of the Centre and North after recording no change in 2005; in the South it expanded by 1.5 per cent after contracting slightly the previous year. The differential reflected the smaller increase in total consumption in the South (0.6 per cent, compared with 1.4 per cent), due to the weaker growth of household spending and the decline in consumption of general government. By contrast, gross fixed investment, which had contracted in the South in 2005, grew slightly more there last year than in the Centre and North (2.5 against 2.2 per cent).

The value of merchandise exports increased again last year in all the macro-regions Table 9.1). The growth was sharper in the regions of the Centre and North and more moderate in the South.

Tavola 9.1

**Exports at current value by geographical area**

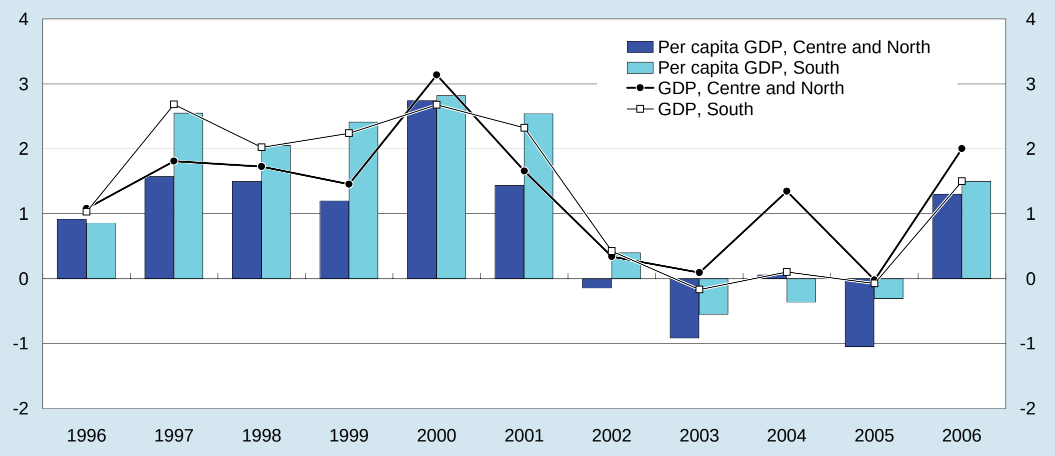
| | Percentage share 2006 (1) | Percentage change on previous year | | | |
|---|---|---|---|---|---|
| | | 2003 | 2004 | 2005 | 2006 |
| North-West | 40.5 | 0.6 | 4.0 | 6.6 | 8.5 |
| North-East | 31.1 | -2.6 | 7.8 | 3.7 | 9.6 |
| Centre | 15.7 | -4.7 | 5.0 | 1.5 | 13.4 |
| South | 11.0 | -2.6 | 7.8 | 11.6 | 6.8 |
| **Italy** | **100.0** | **-1.6** | **7.5** | **5.5** | **9.0** |

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

Between 1996 and 2006 the average GDP growth rate of the South was in line with that of the Centre and North (Figure 9.5). The small positive differential for the South in per capita GDP growth (nearly 0.5 percentage points per year) reflects the increase in the population of the Centre and North due to migration both from southern Italy and from abroad. The gap in terms of per capita GDP remains very wide: in 2006 the figure for the South was 58 per cent of that of the Centre and North, with two thirds of the gap explained by the difference in employment rates and one third by that in productivity.

Figure 9.5

**GDP growth rates**




Sources: Istat, *Conti economici territoriali*, for 1996 to 2005; Svimez estimates for 2006.

The recent improvements in employment growth have mainly come in the regions of the Centre and North. Between 1996 and 2006 employment grew at an average annual rate of 0.8 per cent in the South, less than half as fast as in the Centre and about two thirds as fast as in the North.

The resources for regional policy in Italy come from two sources, the European Structural Funds supplemented by the necessary national co-financing and the Fund for Underutilized Areas, alongside other ordinary sources of financing. According to the Annual Report for 2006 of the Department for Development and Cohesion Policies of the Ministry for Economic Development, capital expenditure drawing on the two funds exceeded €14 billion in 2006, or 24 per cent of the total, the large increase from the previous year (€12.5 billion) reflecting the increase in disbursement for the South, which rose from €9.6 billion to €11.5 billion.

Spending for regional policy consists mainly in investments in infrastructure and transfers to firms or individuals. Although since the end of the 1990s the balance of expenditure has been corrected to the benefit of the former, capital transfers still account for nearly 45 per cent of general government capital expenditure in the South, compared with 53 per cent in 1999.

The revision of the main instruments of incentives for investment (the investment tax credit and Law 488/1992), begun in 2003 with a view to reducing the impact on the State budget, has led to a gradual decline in the amount of resources disbursed and a change in the types of firm that benefit.

The thirty-first call for applications for investment support under Law 488/1992 closed in September 2006. According to initial studies by the Ministry for Economic Development, the new selection mechanisms determined a fall in applications, an increase in participation by large and medium-sized firms with respect to small enterprises, and a sharp drop in the average capital grant per unit of supported investment. The resources used for the investment tax credit, amounting to more than €5 billion since its inception in 2002, fell last year from €1 billion to €850 million. Disbursements for the employment tax credit were at the previous year's level (€260 million) and again were equal to 60 per cent of the resources for which application was made in advance.

All 220 territorial pacts signed throughout Italy were still active at the end of 2006, a decade after they were instituted. The total resources disbursed amounted to €2,806 million, or just over 50 per cent of those assigned to this policy instrument. Last year there was a sizeable decline in expenditure (from €414 million to €253 million) and disbursements for programme contracts (€83 million to €39 million).

The resources provided by the Community Support Frameworks 2000-06 for spending connected with the programmes of the Structural Funds amounted to just over €64 billion (excluding private contributions), of which more than €45 billion goes to the Objective 1 regions. The resources must be used by the end of 2008, on pain of the allocation lapsing. According to data published by the Ministry for Economic Development, as of 31 December just under €41 billion of payments had been made, equal to 66 per cent of the planned total. Spending for actions in the Objective 1 areas did not reach €30 billion (63 per cent of the total available), with execution ratios of less than 50 per cent in Sicily, Campania and Puglia, the three largest southern regions.

The new planning cycle for regional development policy was launched in December 2006 with the approval by the Interministerial Committee for Economic Planning of the National Strategy Framework for 2007-13. The new cycle is to involve measures totalling almost €123 billion, more than €100 billion of which will go to the South. The total amount, in line with that of the previous cycle (€124.5 billion), consists of €28.8 billion of Community resources, together with national co-financing of €29.5 billion, and €64.4 billion of resources assigned to the Fund for Underutilized Areas.

The Finance Law for 2007 introduced additional measures in support of regional policy, financed with ordinary resources.

# 10. THE BALANCE OF PAYMENTS AND THE NET INTERNATIONAL INVESTMENT POSITION

Italy's current account deficit increased sharply in 2006 and, as in 2005, this was largely due to the rise in the prices of energy products. At the same time, exports of goods expanded rapidly, benefiting from the progress of world demand especially in Italy's main outlet markets. The deficit rose from €23.4 billion in 2005 to €37.9 billion and from 1.6 to 2.6 per cent of GDP (Table 10.1).

The current account deficit was pushed up by the swing in the merchandise trade balance from equilibrium in 2005 to a deficit of €9.5 billion and the increase in the deficits on transfers (from €9.8 billion to €13.3 billion) and services (from €0.5 billion to €1.5 billion). The deficit on income remained unchanged.

Corresponding to the overall deficit of €36 billion on current and capital account were net inflows of €35.5 billion on the financial account. As in 2005, the surplus on portfolio investment (€54.8 billion) was the main source of financing for the current account deficit. Direct investment and financial derivatives showed a combined deficit of €2.7 billion (€15.2 billion in 2005), while the deficit on "other investment" rose from €8.2 billion to €17 billion. The official reserves decreased by €0.4 billion.

Italy's net external debt increased from €52.1 billion to €72.5 billion and from 3.7 to 4.9 per cent of GDP, owing to the net capital inflows recorded in the financial account. The growth in the net external debt was curbed by exchange rate and value adjustments (€15.2 billion).

## *The current and capital account*

*Trade in goods.* – For the first time since 1992 the fob-fob merchandise trade balance showed a deficit (€9.5 billion, or 0.6 per cent of GDP), the result of faster growth in the value of imports than exports (14.3 per cent, as against 10.9 per cent).

According to foreign trade data on a cif-fob basis, the energy deficit widened by €11.5 billion, from €38.6 billion to €50.1 billion. The surplus on manufactures alone (excluding refined petroleum products) grew from €36.8 billion to €38.9 billion, thus remaining at 2.6 per cent of GDP. The leading contributor to the surplus on manufactures was the €5.3 billion increase in the surplus on machinery and mechanical equipment, reflecting an expansion of both exports and imports (12.1 and 9 per cent, respectively). Next came the reduction of €0.7 billion in the deficit on transport equipment, followed by the decline in the deficit on electrical equipment and precision instruments and the larger surpluses recorded for non-metallic mineral products, rubber

**Table 10.1**

**Balance of payments** (1)
*(billions of euros)*

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| **Current account** | **-10.0** | **-17.4** | **-13.1** | **-23.4** | **-37.9** |
| Goods | 14.0 | 9.9 | 8.9 | 0.5 | -9.5 |
| *Exports* | *267.6* | *263.6* | *283.3* | *299.4* | *331.9* |
| *Imports* | *253.5* | *253.7* | *274.5* | *298.9* | *341.5* |
| Services | -3.0 | -2.4 | 1.2 | -0.5 | -1.5 |
| *Exports* | *63.8* | *63.4* | *68.2* | *71.9* | *78.4* |
| *Imports* | *66.8* | *65.8* | *67.0* | *72.4* | *79.9* |
| Income | -15.4 | -17.8 | -14.8 | -13.6 | -13.6 |
| Transfers | -5.6 | -7.1 | -8.3 | -9.8 | -13.3 |
| *of which: EU institutions* | *-5.7* | *-6.3* | *-6.5* | *-8.1* | *-8.3* |
| **Capital account** | **-0.1** | **2.3** | **1.7** | **1.0** | **1.9** |
| Intangible assets | -0.2 | -0.1 | .. | 0.1 | -0.1 |
| Transfers | 0.1 | 2.3 | 1.7 | 0.9 | 2.0 |
| *of which: EU institutions* | *1.6* | *3.6* | *2.8* | *3.4* | *3.8* |
| **Financial account** | **8.5** | **17.3** | **9.0** | **20.8** | **35.5** |
| Direct investment | -2.7 | 6.5 | -2.0 | -17.6 | -2.3 |
| *Outward* | *-18.2* | *-8.0* | *-15.5* | *-33.6* | *-33.5* |
| *Inward* | *15.5* | *14.5* | *13.5* | *16.0* | *31.2* |
| Portfolio investment | 16.1 | 3.4 | 26.4 | 43.4 | 54.8 |
| Equities | -13.2 | -16.0 | 0.5 | -16.0 | -8.8 |
| *Assets* | *-6.0* | *-13.8* | *-12.9* | *-20.0* | *-19.3* |
| *Liabilities* | *-7.2* | *-2.2* | *13.4* | *4.1* | *10.5* |
| Debt securities | 29.3 | 19.4 | 25.9 | 59.3 | 63.6 |
| *Assets* | *-10.9* | *-37.3* | *-8.2* | *-67.0* | *-20.3* |
| *Liabilities* | *40.2* | *56.6* | *34.1* | *126.4* | *84.0* |
| Financial derivatives | -2.7 | -4.8 | 1.8 | 2.3 | -0.4 |
| Other investment | 1.0 | 13.7 | -19.6 | -8.2 | -17.0 |
| *of which: banks* (1) | *-41.7* | *40.6* | *-10.0* | *27.0* | *44.0* |
| Change in official reserves | -3.1 | -1.4 | 2.3 | 0.8 | 0.4 |
| **Errors and omissions** | **1.5** | **-2.2** | **2.3** | **1.6** | **0.5** |

(1) MFIs, excluding the Bank of Italy.

and plastic products and other products of manufacturing (including furniture). The surplus on leather and leather products remained about the same even though the rate of growth in imports far exceeded that in exports. By contrast, a similar pattern in textiles and clothing resulted in a diminishing surplus for the fifth consecutive year. The deficit on basic metals and metal products increased by €3.7 billion and that on chemical products by €1.1 billion.

Data on the geographical distribution of trade in goods indicate that the deficit grew above all with countries outside the EU-25, owing to increases in the deficits with oil-producers such as the OPEC countries and Russia (up by €4.5 billion and

€0.4 billion respectively), despite vigorous growth in their imports from Italy. The deficit with China widened further, from €8.7 billion to €11.1 billion, the outcome of booming growth in both exports and imports (24.4 and 26.5 per cent, respectively). The deterioration was concentrated in textiles and clothing, basic metals and metal products, and electrical machinery.

The small overall surplus with the countries of the EU-25 (€1.3 billion) and the deficit with those of the euro area (€10.9 billion) were basically unchanged from the previous year's levels. The slightly wider deficit with Germany was the outcome of rapid growth in both exports and imports (11.1 and 10 per cent, respectively).

*Trade in services.* – The deficit on services widened slightly, from €0.5 billion to €1.5 billion (0.1 per cent of GDP). The largest positive contribution came from foreign travel; the surplus on this item rose from €10.5 billion to €12 billion, with both tourism (the main component of travel for personal reasons) and business travel each accounting for just under half of the growth in the surplus. There was especially rapid growth of 13.5 per cent in spending in Italy by business travellers from abroad. "Other business services" (technical and professional services, merchanting and other trade-related services and operating leasing) were the main cause of the deterioration, with a deficit that rose from €2.1 billion to €4 billion.

The deficit on transport services edged up from €5.2 billion to €5.5 billion. The worsening of the deficit on maritime transport, reflecting larger outlays for goods transport due mainly to higher fuel costs, was almost totally offset by the reduction in that on air transport connected with the growth in tourist inflows.

*Income.* – The deficit on income – €13.6 billion, 0.9 per cent of GDP – was comparable to that of the previous year. Under investment income, the deficit on income from portfolio investment contracted from €9.1 billion to €5.6 billion, while the balance on income from direct investment, which had been negative in 2005, was positive by €0.7 billion. By contrast, the deficit on other investment income grew from €3.3 billion to €8.4 billion, primarily because of the jump of 35.9 per cent in debits.

*Current transfers.* – The growth from €9.8 billion to €13.3 billion in the deficit on total current transfers derived from that on private transfers, which rose from €1.5 to €5.3 billion. The deficit on public transfers diminished from €8.3 billion to €8 billion even though that vis-à-vis the European Union rose slightly, from €8.1 billion to €8.3 billion. The balance on private transfers showed deterioration in all the main sub-items. There was a substantial increase in the amounts paid abroad for taxes and duties, subsidies and other support payments, and other transfers; the deficit on workers' remittances grew from €3.7 billion to €4.1 billion.

The revision of debits under workers' remittances for the period 2004-06, following a methodological change that took into account the findings of a survey carried out at money-transfer agencies, led to an increase of 29 per cent in the amount for 2004 and 61 per cent for 2005. The sharp increase in outflows of workers' remittances signalled by the new data is part of a decade-long trend linked to the growing number of foreign workers in Italy.

### *Investment*

*Direct investment*. – The smaller deficit on foreign direct investment (€2.3 billion, down from €17.6 billion in 2005) reflected a sharp rise in inflows. Italian investment abroad (€33.5 billion) matched the previous year's exceptionally high figure (€33.6 billion), while foreign investment in Italy almost doubled, from €16 billion to €31.2 billion. The very substantial net direct investment inflows and outflows were almost entirely due to acquisitions of equity interests, partly in connection with lively M&A activity.

While in 2005 Italian investment abroad by the banking sector had exceeded that by non-banks, last year it was the latter that kept the pace high, increasing their direct investment from €14.5 billion to €27.1 billion, the highest figure for the last two decades. The increase came mainly from investment in makers of machinery and equipment and in credit and insurance services.

As to foreign direct investment in Italy, last year saw a significant increase for both the bank and non-bank sectors. Inward investment in sectors other than banking rose from €15.1 billion to €23.8 billion, a historically high level, and was concentrated both in amount and in terms of the year-on-year change in virtually the same sectors as outward investment: credit and insurance services, production of machinery and equipment, and transport and communication services.

*Portfolio investment and financial derivatives*. – The growth in the overall surplus for these items, from €45.7 billion to €54.4 billion, was almost entirely due to portfolio investment; after expanding sharply in 2005, portfolio inflows contracted from €130.4 billion to €94.5 billion and outflows from €87 billion to €39.7 billion. The decline mainly involved debt securities.

On the assets side, Italian investment in foreign shares was close to the level of the previous year (€19.3 billion, compared with €20 billion), partly reflecting the favourable performance of equity returns and prices and partly increased resort to foreign-based asset managers. The outflow towards Luxembourg, already large in 2005 at €24.5 billion, grew slightly, to €25.2 billion, and again went almost entirely to investment fund units. France and Germany were the other two euro-area countries to record high or rising Italian portfolio investment. In the case of France, the increase reflected purchases of investment fund units.

Italian investment in foreign debt securities amounted to €20.3 billion, down from €67 billion in 2005. The decline involved investment in the euro area and the rest of the world in equal proportion, the former decreasing from €53.1 billion to €15.4 billion and the latter from €13.9 billion to €5 billion.

On the liabilities side, non-residents' investment in Italian equities rose from €4.1 billion in 2005 (a figure boosted by a single major transaction) to €10.5 billion last year. Their investment in Italian debt securities fell from €126.4 billion to €84 billion. Government securities alone showed a decline of €54 billion, the bulk of it accounted for by BOTs, for which the investment inflow contracted from €24.5 billion to virtually nil (in the presence of very low net issues), and Republic of Italy issues, which recorded considerable net redemptions.

*Other investment and the official reserves.* – The increase in the deficit on "other investment" derives mainly from the swing in the position of the monetary authorities from approximate balance in 2005 to a deficit of €16.8 billion, due to the TARGET balance (in which the position of the Bank of Italy formally replaces that of the banks).

Transactions during the year reduced the official reserves by €0.4 billion in 2006, but the year-end stock rose from €55.9 billion to €57.5 billion, thanks to value adjustments. The €3.8 billion revaluation gain on gold reserves, which grew from €34.3 billion to €38.1 billion, more than compensated for the losses due to exchange rate adjustments reflecting the appreciation of the euro against the main reserve currencies (the dollar, yen and Swiss franc).

Table 10.2

**Net international investment position**
*(millions of euros)*

| | Stocks at end-2005 (1) | January-December 2006 | | | | | Stocks at end-2006 (1) |
|---|---|---|---|---|---|---|---|
| | | Flows (2) | Value adjustments | | | Change in stocks | |
| | | | | Exchange rate (3) | Other | | |
| | (a) | (b) | (c) | (d) | (e) | (f)=(b)+(c) | (a)+(f) |
| | | | **Resident non-banks** | | | | |
| **Assets** | **1,204,939** | **120,365** | **-799** | **-16,986** | **16,188** | **119,566** | **1,324,506** |
| Direct investment | 217,142 | 28,279 | -1,682 | -2,700 | 1,018 | 26,597 | 243,739 |
| Portfolio investment | 753,575 | 38,100 | 1,620 | -13,549 | 15,170 | 39,720 | 793,295 |
| *of which: equities* | *337,037* | *17,965* | *14,485* | *-9,211* | *23,696* | *32,450* | *369,487* |
| Other investment | 221,638 | 52,428 | -737 | -737 | .. | 51,691 | 273,329 |
| Derivatives | 12.584 | 1.558 | .. | .. | .. | 1.558 | 14.142 |
| **Liabilities** | **1,186,567** | **87,797** | **-24,052** | **-6,363** | **-17,689** | **63,745** | **1,250,312** |
| Direct investment | 176,411 | 24,842 | -2,734 | -69 | -2,665 | 22,108 | 198,519 |
| Portfolio investment | 848,096 | 48,112 | -20,490 | -5,466 | -15,024 | 27,623 | 875,718 |
| *of which: equities* | *27,138* | *6,710* | *4,029* | .. | *4,029* | *10,739* | *37,877* |
| Other investment | 140,731 | 8,152 | -828 | -828 | .. | 7,324 | 148,055 |
| Derivatives | 21,329 | 6,691 | .. | .. | .. | 6,691 | 28,020 |
| **Net position** | **18,373** | **32,567** | **23,253** | **-10,624** | **33,877** | **55,821** | **74,194** |
| | | | **Resident banks** | | | | |
| Assets | 344,296 | 53,832 | -3,555 | -3,797 | 243 | 50,277 | 394,573 |
| Liabilities | 492,318 | 139,251 | 6,360 | -8,452 | 14,812 | 145,611 | 637,929 |
| **Net position** | **-148,021** | **-85,420** | **-9,914** | **4,654** | **-14,569** | **-95,334** | **-243,356** |
| | | | **Central bank** | | | | |
| Assets | 79,374 | 16,589 | 1,694 | -2,083 | 3,777 | 18,283 | 97,657 |
| Liabilities | 1,828 | -737 | -136 | -136 | .. | -873 | 955 |
| **Net position** | **77,546** | **17,326** | **1,830** | **-1,947** | **3,777** | **19,156** | **96,702** |
| **Total net position** | **-52,102** | **-35,526** | **15,169** | **-7,917** | **23,085** | **-20,357** | **-72,460** |

(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 net international investment position*

Italy’s year-end net external debt rose from €52.1 billion in 2005 to €72.5 billion in 2006 and from 3.7 to 4.9 per cent of GDP (Table 10.2). All of the deterioration was due to the net capital inflow of €35.5 billion on the financial account.

In the case of total liabilities, which rose from €1,680.7 billion to €1,889.2 billion, value adjustments caused a reduction of €17.8 billion. This was concentrated in the liabilities of the non-bank sectors (€24.1 billion), especially portfolio holdings of bonds, as a consequence of price movements (capital losses on securities). For government securities alone, the capital losses due to the rise in medium and long-term interest rates amounted to €20.6 billion. In the case of the bank sector, adjustments increased liabilities by €6.4 billion, owing primarily to revaluation gains on equity portfolio securities held by non-residents.

In the case of total assets, which rose from €1,628.6 billion to €1,816.7 billion, the adjustment losses were relatively small (€2.7 billion), as the effects of price gains (concentrated mainly in portfolio investment) and exchange rate losses offset each other. The largest reductions due to value adjustments were those on the assets of the bank sector, owing to the prevalence among them of “other investment”, whose losses due to exchange rate adjustments are not counterbalanced by price changes. The overall effect of adjustments on the central bank’s assets was moderately positive (€1.7 billion), thanks above all to the revaluation of the official reserves.

## 11. THE PUBLIC FINANCES

General government net borrowing was 4.4 per cent of GDP in 2006, compared with 4.2 per cent in 2005; excluding the extraordinary costs deriving from the cancellation of the State's claims on TAV S.p.A. in connection with the high speed railway network and from a judgment of the European Court of Justice concerning VAT, the deficit amounted to 2.5 per cent of GDP. On a cyclically adjusted basis and excluding the effects of a larger package of one-off measures, net borrowing fell to 3 per cent of GDP from about 4.5 per cent in 2005.

The improvement in the accounts reflected the large increase of 1.7 percentage points in the GDP ratio of taxes and social security contributions. Revenue benefited from the upturn in economic activity, some temporary provisions and factors, and the measures to enlarge and recover tax bases included in the budget for 2006 and in the package introduced last summer. The ratio of current expenditure to GDP remained unchanged at a high level. Public investment expenditure declined for the second successive year.

The deficit was much smaller than had been forecast, both in preparing the budget and during the year.

The general government borrowing requirement fell by 1.6 percentage points of GDP to 3.7 per cent. The gap with respect to net borrowing (excluding the above-mentioned extraordinary costs) was slightly greater than the already large difference recorded in 2005.

The ratio of the public debt to GDP rose for the second successive year, from 106.2 to 106.8 per cent.

The Stability Programme published last December set three priority objectives for the five years 2007-11: end the excessive deficit situation in 2007; achieve a balanced budget in the medium term; and significantly reduce the ratio of debt to GDP.

At the end of last year Parliament approved the budget for 2007, estimated to reduce the deficit by one percentage point of GDP. One third of the correction was to come from the transfer to INPS of part of the severance pay allocations not assigned to pension funds.

Last March the Combined Report on the Economy and Public Finances, taking account of the results for 2006 and the improved growth prospects, estimated net borrowing in 2007 at 2.3 per cent of GDP (compared with a target of 2.8 per cent). The estimate appears to be based on essentially prudent assumptions.

The Combined Report expects a further increase in the fiscal burden, to 42.8 per cent, close to the peaks of the 1990s. The ratios of primary current expenditure and capital expenditure to GDP are expected to remain basically unchanged.

The objective of a balanced budget is still far off. The deficit expected in 2007 is not small enough to trigger an adequate fall in the ratio of debt to GDP. Any revenue in excess of that forecast must be used first and foremost to reduce the deficit.

With the fiscal burden unchanged and with no reduction in investment, achieving a balanced budget requires major action to curb the growth in primary current expenditure, which in the last five years has risen steadily in relation to GDP. The medium and long-term sustainability of the public finances depends crucially on the full application of the rules introduced by the 1995 pension reform and on the savings generated by the 2004 reform.

### *Budgetary policy for 2006: objectives and forecasts*

In July 2005 the EU Council established that an excessive deficit existed in Italy and called for the Government to reduce it below the 3 per cent limit by 2007, with a significant adjustment already in 2006. In the Economic and Financial Planning Document published at the end of July 2005 the Government set a target of 3.8 per cent of GDP for net borrowing in 2006, as against 4.3 per cent expected at the time for 2005 (Table 11.1). At the end of September a budget adjustment amounting to €11.5 billion (0.8 per cent of GDP) was submitted to Parliament. GDP was expected to grow by 1.5 per cent in 2006.

During the budget bill's passage through Parliament the size of the adjustment was increased twice: in November 2005 (by about €5 billion), to offset the exclusion from the projection on a current legislation basis of the proceeds expected from property sales; and in December (by €4 billion), in connection with the tightening of the objective for the deficit in 2006 to 3.5 per cent of GDP.

In April 2006 the Quarterly Report on the Borrowing Requirement estimated that net borrowing for the year would be 3.8 per cent of GDP, taking account of some revisions made by Istat in the outturn for 2005 and of the worsening of the estimate of economic growth to 1.3 per cent.

In June the committee appointed by the new Government to review the state of the public finances raised the estimate of the deficit to 4.1 per cent of GDP, after revising the revenue and expenditure forecasts upwards, partly on the basis of the results for the early months of the year.

In the summer the Government introduced a supplementary budget designed to raise resources amounting to 0.3 per cent of GDP, primarily through measures to reduce tax avoidance and evasion. About two thirds of the resources were allocated to finance additional expenditure on road and railway infrastructure. The ex ante tax agreement plan and the related condonation scheme were abolished. During Parliament's ratification of the decree amendments were introduced that reduced the revenue expected.

Taking account of this supplementary budget, of the much higher-than-expected tax receipts in June and of the increase in the forecast of growth (to 1.5 per cent), the July Economic and Financial Planning Document raised the forecast for tax revenue. The estimate of the deficit remained basically unchanged, however, at 4 per cent of GDP, reflecting a more prudent evaluation of expenditure.

Table 11.1

**Public finance objectives, estimates and outturn for the year 2006**
*(billions of euros)*

| | General government | | | | *Memorandum items* | |
|---|---|---|---|---|---|---|
| | Net borrowing | Primary surplus | Interest payments | Debt | Real GDP growth rate (%) | Nominal GDP |
| **Objectives** | | | | | | |
| Economic and Financial Planning Document (July 2005) | .... | .... | .... | .... | 1.5 | .... |
| *as a percentage of GDP* | *3.8* | *0.9* | *....* | *107.4* | | |
| Forecasting and Planning Report (September 2005) | 54.7 | 13.1 | 67.8 | .... | 1.5 | 1,435.4 |
| *as a percentage of GDP* | *3.8* | *0.9* | *4.7* | *....* | | |
| Stability Programme (December 2005) | .... | .... | .... | .... | 1.5 | .... |
| *as a percentage of GDP* | *3.5* | *1.3* | *4.7* | *108.0* | | |
| **Estimates released in 2006** | | | | | | |
| Quarterly Report on the Borrowing Requirement (April 2006) | 56.0 | 9.4 | 65.4 | .... | 1.3 | 1,464.0 |
| *as a percentage of GDP* | *3.8* | *0.6* | *4.5* | *....* | | |
| Economic and Financial Planning Document (July 2006) | 59.3 | 7.8 | 67.1 | .... | 1.5 | 1,466.8 |
| *as a percentage of GDP* | *4.0* | *0.5* | *4.6* | *107.7* | | |
| Forecasting and Planning Report (September 2006) (1) | 71.1 | -4.0 | 67.1 | .... | 1.6 | 1,468.6 |
| *as a percentage of GDP* | *4.8* | *-0.3* | *4.6* | *107.6* | | |
| Stability Programme (December 2006) (1) (2) | .... | .... | .... | .... | 1.6 | .... |
| *as a percentage of GDP* | *5.7* | *-0.9* | *4.8* | *107.6* | | |
| **Outturn** (3) | 65.5 | 2.0 | 67.6 | 1,575.4 | 1.9 | 1,475.4 |
| *as a percentage of GDP* | *4.4* | *0.1* | *4.6* | *106.8* | | |

(1) The September estimates include the effects of the judgment of the European Court of Justice concerning VAT (estimated at €18.6 billion); the December estimates also include the effects of the cancellation of the State's claims on the high-speed railway system (estimated at about €13 billion). – (2) Interest payments and the primary surplus are not directly comparable with those indicated in the other rows because they are calculated gross of financial intermediation services indirectly measured (FISIMs) and net of the effects of swaps and forward rate agreements. – (3) Sources: Istat and, for the debt, Bank of Italy.

In September the Forecasting and Planning Report further increased forecast tax revenue by about half a percentage point of GDP, but the estimate of the deficit was raised to 4.8 per cent of GDP, to take account of the judgment of the European Court of Justice concerning VAT. Excluding that cost, the deficit was expected to be 3.6 per cent of GDP.

In December 2006, when the Government published the Stability Programme update, it announced the decision to cancel the State's claims on TAV S.p.A. in connection with the financing of the high-speed railway network (about €13 billion); this led to the inclusion in the budget for 2006 of a corresponding capital transfer payment. The forecast of net borrowing was increased to 5.7 per cent of GDP.

## *Net borrowing in 2006*

The outturn for 2006 showed general government net borrowing of 4.4 per cent of GDP, as against 4.2 per cent in 2005 (Table 11.2 and Figure 11.1). Excluding the effects of the two extraordinary items referred to above, the deficit was 2.5 per cent of GDP. The improvement reflected the rapid growth in revenue, which increased by 1.7 percentage points of GDP. Excluding the two extraordinary items, expenditure remained basically unchanged in relation to GDP.

**Table 11.2**

**Main indicators of the general government finances** (1)
*(as a percentage of GDP)*

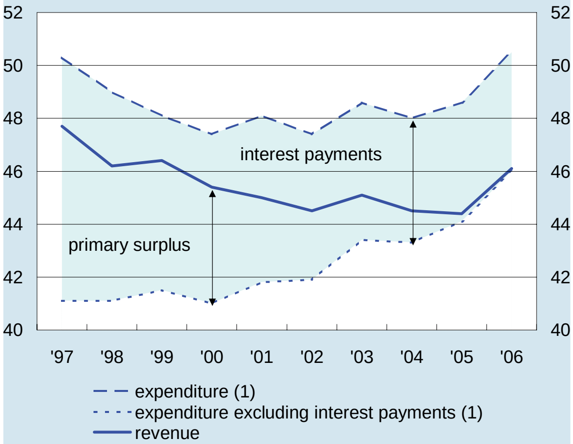
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|---|
| Revenue | 47.7 | 46.2 | 46.4 | 45.4 | 45.0 | 44.5 | 45.1 | 44.5 | 44.4 | 46.1 |
| Expenditure (2) (3) | 50.3 | 49.0 | 48.1 | 47.4 | 48.1 | 47.4 | 48.6 | 48.0 | 48.6 | 50.5 |
| *of which: interest payments* | *9.3* | *7.9* | *6.6* | *6.3* | *6.3* | *5.5* | *5.1* | *4.7* | *4.5* | *4.6* |
| Primary surplus | 6.6 | 5.1 | 4.9 | 4.3 | 3.2 | 2.7 | 1.6 | 1.3 | 0.3 | 0.1 |
| Net borrowing | 2.7 | 2.8 | 1.7 | 2.0 | 3.1 | 2.9 | 3.5 | 3.5 | 4.2 | 4.4 |
| Borrowing requirement | 1.8 | 2.6 | 1.4 | 2.2 | 4.6 | 2.9 | 3.0 | 3.6 | 4.9 | 3.7 |
| Borrowing requirement net of privatization receipts | 2.9 | 3.3 | 3.4 | 3.5 | 4.9 | 3.1 | 4.3 | 4.2 | 5.3 | 3.7 |
| Borrowing requirement net of settlements of past debts and privatization receipts | 2.9 | 3.1 | 2.8 | 3.1 | 4.2 | 2.7 | 3.6 | 4.1 | 5.1 | 3.7 |
| Debt | 118.1 | 114.9 | 113.7 | 109.1 | 108.7 | 105.6 | 104.3 | 103.8 | 106.2 | 106.8 |

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 also deducted from expenditure in the national accounts.

The improvement in the public finances was unexpectedly large. The official forecasts – which were in line with those of other sources – were marked by considerable caution in a context of uncertainty about the strength of the recovery and its impact on revenue. The divergence with respect to the forecasts reflects the more favourable macroeconomic developments, including the composition of growth, and an increase for receipts of the main taxes and contributions that was larger than would have been consistent with the changes in the corresponding bases (see the section, Revenue in 2006). Compared with the forecasts made in the second half of the year, there

**Figure 11.1**

**General government revenue and expenditure**
*(as a percentage of GDP)*



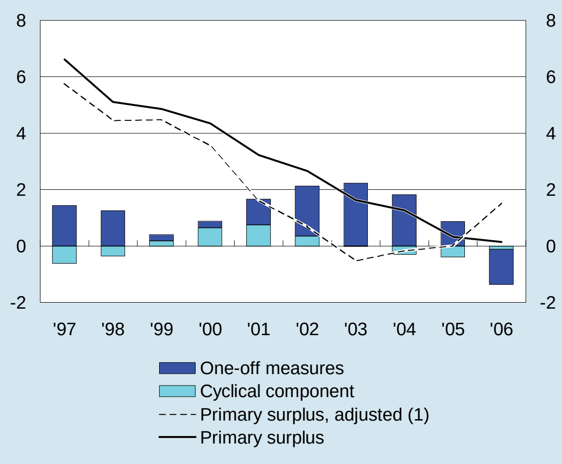

Source: Based on Istat data.
(1) This item includes, with a negative sign, the proceeds of the sale of public assets. The figure for 2000 does not include the proceeds of the sale of UMTS licences, which were also deducted from expenditure in the national accounts.

was also a decline in intermediate consumption – the first for more than ten years – and a further fall in investment, despite the support measures adopted in the summer.

*Net borrowing adjusted for cyclical factors and one-off measures.* – Excluding the effects of the economic cycle and one-off measures, net borrowing fell from about 4.5 per cent of GDP in 2005 to 3 per cent in 2006; the primary surplus rose from virtually nil to about 1.5 per cent (Figure 11.2). The unfavourable effect of the cycle on the public finances in 2005, equal to about half a percentage point of GDP, was almost completely annulled. One-off measures, which had reduced net borrowing by more than half a percentage point in 2005, increased it by more than one point in 2006.

Figure 11.2

**Primary surplus and temporary effects**
*(as a percentage of GDP)*



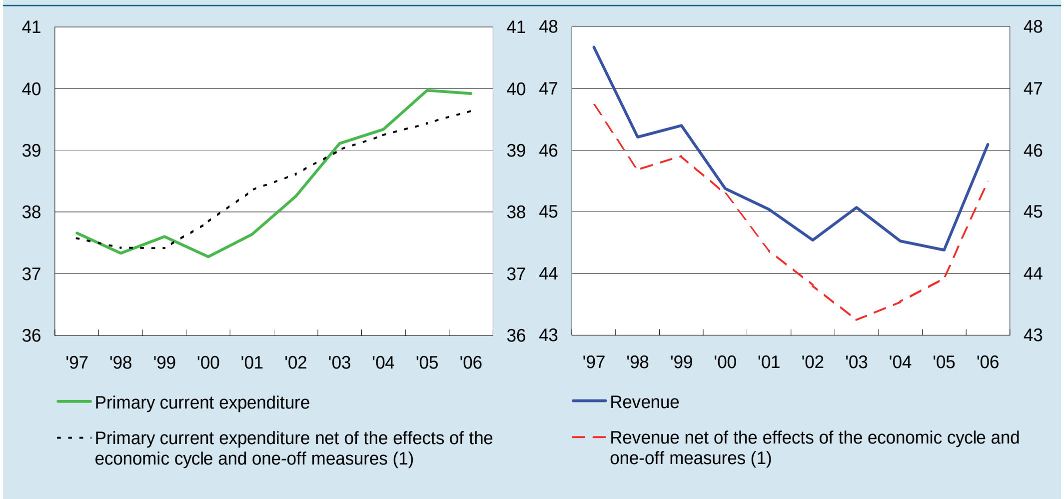

(1) For the effects of the economic cycle and one-off measures; as a percentage of trend GDP.

The main transitory factors affecting the budget balance are the economic cycle and measures with temporary effects. The analysis does not consider such transitory factors as fluctuations in share and property prices or interest rates. These affect the public finances, but their impact is hard to quantify.

In the last nine years the primary surplus adjusted for the effects of the economic cycle and one-off measures has contracted by more than 4 percentage points of GDP. Between 1997 and 2003 the balance swung from a surplus of almost 6 percentage points of GDP to a deficit of about half a point. Of the total deterioration 2.8 points

Figure 11.3

**General government primary current expenditure and revenue**
*(as a percentage of GDP)*




(1) As a percentage of trend GDP.

were due to the increase in primary expenditure, especially capital disbursements and health expenditure, and 3.5 points to the fall in revenue (Figure 11.3), which can be attributed to the effects of legislative measures adopted in the same period.

From 2004 onwards, by contrast, the adjusted primary current balance improved, to a limited extent in the first two years and more significantly in 2006. The improvement reflects the increase in revenue (2.2 percentage points of GDP), which can be attributed to: the net effect of the legislative measures that increased direct corporate taxes and indirect taxes (in total nearly one percentage point of GDP) and those that reduced social security contributions and the taxation of households (about half a point); fiscal drag (about one third of a point); the faster growth of tax bases than GDP (about one third of a point); and the working of a series of factors that arose mainly in 2006 and were not all permanent. Over the same three years current expenditure continued to grow in relation to GDP, while capital expenditure contracted.

### *Revenue in 2006*

General government revenue increased by 7.7 per cent to €680.1 billion, rising from 44.4 to 46.1 per cent of GDP (Table 11.3). The fiscal burden increased by 1.7 percentage points to 42.3 per cent of GDP; the tax component contributed nearly 1.6 points of the increase.

**Table 11.3**

**General government revenue** (1)
*(as a percentage of GDP)*

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|---|
| Direct taxes | 15.8 | 14.3 | 14.9 | 14.4 | 14.7 | 13.9 | 13.4 | 13.3 | 13.4 | 14.5 |
| Indirect taxes | 12.2 | 15.1 | 14.9 | 14.7 | 14.2 | 14.3 | 14.0 | 14.1 | 14.2 | 14.8 |
| **Current tax revenue** | **28.0** | **29.3** | **29.8** | **29.1** | **28.9** | **28.2** | **27.4** | **27.4** | **27.6** | **29.3** |
| Actual social security contributions | 14.6 | 12.2 | 12.2 | 12.1 | 12.0 | 12.2 | 12.4 | 12.4 | 12.6 | 12.8 |
| Imputed social security contributions | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.2 | 0.2 |
| **Current fiscal revenue** | **43.0** | **42.0** | **42.3** | **41.5** | **41.2** | **40.6** | **40.0** | **40.0** | **40.5** | **42.3** |
| Capital taxes | 0.7 | 0.4 | 0.1 | 0.1 | 0.1 | 0.2 | 1.3 | 0.6 | 0.1 | 0.0 |
| **Tax revenue and social security contributions** | **43.7** | **42.3** | **42.4** | **41.6** | **41.3** | **40.8** | **41.4** | **40.6** | **40.6** | **42.3** |
| Other current revenue | 3.7 | 3.6 | 3.6 | 3.4 | 3.5 | 3.5 | 3.4 | 3.6 | 3.5 | 3.5 |
| Other capital revenue | 0.3 | 0.3 | 0.4 | 0.3 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 |
| **Total revenue** | **47.7** | **46.2** | **46.4** | **45.4** | **45.0** | **44.5** | **45.1** | **44.5** | **44.4** | **46.1** |

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

*Tax revenue.* – Tax revenue grew by 9.5 per cent to €432.1 billion. Direct taxes increased by 12.4 per cent, indirect taxes by 7.8 per cent. Capital taxes decreased by €1.6 billion as receipts of the building offences regularization scheme dried up.

Just over half the growth in tax revenue can be attributed to the expansion of the main tax bases. This assessment takes account of some of the features of the economic cycle that were already present in earlier years and that contributed to the increase in the elasticity of revenue with respect to GDP. They are: the faster growth in total wages and salaries than in GDP, the continuing rise in share prices and interest rates, and the increase in the prices of oil and other energy products. A contribution to the high elasticity of total revenue with respect to GDP also came from the greater reactivity of personal income tax receipts to the corresponding tax base as a consequence of the reforms of the last few years. No account is taken, however, of the large increases in property prices owing to the difficulty of quantifying their effects.

A further 30 per cent of the growth in tax revenue can be attributed to the discretionary measures included in the Finance Law for 2006 and the July 2006 supplementary budget, which were partly permanent and partly temporary. Another 5 per cent can be attributed to favourable developments during the year. The remainder of the increase was influenced by taxpayers' greater compliance as a result of the intensification of the measures to fight tax evasion and avoidance, and the hard-to-measure effects of some structural changes in the economy. The latter include the greater role of large-scale retailing, which reduces the scope for evading VAT, and the shift in the composition of household spending towards durable goods and telephone services, which are subject to VAT at 20 per cent and offer less scope for evasion owing to the structure of supply.

The following analysis of individual taxes is based on receipts allocated to the State budget on a cash basis. Total receipts, net of accounting settlements with the Sicily and Sardinia regions, increased by 9.6 per cent. Excluding revenue from lotto and lotteries, the increase was 10.6 per cent.

Personal income tax receipts grew by 7.1 per cent and €9.4 billion, mainly as a result of the increase in withholdings from wages and salaries and pensions, which grew by 7.9 per cent and €7.8 billion. The number of employees rose by 2 per cent, their per capita earnings by 2.8 per cent.

Corporate income tax receipts grew by 17.1 per cent and €5.8 billion. The increase reflects the cyclical recovery and the measures enlarging the tax base included in the budget for 2006. These effects were partly offset by the increase, for 2005 alone, of the payment on account from 99 to 102.5 per cent.

Receipts of the taxes on capital income grew by 37.3 per cent and €3.3 billion. There was a particularly large increase of €0.9 billion in receipts of the tax on managed assets, reflecting the recovery in share prices and the fall in the volume of tax credits, which had almost annulled the yield in the preceding years. The increase of €1.5 billion in the tax on bond interest income reflected the rise in interest rates from December 2005 onwards and the large increase in redemptions of post office savings certificates in 2005, which generated about €0.7 billion of additional revenue.

Lastly, the growth in direct tax receipts benefited from some temporary measures introduced or renewed in the budget for 2006, which generated an unexpectedly large revenue of €5.8 billion, compared with €1.8 billion in 2005, and from the payment of about €1 billion of tax on insurance companies' mathematical provisions, the tax for 2005 having been paid in 2004.

Among indirect taxes, there were particularly large increases in VAT (8.7 per cent and €9.2 billion) and other business taxes (13 per cent and €2.3 billion).

*Social security contributions.* – Actual social security contributions grew by 4.7 per cent. All the components grew more than was to be expected on the basis of the expansion in the related bases and the changes in the law. Some of the divergence in the private sector may have reflected a reduction in evasion, partly as a consequence of the measures taken to foster the regularization of employment relationships.

## *Expenditure in 2006*

General government expenditure rose from 48.6 per cent of GDP in 2005 to 50.5 per cent in 2006 (Table 11.4). Excluding the extraordinary charges caused by the judgment of the European Court of Justice concerning the Italian VAT regime and those due to the cancellation of the State's claims on TAV S.p.A., it remained unchanged at 48.6 per cent (€716.6 billion). Primary current expenditure grew by 3.6 per cent, but declined in relation to GDP from 40 to 39.9 per cent owing to the fall in intermediate consumption. For the first time since 1995 interest payments rose in relation to GDP, from 4.5 to 4.6 per cent. Excluding the proceeds of property sales and the extraordinary charges referred to above, capital expenditure declined from 4.3 to 4.2 per cent of GDP.

Table 11.4

**General government expenditure** (1)
*(as a percentage of GDP)*

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|---|
| Compensation of employees | 11.5 | 10.6 | 10.6 | 10.4 | 10.5 | 10.6 | 10.8 | 10.8 | 11.0 | 11.0 |
| Intermediate consumption | 4.8 | 4.9 | 5.0 | 5.0 | 5.1 | 5.2 | 5.3 | 5.4 | 5.5 | 5.3 |
| Market purchases of social benefits in kind | 2.0 | 2.0 | 2.1 | 2.3 | 2.5 | 2.6 | 2.6 | 2.7 | 2.8 | 2.8 |
| Social benefits in cash | 17.0 | 16.7 | 16.9 | 16.4 | 16.2 | 16.5 | 16.8 | 16.9 | 17.0 | 17.1 |
| Interest payments | 9.3 | 7.9 | 6.6 | 6.3 | 6.3 | 5.5 | 5.1 | 4.7 | 4.5 | 4.6 |
| Other current expenditure | 2.5 | 3.2 | 3.1 | 3.1 | 3.2 | 3.3 | 3.6 | 3.6 | 3.6 | 3.6 |
| **Total current expenditure** | **47.0** | **45.2** | **44.2** | **43.6** | **43.9** | **43.8** | **44.2** | **44.1** | **44.5** | **44.5** |
| Gross fixed investment (2) | 2.2 | 2.3 | 2.4 | 2.3 | 2.4 | 1.7 | 2.5 | 2.4 | 2.3 | 2.3 |
| Other capital expenditure (3) | 1.2 | 1.4 | 1.5 | 1.4 | 1.8 | 1.9 | 1.9 | 1.5 | 1.7 | 3.7 |
| **Total capital expenditure** (2)(3) | **3.4** | **3.8** | **3.9** | **3.7** | **4.2** | **3.6** | **4.3** | **3.9** | **4.1** | **6.0** |
| **Total expenditure** (2)(3) | **50.3** | **49.0** | **48.1** | **47.4** | **48.1** | **47.4** | **48.6** | **48.0** | **48.6** | **50.5** |
| *of which: expenditure excluding interest payments* (2)(3) | *41.1* | *41.1* | *41.5* | *41.0* | *41.8* | *41.9* | *43.4* | *43.3* | *44.1* | *46.0* |

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".

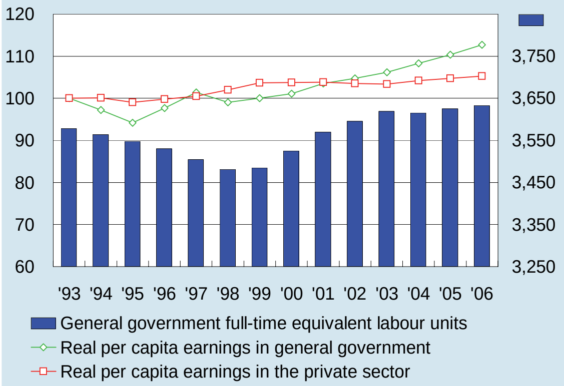
*Social benefits in cash.* – This item grew by 4.4 per cent and rose from 17 to 17.1 per cent of GDP. Expenditure on pensions increased by 3.7 per cent and remained virtually unchanged in relation to GDP at 15.4 per cent. The other social benefits in cash grew by 9.9 per cent, compared with 2.2 per cent in 2005, and were boosted by the increase of 22.2 per cent in disbursements of severance pay to public employees owing to the large number of retirements at the end of 2005 and during 2006. Expenditure on unemployment benefits and wage supplementation increased by 6.8 per cent, in part as a result of the greater resources allocated to unemployment benefit schemes by the Finance Law for 2006.

*Compensation of employees.* – This item grew by 4.1 per cent, compared with 4.5 per cent in 2005. The growth reflected that in per capita compensation since the number of public employees remained almost unchanged.

Figure 11.4

**Earnings and employment in the public sector**

*(base year 1993 = 100; thousands)*




Source: Based on Istat data.

Between 1993 and 2001 real per capita gross earnings grew at an average annual rate similar to that in the private sector (about 0.4 per cent). In the five following years the average rate of growth was much higher in the public sector (about 1.8 per cent) than in the private sector (0.3 per cent; Figure 11.4). The number of full-time equivalent employees in general government fell by 2.7 per cent between 1993 and 1998 and then increased by more than 4 per cent between 1998 and 2006.

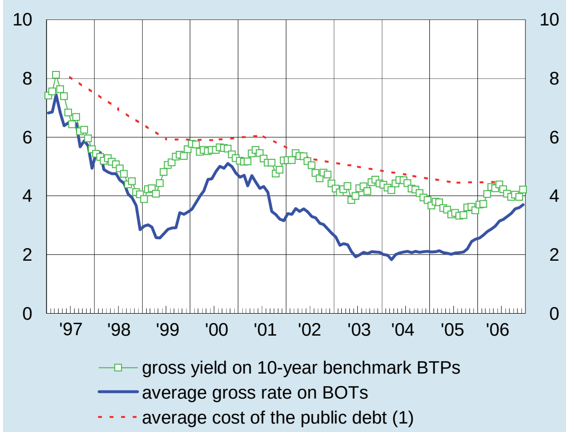
*Other primary current expenditure items.* – Intermediate consumption contracted by 0.8 per cent, after growing by 5 per cent in 2005. The decline was attributable to central government and municipalities, whose spending in this field was curbed by the restrictions imposed by the budget for 2006. In the last decade intermediate consumption has grown at an average annual rate of 2.5 per cent in real terms, the result of near stability for central government and annual growth of 3.6 per cent for local government.

Social benefits in kind grew by 3.4 per cent, compared with 5.6 per cent in 2005. The slowdown was due to the reduction in expenditure on general health care, which in 2005 had been boosted by the renewal of national health service agreements; in fact the reduction more than offset the rise in expenditure on pharmaceuticals.

Figure 11.5

**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.

*Health service.* – Health care expenditure included under general government rose by 5.7 per cent, to €94.7 billion; in 2005 there had been a rise of 6.4 per cent.

*Interest payments.* – After decreasing by 2.3 per cent in 2005, this item grew by 5.2 per cent. The growth was curbed by net receipts of swaps amounting to €0.6 billion, down from €2.4 billion in 2005; excluding these transactions, the average cost of the debt declined from 4.4 to 4.3 per cent: the redemption of high-yielding medium and long-term securities more than offset the rise in yields at issue (Figure 11.5).

*Capital expenditure.* – Excluding the proceeds from the disposal of real estate (€1.4 billion compared with €3.2 billion in 2005), the extraordinary charges caused by the judgment of the European Court of Justice concerning VAT (€16 billion) and those due to the cancellation of the State's claims on TAV S.p.A. (€13 billion), capital expenditure increased by 0.4 per cent to €61.4 billion. Investment fell for the second successive year (-3.4 per cent in 2006; -2.9 per cent in 2005), entirely owing to the fall recorded by central government. After growing by 11.5 per cent in 2005, investment grants contracted by 0.2 per cent.

### *Local government*

Between 2003 and 2006 local government own revenue (which excludes transfers from public entities, international aid and investment grants) remained basically stable in relation to GDP at about 8.3 per cent, reflecting the suspension of the right to raise the rates for the regional tax on productive activities (IRAP) and the personal income tax surcharge. Over the same period local government expenditure rose from 14.9 to 15.7 per cent of GDP.

In 2006 local government recorded a deficit equal to 1.1 per cent of GDP, compared with 0.8 per cent in 2005; the deterioration reflected the fall in revenue by 0.2 percentage points of GDP and the rise in expenditure by 0.1 points.

Local government own revenue grew by 3.6 per cent and €4.2 billion. The increase of 3.7 per cent and €3.4 billion in tax revenue was influenced by the sharp rise in IRAP receipts following the rate rises introduced in some regions to finance health service deficits.

The sector's expenditure increased by 4.2 per cent, driven by contract renewals in the health service and other health care outlays. The remaining items were influenced by the constraints imposed by the domestic stability pact: intermediate consumption outside the health sector, mainly concerning municipalities, diminished slightly. Investment remained basically stable after the sharp contraction of 4.9 per cent in 2005.

*Regional health services.* – There are pronounced disparities between regional health service budget outcomes. In the last few years some regions maintained financial balance, while others recorded deficits that they subsequently made good, in part through recourse to additional financing by the State. Six regions (Abruzzo, Campania, Lazio, Liguria, Molise and Sicily) accumulated deficits, still to be made good, in the form of accounts payable to suppliers. The debts to suppliers and others accumulated in the period 2001-05 are estimated at about €21.1 billion (see Parliamentary Act C2534 of 2007), with Lazio and Campania accounting for almost 80 per cent of the total. Some regions recorded further large deficits in 2006. These are being examined by the health service deficit audit committees set up with representatives of central government and regional governments.

Table 11.5

**Local government current revenue** (1)
*(millions of euros)*

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| **Direct taxes** | **21,058** | **23,370** | **24,558** | **23,912** | **24,085** |
| Regions (2) | 18,559 | 20,356 | 21,329 | 20,847 | 20,929 |
| *of which: personal income surtax* | *4,975* | *6,166* | *6,741* | *6,430* | *6,198* |
| *auto taxes (households)* | *3,607* | *3,647* | *3,641* | *3,621* | .... |
| Municipalities | 2,499 | 3,014 | 3,229 | 3,065 | 3,156 |
| *of which: personal income surtax* | *1,099* | *1,576* | *1,630* | *1,528* | *1,561* |
| *ICI (on buildable land)* | *1,044* | *1,084* | *1,135* | *1,140* | .... |
| **Indirect taxes** | **59,706** | **62,086** | **62,350** | **65,812** | **69,463** |
| Regions (2) | 42,571 | 44,018 | 43,360 | 46,514 | 49,669 |
| *of which: IRAP* | *31,132* | *32,097* | *31,690* | *34,587* | *37,561* |
| *share of excise duty on petrol* | *2,885* | *2,911* | *2,727* | *2,334* | *2,173* |
| *auto taxes (companies)* | *852* | *864* | *868* | *861* | .... |
| *surtax on methane* | *418* | *521* | *494* | *490* | .... |
| *special tax for waste disposal in tips* | *251* | *231* | *235* | *233* | .... |
| Provinces | 3,719 | 3,922 | 4,143 | 4,194 | 4,269 |
| *of which: tax on auto liability insurance* | *1,827* | *1,952* | *1,992* | *2,015* | .... |
| *transcription tax* | *1,076* | *1,150* | *1,242* | *1,162* | .... |
| Municipalities | 13,416 | 14,146 | 14,847 | 15,104 | 15,525 |
| *of which: ICI (excluding on buildable land)* | *9,581* | *9,951* | *10,417* | *10,460* | .... |
| *tax on advertising and bill posting rights* | *303* | *382* | *398* | *402* | .... |
| **Transfers from public entities** (consolidated) | **54,298** | **51,040** | **64,363** | **70,594** | **69,518** |
| Regions | 43,026 | 39,359 | 51,135 | 57,339 | 55,436 |
| *of which: share of VAT* | *28,370* | *30,328* | *34,492* | *35,447* | *41,275* |
| Provinces | 2,712 | 3,147 | 3,192 | 3,372 | 3,372 |
| Municipalities | 15,408 | 16,000 | 17,293 | 17,374 | 18,256 |
| **Other current revenue** | **17,524** | **19,001** | **21,291** | **21,291** | **21,974** |
| Regions | 4,038 | 4,697 | 5,776 | 5,116 | 5,195 |
| Provinces | 1,182 | 1,337 | 1,464 | 1,564 | 1,604 |
| Municipalities | 12,304 | 12,967 | 14,051 | 14,611 | 15,175 |
| **TOTAL CURRENT REVENUE** | **152,586** | **155,497** | **172,562** | **181,609** | **185,040** |

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.

In the last few years rules have been introduced to make local government officials responsible for controlling health service deficits; at the same time additional resources have been allocated to make good past deficits.

The accounts of the Local Health Units for 2006 show the persistence of significant geographical disparities in health expenditure, even between regions with similar socio-economic characteristics (Figure 11.6). Sectoral analyses confirm the existence of scope for savings in this field.

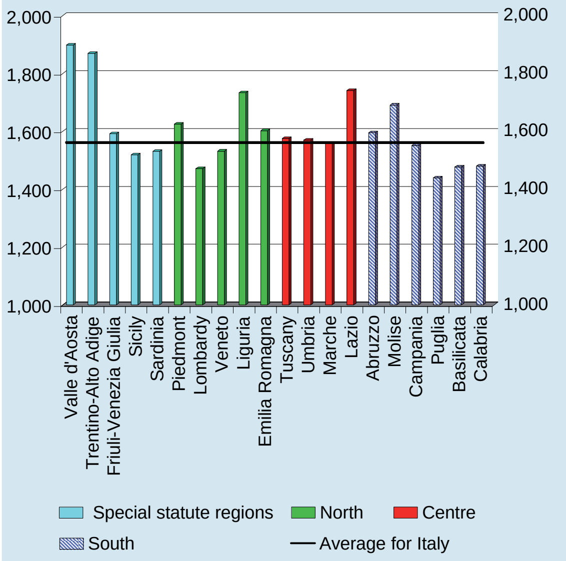
## *The borrowing requirement and debt in 2006*

*The borrowing requirement.* – In 2006 the total general government borrowing requirement contracted significantly (Tables 11.2 and 11.6). It amounted to €54.5 billion and 3.7 per cent of GDP, which was €15.8 billion and 1.2 percentage points less than in 2005. Privatization receipts were virtually nil, whereas in the five preceding years they had averaged 0.5 per cent of GDP.

Excluding the effects of one-off measures (about 0.5 per cent of GDP, compared with about 1.5 per cent in 2005), the borrowing requirement was just over 4 per cent of GDP; in the three preceding years it had been above 6 per cent. The corresponding primary balance returned to surplus after the significant deficits recorded in the period 2003-05.

Figure 11.6

**Per capita health service costs by region** (1)




Source: *Relazione generale sulla situazione economica del Paese*, 2006.
(1) Data adjusted for interregional mobility.

Table 11.6

**General government balances and debt**
*(millions of euros)*

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| Net borrowing | 37,085 | 46,614 | 48,066 | 59,523 | 65,504 |
| Total borrowing requirement | 37,713 | 40,111 | 49,675 | 70,293 | 54,535 |
| Borrowing requirement net of privatization receipts | 39,664 | 56,976 | 57,991 | 74,911 | 54,574 |
| Debt | 1,367,184 | 1,392,401 | 1,443,407 | 1,511,210 | 1,575,447 |
| *Memorandum items:* | | | | | |
| Settlements of past debts (1) | 5,328 | 8,537 | 529 | 1,864 | 243 |
| Privatization receipts (-) (1) | -1,951 | -16,866 | -8,316 | -4,618 | -38 |

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

*The disparity between the borrowing requirement and net borrowing.* – Comparing the borrowing requirement with net borrowing can reveal inconsistencies in the public finance data such as those that have led to major deficit revisions in some euro-area countries. Since the various components of the disparity may be of opposite sign and cancel out in the aggregate, it is necessary to extend the consistency checks to the individual determinants.

In 2006 the general government borrowing requirement net of privatization receipts was less than general government net borrowing for the first time since 1992;

the difference amounted to 0.7 per cent of GDP (Table 11.7). The change in the sign of the difference between the two balances reflects the inclusion in net borrowing of the extraordinary charges caused by the judgment of the European Court of Justice concerning VAT and those due to the cancellation of the State's claims on TAV S.p.A., neither of which gave rise to payments during the year. When these charges are excluded, the disparity becomes positive again and equal to 1.2 points of GDP, a value slightly higher than that recorded in 2005 and twice the average for the period 2002-04 (Figure 11.7).

Table 11.7

**Reconciliation between net borrowing and change in the debt**
*(as a percentage of GDP)*

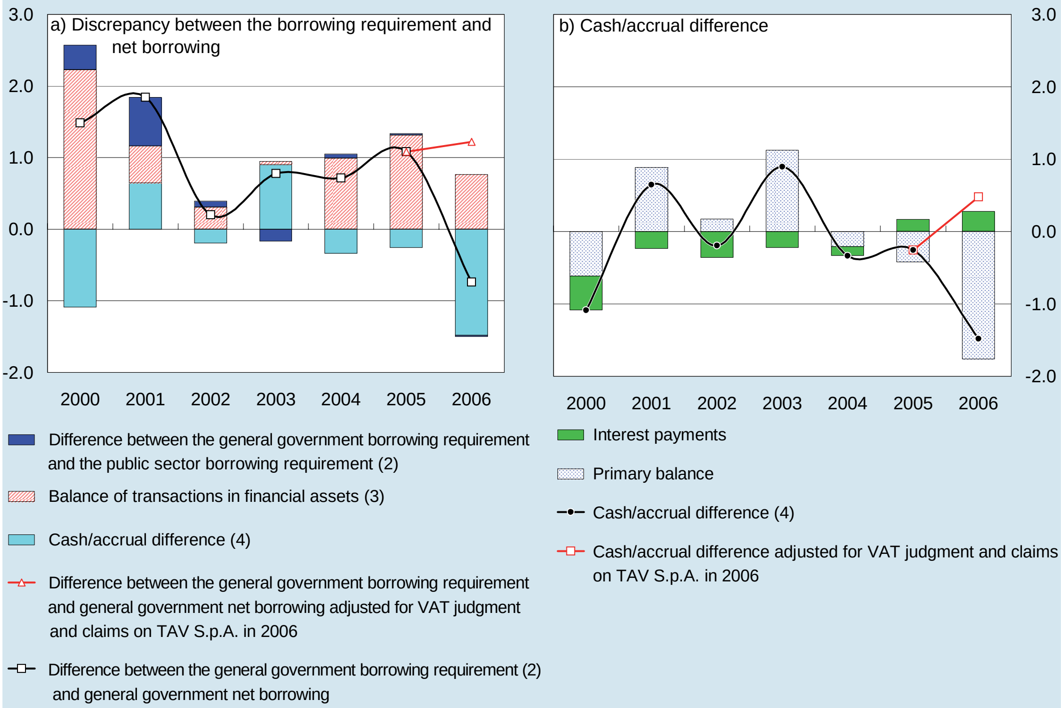
| | | 1997 | 1998 | 1999 | 2000 (1) | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 (2) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| (a) | **Net borrowing (Istat)** | **2.7** | **2.8** | **1.7** | **2.0** | **3.1** | **2.9** | **3.5** | **3.5** | **4.2** | **4.4** |
| (b) | Balance of financial items (3) | 0.0 | -0.1 | 0.6 | 2.2 | 0.5 | 0.3 | 0.1 | 1.0 | 1.3 | 0.8 |
| (c) | Cash-and-accrual-basis difference (4) | 0.5 | 0.6 | 0.2 | -1.1 | 0.6 | -0.2 | 0.9 | -0.3 | -0.3 | -1.5 |
| | *primary balance* | *0.9* | *1.2* | *0.3* | *-0.6* | *0.9* | *0.2* | *1.1* | *-0.2* | *-0.4* | *-1.8* |
| | *interest payments* | *-0.4* | *-0.6* | *-0.1* | *-0.5* | *-0.2* | *-0.4* | *-0.2* | *-0.1* | *0.2* | *0.3* |
| (d)=(a)+(b)+(c) | **Public sector borrowing requirement (MEF)** | **3.2** | **3.3** | **2.6** | **3.1** | **4.2** | **3.0** | **4.4** | **4.1** | **5.2** | **3.7** |
| (e)=(g)-(d) | Discrepancy between the general government and the public sector borrowing requirements | -0.3 | 0.0 | 0.8 | 0.3 | 0.7 | 0.1 | -0.2 | 0.1 | 0.0 | 0.0 |
| (g) | **General government borrowing requirement net of privatization receipts (BI)** | **2.9** | **3.3** | **3.4** | **3.5** | **4.9** | **3.1** | **4.3** | **4.2** | **5.3** | **3.7** |
| (h) | Privatization receipts (-) | -1.0 | -0.7 | -2.0 | -1.3 | -0.4 | -0.2 | -1.3 | -0.6 | -0.3 | 0.0 |
| (i)=(g)+(h) | **Total borrowing requirement (BI)** | **1.8** | **2.6** | **1.4** | **2.2** | **4.6** | **2.9** | **3.0** | **3.6** | **4.9** | **3.7** |
| (l) | Change in Treasury's deposits at the Bank of Italy | 0.1 | -0.7 | 0.6 | -0.8 | 0.2 | 0.0 | -0.6 | 0.2 | -0.1 | 0.6 |
| (m) | Issue discounts | 0.1 | -0.5 | -0.1 | 0.0 | -0.2 | -1.9 | -0.3 | 0.0 | -0.2 | 0.2 |
| (n) | Change in the euro value of foreign exchange liabilities | 0.5 | 0.0 | 0.6 | 0.1 | 0.0 | -0.3 | -0.2 | -0.1 | 0.1 | -0.1 |
| (o)=(i)+(l)+(m)+(n) | **Change in debt (BI)** | **2.6** | **1.5** | **2.5** | **1.5** | **4.6** | **0.8** | **1.9** | **3.7** | **4.8** | **4.4** |
| (p)=(a)-(o) | Difference between net borrowing and the change in debt | 0.1 | 1.3 | -0.7 | 0.5 | -1.5 | 2.1 | 1.6 | -0.2 | -0.6 | 0.1 |
| (f)=(a)-(g) | *Difference between general government net borrowing and the general government borrowing requirement* | *-0.2* | *-0.5* | *-1.6* | *-1.5* | *-1.8* | *-0.2* | *-0.8* | *-0.7* | *-1.1* | *0.7* |
| (q)=(g)-(o) | *Difference between the general government borrowing requirement and the change in debt* | *0.2* | *1.9* | *0.9* | *2.0* | *0.3* | *2.3* | *2.4* | *0.5* | *0.5* | *-0.7* |

Sources: For net borrowing and interest payments on an accrual basis, Istat; for the public sector borrowing requirement and interest payments on a cash basis, the Ministry for the Economy and Finance – MEF (Quarterly Report on the Borrowing Requirement and the Combined Report on the Economy and Public Finances, various years); for the general government borrowing requirement and debt, the change in the Treasury's deposits at the Bank of Italy, issue discounts and the change in the euro value of foreign exchange liabilities, the Bank of Italy (BI); and for the balance of financial asset items, for the years 1997-2002 based on financial accounts data and for the years 2003-06 based on Istat press release dated 23 April 2007.
(1) The data on the borrowing requirement and net borrowing in 2000 exclude the proceeds of the sale of UMTS licences. – (2) Provisional data. Excluding the extraordinary charges, net borrowing in 2006 was equal to 2.5 per cent of GDP and the cash-and-accrual-basis difference to half a percentage point of GDP. – (3) The balance of financial items includes the change in the assets in relation to the following financial instruments: cash and deposits and securities and loans; it does not include the change in the Treasury's deposits at the Bank of Italy or privatization receipts. A positive value means a net acquisition of financial assets. – (4) The difference between the primary balance on a cash and an accrual basis is obtained as a residual.

Figure 11.7

**Analysis of the disparity between the general government borrowing requirement and general government net borrowing** (1)

*(as a percentage of GDP)*




Sources: See Table 11.7.
(1) The data on the borrowing requirement and net borrowing in 2000 exclude the proceeds of the sale of UMTS licences; the data for 2006 are provisional. – (2) Borrowing requirement net of privatization receipts. – (3) The balance of transactions in financial assets includes the change in the assets in relation to the following financial instruments: cash and deposits, and securities and loans; it does not include the change in the Treasury's deposits at the Bank of Italy or privatization receipts. A positive value means a net acquisition of financial assets. – (4) The difference between the primary balance on a cash and an accrual basis is obtained as a residual.

The disparity can be analyzed in terms of its three components: the balance of transactions in financial assets; discrepancies due to the different accounting principles applied in calculating the two indicators (cash basis for the borrowing requirement, accrual basis for net borrowing); and other statistical discrepancies.

In recent years the main component of the disparity has been that in respect of the balance of transactions in financial assets. This balance measures the net acquisition of financial assets except for the changes in the Treasury's deposits at the Bank of Italy and privatization receipts. In 2006 it was equal to 0.8 per cent of GDP, which was less than in 2005 (1.3 per cent) and the average for the years 1999-2004 (1.1 per cent, excluding in 2003 the effects of the transformation of the Cassa Depositi e Prestiti). In the period 2003-05 the build-up of claims on the railways in connection with the financing of the high-speed railway network had contributed to keeping the balance of financial transactions high.

Excluding the effects caused by the judgment of the European Court of Justice concerning VAT and those due to the cancellation of the State's claims on TAV S.p.A., the cash/accrual difference amounted to 0.5 per cent of GDP. Contributory factors comprised: the inclusion in the accounts on an accrual basis of social security contributions larger than those actually received and the exclusion of public employees' back pay, owed under the contracts concluded in 2005 and allocated to that year on an accrual basis. Interest payments were also higher on a cash basis owing to the major redemptions of post office savings certificates, the interest on which is paid at maturity. The cash/accrual difference had been negative in 2005 (-0.3 per cent of GDP) and virtually nil on average in the period 1999-2004.

*The public debt.* – In 2006 the ratio of the public debt to GDP rose for the second successive year and reached 106.8 per cent. The increase was equal to 0.6 percentage points of GDP, as against 2.4 points in 2005. The slowdown reflected the faster growth in GDP. Not counting the debt needed to finance the increase in the Treasury's deposits at the Bank of Italy to make future VAT refunds in connection with the judgment of the European Court of Justice, the ratio of the debt to GDP remained stable. The debt includes, at face value, the €39.6 billion of post office savings certificates issued up to April 2001 and assigned to the Ministry for the Economy and Finance when the Cassa Depositi e Prestiti was transformed into a limited company in 2003. The value at maturity of these securities is €104.9 billion.

The increase in the debt was equal to €64.2 billion, compared with €67.8 billion in 2005. In addition to the general government borrowing requirement (€54.5 billion in 2006 and €70.3 billion in 2005) and to the increase in the Treasury's deposits at the Bank of Italy (€8.2 billion in 2006, after a decrease of €1.2 billion in 2005), the increase was due to the issue discounts of €2.3 billion in 2006, as against issue premiums of €2.4 billion in 2005. On the other hand the appreciation of the euro reduced the value of foreign exchange liabilities by €0.8 billion, after depreciation had caused an increase of €1.1 billion in 2005.

In 2006 the ratio of local government debt to GDP rose by 1 percentage point to 7.3 per cent, thus prolonging the upward trend of recent years (Table 11.8).

Table 11.8

**Breakdown of the public debt by subsector**
*(as a percentage of GDP)*

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|---|
| **General government** | **118.1** | **114.9** | **113.7** | **109.1** | **108.7** | **105.6** | **104.3** | **103.8** | **106.2** | **106.8** |
| *Central government* | *115.6* | *112.4* | *110.4* | *105.4* | *104.7* | *101.5* | *98.7* | *98.2* | *99.9* | *99.4* |
| *Local government* | *2.4* | *2.4* | *2.9* | *3.3* | *3.3* | *3.6* | *5.3* | *5.5* | *6.3* | *7.3* |
| *Social security institutions* | *0.0* | *0.0* | *0.4* | *0.5* | *0.6* | *0.4* | *0.2* | *0.1* | *0.0* | *0.0* |

The increase in the debt was significant throughout the country. The ratio of local debt to local GDP rose by about 1.4 percentage points in the Centre (to 10.5 per cent), by about one point in the South and the North-West (to respectively 8.5 and 6 per cent), and by half a point in the North-East (to 5 per cent).

## *Budgetary policy for 2007*

*Forecasts and targets.* – The Economic and Financial Planning Document published in July 2006 estimated net borrowing on a current programmes basis at 4.1 per cent of GDP in 2007, virtually unchanged with respect to the value expected at the time for 2006. The primary surplus on a current programmes basis was forecast to be 0.8 per cent of GDP, an increase of 0.3 percentage points compared with the forecast for the previous year (Table 11.9). The estimates took account of the effects of the June supplementary budget measures (half a percentage point of GDP).

Table 11.9

**Public finance objectives and estimates for the year 2007**
*(billions of euros)*

| | General government | | | | *Memorandum items* | |
|---|---|---|---|---|---|---|
| | Net borrowing | Primary surplus | Interest payments | Debt | Real GDP growth rate (%) | Nominal GDP |
| **Estimates on a current programmes basis** | | | | | | |
| Economic and Financial Planning Document (July 2006) | 61.4 | 11.8 | 73.1 | …. | 1.5 | 1,513.9 |
| *as a percentage of GDP* | *4.1* | *0.8* | *4.8* | *108.5* | | |
| Combined Report on the Economy and Public Finances (March 2007) | 34.6 | 39.4 | 74.0 | …. | 2.0 | 1,534.2 |
| *as a percentage of GDP* | *2.3* | *2.6* | *4.8* | *105.4* | | |
| **Objectives** | | | | | | |
| Economic and Financial Planning Document (July 2006) | …. | …. | …. | …. | 1.2 | 1,508.4 |
| *as a percentage of GDP* | *2.8* | *2.1* | *4.8* | *107.5* | | |
| Forecasting and Planning Report (September and November 2006) | 42.1 | 30.7 | 72.8 | …. | 1.3 | 1,510.2 |
| *as a percentage of GDP* | *2.8* | *2.0* | *4.8* | *106.9* | | |
| Stability Programme (December 2006) (1) | …. | …. | …. | …. | 1.3 | …. |
| *as a percentage of GDP* | *2.8* | *2.3* | *5.0* | *106.9* | | |

(1) The figures for interest payments and the primary surplus are not directly comparable with those given in the other planning documents for the year because they are calculated gross of financial intermediation services indirectly measured (FISIMs) and net of the effects of swaps and forward rate agreements.

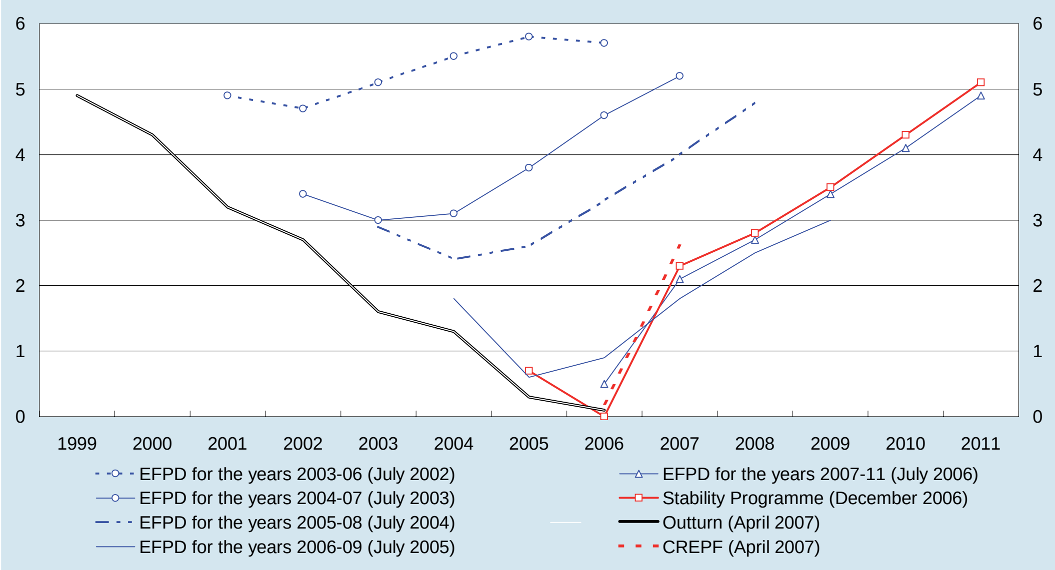
The Document set the target for net borrowing at 2.8 per cent of GDP and that for the primary surplus at 2.1 per cent (Figure 11.8), with a planned adjustment equal to 1.3 percentage points of GDP. The ratio of debt to GDP was expected to fall by 0.2 points and GDP to grow by 1.2 per cent.

The Forecasting and Planning Report published in September 2006 reaffirmed the objective for net borrowing. The good performance of revenue in 2006 and the improved outlook for growth made it possible to reduce the size of the budgetary adjustment to one per cent of GDP. In December the Stability Programme update confirmed the macroeconomic forecasts and the objective for net borrowing contained in the Forecasting and Planning Report.

*The budget.* – The budget approved by Parliament at the end of 2006 is intended to raise resources amounting to 2.3 per cent of GDP, or more than twice what would be needed for the adjustment envisaged in the Forecasting and Planning Report; the difference is allocated to finance growth and for other purposes (Figure 11.9). In March the EU Commission deemed the budget to be consistent with bringing the excessive deficit to an end in 2007.

Figure 11.8

**Primary surplus: objectives and outturn**
*(as a percentage of GDP)*



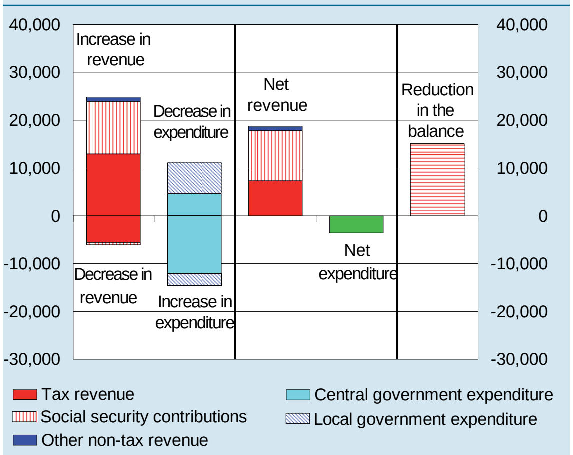

Legend: EFPD = Economic and Financial Planning Document; CREPF = Combined Report on the Economy and Public Finances.

The correction is achieved through a large increase in revenue amounting to 1.2 per cent of GDP that more than offsets a limited increase in expenditure, due to an increase in the disbursements of central government and a decrease in those of local government. The latter, however, could achieve the budgetary objectives set in the Finance Law by boosting revenue. To involve the local authorities in pursuit of the objectives set for the public finances, while respecting their autonomy, the Finance Law amended the domestic stability pact and shifted the emphasis from control of expenditure to compliance with a constraint on the budget balance.

One third of the increase in revenue derives from the transfer to INPS of part of the severance pay provisions not allocated to pension funds by employees of firms with more than 50 workers. In respect of these receipts the public finances will bear the burden of compensating firms for the higher cost of alternative forms of finance and that of the redemption of the severance pay provisions, currently revalued at an annual rate of 3 per cent. The entry into force of the rule is contemporaneous with the introduction, brought forward to 2007, of the tacit approval mechanism for the allocation to supplementary pensions of future severance pay contributions.

Figure 11.9

**Budget for 2007: composition and effects on net borrowing** (1)
*(millions of euros)*




(1) A positive (negative) value implies a reduction (rise) in net borrowing.

*The most recent estimates.* – In March the Government updated the public finance estimates, taking account of the outturn for 2006 and the more favourable macroeconomic context. According to the Combined Report on the Economy and Public Finances, net borrowing and the primary surplus should be 2.3 and 2.6 per cent of GDP respectively, compared with 2.5 and 2.1 per cent in 2006 (excluding the above-mentioned extraordinary charges). The ratio of revenue to GDP is expected to rise by 0.4 percentage points to 46.5 per cent, a level not far from the peak recorded in 1997. The ratio of primary current expenditure to GDP is expected to fall by 0.2 points to 39.7 per cent, thus remaining at a level among the highest of the last sixty years. Capital expenditure is expected to rise from 4.1 to 4.2 per cent of GDP (excluding the extraordinary items included in the accounts for 2006).

The revenue forecast appears to discount the drying up of part of the extra revenue recorded in 2006 compared with the estimates published in last September's Forecasting and Planning Report (0.7 per cent of GDP). Moreover, the forecast does not include the increases in receipts connected with the revision of the taxation of income from financial assets envisaged in the enabling law linked to the budget.

However, as stressed in the Combined Report, the financing needs of some public enterprises could exceed the current forecasts. In addition, the quantification of the effects of some of the budget measures (especially those concerning severance pay contributions and the fight against tax evasion and avoidance) is somewhat uncertain. Events last year showed how difficult it is to forecast the public finances. Episodes in the past, especially at the beginning of this decade in Italy and other European countries, suggest the advisability of postponing decisions on the use of larger-than-expected receipts until the uncertainty as to whether the additional amounts are structural has been overcome. The distance that still separates the budget from the objective of balance suggests that such receipts should be used to reduce the deficit.

The Combined Report foresees a significant reduction in the public sector borrowing requirement, from 3.7 per cent of GDP in 2006 to 2.5 per cent in 2007. The disparity between the borrowing requirement and net borrowing would be eliminated after averaging about one percentage point of GDP in recent years. This would lead to a fall of more than one percentage point in the ratio of the debt to GDP, even in the absence of privatization receipts.

## *Medium-term plans and prospects*

*Population ageing, medium-term objectives and debt dynamics.* – Rapid achievement of a balanced budget, in 2011 according to the Stability Programme, is essential if the debt is to be reduced significantly, so as to create adequate resources with which to defray the costs deriving from the ageing of the population.

According to estimates made by Istat, the ratio of persons over sixty to the population of working age is likely to rise from 42.3 per cent in 2005 to 52.7 per cent in 2020, and to 82.8 per cent in 2040, after which it would continue to rise. According to estimates made by the State Accounting Office, the ratio to GDP of expenditure that is affected by the ageing of the population will remain basically unchanged until 2020, after which it will rise. The increase between 2005 and 2040 is estimated at 2.9 percentage points. The increase of 1.7 points in expenditure on pensions and that of 1.8 points on health care and long-term assistance will be partially offset by savings in the education sector. In the absence of corrective measures, the expenditure items considered are likely to increase more and earlier.

The revision of the transformation coefficients makes it possible to take account – albeit with a long lag – of the evolution of life expectancy and is essential to maintain long-term equilibrium between the expenditure and revenue of the pension system. When life expectancy increases, changing the coefficients reduces the income replacement rate while keeping pension wealth unchanged; the worker is entitled to a smaller monthly pension but for a larger number of years. When the retirement age is flexible, this creates an incentive to work for a longer time. According to the State Accounting Office, in the absence of such revisions, the ratio of expenditure on pensions to GDP would be higher by 0.7 percentage points in 2030, by 1.5 points in 2040 and by about 2 points in 2050.

According to official assessments, the measures taken in 2004 to tighten retirement requirements with effect from 2008 reach their maximum expenditure-curbing effect of 0.7 percentage points of GDP in 2012. The effect then remains basically stable (0.6-0.7 points) for the next two decades. It becomes negative in the period 2040-50, when higher pensions begin to be paid as a consequence of longer contribution periods.

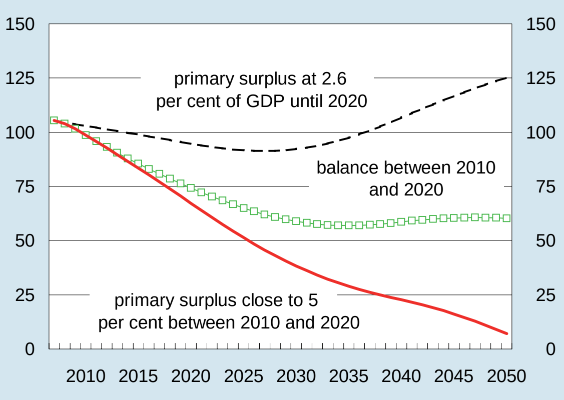
The importance of the budgetary policy choices of the coming years emerges clearly from three simple simulations of the performance of the ratio of debt to GDP in the period 2007-2050, based on scenarios that differ only with regard to the medium-term corrective budgetary measures (Figure 11.10). All the simulations assume: the average cost of the debt to be constant from 2010 onwards and equal to 4.8 per cent (in line with the Stability Programme); a real rate of GDP growth of 1.5 per cent (in line with the estimates of the potential growth rate); inflation of 2 per cent; and a gap between the borrowing requirement net of disposals and net borrowing equal to half a percentage point of GDP every year.

In the first simulation the primary surplus is kept at the level currently expected for 2007 (2.6 per cent of GDP, even though this includes a one-off component equal to about 0.4 percentage points) until 2020, after which it is allowed to deteriorate as a consequence of the ageing of the population. In this case the ratio of debt to GDP slowly declines over the coming years to just above 90 per cent between 2025 and 2030, after which it rises again.

In the other two simulations it is assumed that budgetary balance is achieved in 2010, a year earlier than indicated in the Stability Programme. This is in line with the undertaking recently entered into by the euro-area countries and fostered by the smaller Italian deficit

**Figure 11.10**

**Medium-term objectives and related performance of the ratio of debt to GDP**
*(percentages)*



now expected for 2007 and the more favourable growth expectations (for the three years 2007-09 the Combined Report indicates an annual average of 1.8 per cent, compared with that of 1.5 per cent contained in the Stability Programme).

In the second simulation the primary surplus is kept at the level necessary to ensure budgetary balance up to 2020, falling from just under 5 per cent of GDP in 2010 to about 3.5 per cent in 2020, thanks to the savings in interest payments due to the reduction in the debt. Subsequently, as in the first simulation, the primary surplus deteriorates as a consequence of the ageing of the population. In this case the ratio of debt to GDP declines to about 80 per cent as early as the middle of the next decade and to below 60 per cent before 2030, after which it stabilizes at this level.

Effects of the demographic evolution on the public finances greater than those officially estimated would make it necessary, in this second scenario as well, to take additional measures to attenuate the growth in expenditure in the long run. These interventions would nonetheless be on a much smaller scale than that required in the first simulation: keeping the budget balanced in the next decade permits increasing savings on interest payments, amounting to almost 3 per cent of GDP in 2050.

In the third simulation the primary surplus remains at the level necessary to ensure budgetary balance in 2010 (just below 5 per cent of GDP) up to 2020, and then deteriorates as a consequence of the ageing of the population, as in the two other simulations. In this case the ratio of debt to GDP declines to below 60 per cent before 2025 and continues to decline thereafter.

If achievement of budgetary balance in 2010 is entrusted entirely to primary current expenditure, this will have to fall, in real terms, by about half a percentage point per year over the next three years, compared with an average annual increase of 2.3 per cent over the last ten years. The size of the necessary adjustment calls for an extensive correction based on structural reforms and involving local authorities. Scope for savings is present in all the main items of the public accounts (see the Section, *Expenditure in 2006*).

*Fiscal policy and economic growth.* – The reduction of current expenditure will have to be larger if, in addition to lowering the debt ratio, the aim is to support growth by accelerating the development of infrastructure and reducing the fiscal burden.

Between 1992 and 2006 public investment expenditure averaged 2.3 per cent of GDP in Italy, compared with 2.6 per cent in the rest of the euro area. There is a wide gap between the endowment of infrastructure in Italy and that in the other main European countries. In fact Italy's poor endowment of infrastructure is one of the reasons for its falling below the other main industrial countries in international rankings of competitiveness.

Taxes and social security contributions rose in Italy from 40.6 per cent of GDP in 2005 to 42.3 per cent in 2006, which is close to the peaks recorded in the 1990s and more than 0.6 percentage points above the euro-area average (Table 11.10). The gap is wider in terms of the amounts effectively paid by the taxpayers who fulfil their obligations, owing to the large size of the underground economy in Italy.

Table 11.10

**Fiscal burden and statutory rates of the main taxes** (1)

| | Italy 2006 | Italy Change 2000-2006 | France 2006 | France Change 2000-2006 | Germany 2006 | Germany Change 2000-2006 | Spain 2006 | Spain Change 2000-2006 | Euro area 2006 | Euro area Change 2000-2006 | United Kingdom 2006 | United Kingdom Change 2000-2006 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Fiscal burden** (2) | **42.3** | **0.7** | **46.1** | **0.5** | **40.5** | **-2.2** | **37.5** | **2.7** | **41.7** | **-0.4** | **38.2** | **0.6** |
| **Statutory tax rates on labour income** (3) | | | | | | | | | | | | |
| Tax wedge as a % of labour costs | 45.2 | -1.2 | 50.2 | 0.6 | 52.5 | -1.5 | 39.1 | 0.5 | 43.0 | -0.6 | 33.9 | 1.7 |
| Tax wedge as a % of gross earnings | | | | | | | | | | | | |
| borne by employer | 32.1 | -2.0 | 42.3 | 1.1 | 20.5 | 0.0 | 30.6 | 0.0 | 25.0 | -0.8 | 10.7 | 1.4 |
| borne by worker | 27.6 | -0.6 | 29.1 | 0.3 | 42.7 | -1.8 | 20.5 | 0.7 | 29.2 | -0.5 | 26.8 | 1.3 |
| *of which: personal taxation* | *18.4* | *-0.6* | *15.6* | *0.2* | *21.1* | *-2.9* | *14.1* | *0.7* | *16.0* | *-0.5* | *17.6* | *0.5* |
| **Implicit tax rates on labour income** (4) | | | | | | | | | | | | |
| as a % of gross earnings | 42.0 | 0.2 | 42.4 | 0.8 | 39.2 | -1.5 | 29.4 | 1.3 | 36.6(5) | -0.9 | 24.8 | -0.6 |
| **Statutory tax rates on capital income** (4) | | | | | | | | | | | | |
| Corporate income tax | 37.3 | -4.0 | 33.3 | -3.4 | 38.6 | -13.0 | 35.0 | 0.0 | 29.7 | -6.9 | 30.0 | 0.0 |
| **Statutory tax rates on consumption** (6) | | | | | | | | | | | | |
| Ordinary VAT rate | 20.0 | 0.0 | 19.6 | -1.0 | 19.0 | 3.0 | 16.0 | 0.0 | 19.4 | 0.7 | 17.5 | 0.0 |

(1) The changes are calculated as the difference between the rates in 2000 and 2006, except for two cases: the implicit tax rates on labour income, for which they are the difference between 2000 and 2004, and statutory tax rates on consumption, for which they are calculated between 2000 and 2007. – (2) Sources: for Italy, Istat; for the other countries and the euro area, European Commission, *Spring Forecasts*, May 2007. – (3) Source: OECD, 2007, *Taxing Wages 2005-2006*. The rates refer to the average industrial worker, unmarried and without children. – (4) Source: European Commission, 2006, *Structures of the taxation systems in the European Union: 1995-2004*. The implicit rates on labour income refer to 2004. – (5) The euro-area average is calculated excluding Portugal, for which the figure for 2006 is not indicated. – (6) Source: European Commission, 2007, *VAT Rates Applied in the Member States of the European Community.* Rates in force in 2007.

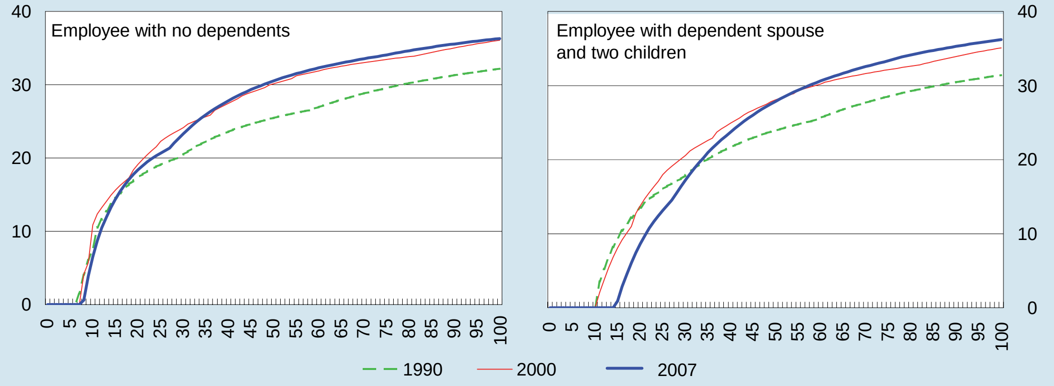
On the basis of a European comparison, the Italian statutory tax rate currently applicable to corporate incomes is higher than in every other country except Germany, where, moreover, the Government has recently announced large reductions effective as of 2008. Between 2000 and 2006 the euro-area average corporate income tax rate fell by 6.9 percentage points, to 29.7 per cent; in Italy it fell by 4 points, to 37.25 per cent (including IRAP, the regional tax on productive activities).

The statutory tax rates on labour income are also among the highest by international standards. In 2006, excluding IRAP, the fiscal component was 45.2 per cent of labour costs, against a euro-area average of 43 per cent. The tax wedge in Italy was smaller than in France (50.2 per cent) and Germany (52.5 per cent), but much higher than in Spain (39.1 per cent) and the United Kingdom (33.9 per cent).

During the 1990s the average personal income tax rates increased significantly, partly as a consequence of fiscal drag (Figure 11.11).

Figure 11.11

**Effective average personal income tax rates in Italy: 1990, 2000 and 2007** (1)
*(as a percentage of total income)*




(1) Total income is shown on the x-axis in thousands of euros. It is estimated in real terms at 2006 prices.

At 20 per cent the ordinary VAT rate in Italy is slightly higher than the euro-area average and the rates in France and Germany; it is much higher than the rates in Spain and the United Kingdom.

## 12. THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

The financial saving of households (the difference between flows of financial assets and liabilities) decreased in 2006 in connection with a reduction in overall saving and still substantial investment in new residential property. In relation to GDP it fell to 4.4 per cent, below the average of 6 per cent recorded over the last decade.

In the course of the year expectations of increases in interest rates led households to concentrate a higher proportion of their financial investment in shorter-term assets. Debt continued to grow rapidly, although at a more moderate pace than in the previous year, reflecting a slowdown in activity in the property market and the increase in the cost of credit. Households' debt servicing costs (payments of interest and principal) increased slightly in relation to disposable income, but remain about half the equivalent proportion for the euro area.

Over the year as a whole the gross operating profit of non-financial enterprises declined in relation to value added, despite the recovery in activity, which was more pronounced in the final quarter. Self-financing decreased, owing mainly to higher interest expenses and taxes; as a result of the recovery in investment, firms' borrowing requirement increased to 2.3 per cent of GDP and was covered mainly by bank loans. Debt rose to 67 per cent of GDP, but was still low by international standards.

Over the last decade non-financial firms in the leading industrial countries have turned increasingly to capital markets, in part to finance mergers and acquisitions. Italy still lags behind in this respect: whereas in the last three years Italy accounted for around 18 per cent of the euro area's GDP, Italian companies were responsible for only 8 per cent of the equity capital raised in the markets and 10 per cent of bond issues; moreover, they accounted for only 4 per cent of the value of mergers and acquisitions.

### *Households' financial saving and debt*

In 2006 the financial saving of the household sector (comprising consumer households, producer households and non-profit institutions serving households) declined to €65 billion (Table 12.1). The decrease was associated with the contraction in overall saving and the pace of investment in real estate, which remained strong although slower than in 2005.

At the end of 2006 the net financial assets of Italian households were equal to 2.7 times disposable income, the same as in 2005. This is higher than the average for the euro area (estimated at about twice disposable income in 2005) and in part reflects the lower level of debt in Italy.

Table 12.1

**Financial balances** (1)
*(millions of euros and percentages)*

| | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|
| Households | 68,615 | 82,736 | 74,743 | 64,863 |
| *of which: external balance* | *4,578* | *1,325* | *42,140* | *32,601* |
| Non-financial corporations | -26,310 | -11,907 | -25,577 | -34,155 |
| *of which: external balance* | *24,119* | *13,622* | *54,242* | *30,728* |
| General government | -45,957 | -49,319 | -61,766 | -68,173 |
| *of which: external balance* | *-64,995* | *-19,271* | *-91,579* | *-37,062* |
| Monetary financial institutions | 33,184 | 19,512 | 11,398 | -17,244 |
| *of which: external balance* | *-25,889* | *27,566* | *-48,209* | *-73,243* |
| Other financial intermediaries (2) | -35,826 | -29,262 | 17,222 | 14,704 |
| *of which: external balance* | *22,767* | *-44,638* | *5,776* | *-16,244* |
| Insurance companies (3) | -17,672 | -15,710 | -26,853 | 2,091 |
| *of which: external balance* | *15,455* | *17,446* | *26,798* | *25,306* |
| Rest of the world account | 23,965 | 3,950 | 10,831 | 37,914 |
| | | **As a percentage of GDP** | | |
| Households | 5.1 | 5.9 | 5.3 | 4.4 |
| Non-financial corporations | -2.0 | -0.9 | -1.8 | -2.3 |
| General government | -3.4 | -3.5 | -4.3 | -4.6 |
| Financial corporations (4) | -1.5 | -1.8 | 0.1 | 0.0 |
| Rest of the world account | 1.8 | 0.3 | 0.8 | 2.6 |
| | | **As a percentage of GDP, adjusted for inflation** (5) | | |
| Households | 3.0 | 3.6 | 2.9 | 3.1 |
| Non-financial corporations | -1.0 | 0.3 | -0.5 | -1.6 |
| General government | -1.6 | -1.6 | -2.2 | -3.4 |

(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 euros 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 by 4 per cent between 2005 and 2006. About one quarter of the increase was due to the rise in the value of equity holdings and the remainder to new investment.

Italian households hold a similar proportion of cash and fixed-rate instruments (deposits and bonds) as households in the leading euro-area countries, but a higher percentage of investment fund units, shares and other equities, the market value of which is partly estimated as they are largely non-marketable securities. By contrast, the proportion of investments in pension funds and insurance products is much smaller; the difference in relation to France, Germany and the Anglo-Saxon countries has narrowed only slightly over the last decade.

*Saving for retirement*. – The effects of the reform of the pension system on households' saving decisions can be examined on the basis of data from the Bank of Italy survey of Italian households' budgets. Econometric analysis shows that the pension legislation, which from the mid-1990s onwards reduced public pensions and defined the rules and instruments for supplementary pensions, has had only a limited impact on household saving and the switching of accumulated wealth from traditional instruments into pension funds.

The analysis suggests that the generations and categories of workers most affected by the pension reforms (young people, public employees and the self-employed) are not fully exploiting the tax advantages associated with investment in supplementary pension plans, partly because of liquidity constraints. Other socio-economic conditions being equal, young workers have lower rates of investment in pension funds than older workers; the same holds true of public employees by comparison with workers in the private sector. By contrast, self-employed persons invest more than other workers, although the differential has gradually diminished. Overall, the analysis confirms the importance of efforts on the part of the public authorities to provide workers with adequate information on their pension situation and the instruments available to them.

*Financial liabilities.* – Households' financial debt continued to grow rapidly in 2006, rising by €50 billion (Table 12.2); it increased by 4 percentage points in relation to disposable income, to stand at 47 per cent at the end of the year.

Table 12.2

**Households' financial assets and liabilities** (1)
*(millions of euros and percentage composition)*

| | End-of period stocks | | | Flows | |
|---|---|---|---|---|---|
| | Dec. 2006 | Percentage composition | | 2005 | 2006 |
| | | Dec. 2005 | Dec. 2006 | | |
| **ASSETS** | | | | | |
| Cash and sight deposits | 583,824 | 17.0 | 17.2 | 37,007 | 31,273 |
| *of which: deposits* | *499,811* | *14.7* | *14.8* | *27,648* | *23,357* |
| Other deposits | 346,571 | 9.8 | 10.2 | 10,504 | 26,972 |
| *bank* (2) | *241,603* | *2.5* | *7.1* | *-2,923* | *20,008* |
| *post office* (2) | *104,968* | *7.3* | *3.1* | *13,427* | *6,964* |
| Short-term securities | 13,065 | 0.1 | 0.4 | -15,219 | 11,802 |
| Medium and long-term securities | 532,654 | 16.5 | 15.7 | -25,115 | 12,805 |
| *of which: government* | *152,109* | *5.4* | *4.5* | *-31,555* | *-9,582* |
| *corporate* | *50,891* | *1.4* | *1.5* | *9,653* | *6,025* |
| *bank* | *329,654* | *9.7* | *9.7* | *-3,212* | *16,362* |
| Investment fund units | 224,801 | 8.3 | 6.6 | -7,065 | -36,869 |
| Shares and other equity | 730,722 | 21.4 | 21.6 | 27,617 | 5,119 |
| External assets | 322,504 | 8.6 | 9.5 | 42,140 | 32,601 |
| *of which: deposits* | *14,373* | *0.1* | *0.4* | *794* | *11,404* |
| *short-term securities* | *1,150* | *0.0* | *0.0* | *294* | *463* |
| *medium and long-term securities* | *125,369* | *3.7* | *3.7* | *27,909* | *9,736* |
| *shares and other equity* | *100,254* | *2.8* | *3.0* | *-654* | *1,226* |
| *investment fund units* | *81,358* | *2.0* | *2.4* | *13,797* | *9,772* |
| Insurance and pension fund reserves (3) | 611,202 | 17.8 | 18.1 | 56,501 | 33,559 |
| *of which: life insurance reserves* | *373,363* | *10.9* | *11.0* | *41,736* | *20,832* |
| Other financial assets (4) | 20,668 | 0.5 | 0.6 | 4,203 | 3,070 |
| **Total assets** | **3,386,011** | **100.0** | **100.0** | **130,573** | **120,332** |
| **LIABILITIES** | | | | | |
| Short-term debt (5) | 53,969 | 9.8 | 9.1 | -32 | 796 |
| *of which: bank* | *51,810* | *9.5* | *8.7* | *-245* | *506* |
| Medium and long-term debt (6) | 425,649 | 69.9 | 71.5 | 52,693 | 48,964 |
| *of which: bank* | *378,943* | *62.9* | *63.6* | *46,054* | *40,071* |
| Other financial liabilities (7) | 115,962 | 20.3 | 19.5 | 3,170 | 5,711 |
| **Total liabilities** | **595,580** | **100.0** | **100.0** | **55,831** | **55,471** |
| **BALANCE** | **2,790,431** | | | **74,742** | **64,861** |

(1) Consumer households, producer households and non-profit institutions serving households. Rounding may cause discrepancies in totals. – (2) The data are affected by the transfer of Cassa Depositi e Prestiti S.p.A., in September 2006, from the sector "Other financial intermediaries" to the sector "Other monetary financial institutions: other intermediaries". – (3) Insurance technical reserves of both the life and casualty sectors, pension funds and severance pay entitlements. – (4) Trade credit and other minor items. – (5) Includes finance provided by factoring companies. – (6) Includes finance provided by leasing companies, consumer credit from financial corporations and other minor items. – (7) Staff pension provisions and other minor items.

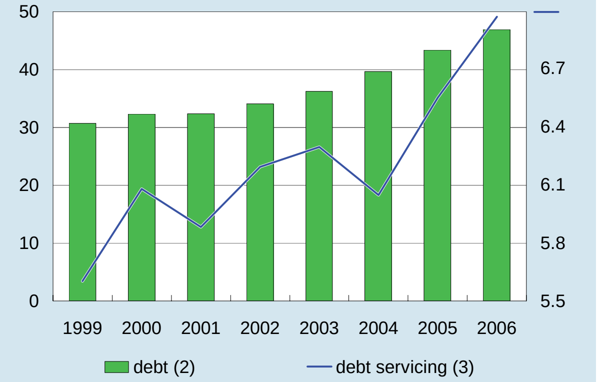
The average debt of Italian households remains low by international standards; in 2005, the last year for which comparable data are available, it was equivalent to 43 per cent of disposable income, against 66 per cent in France, 100 per cent in Germany, 128 per cent in the United States and 148 per cent in the United Kingdom.

The increase in liabilities in 2006 is attributable largely to the continued strong uptake of bank mortgage loans for house purchases, which increased more slowly, mainly owing to the slowdown in property sales.

Figure 12.1

**Households' debt (1)**

*(as percentage of gross disposable income)*




Sources: Bank of Italy, Istat.
(1) Consumer households, producer households and non-profit institutions serving households. The figure for gross disposable income in 2006 is a Bank of Italy estimate. – (2) Left-hand scale. End-of period stocks. – (3) Right-hand scale. The indicator relates only to consumer households. The figure for debt servicing (total payments of interest and principal) is a Bank of Italy estimate.

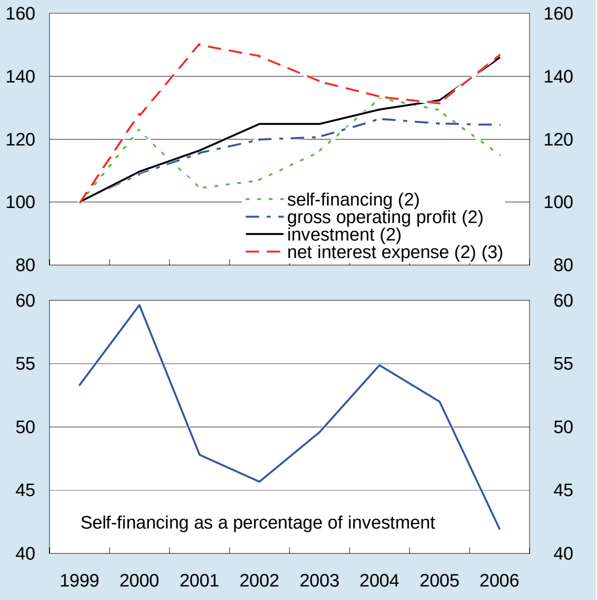
Households' debt servicing costs (payments of interest and instalment repayments of the principal) rose by 0.4 percentage points in relation to disposable income, to 7 per cent (Figure 12.1), a low figure by international standards. Most of the increase was due to interest payments, which were affected by the rise in rates in the course of the year.

## *The financing of firms and their financial assets*

*Profitability and self-financing.* – The cyclical recovery in 2006 was not reflected in an improvement in profitability until the final quarter. Over the year as a whole gross operating profit declined to 35 per cent of value added, one percentage point less than in 2005 and low even by comparison with the last five years of weak economic activity. Net interest expense rose from 4.5 per cent of value added in 2005 to 4.9 per cent last year (Figure 12.3), reflecting in equal measure the rise in interest rates and the growth in debt. The financial deficit of firms increased from €26 billion to €34 billion (Table 12.3 and Figure 12.2).

Figure 12.2

**The external funding requirement of firms** (1)




Sources: Bank of Italy, Istat.
(1) Estimates based on national accounts data for the sector "non-financial corporations", 1999-2005. The data for 2006 are estimated on the basis of the national accounts for the year. Investment includes inventories. – (2) Indices, 1999=100. – (3) Bank of Italy estimates.

**Table 12.3**

**Financial assets and liabilities of firms** (1)
*(millions of euros and percentage composition)*

| | End-of-period stocks | | | Flows | |
|---|---|---|---|---|---|
| | Dec. 2006 | Percentage composition | | 2005 | 2006 |
| | | Dec. 2005 | Dec. 2006 | | |
| **ASSETS** | | | | | |
| **Domestic assets** | **1,220,552** | **75.5** | **74.4** | **28,287** | **40,622** |
| Cash and sight deposits | 168,977 | 10.4 | 10.3 | 15,841 | 17,043 |
| Other deposits | 10,238 | 0.7 | 0.6 | 47 | -442 |
| *of which: bank* | *10,238* | *0.7* | *0.6* | *47* | *-442* |
| Short-term securities | 291 | 0.0 | 0.0 | -300 | 251 |
| Medium and long-term securities | 47,134 | 3.0 | 2.9 | 3,232 | 2,826 |
| *of which: government* | *10,669* | *0.7* | *0.7* | *-2,554* | *1,321* |
| *corporate* | *24,007* | *1.5* | *1.5* | *6,266* | *2,343* |
| Shares and other equity | 627,847 | 37.8 | 38.3 | 3,579 | 1,393 |
| Investment fund units | 3,134 | 0.3 | 0.2 | -98 | -430 |
| Trade credit receivable | 294,834 | 19.9 | 18.0 | 2,667 | 2,595 |
| Other financial assets (2) | 68,097 | 3.4 | 4.2 | 3,319 | 17,386 |
| **External assets** | **420,227** | **24.5** | **25.6** | **54,829** | **51,598** |
| *of which: deposits* | *33,027* | *1.7* | *2.0* | *17,496* | *9,147* |
| *trade credit receivable* | *58,454* | *4.0* | *3.6* | *235* | *-764* |
| *short-term loans* | *109,158* | *5.3* | *6.7* | *28,441* | *32,857* |
| *securities* | *21,740* | *1.4* | *1.3* | *2,640* | *1,344* |
| *shares and other equity* | *183,490* | *11.1* | *11.2* | *3,093* | *8,619* |
| **Total assets** | **1,640,779** | **100.0** | **100.0** | **83,115** | **92,220** |
| **LIABILITIES** | | | | | |
| **Domestic liabilities** | **2,614,306** | **89.6** | **89.1** | **108,106** | **105,505** |
| Short-term debt (3) | 346,269 | 11.7 | 11.8 | 3,759 | 29,889 |
| *of which: bank* | *314,466* | *10.5* | *10.7* | *3,409* | *30,462* |
| Medium and long-term debt (4) | 492,233 | 16.6 | 16.8 | 47,407 | 44,301 |
| *of which: bank* | *405,294* | *13.1* | *13.8* | *34,906* | *52,640* |
| Securities | 53,014 | 1.7 | 1.8 | 4,905 | 5,378 |
| *of which: medium and long-term* | *39,712* | *1.3* | *1.4* | *2,614* | *3,726* |
| Shares and other equity | 1,283,738 | 43.7 | 43.8 | 41,496 | 15,286 |
| Trade credit payable | 300,851 | 11.0 | 10.3 | 2,721 | 2,648 |
| Other financial liabilities (5) | 138,201 | 4.8 | 4.7 | 7,818 | 8,003 |
| **External liabilities** | **319,664** | **10.4** | **10.9** | **587** | **20,871** |
| *of which: trade credit payable* | *29,342* | *1.1* | *1.0* | *2,617* | *585* |
| *financial debt* | *101,164* | *3.4* | *3.4* | *14,074* | *7,850* |
| *of which: medium and long-term securities* | *14,033* | *0.5* | *0.5* | *-2,362* | *486* |
| *shares and other equity* | *184,993* | *5.7* | *6.3* | *-15,294* | *14,162* |
| **Total liabilities** | **2,933,970** | **100.0** | **100.0** | **108,693** | **126,376** |
| **BALANCE** | **-1,293,191** | | | **-25,578** | **-34,156** |

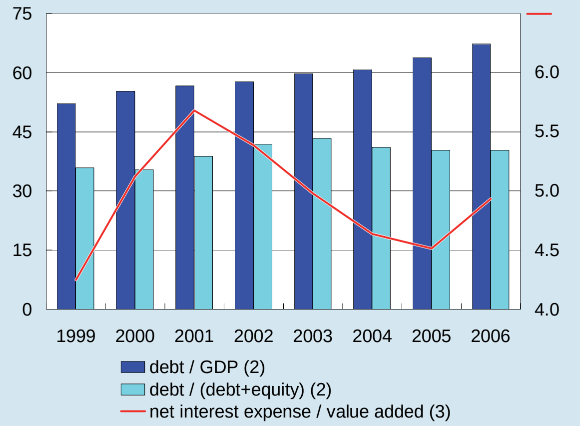
(1) The data refer to "non-financial corporations". Rounding may cause discrepancies in totals. – (2) Insurance technical reserves, domestic derivatives and other minor items. – (3) Includes finance provided by factoring companies. – (4) Includes finance provided by leasing companies. – (5) Staff pension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

*Debt and the financial situation of firms.* – The financial debt of firms increased substantially, by €87 billion compared with €70 billion in 2005, to the equivalent of 67 per cent of GDP. By contrast, their leverage, calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices, remained unchanged at 40 per cent owing to the effect of the rise in share prices on the valuation of their equity (Figure 12.3). Growth occurred in all components of debt: loans and securities, short and long-term debt; in particular, short-term bank loans accelerated sharply, reflecting increased demand for working capital generated by the recovery in economic activity.

Figura 12.3

**Corporate debt** (1)

*(percentages)*




Sources: Bank of Italy, Istat.
(1) The data relate to "non-financial corporations". – (2) Left-hand scale. – (3) Right-hand scale. The figures for net interest expense are internal Bank of Italy estimates. Value added for 2006 is estimated from national accounts data.

The financial situation of large companies improved in relation to the average. On the basis of the consolidated accounts of the leading quoted industrial groups, profitability remained high in 2006 and debt ratios continued to fall; nevertheless, the leverage of such companies remains higher than that of listed companies in the same sectors and of the same size in the other euro-area countries.

Although the ratio of debt to GDP in Italy rose in 2005, it remained lower than in the other industrial countries except Germany. The disparity in relation to the other countries has narrowed considerably since the mid-1990s, when Italian firms were still highly leveraged by international standards.

The composition of Italian firms' financial debt differs from that in the other industrial countries primarily on account of lower fund-raising in the bond market. In the last three years gross bond issues in international markets by non-financial companies were equal to 0.9 per cent of GDP in Italy, 1.5 per cent in the euro area and 1.6 per cent in the United Kingdom.

Bond issues are much less used in the major euro-area countries than in the United States, where corporations are financed to a large extent by issuing marketable instruments in the markets. However, since 1999, in parallel with the introduction of the euro, European firms have greatly increased their recourse to the bond market, such that in 2006 they issued paper worth about €100 billion, five times the level of 1995. In addition, there has been greater market participation by issuers with a lower rating or located in countries where bond issues used not to be a common means of fund-raising, such as Italy, Austria and Greece. Empirical analysis with regard to Europe suggests that when smaller companies decide to issue bonds it is mainly because of the need to finance growth, while among large companies the motive is primarily a desire to rebalance their financial structure by diversifying their sources of finance and lengthening the maturity of their debt.

*Trade credit payable.* – In 2006, in connection with the pick-up in economic activity, trade credit payable by Italian firms increased by about €3 billion; at the end of the year it made up 11 per cent of firms' total financial liabilities.

*Share issues, venture capital and private equity.* – In 2006 the increase in the net worth of firms due to retained profits and capital increases amounted to about €30 billion, of which €4 billion came from issues of listed shares. The total value of share issues by listed companies was lower than in 2005, when they had amounted to €8 billion; however, the number and value of initial public offerings of shares increased.

Empirical analysis of data on a sample of European firms that listed between 1995 and 2003 indicates that access to the equity market enabled them to reduce their leverage after a period of rapid corporate growth. On the other hand, the link between listing and the performance of profits and investment in the years immediately thereafter appears to be weaker.

According to the Italian Private Equity and Venture Capital Association, investment and fund-raising by private equity and venture capital companies in Italy increased to €3.7 billion and €2.3 billion respectively last year but is still far smaller than in the leading industrial countries. Around two thirds of investment related to transactions involving changes in the ownership of large companies, while funding for business start-ups or companies in high-technology sectors played a marginal role, as it had in earlier years, amounting to 1 and 7 per cent respectively.

The Italian venture capital and private equity market differs from markets elsewhere on account of the low level of investment in young companies. On average over the decade from 1996 to 2005, such financing was equivalent to 0.27 per cent of GDP in the United States, 0.10 per cent in the European countries and 0.05 per cent in Italy. Various factors are responsible for the relative underdevelopment of venture capital in Italy. First, the financiers of venture capital companies include few institutional investors, such as pension funds, with a long investment horizon and particularly likely to support projects that will not yield returns for a considerable period of time. Moreover, the fact that the equity market is less developed makes it less easy for the venture capital fund to exit once it can no longer contribute to the growth of the enterprise. Recent empirical analysis suggests that the lower level of success of this type of intermediation in Europe than in the United States may also reflect the lower profitability of projects financed by means of venture capital on the old continent.

*Financial assets and mergers and acquisitions.* – Italian firms increased their investment in financial assets from €83 billion to €92 billion in 2006. Their net purchases of shares and other equity rose in connection with mergers and acquisitions.

In the international markets, the process of corporate consolidation, which has been under way since the mid-1990s and has revived considerably since 2004, remains intensive. According to Thomson Financial, which monitors the main transactions at world level, about 7,600 mergers and acquisitions of majority interests with a total value of more than €750 billion were announced by non-financial companies in 2006, around 8 per cent more than in the previous year. The current wave of consolidation is more widespread internationally than those that occurred in the past. US companies continue to predominate, but their share has fallen from 60 per cent in 1995-97 to 44 per cent in the last three years; over the same period the share of euro-area companies has increased from 9 to 24 per cent. China and India, which had virtually no involvement at the end of the last decade, accounted for 3 per cent of M&A activity in 2006.

In 2006 activity in the market in corporate control was brisk in Italy as well; Italian firms announced 131 mergers and acquisitions worth €9 billion, two more than in the previous year. Disregarding the acquisition of a US company for about €4 billion by Lottomatica, it was the energy sector that saw the most activity. The proportion of acquisitions of foreign companies by Italian firms declined, as did the share of counterparties situated in euro-area countries. In addition, foreign acquirers announced 63 acquisitions of Italian companies, almost all small in size. Among the acquisitions of large Italian concerns by foreign companies announced to the market, the Abertis-Autostrade transaction remains suspended, pending the resolution of legal actions between the relevant authorities and with the companies involved.

In the first few months of 2007 ENEL and a Spanish partner launched a takeover bid worth a total of about €40 billion for control of Endesa, the main Spanish electricity generator. In April the largest Spanish telephony company, Telefónica, acquired the relative majority stake in the holding company of Telecom Italia.

# 13. THE FINANCIAL MARKETS AND INSTITUTIONAL INVESTORS

The Italian stock market rose considerably in 2006, in line with those of the other euro-area countries, reflecting listed companies' better-than-expected profits against a backdrop of rising real interest rates.

The nominal long-term yields on government securities increased, as in the other main countries of the area. The yield spread between the 10-year BTP and the corresponding Bund remained practically unchanged during the year.

The rise in interest rates increased the cost of bond issues for firms. The yield differential between euro-denominated bonds of non-financial corporations and government securities nevertheless remained stable and very small. Banks' net bond issues grew very substantially, while those of large non-financial corporations remained modest. The presence of medium-sized and low-rated companies in this market remained negligible.

Italian institutional investors registered net redemptions of €5 billion, compared with net fund-raising of €68 billion in 2005 (Table 13.1). Primarily this was due to an increased preference on the part of Italian households for direct investment in domestic government securities. The importance of institutional investors remains relatively limited by international standards, mainly because of the small presence of pension funds.

**Table 13.1**

**Italian institutional investors: net fund-raising and assets under management**
*(millions of euros and percentages)*

| | Net flows | | End-of-period stocks | | | |
|---|---|---|---|---|---|---|
| | 2005 | 2006 (1) | 2005 | 2006 (1) | Percentage composition | |
| | | | | | 2005 | 2006 (1) |
| Investment funds (2) | -3,788 | -39,181 | 416,628 | 391,021 | 30.2 | 27.6 |
| Insurance companies (3) | 44,130 | 21,578 | 417,957 | 439,535 | 30.3 | 31.1 |
| Pension funds (4) | 4,173 | 2,408 | 34,655 | 37,062 | 2.5 | 2.6 |
| Individually managed portfolios | 35,410 | 26,719 | 512,713 | 547,580 | 37.1 | 38.7 |
| **Total** | **79,925** | **11,524** | **1,381,953** | **1,415,198** | **100.0** | **100.0** |
| **Consolidated total** (5) | **68,244** | **-4,573** | **1,110,003** | **1,122,010** | **–** | **–** |
| *as a percentage of GDP* | *4.8* | *-0.3* | *78.0* | *76.0* | – | – |

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 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 and of the technical reserves of insurance companies deriving from the management of open pension funds.

## *Public sector securities*

*Supply and demand.* – Net issues of Italian public securities during 2006 remained unchanged at €38 billion; the end-year stock declined from 87.8 to 87.4 per cent of GDP.

The average residual maturity of government securities held stable at 6 years and 7 months, while their average financial duration shortened by 2 months to 4 years and 8 months. There were net redemptions of CTZs and CCTs, while BOTs and BTPs recorded net issues. Net issues of 30-year bonds increased from €6 billion to €8.7 billion, while those of bonds indexed to euro-area consumer prices declined from €18.2 billion to €11.8 billion. The latter's share of total outstanding public securities nevertheless rose from 3.7 to 4.5 per cent.

Net issues by Italian local authorities remained basically unchanged at €6.7 billion. At the end of the year the stock amounted to €35.7 billion, or 2.8 per cent of total outstanding Italian public sector securities.

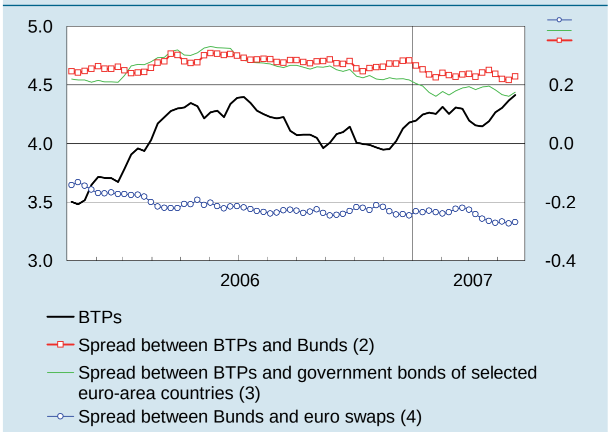
Households and firms returned to substantial net purchases of public securities, while Italian investment funds made net sales and foreign investors sharply curtailed their net purchases. Banks made considerably smaller net purchases than in 2005, most of them involving fixed-rate issues with maturity longer than one year.

*Interest rates.* – Interest rates on medium and long-term government securities rose gradually in the first half of 2006 in Italy as in the euro area (Figure 13.1). The rise came to a halt in July. Over the year the yield on ten-year bonds rose from 3.5 to 4.2 per cent. In the first four months of 2007 medium and long-term rates began to rise again, in connection with improving expectations for economic growth in the euro area.

Figure 13.1

**Gross yields on 10-year BTPs and main interest rate spreads** (1)

*(weekly averages; percentages and percentage points*




Source: Based on Bloomberg data.
(1) Yields on benchmark ten-year bonds. – (2) Spread between BTPs and Bunds, adjusted to take account of differences in the residual life of the two securities; right-hand scale. – (3) Spread 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); right-hand scale. – (4) Spread between ten-year Bunds and ten-year euro swaps; right-hand scale.

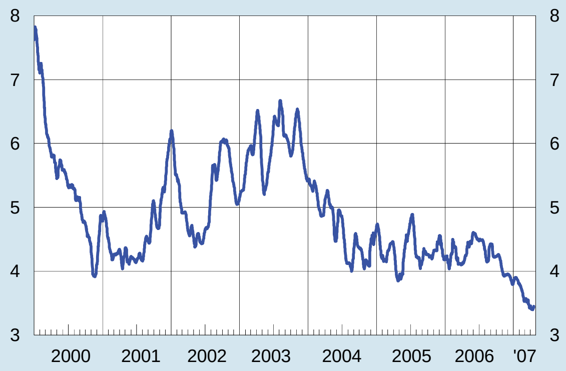
The yield spread between the benchmark 10-year BTP and the corresponding Bund remained small, reaching a maximum of 30 basis points at the end of April 2006 on the occasion of the parliamentary elections in Italy and the generalized widening of bond spreads on international markets. It then narrowed gradually to 23 basis points in the first quarter of 2007. The downgrading of Italy's public debt by two rating agencies in October had no appreciable effect on the spread.

The volatility of long-term rates implicit in the prices of options on 10-year Bund futures diminished slightly from the already low levels of 2005 (Figure 13.2). There was a perceptible further decline in the first four months of 2007.

## *Corporate bonds and bank bonds*

Figure 13.2

**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 the Eurex market.

*Issuance.* – Net Italian corporate bond issues increased again, from €78 billion to €87 billion (Table 13.2). The growth was due almost entirely to bank issues for maturity matching purposes. Net issues by non-financial corporations, though increasing, remained very modest and restricted to large and medium-sized companies.

Italian non-financial companies' resort to the bond market is still limited. Outstanding corporate bonds amount to 3 per cent of GDP, compared with 7 per cent in the euro area as a whole. Issues expanded with the introduction of the single monetary policy and remained at high levels through 2004 before declining in the two following years. Most of the issues are accounted for by a small number of large corporations with high credit ratings. About 80 per cent of gross issues between 1995 and 2006 was concentrated in the automobile, motorway, energy and telecommunications sectors (the latter alone accounting for 45 per cent). Resort to the market by medium-sized firms and firms with poor credit ratings, which had expanded somewhat until 2003, has virtually collapsed as a result of the repercussions on investor confidence of the Cirio and Parmalat defaults.

Net Italian bond issues in connection with securitizations decreased sharply compared with 2005, from €31 billion to €19 billion. Part of the fall was due to the decreased volume of placements by public sector entities. The largest share of securitizations involved the issue of residential mortgage-backed securities by banks. Covered bond issues were worth €4 billion, as in 2005.

Table 13.2

**Medium and long-term bonds of Italian banks and firms** (1)
*(at face value; millions of euros)*

| | Net issues (2) | | | Stocks | | | As a % of GDP |
|---|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 | 2006 |
| Banks | 43,048 | 41,502 | 60,371 | 442,868 | 484,370 | 544,742 | 37 |
| Other financial corporations | 14,938 | 35,842 | 16,075 | 126,909 | 162,831 | 185,299 | 13 |
| Non-financial corporations | 8,848 | 1,086 | 4,438 | 45,002 | 46,167 | 50,626 | 3 |
| **Total** | **66,834** | **78,430** | **80,844** | **614,779** | **693,368** | **780,667** | **53** |
| *Memorandum item:* | | | | | | | |
| International market (3) | 68,622 | 55,685 | 80,430 | 256,060 | 312,345 | 392,665 | 27 |

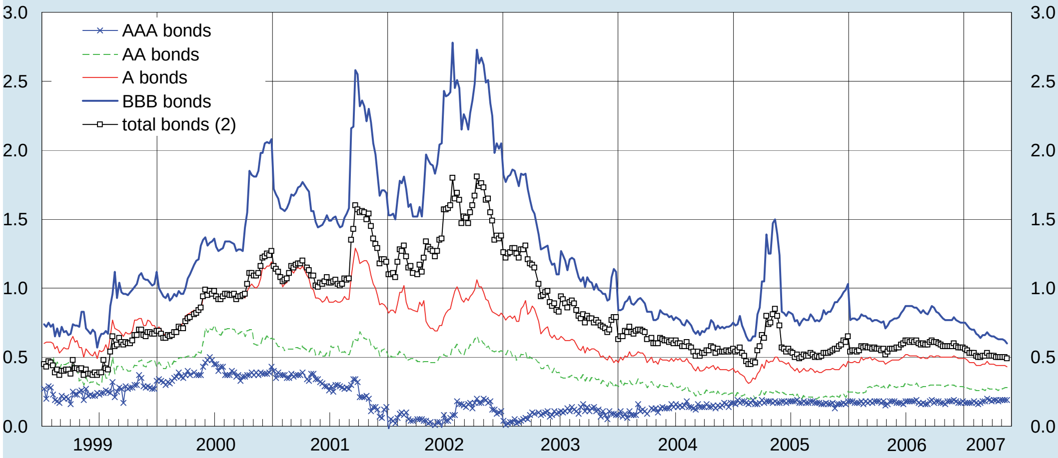
Source: For the euro area, based on ECB data.
(1) The nationality and sector refer to the issuer and not to its parent company, except as indicated. Only includes securities with a maturity at issue of more than one year. – (2) Difference between the face value of issues and redemptions. – (3) Source: 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.

Cassa Depositi e Prestiti was the sole Italian company authorized to issue covered bonds in 2006, since the other authorized entity, Infrastrutture S.p.A., was merged into it at the start of the year. In May 2007 the legislative process that began with Law 80 of 14 May 2005 was completed, enabling Italian banks with adequate capital to issue these instruments.

*Yields.* – The Euromarket yield spreads on euro-denominated bonds of non-financial corporations rated at least BBB- or Baa3 remained extremely small, though there was a temporary widening in May and June in concomitance with the sharp downward correction on equity markets and the rise in oil prices. At the end of 2006 the spread over government securities of comparable maturity was 0.6 percentage points, as a year earlier (Figure 13.3).

**Figure 13.3**

**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 no 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).

With the default rate remaining low, yield spreads on private-sector bond issues in the Euromarket were not appreciably affected by the rises in official interest rates. Starting in the second half of 2005, however, the rating agencies began to indicate a moderate deterioration in creditworthiness internationally. In the future the increasing resort to transactions that transfer risks from shareholders to creditors, such as share buy-backs, generous dividends and leveraged buy-outs, could result in a downward adjustment of issuers' credit ratings.

The yield spread of euro-denominated Italian corporate issues over government securities remained in line with those of similar issuers in other euro-area countries both on the primary and on the secondary market. Spreads for the lowest-rated issuers held steady near their historical lows.

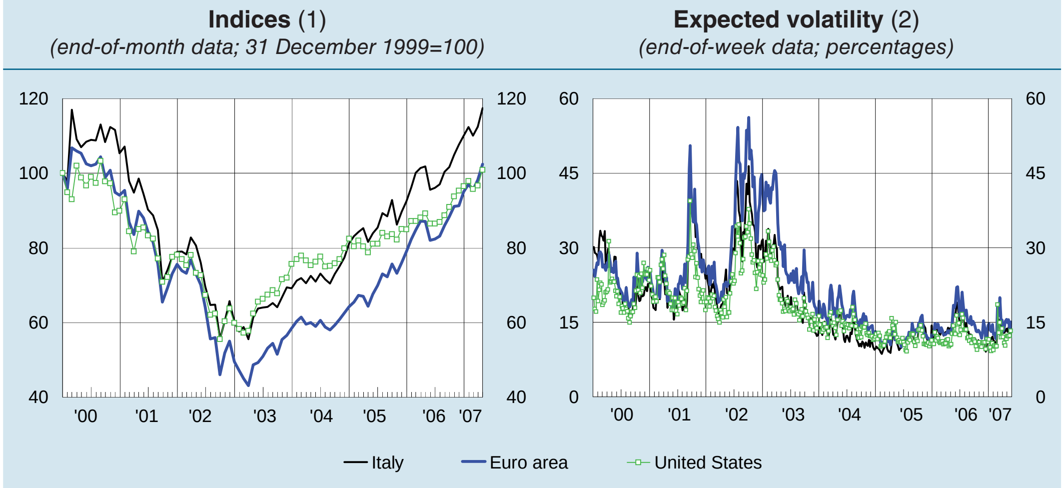
In the first four months of 2007 the yield differentials on bonds of the best-rated Italian corporations narrowed slightly, in line with the market. Those on riskier securities narrowed more substantially, thanks in part to the sharp decrease in differentials in the automobile sector. The bond market was not significantly affected by the turbulence in the equity markets or the temporary rise in volatility in late February and March.

## *The equity market*

*Share prices and trading.* – Share prices on the Italian equity markets rose sharply in 2006. The MIB index rose 19 per cent, in line with the Euro Stoxx index for the main euro-area companies (Figure 13.4).

**Figure 13.4**

**Share markets**




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. – (2) Volatility implied by stock index options on the main stock exchanges.

Italian listed corporations continued to pay generous dividends, equal to 3.2 per cent of total capitalization compared with a euro-area average of 2.5 per cent. Italy's high-tech index (TechSTAR) gained 17 per cent, compared with 8 per cent for the Techmark index in the United Kingdom and 10 per cent for Nasdaq in the United States.

In the first four months of 2007 share prices rose further both in Italy and in the euro area (by 3 and 2 per cent respectively), as the sharp fall in the first half of March due to tensions originating in Chinese stock markets was promptly made good over the following two weeks. The markets were sustained by listed companies' high current earnings against a backdrop of rising interest rates and slightly declining medium-term profit growth expectations.

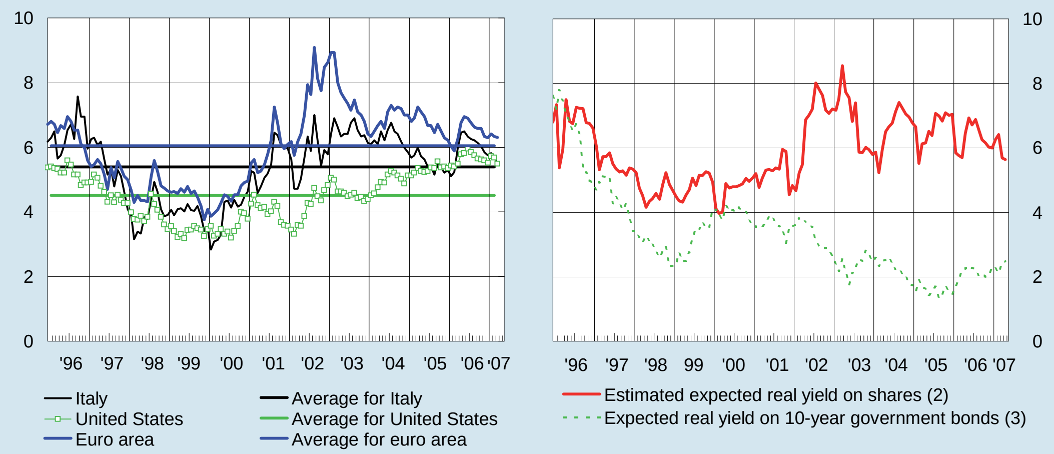
The volatility of Italian equities implicit in option prices, which increased temporarily in May and June with the emergence of uncertainty about the outlook for monetary policy in the United States and the rise in oil prices, remained at historically low levels.

The earnings/price ratio of Italian shares rose from 5.2 to 5.8 per cent in 2006, near the average for the past twenty years. At the end of the year the expected real yield on shares, based on forecast earnings growth, was 5.5 per cent, against 2.1 per cent for long-term government bonds (Figure 13.5).

Figure 13.5

**Current earnings/price ratios in selected industrial countries** (1)
*(end-of month data; percentages)*

**Expected real yields on euro-area shares and government bonds**
*(monthly data; percentages)*




Sources: Based on IBES, Consensus Economics, Bloomberg and Thomson Financial data.
(1) The averages are calculated from January 1990. – (2) 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. – (3) Spread between the interest rate on ten-year government bonds and long-term inflation expectations.

Especially sharp gains were recorded by metallurgical and automobile shares (96 and 66 per cent respectively), owing mainly to the performance of Tenaris, one of the world's leading steel pipe producers, and Fiat. Utilities shares rose by 24 per cent, led by electricity companies, which benefited from the process of consolidation among the main euro-area utilities, which involved Enel. Bank shares (which also gained 24 per cent) were driven by mergers and high operating profits. The performance of oil companies (9 per cent), media firms (1 per cent) and telecommunications corporations (-6 per cent) was worse than the market average; similar sectoral trends were registered in the rest of the euro area.

The Star segment of medium-cap firms that meet higher standards in terms of transparency for investors and corporate governance outperformed the general index for the third successive year and gained 26 per cent.

*Supply and demand.* – The upswing in new listings in Italy continued. Twenty-one new companies made initial public offerings, compared with 15 in 2005 (Table 13.3), including 9 in the Star segment and 7 in the Expandi market for small and medium-sized enterprises. Again there were no additions to the TechSTAR list. Total fund-raising by the newly listed companies was less than 1 per cent of the average total stock exchange capitalization for the year. New listings in the euro area increased considerably, from 99 to 201.

At the end of the year 284 companies were listed on the Italian stock exchange, up from 275 twelve months earlier. Price rises contributed to an increase in total capitalization from €677 billion to €779 billion and from 49 to 53 per cent of GDP. The ratio to GDP was 54 per cent in Germany, 101 per cent in the four Euronext countries (Belgium, France, the Netherlands and Portugal), 150 per cent in the United Kingdom and 145 per cent in the United States.

Tavola 13.3

**Main indicators of the Italian stock exchange**
*(millions of euros, except as indicated)*

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Annual change in prices (1) | -25.1 | -23.7 | 14.9 | 17.5 | 20.0 | 19.0 |
| Listed Italian companies (number at end of year) | 288 | 288 | 271 | 269 | 275 | 284 |
| *of which: in the STAR segment* | *37* | *41* | *40* | *46* | *70* | *75* |
| Total market capitalization (2) | 592,319 | 457,992 | 487,446 | 568,901 | 676,606 | 778,501 |
| *as a percentage of GDP* | *48.6* | *36.3* | *37.5* | *43.1* | *47.7* | *52.8* |
| percentage breakdown: (3) | | | | | | |
| *industrials* | *23* | *25* | *23* | *23* | *26* | *29* |
| *insurance* | *13* | *11* | *12* | *12* | *12* | *10* |
| *banking* | *23* | *22* | *26* | *25* | *32* | *33* |
| *finance* | *3* | *3* | *4* | *3* | *4* | *4* |
| *services* | *39* | *39* | *35* | *37* | *26* | *24* |
| **Total** | **100** | **100** | **100** | **100** | **100** | **100** |
| Gross share issues (4) | 6,171 | 3,894 | 8,710 | 3,197 | 12,599 | 6,098 |
| *of which: in the STAR segment* | *86* | *264* | *26* | *89* | *279* | *290* |
| Market value of newly-listed companies (5) | 10,554 | 5,142 | 1,412 | 5,999 | 6,405 | 12,919 |
| *of which: foreign companies* | .. | *2,067* | .. | .. | .. | .. |
| *of which: in the STAR segment* | .. | .. | .. | .. | *797* | *3,620* |
| Dividends distributed (6) | 15,889 | 18,650 | 17,030 | 22,517 | 23,708 | 24,861 |
| Earnings/price ratio (7) | 6.0 | 5.9 | 6.4 | 6.0 | 5.2 | 5.9 |
| Dividend yield (7) | 2.8 | 3.8 | 3.4 | 3.4 | 3.0 | 3.2 |
| Turnover: | | | | | | |
| *spot market* (8) | *620,004* | *572,940* | *580,703* | *641,376* | *893,853* | *1,078,390* |
| *S&P/MIB30 index futures* (9) | *829,416* | *673,836* | *527,024* | *467,122* | *585,445* | *761,580* |
| *S&P/MIB30 index options* (9) | *246,555* | *176,513* | *153,998* | *152,839* | *209,526* | *262,312* |
| Turnover ratio (10) | 88 | 109 | 123 | 121 | 144 | 148 |

Sources: Borsa Italiana and 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: through 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 the contract on the MIB30 index. – (10) Turnover as a percentage of average market capitalization for the year. Italian companies.

## *Investment funds*

*Fund-raising and net assets.* – Net redemptions of harmonized Italian investment funds increased sharply last year from €18.1 billion to €50.2 billion (Table 13.4). This outflow was only partly offset by net subscriptions of other types of Italian funds (open and closed-end) and foreign funds controlled by Italian intermediaries (€11 billion and €11.8 billion respectively). The net redemptions involved all segments except flexible funds. Despite modest net redemptions in Germany and Spain, there was a further increase in net subscriptions in the rest of the euro area.

Table 13.4

**Italian investment funds: market structure** (1)
*(amounts in millions of euros)*

| | Number of funds (2) | | Net assets | | Net fund-raising | |
|---|---|---|---|---|---|---|
| | 2005 | 2006 | 2005 | 2006 | 2005 | 2006 |
| Harmonized open-end funds | 871 | 842 | 352,103 | 311,582 | -18,062 | -50,183 |
| equity | 376 | 346 | 74,845 | 68,770 | -7,983 | -12,133 |
| balanced | 71 | 64 | 33,214 | 30,790 | 779 | -3,175 |
| bond | 306 | 302 | 157,359 | 121,255 | -2,737 | -36,848 |
| money market | 42 | 40 | 72,840 | 67,009 | -11,373 | -7,079 |
| flexible | 76 | 90 | 13,845 | 23,758 | 3,252 | 9,052 |
| Non-harmonized open-end funds | 354 | 417 | 50,164 | 60,047 | 11,476 | 8,026 |
| hedge funds | 162 | 206 | 16,957 | 23,592 | 4,494 | 5,543 |
| *of which: funds of funds* | *152* | *193* | *16,471* | *22,411* | *4,364* | *4,906* |
| other | 192 | 211 | 33,207 | 36,455 | 6,982 | 2,483 |
| *of which: funds of funds* | *142* | *135* | *18,988* | *20,897* | *5,442* | *1,089* |
| **Total open-end funds** | **1,225** | **1,259** | **402,267** | **371,629** | **-6,586** | **-42,157** |
| Closed-end securities funds | 69 | 75 | 2,385 | 3,182 | -48 | 359 |
| *of which: reserved to qualified investors* | *48* | *61* | *1,631* | *2,484* | *36* | *501* |
| Closed-end real estate funds | 60 | 116 | 11,976 | 16,210 | 2,846 | 2,617 |
| *of which: reserved to qualified investors* | *37* | *88* | *5,910* | *8,893* | *2,247* | *1,808* |
| **Total closed-end funds** | **129** | **191** | **14,361** | **19,392** | **2,798** | **2,976** |
| **Total** | **1,354** | **1,450** | **416,628** | **391,021** | **-3,788** | **-39,181** |
| *Memorandum item:* | | | | | | |
| Foreign funds controlled by Italian intermediaries (3) | 695 | 742 | 182,846 | 202,553 | 18,328 | 11,781 |
| *of which: hedge funds* | *....* | *20* | *3,708* | *5,780* | *120* | *898* |

Sources: Bank of Italy and Assogestioni.
(1) Includes SICAVs. – (2) For Italian funds, those in operation at the end of the year indicated. For foreign funds, those acquired by Italian investors. – (3) Funds run by management companies resident in Luxembourg or Ireland. Net assets and net fund-raising refer to the value of units held and subscribed, respectively, by Italian and foreign investors. The data on fund-raising are net of redemptions.

The substantial redemptions of harmonized Italian investment fund units reflected households' increasing preference for direct investment in low-risk assets such as government securities and bank bonds. With real interest rates on government securities rising again, this portfolio adjustment was presumably encouraged by the low average yields of bond and money market funds (0.4 and 1.9 per cent respectively). The redemptions of Italian fund units also depend on banks' marketing strategies, which have directed investors towards the funds of subsidiaries in other countries that offer better tax treatment of business income. Finally, increased offerings of funds by foreign banks may have reduced the fund-raising of Italian funds.

The net assets of the harmonized funds controlled by Italian intermediaries fell to €508 billion at the end of 2006 from €531 billion a year earlier; their share of overall investment fund assets in the euro area dropped by more than 2 percentage points to 10.8 per cent. The total assets of non-harmonized funds controlled by Italian intermediaries amounted to €85 billion or 9.9 per cent of the area-wide total.

*Supply.* – The consolidation of harmonized open-end funds continued, the number doing business in Italy falling for the third consecutive year, while the supply of new types of investment funds, such as hedge funds and closed-end real estate funds, continued to grow. Harmonized open-end funds' share of the total assets of Italian investment funds fell by 5 percentage points to 80 per cent; the biggest gainers were hedge funds, whose share rose from 4 to 6 per cent.

Exchange-traded funds (ETFs) continued to expand rapidly. These instruments, which replicate financial indices and are traded on regulated markets, have low management fees and are highly liquid.

*Asset allocation.* – Reflecting the large volume of net redemptions, harmonized Italian investment funds made net sales of all the main types of securities except equities of other euro-area countries. The combined share of short-term and index-linked Italian government securities and foreign securities fell by some 5 percentage points. At the end of the year Italian equities accounted for 6.7 per cent of the total portfolio, foreign equities for 24.4 per cent.

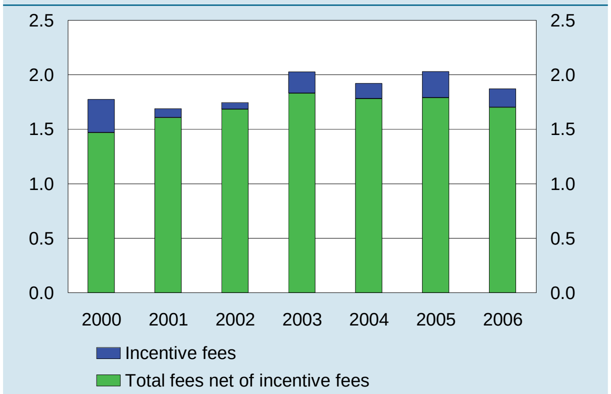
*Yields and fees.* – In 2006 the average yield on Italian harmonized investment funds net of taxes and fees was 4.2 per cent. Equity funds and flexible funds benefited from the strong performance of stock markets and yielded respectively 11.4 and 5.5 per cent. The rise in interest rates penalized bond funds, over half of which registered net losses for the year. The average yield for bond funds was 0.4 per cent, against 1.9 per cent for money market funds.

The total fees paid by harmonized investment funds (management fees, incentive fees, fees paid to depositary banks, securities brokerage fees and other minor items) – which are ultimately borne by subscribers – amounted to €4.7 billion, of which €4.1 billion went to fund management companies. The ratio of total fees to average annual net assets declined by 0.2 percentage points to 1.9 per cent (Figure 13.6), owing to a decrease of 0.1 points in both management fees and management company incentive fees.

Figure 13.6

**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.

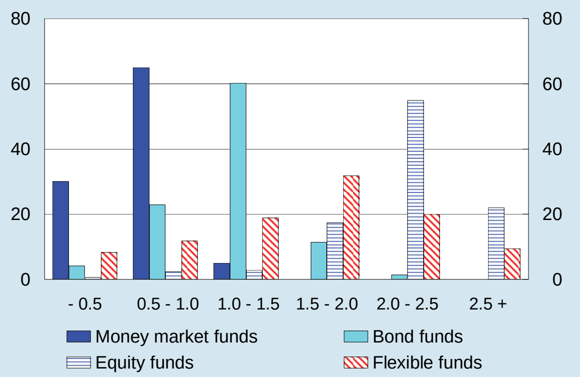
Net of incentive fees, two thirds of money market funds paid fees ranging between 0.5 and 1 per cent (Figure 13.7). Sixty per cent of bond funds paid fees of between 1 and 1.5 per cent. The dispersion of fees among equity funds and flexible funds was much greater. In these two segments, 70 and 50 per cent of the funds, respectively, paid fees of between 1.5 and 2.5 per cent; 20 and 10 per cent respectively paid even higher fees.

Borsa Italiana reports that the total annual fees earned by ETF management companies were very low. At the end of April 2007 they averaged 0.41 per cent of the funds' net assets (0.19, 0.44, 0.47 and 0.50 per cent respectively for bond, equity, commodity and real estate funds).

## *Individual portfolio management*

Figure 13.7

**Italian securities investment funds: total fees according to type of fund, 2006** (1)
*(percentages)*




(1) For each fund category, frequency distribution of 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.

The net flow of savings into individually managed portfolios declined from €35 billion to €26 billion. Total assets under management rose by 6.1 per cent to €544 billion. The sharp decline in net fund-raising can be ascribed to households, which returned to direct investment in government securities and private sector bonds. The portfolio reallocation was induced by the low average yields of the portfolio management services. Their average financial yield (estimated as the percentage increase in net assets less net fund-raising) came to just 1.4 per cent, as against 6.2 per cent in 2005.

Portfolio managers made considerable net sales of Italian government securities and investment fund units and net purchases of Italian equities and foreign securities. The share of Italian equities in the total portfolio rose to 6 per cent and that of foreign securities to 54.7 per cent.

The share of foreign investment funds in individual portfolios rose to over 30 per cent of the total, while that of Italian funds fell to below 10 per cent. Data on portfolios managed by asset management companies alone show that 92 per cent of the investment funds in which they held units were controlled by companies belonging to the same group as the manager, roughly unchanged during the year; for units in foreign funds, the corresponding figure declined by 4 points to 79 per cent.

## *Insurance companies*

In 2006 the premium income of insurance companies diminished by 2.9 per cent after more than a decade of rapid growth. The contraction was due entirely to the life sector, where premium income from traditional (with-profits) policies contracted sharply, while that from unit-linked policies recorded a moderate increase. There was continued growth in the volume of insurance policies linked to individual retirement plans, introduced in 2001.

Insurance companies' technical reserves rose by 5.2 per cent to €440 billion, thanks in part to the good performance of the financial markets. Among their assets, there was an increase in the share invested in fixed-income securities, Italian government paper in particular.

In 2006 and the first four months of 2007 the share prices of Italian insurance companies rose by 18 per cent, about 9 points less than those in the other euro-area countries. The cause would appear to be a comparatively smaller increase in earnings.

There were no major changes in the composition of the companies' investment portfolios between 2002 and 2006 except for a drop of 10 percentage points to 32 per cent in the proportion of Italian government securities and a corresponding rise in that of other euro-denominated bonds to 39 per cent.

## *Pension funds and non-INPS social security institutions*

In 2006 the assets managed by pension funds increased by 7.1 per cent to €36.4 billion, thanks to a 20.9 per cent increase in the resources administered by funds established after the reform of 1993 (Table 13.5). The assets of non-INPS social security institutions rose by 4.9 per cent.

Table 13.5

**Pension funds and non-INPS social security institutions in Italy: main assets** (1)
*(balance sheet values; end-of-period data in millions of euros)*

| | 2005 | | | | 2006 (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** | **2,198** | **1,514** | **684** | **3,017** | **3,419** | **2,491** | **928** | **2,844** |
| **Securities portfolio** | **25,675** | **15,647** | **10,028** | **10,628** | **27,998** | **16,018** | **11,980** | **11,678** |
| Corporate bonds | 16,186 | 9,855 | 6,331 | 7,281 | 17,391 | 9,733 | 7,659 | 8,278 |
| Equities | 4,001 | 1,575 | 2,426 | 1,482 | 4,864 | 1,915 | 2,949 | 1,520 |
| Investment fund units | 5,489 | 4,217 | 1,271 | 1,865 | 5,743 | 4,371 | 1,372 | 1,880 |
| **Mortgage loans and other financial assets** | **2,606** | **2,680** | **-74** | **3,864** | **2,592** | **2,641** | **-49** | **6,940** |
| **Real estate** | **4,176** | **4,176** | **..** | **9,760** | **3,053** | **3,053** | **..** | **6,878** |
| **Total assets** | **34,655** | **24,016** | **10,639** | **27,269** | **37,062** | **24,203** | **12,859** | **28,340** |

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.

On the basis of data from the Pension Fund Supervisory Commission (COVIP), the number of subscribers to the new-style occupational and open pension funds grew by 5 per cent, down from 7.5 per cent in 2005. The total number of subscribers (1,646,000) is no more than 13 per cent of the potential pool. According to COVIP estimates, the average return of the new-style funds net of taxes and operating costs was 3.4 per cent in 2006, compared with 8.5 per cent in 2005; occupational pension funds yielded on average 3.8 per cent and open pension funds 2.4 per cent.

*The development of supplementary retirement schemes in Italy.* – More than ten years since the beginning of the reform process that introduced supplementary retirement instruments and rules, Italy still lags far behind not only the United States and the United Kingdom in the development of pension funds but also such institutionally and structurally similar economies as France, Germany and Spain. Pension fund assets are equal to less than 3 per cent of Italian GDP, below the euro-area average of 15 per cent and incomparably lower than the ratio of approximately 65 per cent found in the United States and the United Kingdom. Pension fund growth among the different groups of workers is uneven. It is slower among young people, women, the self-employed and workers in small firms – precisely the groups that suffer most from discontinuous employment and variable earnings and for whom the possibility of accumulating retirement savings over a long period is an especially important advantage.

The lag in supplementary retirement schemes helps to limit the diversification of the Italian capital markets. In fact the countries where pension funds are most developed also have highly developed markets for both equities and bonds. There is a very close link between pension funds and stock markets. The presence of institutional investors is conducive to listing even by comparatively small firms; it spurs competition between brokers in such essential areas as order collection, trading, securities placement, and analysis; and it encourages openness of the financial system to innovation. In Italy the small number of listed firms and the generally low level of capital market diversification threaten in turn to limit the investment opportunities of the pension funds, which consequently might direct their resources mainly to foreign markets.

Sample surveys report that more than a decade after the radical reform of the Italian social security system, workers are only partially aware of the extent of the cuts made to public pensions; those who turn to supplementary pension schemes are mostly the better educated and more financially sophisticated, who presumably are more able to gather and understand the information. The data confirm the importance of stepping up the public commitment to providing workers with the information they need to gain a true understanding of their retirement situation.

The new rules on supplementary retirement schemes contained in Legislative Decree 252/2005 should give considerable impetus to the growth of Italian pension funds. Law 296/2006 brought its entry into force forward by a year, to 1 January 2007. Severance pay provisions will begin to be channelled into pension funds as early as the second half of 2007 unless the employee expressly decides otherwise.

So far Italian working people have been reluctant to forgo severance pay, which they consider to be more flexible and less risky than supplementary retirement schemes. However, thanks in part to recent rule changes, the provisions on redemptions, early lump-sum withdrawals, payouts and portability now make the use of accumulated pension fund wealth as flexible as that of severance pay funds. Financially, the low risk of the severance pay funds corresponds to low returns. In many periods during the past workers would have done better investing these savings in the financial market. For pension fund members the benefit of the possibility of investing in market assets is combined with the additional contribution of the employer and favourable tax treatment, enhanced still further by the introduction of a lower tax rate on benefits.

In order for pension fund membership to be truly beneficial for Italian workers, however, it is essential that the operating costs be low. Cost reductions can come not only from increasing the volume of assets under management, with consequent economies of scale, but also from the transparency and comparability of fees between different schemes. This is indispensable to enable workers to switch from more costly to less costly schemes that better serve their needs, thereby stimulating competition among the different forms of supplementary retirement provision.

# 14. CREDIT INSTITUTIONS

In 2006 bank lending accelerated owing to strong corporate demand for funds fuelled by the recovery in activity; bank lending to households continued to grow apace. The proportion of loans associated directly or indirectly with real estate activity increased further.

Banks kept credit conditions easy, gradually bringing interest rates into line with the changes in official rates. The ratio of new bad debts to total lending remained historically low.

Bank's domestic funding grew rapidly, especially in the form of bonds; the demand for current account deposits slowed as the yield differential in relation to alternative short-term assets widened. Banks bridged the gap between the growth in lending and that in domestic funding by increasing their borrowing abroad and reducing the liquid assets in their portfolios.

Bank profits increased, benefiting from the expansion in total assets and the good performance of the financial markets. Return on equity (ROE), calculated on the basis of unconsolidated data and applying the new international accounting principles (IAS/IFRS), rose from 9.8 per cent in 2005 to 11.8 per cent last year.

## *Lending*

In 2006 bank lending expanded by 11.5 per cent, almost 3 percentage points more than in the previous year (Table 14.1). The acceleration occurred exclusively in short-term lending, which began to grow strongly again after three years of stagnation. The ratio of total lending to GDP rose by six percentage points to 94 per cent (Figure 14.1).

*Lending to firms.* – Lending to non-financial companies accelerated to 12 per cent, in line with the euro-area average. Among the other countries in the area, lending increased particularly rapidly in Spain, owing to stronger growth in investment, especially in the construction sector, and to mergers and acquisitions; it began to grow again in Germany, reflecting the improvement in economic activity.

According to information from the Italian banking groups that participate in the Eurosystem's quarterly Bank Lending Survey, the acceleration in lending to Italian firms in 2006 was ascribable mainly to the increase in demand for credit to finance fixed investment, inventories and working capital. Demand for loans to finance debt restructuring remained high but declined slightly in proportion to total demand; by contrast, demand associated with mergers and acquisitions remained essentially unchanged. The strong expansion in corporate credit is also partly attributable to a reduction in self-financing.

Table 14.1

**Banks' main assets and liabilities** (1)
*(end-of-period data)*

| | Percentage changes | | | | | | | | Stocks (millions of euros) |
|---|---|---|---|---|---|---|---|---|---|
| | On 12 months earlier | | | On previous quarter, annualized (2) | | | | | |
| | Dec. 2005 | Dec. 2006 | Mar. 2007 | 2006 | | | | 2007 | December 2006 |
| | | | | Q1 | Q2 | Q3 | Q4 | Q1 | |
| **Assets** | | | | | | | | | |
| Securities | 19.4 | 5.3 | 7.5 | -7.4 | 6.8 | 9.0 | 12.7 | 1.6 | 219,013 |
| *of which*: *government securities* | *14.5* | *3.8* | *11.0* | *-17.4* | *17.3* | *1.7* | *15.3* | *10.4* | *110,988* |
| Loans | 8.7 | 11.5 | 11.6 | 11.2 | 11.8 | 13.4 | 9.7 | 11.6 | 1,384,340 |
| *of which:* (3) | | | | | | | | | |
| *short-term (a)* | *2.0* | *10.5* | *10.3* | *5.1* | *12.5* | *8.9* | *15.5* | *4.4* | *484,935* |
| *medium and long-term (b)* | *13.0* | *11.6* | *10.9* | *14.8* | *10.8* | *12.7* | *8.6* | *11.8* | *837,261* |
| *(a)+(b)* | *8.6* | *11.2* | *10.7* | *11.1* | *11.4* | *11.3* | *11.0* | *9.1* | *1,322,197* |
| *repos* | *48.5* | *33.6* | *130.3* | *43.4* | *52.9* | *737.5* | *-82.7* | *....* | *10,387* |
| *bad debts* (4) | *-16.5* | *3.8* | *3.4* | *10.8* | *-2.6* | *8.2* | *-0.6* | *8.9* | *47,196* |
| External assets | 11.0 | 19.8 | 22.9 | 25.3 | -3.3 | 43.0 | 19.0 | 38.6 | 329,352 |
| **Liabilities** | | | | | | | | | |
| Domestic funding (5) | 7.8 | 9.9 | 9.7 | 11.4 | 8.9 | 10.2 | 9.2 | 10.7 | 1,390,875 |
| Deposits | 6.9 | 8.3 | 8.0 | 9.7 | 7.7 | 9.4 | 6.5 | 9.0 | 846,131 |
| *of which:* (6) | | | | | | | | | |
| *current accounts* | *8.0* | *6.7* | *4.7* | *8.3* | *4.3* | *5.0* | *9.2* | *0.5* | *629,210* |
| *with agreed maturity* | *2.7* | *9.8* | *5.9* | *10.8* | *-1.3* | *24.4* | *6.8* | *-4.3* | *45,812* |
| *redeemable at notice* | *2.5* | *-0.8* | *0.2* | *-2.0* | *0.4* | *-0.6* | *-0.9* | *2.0* | *69,016* |
| *repos* | *4.9* | *29.4* | *41.2* | *38.5* | *47.5* | *45.9* | *-5.6* | *96.1* | *93,955* |
| Bonds (5) | 9.3 | 12.5 | 12.3 | 14.0 | 10.7 | 11.6 | 13.5 | 13.3 | 544,744 |
| External liabilities | 11.8 | 25.6 | 24.9 | 43.7 | 8.5 | 35.9 | 17.6 | 40.5 | 420,067 |

(1) The figures for March 2007 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.

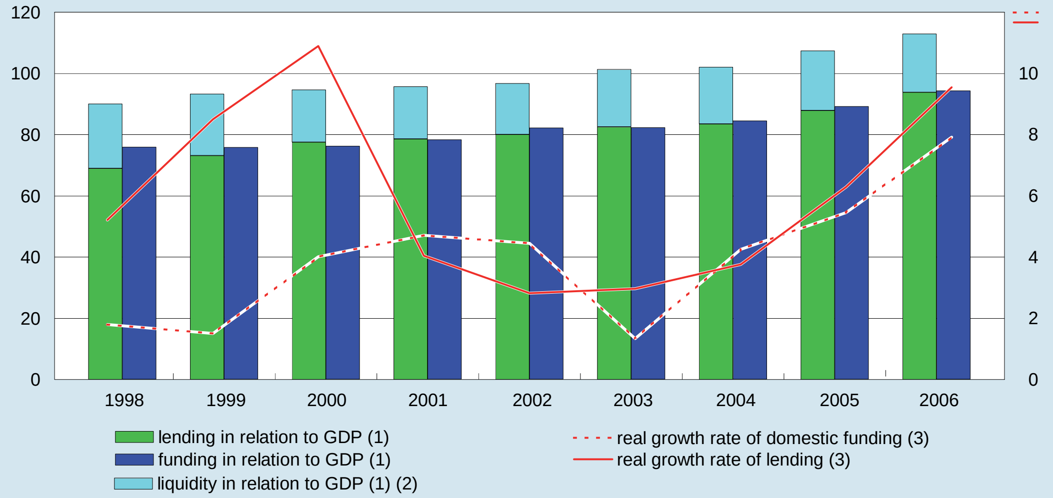
The acceleration in bank lending occurred across all the main sectors of activity, although almost two thirds of it was attributable to services, where the fastest growth was in transport services, the wholesale and retail trade, and real-estate services. Lending to construction firms, especially those engaged in housebuilding, continued to expand rapidly.

In manufacturing industry there was particularly strong growth in lending to firms producing transport equipment, metal products, and rubber and plastic products, where the growth in production was greatest. After contracting for five years, credit to the textile and clothing branch grew by 3.5 per cent, in line with the recovery in production.

The growth in bank lending to medium-sized and large firms, which recorded a very substantial increase in turnover, was almost twice as large as the increase in lending to companies with fewer than twenty employees (12.5 per cent and 6.8 per cent respectively). The growth differential was due mainly to the performance of short-term loans (Figure 14.2), a significant part of which consisted of advances against trade credit.

Figure 14.1

**Indicators of banking intermediation**
*(year-end data; percentages)*




Sources: Supervisory reports and Istat.
(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.

Bank lending to firms in the South continued to outstrip lending in the rest of the country, rising by 18.1 per cent compared with 10.4 per cent in the Centre and North. The disparity was particularly large in the case of firms providing services in the branches of real estate, financial and insurance advice, hotels and retailing.

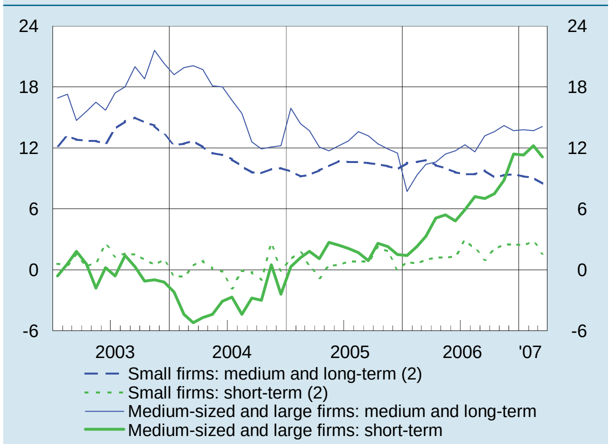
The recovery in economic activity was reflected in a sharp increase in claims assigned to banks and financial companies for factoring (Table 14.2). Leasing credit also increased at a sustained pace, especially in the real-estate branch.

*Lending to households*. – Bank lending to households continued to grow rapidly, although the rate of 10.3 per cent was lower than in 2005. One half of the slowdown can be attributed to the slower increase in property prices and the rise in interest rates, and the other half to the purely accounting effect of the securitization of mortgage loans.

In recent years Italian banks have made increasing use of securitization operations. In 2006 assignments of loans without recourse by Italian credit institutions, predominantly by means of securitization, amounted to €28 billion, compared with

Figure 14.2

**Bank lending according to size on firm and maturity** (1)
*(monthly data; 12-month percentage changes)*




(1) Loans exclude repos, bad debts and other minor items included in the Eurosystem's harmonized definition of the aggregate. The percentage changes are calculated net of reclassifications, exchange rate variations and other changes not due to transactions. – (2) Limited partnerships, general partnerships, informal partnerships, de facto companies and sole proprietorships with fewer than 20 workers.

€29 billion in 2005; a large proportion of the operations involved performing loans (€25 billion, against €18 billion in 2005). On the basis of bank returns to the Central Credit Register, it is estimated that last year 58 per cent of securitized loans were to households, 28 per cent to non-financial enterprises and 13 per cent to general government, compared with 44 per cent, 53 per cent and 1 per cent respectively in 2005. If securitized loans were imputed to new credit granted in 2006, since they continue to finance the economy even though they have disappeared from banks' balance sheets, the growth in lending to households would be higher, 13.8 per cent (15.4 per cent in 2005).

Table 14.2

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

| | Percentage changes on previous year | | | Outstanding 2006 (1) | Percentage of total |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 (1) | | |
| | | | **Leasing** | | |
| Total credit | 4.1 | 9.5 | 13.3 | 79,686 | 100.0 |
| Financial companies | 1.6 | 9.5 | 15.2 | 55,883 | 70.1 |
| *of which: real estate credit* | *4.6* | *14.0* | *17.5* | *32,058* | *40.2* |
| Banks | 13.7 | 9.4 | 9.2 | 23,803 | 29.9 |
| | | | **Factoring** | | |
| Total credit | -4.2 | 0.7 | 12.1 | 28,722 | 100.0 |
| Financial companies | -5.6 | 3.6 | 11.3 | 23,157 | 80.6 |
| Banks | 4.4 | -16.7 | 15.4 | 5,565 | 19.4 |

Source: Supervisory reports.
(1) Provisional.

The rate of growth in lending to consumer households for house purchases, though declining, remained high (12.3 per cent; Table 14.3). The raising of interest rates led to an increase in demand for fixed-rate mortgages, which rose to one quarter of new disbursements, compared with 15 per cent in 2005. In the euro area the proportion is more than half.

Consumer credit continued to expand rapidly, especially as regards credit "not targeted" on the direct purchase of goods and services (credit secured against salary, personal loans, revolving credit), which represented 53 per cent of the total.

The consumer credit market in Italy, which has expanded rapidly in recent years, is still less developed than in other countries. At the end of December bank loans for the purchase of consumer goods were equivalent to 3 per cent of GDP, compared with 7 per cent in the euro area; the corresponding ratios for Germany, France and Spain were 7, 8 and 9 per cent respectively.

*Lending according to size of bank.* – Over the last decade the growth in lending by large banks had been slower owing to reorganization within banking groups, but in 2006 it matched that in lending by "small" and "minor" banks. At the end of December the largest banks were responsible for 70 per cent of lending to firms and 69 per cent of that to households; in 1997 their shares of these market segments had been 79 and 78 per cent respectively.

Table 14.3

**Lending to households**
*(end-of-period data; millions of euros and percentages)*

| | Percentage changes on previous year | | | Outstanding 2006 (1) | Percentage of total |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 (1) | | |
| | | | **Loans for house purchases** | | |
| Total | 20.7 | 18.0 | 12.3 | 223,377 | 100.0 |
| *up to 5 years* | *-4.0* | *-0.7* | *-19.8* | *1,244* | *0.6* |
| *over 5 years* | *21.0* | *18.2* | *12.6* | *222,134* | *99.4* |
| | | | **Consumer credit** | | |
| Total credit | 18.1 | 19.4 | 17.9 | 85,294 | 100.0 |
| *of which: credit cards* | *18.0* | *21.8* | *12.5* | *11,449* | *13.4* |
| *for purchases of motor vehicles* | *17.5* | *15.3* | *16.2* | *29,948* | *35.1* |
| Banks | 16.3 | 17.2 | 12.7 | 47,020 | 55.1 |
| *of which: credit cards* | *24.5* | *28.8* | *12.1* | *4,682* | *5.5* |
| *for purchases of motor vehicles* | *22.4* | *19.5* | *14.5* | *13,633* | *16.0* |
| Financial companies | 20.8 | 22.5 | 25.1 | 38,274 | 44.9 |
| *of which: credit cards* | *14.3* | *17.4* | *12.7* | *6,767* | *7.9* |
| *for purchases of motor vehicles* | *13.9* | *11.9* | *17.8* | *16,315* | *19.1* |
| | | | **Other lending** | | |
| Total credit | 2.3 | 4.2 | 3.8 | 56,922 | 100.0 |

Source: Supervisory reports.
(1) Provisional.

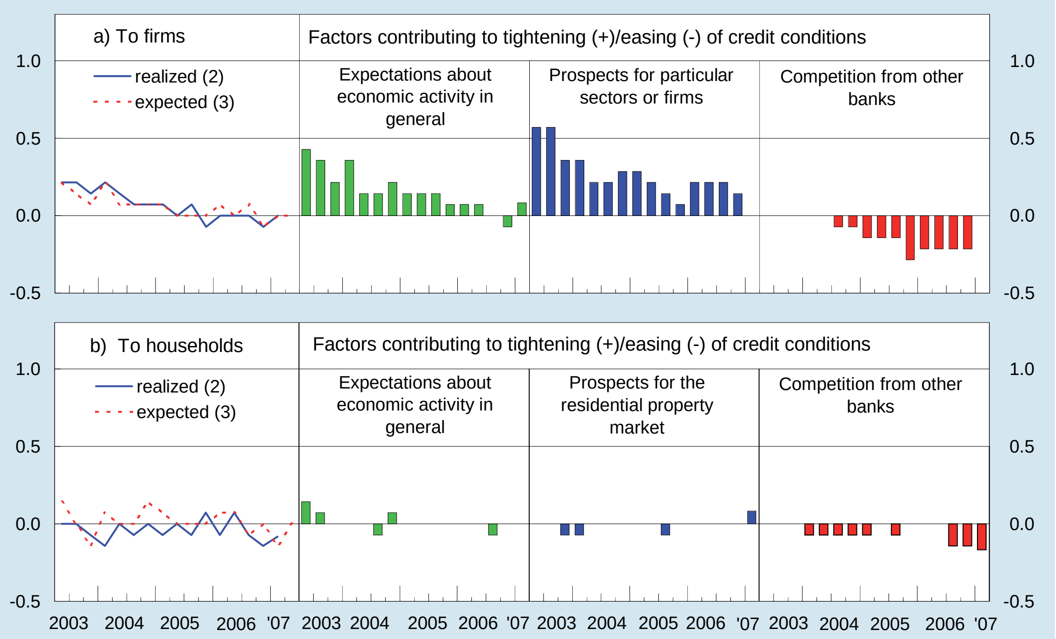
## *Lending conditions and interest rates*

*Credit supply*. – Information from the Italian banking groups participating in the Eurosystem's quarterly Bank Lending Survey shows that, despite the increase in money market rates, lending conditions for firms remained easy in 2006, benefiting from the improvement in economic activity and the further intensification of competitive pressure (Figure 14.3). In December the index measuring the tightness of lending conditions, calculated by aggregating the qualitative data provided by the banks, reached its lowest point since the survey began in 2003. The absence of supply constraints is confirmed by indicators based on the cost of credit: the differential between the average rate on short-term loans to firms and the minimum rate, which tends to widen when credit is tight, decreased further to 2 percentage points; and the dispersion of interest rates charged to different sizes of firm was broadly unchanged.

The conditions applied to loans to households also remained easy; growing competitive pressure translated into an increase in the loan-to-value ratio and a lengthening of the average term to maturity. In some cases the price margins applied to more risky classes of customer increased.

Figure 14.3

**Indices of lending conditions and their main determinants** (1)




Source: Quarterly Bank Lending Survey in the euro area.
(1) The indices are constructed by aggregating the qualitative replies from the 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.

*Interest rates*. – Lending rates in Italy adjusted gradually to the increase in official rates, as occurred in similar periods of monetary tightening in the past. Between late 2005, when rates were at their lowest, and March 2006 the average rate on short-term loans to firms rose by one percentage point, whereas official rates increased by 1.75 points (Figure 14.4).

The differential between the interest rates on short-term loans to firms in the South and those charged to firms in the Centre and North, adjusted for differences in the sectoral composition and size of borrowers, narrowed slightly to 1.3 percentage points. The disparity reflects the higher risk attaching to firms in the South.

In Italy the annual percentage rate of charge (APRC) on new lending to households for house purchases has risen by 1.5 percentage points since money market rates began to be raised, to stand at 5.4 per cent (Figure 14.5). In the euro area it has risen by 1.1 points to 4.9 per cent.

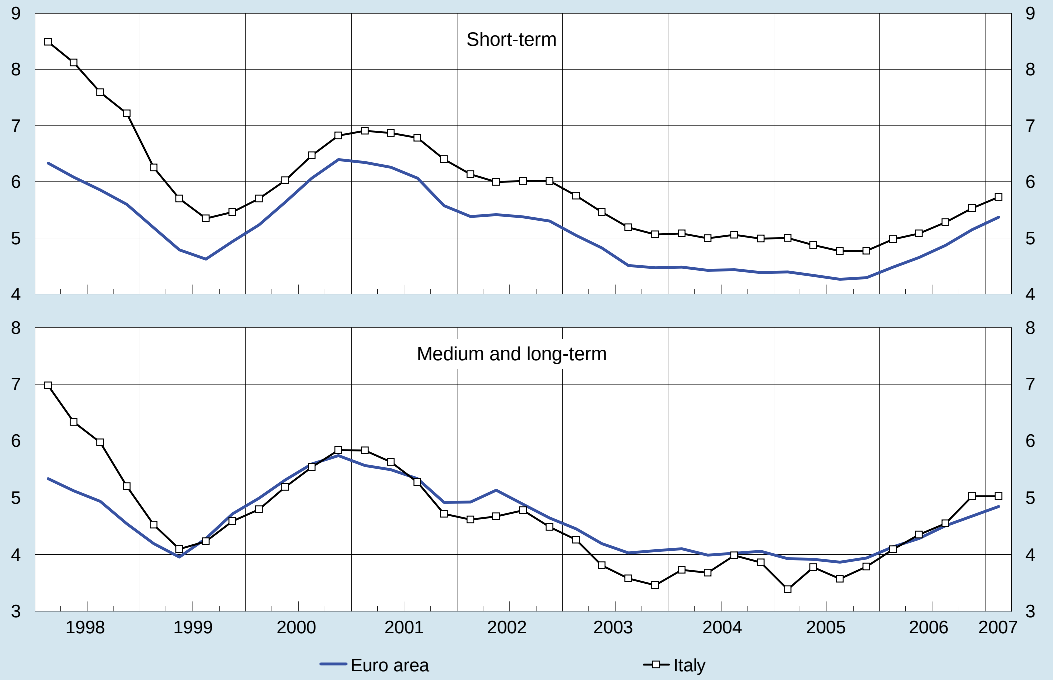
The APRC on consumer credit from Italian banks increased by half a percentage point to 9.3 per cent; the differential in relation to the euro-area average of 8.2 per cent remains large.

## *Funding*

Banks' domestic funding rose by 9.9 per cent in 2006, in line with developments in the euro area (Table 14.1).

Figure 14.4

**Interest rates on bank loans to firms** (1)
*(quarterly data)*



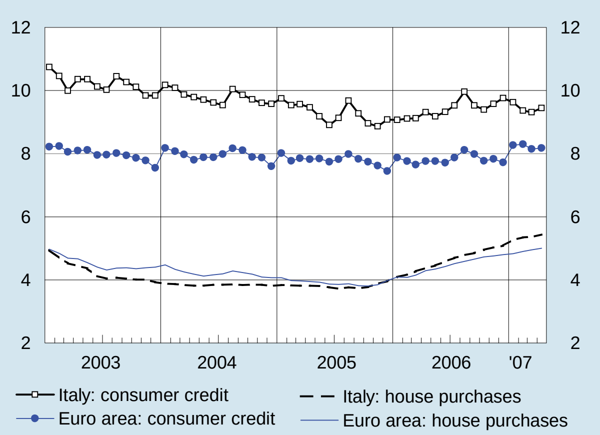

Sources: Statistical supervisory reports and Central Credit Register.
(1) The data up to December 2002 have been reconstructed on the basis of non-harmonized interest rates; rates from 2003 onwards have been collected and processed using the Eurosystem's harmonized method; short-term loans relate to contracts with a maturity of one year or less.

In Italy the growth of current account deposits slowed from 8 to 6.7 per cent owing to an increase in the opportunity cost in relation to short-term securities; the differential between Treasury bill rates and current account interest rates, net of tax, rose from 1.7 to 2.4 percentage points. However, there was stronger demand for less liquid deposits, such as those with an agreed maturity and repos, the returns on which reacted more swiftly to the increases in official rates. Deposits rose by 8.3 per cent overall, compared with 6.9 per cent in 2005.

Issues of bank bonds increased by 12.5 per cent to account for 39 per cent of total funding (Figure 14.6); 41 per cent of new issues was placed on the Euromarket, compared with 31 per cent in 2005; one quarter was at a fixed rate, the same proportion as in the previous year.

Figure 14.5

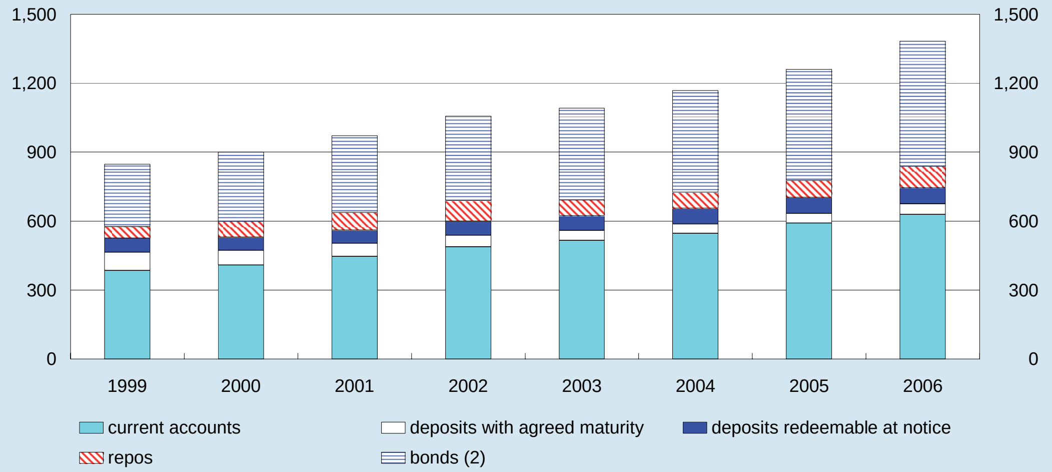
**Interest rates on loans to households** (1)
*(monthly data)*




Source: Based on ECB data.
(1) APRC on new loans. Contracts concluded during the reference period or which constitute a renegotiation of previous terms and conditions. The 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.

Figure 14.6

**Bank funding** (1)
*(year-end data; billions of euros)*



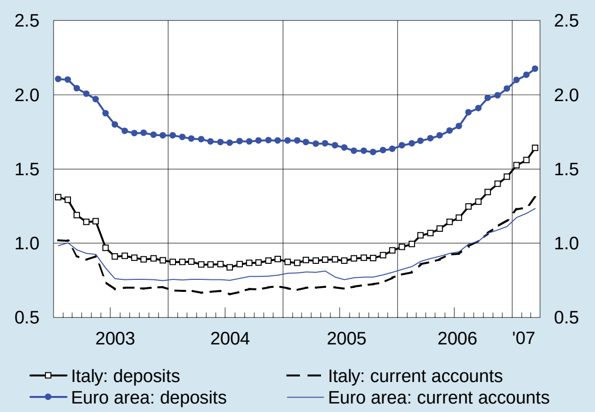

(1) Excludes deposits of central government. – (2) Total debt securities, including bonds held by non-residents.

Bank deposit rates adjusted more slowly than lending rates to the changes in monetary conditions. Between the low point recorded in late 2005 and the end of March 2006 the average rate on firms' and households' current accounts rose by 0.6 percentage points in Italy, to 1.3 per cent, comparable to the average rise in the euro area (Figure 14.7).

The disparity between deposit rates paid in Italy and the euro-area average declined slightly, to 0.5 percentage points. Differences in the types of deposit held by customers accounted for 0.2 percentage points of the difference. At the end of March current accounts, which are normally the least remunerative of the various instruments owing to their greater liquidity, represented 73 per cent of total deposits in Italy, compared with 37 per cent in the euro area. The remaining 0.3 points of the difference can be ascribed to the higher rates paid on deposits with an agreed maturity held by households and firms in the other euro-area countries. In Italy the regime for taxing interest income favours the holding of deposits with an agreed maturity over bank bonds, the return on which is broadly the same as that on government securities with a similar maturity.

Figure 14.7

**Interest rates on deposits**
*(monthly data)*




Source: Based on ECB data.

## *The banks' securities portfolio and net external position*

*The securities portfolio.* – The value of banks' holdings of securities, excluding the effect of price changes, increased by 5.3 per cent in 2006 (Table 14.1).

Whereas holdings of non-financial companies' bonds decreased, those of bank bonds grew and their share of the portfolio rose from 36 to 39 per cent. About 11 per cent of the banks' portfolio consisted of securities issued by vehicle companies in connection with securitization operations (8 per cent in 2005).

The ratio of liquid assets (cash and securities other than shares) to the sum of lending and liquid assets fell by almost one percentage point in 2006 to 16 per cent, in line with the average for the euro area.

At the end of December the market value of Italian banks' holdings of shares and other equity in non-banking companies in the euro area amounted to €70 billion, equal to 2.9 per cent of their total assets excluding interbank claims. The corresponding proportions in Germany, France and Spain were 5.3, 3.7 and 4.2 per cent respectively.

*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 €25 billion in 2006 to stand at €90 billion at the end of December. It was entirely vis-à-vis counterparties in countries outside the euro area, some two thirds being residents of the United Kingdom and the United States. The component subject to exchange rate risk declined slightly, from 61 to 58 per cent.

## *Profit and loss accounts*

This section comments on the unconsolidated profit and loss accounts of banks operating in Italy, including the branches of foreign banks. On this basis it is possible to assess the profitability of the banking industry in this country. Analysis of the profit and loss accounts of Italian banking groups, which include the operations of foreign subsidiaries and non-banking companies within the area of consolidation, is carried out in Chapter 15: *The structure, profitability, capital and risk of intermediaries*.

Net interest income rose by 10.4 per cent in 2006 (Table 14.4) owing to the large growth in the volume of business; the spread between the average lending rate and the average cost of funds remained broadly unchanged, at 1.9 percentage points.

With effect from 2006 it is compulsory for banks to adopt the new IAS/IFRS standards for the preparation of their unconsolidated accounts. The regulations lay down that, as a rule, the new accounting criteria be applied retroactively, with an obligation to present at least one year's comparative data. In order to provide a uniform basis for comparing the data in the 2005 and 2006 profit and loss accounts, the Bank of Italy has asked Italian banks, excluding credit cooperatives, to present their 2005 accounting data in accordance with the new accounting principles. At the time of writing, replies had been received from 317 banks representing more than 90 per cent of the total assets of the Italian banking system. The 2005 data for banks not included in the survey have been partly estimated.

Income from services increased by 5.2 per cent. The growth was attributable to commission from the sale of the products of insurance companies, investment firms and asset management companies and, to a smaller extent, the increase in commission from collection and payment services. Income from asset management declined.

Net income from trading in securities in the banks' portfolio more than doubled, almost entirely owing to profits on the sale or repurchase of available-for-sale financial

Table 14.4

**Profit and loss accounts of Italian banks** (1)

| | 2005 | 2006 | 2006 |
|---|---|---|---|
| | **As a percentage of total assets** | | **Percentage changes** (3) |
| Net interest income (a) | 1.41 | 1.43 | 10.4 |
| Other net income (b) (2) | 1.52 | 1.58 | 13.8 |
| | | | *(11.2)* |
| *of which: trading and valuation at fair value* | *0.10* | *0.19* | *103.9* |
| *services* | *0.82* | *0.79* | *5.2* |
| *dividends and similar income* (2) | *0.34* | *0.40* | *27.2* |
| | | | *(16.8)* |
| Gross income (c=a+b) (2) | 2.93 | 3.01 | 12.2 |
| | | | *(10.8)* |
| Operating expenses (d) | 1.74 | 1.71 | 7.3 |
| *of which: banking staff costs* (3) | *0.93* | *0.92* | *8.1* |
| Operating profit (e=c-d) (2) | 1.20 | 1.30 | 19.2 |
| | | | *(16.2)* |
| Value adjustments, readjustments and allocations to provisions (f) | 0.31 | 0.27 | -3.8 |
| *of which: in respect of loans* | *0.18* | *0.17* | *2.0* |
| Extraordinary income (g) | 0.03 | 0.06 | 139.4 |
| Profit before tax (h=e-f+g) (2) | 0.92 | 1.10 | 30.7 |
| | | | *(27.7)* |
| Tax (i) | 0.26 | 0.28 | 17.7 |
| Net profit (h-i) | 0.66 | 0.82 | 35.8 |
| | **Other indicators** | | |
| Net profit as a percentage of capital and reserves (ROE) (4) | 9.8 | 11.8 | |
| | **Amounts** | | **Percentage changes** |
| Total assets (millions of euros) | 2,545,416 | 2,784,287 | 9.4 |
| Average number of employees | 337,411 | 339,112 | 0.5 |
| *of which: banking staff* | *336,515* | *338,540* | *0.6* |
| Total assets per employee (thousands of euros) | | | |
| at current prices | 7,544 | 8,211 | 8.8 |
| at constant prices (5) | 6,050 | 6,326 | 4.6 |
| Staff costs per employee (thousands of euros) | | | |
| at current prices (6) | 67.8 | 71.0 | 4.6 |
| at constant prices (5) (6) | 54.4 | 54.7 | 0.5 |
| *Memorandum items* (7): | | | |
| Total assets (millions of euros) | 2,552,282 | 2,793,029 | 9.4 |
| Total number of employees (8) | 336,790 | 339,886 | 0.9 |
| *of which: banking staff* (8) | *335,917* | *339,878* | *1.2* |

(1) Rounding may cause discrepancies. The data for 2006 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. – (5) Deflated using the general consumer price index (1995=100). – (6) Excludes the extraordinary costs incurred in connection with early severance incentives, directors' fees and expenses for pensioned staff. – (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.

assets (debt securities, equities in listed and unlisted companies, units in collective investment undertakings, loans).

Dividends on non-bank shares and other equity rose by 16.8 per cent. Gross income rose by 10.8 per cent.

Staff costs increased by 8.1 per cent; net of the cost of early retirement schemes and directors' fees, the increase was 5.2 per cent. The number of bank employees rose by an annual average of 0.6 per cent. Staff costs per employee increased by 4.6 per cent to €71,000, reflecting increases under the national labour contract of February 2005 for the banking industry and allocations to provisions in respect of its forthcoming renewal.

Total operating expenses rose by 7.3 per cent and operating profit by 16.2 per cent.

Value adjustments to assets and allocations to provisions declined by 3.8 per cent and absorbed about one fifth of operating profit. Following two years of substantial reductions, loan losses increased slightly to 2 per cent. Extraordinary income more than doubled, mainly on account of the sale of shareholdings.

Profit after direct taxes rose by 35.8 per cent. Return on equity (ROE), obtained by adding in the net income of foreign branches (€0.5 billion), was 11.8 per cent, compared with 9.8 per cent in 2005.

# SUPERVISION OF BANKS AND OTHER INTERMEDIARIES

# 15. THE STRUCTURE, PROFITABILITY, CAPITAL AND RISKS OF INTERMEDIARIES

The pace of consolidation of the Italian banking system picked up sharply last year, with transactions involving large groups and cooperative banks of substantial size that significantly increased the system's degree of concentration (Table 15.1). Further mergers and acquisitions are now under way between large intermediaries.

Table 15.1

**The structure of the Italian financial system**

| | 31 December 2005 | | | 31 December 2006 | | |
|---|---|---|---|---|---|---|
| | Number of intermediaries | | | Number of intermediaries | | |
| | Group members | Non-group | Total | Group members | Non-group | Total |
| **Banking groups** | | | **85** | | | **87** |
| **Banks** | **230** | **554** | **784** | **227** | **566** | **793** |
| *limited company banks* | *201* | *42* | *243* | *198* | *47* | *245* |
| *cooperative banks* (banche popolari) | *18* | *18* | *36* | *18* | *20* | *38* |
| *mutual banks* (banche di credito cooperativo) | *11* | *428* | *439* | *11* | *425* | *436* |
| *branches of foreign banks* | – | *66* | *66* | – | *74* | *74* |
| **Investment firms** | **23** | **85** | **108** | **18** | **88** | **106** |
| **Asset management companies and SICAVs** | **61** | **121** | **182** | **67** | **132** | **199** |
| **Financial companies entered in the register referred to in Article 107 of the Consolidated Law on Banking** | **101** | **308** | **409** | **99** | **345** | **444** |
| **Electronic money institutions** | – | – | – | – | **3** | **3** |
| **Other supervised intermediaries** (1) | – | **2** | **2** | – | **2** | **2** |

(1) Bancoposta and Cassa depositi e prestiti.

## STRUCTURE

### *Banks and banking groups*

*Mergers and acquisitions.* – Under the stimulus of competition and increasing financial market integration, the consolidation of the Italian banking system intensified.

Including recently announced transactions, the share of system assets attributable to Italian groups that have merged with or been acquired by other Italian groups since the beginning of 2006 is estimated at 23.5 per cent, compared with 7.2 per cent during the four years from 2002 to 2005.

The merger between Banca Intesa and Sanpaolo IMI, which became effective for legal and accounting purposes on 1 January 2007, has created a major player on the European market, with assets of €580 billion. The group has some 5,800 branches in Italy and is present abroad in 10 countries through 14 banking subsidiaries, with especially large market shares in central and eastern Europe. Its share of the domestic market, calculated on total assets, is 20.2 per cent.

UniCredit, after acquiring the German group Bayerische Hypo- und Vereinsbank A.G. (HVB) in 2005, initiated operations in 2006 to achieve the expected objectives of the integration by simplifying the group's structure and governance. The UniCredit group has taken on a configuration organized on three dimensions: divisional (by lines of business), geographical, and group-wide, for the functions that concern all of the group's divisions and legal entities. The main operations carried out in 2006 include the reorganization of asset management activities, the assumption by UniCredit of direct control of Bank Austria Creditanstalt A.G., and the transfer of the subsidiaries in central and eastern Europe to the latter. In the first few months of 2007 the operations of UniCredit Banca Mobiliare were transferred to the Italian branch of HVB, which in the future will centralize the group's investment banking operations. Reorganization of the leasing segment is under way.

On 20 May 2007 the boards of directors of UniCredit and Capitalia approved the plan for the merger of Capitalia into UniCredit. The transaction, which must obtain the required authorizations, would create the largest bank in the euro area, with a market value of about €100 billion.

The opening months of 2007 brought further sizeable concentrations between cooperative banks, which sought to cope with the growing competitive pressure and play an active role in the consolidation of the Italian banking system.

In March 2007, at the conclusion of its tender offer for Banca Popolare di Intra, Veneto Banca held 75.4 per cent of the capital of that Piedmont-based institution. With €15 billion of assets, the new group ranks eighth among cooperative banks. It will adopt the federal model, with Veneto Banca playing the twofold role of parent company and network bank.

The concentration between Banche Popolari Unite and Banca Lombarda e Piemontese S.p.A. created a new cooperative banking group named Unione di Banche Italiane S.C.p.A. on 1 April 2007. The UBI group has total assets of €117 billion, ranking fifth among all Italian banking groups, and a network of 1,970 branches.

The merger between Banco Popolare di Verona e Novara and Banca Popolare Italiana will be completed on 1 July 2007 with the formation of a new cooperative bank holding company listed on the stock exchange. The operation will give birth to Italy's largest cooperative banking group, with total assets of €120 billion and a network of 2,200 branches.

*The degree of concentration of the Italian banking system.* – Italian banking groups are increasing the scale of their operations. Taking into account the mergers and acquisitions completed in the first few months of 2007, their average domestic assets have grown from €20 billion in 2001 to reach €27 billion.

The concentration of the banking system is increasing. The top five groups' share of system assets on the domestic market rose from 45 per cent in 2005 to 48.7 per cent and the Herfindahl-Hirschman index, calculated on the total assets of the units operating in Italy, from 505 to 711 (on a scale of 10,000). Both indicators will rise further, to 53.5 per cent and 850 respectively, when the merger between UniCredit and Capitalia goes through; the top five groups' market share would be larger than in Germany but smaller than in France.

The structure of the system is evolving rapidly and is now characterized by four classes of intermediaries. The top tier is composed of two groups (UniCredit and Intesa Sanpaolo), large even by European standards and with significant international operations, whose overall share of the domestic banking market would expand appreciably (from 31.7 to 37.5 per cent) following the UniCredit-Capitalia merger. Alongside the two largest groups there would be some medium-sized/large groups with prevalently domestic operations.

The intermediate class consists of a good many groups and stand-alone banks with prevalently traditional business whose average size is well below that of the six largest groups. The most numerous class consists of 596 small intermediaries specialized in financing the local economy. This class includes mutual banks and the branches of small foreign banks.

*The internationalization of the system.* – Italian banks' international presence remained at about the level reached in 2005 with the acquisition of HVB by UniCredit. At the end of 2006 there were 26 Italian groups established abroad, one more than a year earlier. The foreign units' assets were equal to 26.4 per cent of total system assets (25 per cent at the end of 2005); for the five largest banking groups the figure was 38.3 per cent. According to the data published in the report EU Banking Structures, for a sample of 46 large European banking groups in 2005 the ratio of foreign assets to total assets averaged about 38 per cent.

The main markets for the Italian groups remain those of eastern Europe that have been targeted by commercial development strategies in recent years. In these countries the overall share of the banking market held by foreign intermediaries averages 75.3 per cent; the share held by Italian groups comes to about 20 per cent (Table 15.2). Italian-owned banks account for roughly half of the national banking system in Croatia and for about one fifth in Slovakia, Poland, Bulgaria and Hungary. Following the UniCredit-HVB transaction, they also hold significant market shares in Germany and Austria.

The presence of foreign intermediaries on the Italian market expanded in 2006. Counting the acquisition by Crédit Agricole of controlling interests in Cassa di Risparmio di Parma e Piacenza and Banca Popolare Friuladria, the 74 branches and 24 subsidiaries of foreign banks in Italy account for respectively 7.6 and 11 per cent of the total assets of the units operating in Italy, compared with 6.8 and 10 per cent at the end of 2005.

The external openness of the banking system seems greater in Italy than in the other main countries of continental Europe (Germany, France and Spain), where branches and subsidiaries of foreign banks held, on average, 10.5 per cent of total assets on a non-consolidated basis at the end of last year.

Table 15.2

**Presence of foreign banks in selected European countries**
*(at 31 December 2006)*

| | Number of banks | | | Assets | | |
|---|---|---|---|---|---|---|
| | Total | *of which:* | | Total (billions of euros) (2) | *of which:* | |
| | | foreign-controlled branches and subsidiaries | Italian-controlled branches and subsidiaries | | % share held by foreign-owned banks | % share held by Italian-owned banks |
| Austria | 834 | 49 | 14 | 796.0 | 19.4 | 18.3 |
| Belgium | 105 | 79 | 2 | 1,221.4 | 23.3 | 0.1 |
| Bulgaria | 32 | 23 | 3 | 21.6 | 80.1 | 19.8 |
| Croatia | 44 | 15 | 7 | 42.3 | 90.8 | 44.7 |
| Czech Republic | 37 | 28 | 3 | 114.6 | 96.7 | 7.6 |
| France | 411 | 161 | 10 | 5,434.7 | 10.1 | 0.1 |
| Germany | 2,048 | 139 | 13 | 7,189.6 | 11.1 | 3.9 |
| Hungary | 210 | 32 | 4 | 88.0 | 88.0 | 15.3 |
| Luxembourg | 156 | 148 | 17 | 839.6 | 93.6 | 3.4 |
| Netherlands | 344 | 34 | 1 | 1,975.4 | 14.3 | .. |
| Poland | 63 | 40 | 4 | 177.8 | 69.7 | 21.2 |
| Romania | 38 | 33 | 15 | 51.0 | 88.6 | 8.3 |
| Russia | 1,143 | 64 | 3 | 404.8 | 12.1 | 2.1 |
| Slovakia | 24 | 22 | 3 | 40.9 | 97.0 | 26.5 |
| Slovenia | 25 | 8 | 2 | 33.8 | 29.2 | 11.4 |
| Spain | 276 | 90 | 5 | 2,480.0 | 9.5 | 0.2 |

Sources: Based on data provided by national central banks and supervisory authorities; individual supervisory reports and Register of Banking groups.
(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, mortgage banks and building societies. Croatia: includes commercial banks and housing savings banks. France: includes commercial banks, cooperative banks and branches of banks belonging to the European Economic Area. Germany: includes *Landesbanken*, cooperative banks, cooperative banks' central credit institutions and banks with special tasks. Hungary: includes savings cooperatives. Poland: does not include cooperative banks. Slovenia: includes commercial banks and savings banks. Spain: includes deposit institutions only. The data for assets of foreign-owned branches refer to 31 December 2005. – (2) Total assets shown in company accounts.

## *Non-bank intermediaries*

*Asset management companies.* – The limited growth in the total assets managed by Italian-owned companies was reflected in an increase in foreign intermediaries' market share, which rose from 25.5 to 29.1 per cent. The growing penetration of the Italian market by foreign intermediaries was made possible not only by the more favourable tax treatment of foreign funds compared with Italian funds, but also by the progressive opening of sales networks to distribution of third-party products.

In the hedge fund sector, 95 per cent of which consists of vehicles that invest virtually entirely in foreign hedge funds (funds of funds), management companies not belonging to banking or insurance groups increased their already considerable market share from 27.5 to 28.3 per cent. Foreign intermediaries are also important players, managing just under 30 per cent of total assets.

Most of the investment in Italian hedge funds comes from financial intermediaries and institutional investors (58 per cent); firms and households account for 37 per cent. At the end of 2006 Italian hedge funds' average financial leverage (the ratio of debt to net assets) was low at 20 per cent, in line with the year-earlier level; their borrowings were from domestic banks. The low leverage reflected the prevalence of funds of funds, which carry little debt; "pure" hedge funds that invest directly in financial instruments other than units of collective investment undertakings had a higher leverage ratio (110 per cent).

Closed-end securities funds are mainly the preserve of management companies not belonging to banking or insurance groups; they had 57 per cent of these funds' total assets under management at the end of the year, while nearly 12 per cent was attributable directly or indirectly to foreign intermediaries. Approximately 78 per cent of the assets under management belong to funds reserved to qualified investors.

Among real-estate funds, bank or insurance-controlled intermediaries accounted for 58.9 per cent of total assets under management, equally divided between products reserved to institutional investors and those offered to retail investors, down from 63.3 per cent in 2005; independent operators and property companies accounted for the remaining 33 per cent (29.5 per cent in 2005).

*The outlook for the asset management industry.* – The Italian asset management industry continues to be based on vertical integration between distribution networks (banks and insurance companies) and product factories, with the former playing the predominant role.

At the end of 2006 Italian and foreign banking and insurance groups held approximately 84 per cent of the market. The prevalence of fund managers belonging to banking and insurance groups is characteristic of all the main markets of continental Europe. Eighteen of the top 20 European operators in asset management as ranked by *Institutional Investor* were banking or insurance groups.

In Italy, vertical integration, with the concentration of groups' asset management activities within their respective asset management companies, has led to the growth of product factories, but it has not stimulated asset management companies to develop autonomous strategies for supplying their products outside their groups.

The expansion of the Italian asset management industry depends on the capacity of intermediaries to attain adequate size, including through mergers and acquisitions, to sustain innovation and improve the quality of products. Adopting consistent strategies of growth can enable the largest operators to play an important role in the continental market as well.

In recent years, partly as a result of mergers and acquisitions, the Intesa Sanpaolo and UniCredit banking groups and the Generali insurance group have increased their combined share of total assets under management in Italy to 57 per cent (60 per cent counting the UniCredit-Capitalia merger). They have also attained a volume similar to that of their main European competitors, but compared with the latter their supply is still channelled very largely through group networks and their international distribution is less highly developed.

Smaller intermediaries, many of them outside groups, held about 6 per cent of the market at the end of last year. They have expanded rapidly, thanks to their specialized, high-quality products, which gives access to numerous third-party sales networks, and as a result of some mergers.

The intermediate part of the market, with about 37 per cent of assets under management, is composed of mainly bank-controlled companies, generally smaller than foreign asset managers and offering a range of largely unspecialized products.

*Investment firms.* – At the end of 2006 there were 106 registered investment firms, compared with 108 a year earlier. Turnover in the sector remains high. During the year 8 new firms were established (3 of them foreign-owned), while 10 firms ceased operating (3 as a consequence of reorganization within their respective banking groups and 7 because of winding-up).

*Financial companies.* – The increase in the number of financial companies in the special registry referred to in Article 107 of the Consolidated Law on Banking was due mainly to securitization special purpose vehicles (45 additions in 2006, compared with 35 in 2005), which make up more than half of all registered financial companies. The number of newly registered consumer credit and credit card companies also rose. Most of the deletions from the special register were again due to organizational rationalization within banking groups.

Financial companies' share of the consumer credit market grew moderately, from 42 to 45 per cent, but banks continued to dominate the sector with 55 per cent. The market share of independent intermediaries contracted from 21 to 15 per cent.

Foreign intermediaries maintain a significant presence, directly or indirectly controlling 42 registered financial companies at the end of the year. Their presence is greatest in consumer credit, where their market share is 19 per cent overall (14 per cent for foreign banking groups alone).

## PROFITABILITY, CAPITAL AND RISKS

### *Banking groups*

Italian banks' progress in recent years has significantly improved their position relative to the banks of the other main European countries. The gap between Italian and foreign groups in terms of operating efficiency has been virtually closed. Progress still needs to be made in loan quality and capital adequacy. Loan quality is affected by structural factors, such as the high percentage of generally riskier loans to small and medium-sized enterprises, and business practices that can result in slower payments by firms than in other countries. The lower ratio of capital to risk-weighted assets is accompanied by better quality of the components of regulatory capital.

*Profitability.* – Last year saw a further improvement in the profitability of Italian banking groups (which account for about 90 per cent of the total assets of the banking system), thanks in part to additional efficiency gains and robust credit demand. For the five largest banking groups, the return on equity increased to 15.6 per cent (Table 15.3).

Gross income rose by 8.8 per cent. The increase in net interest income was driven by the expansion in the volume of business, while that in non-interest income reflected trading profits and gains in the fair value of financial assets. The ratio of non-interest income to gross income, a gauge of the diversification of revenues, diminished slightly, to 47.4 per cent.

Table 15.3

**Consolidated income statement of Italian banking groups**
*(millions of euros; growth rates and percentage indicators)*

| | All groups | | | Main groups (1) | | |
|---|---|---|---|---|---|---|
| | 2005 | 2006 | Change | 2005 | 2006 | Change |
| Net interest income (a) | 40,900 | 45,006 | 10.0 | 24,985 | 27,242 | 9.0 |
| Non-interest income (b) | 37,768 | 40,607 | 7.5 | 23,699 | 25,354 | 7.0 |
| *of which: commissions* | *28,173* | *28,307* | *0.5* | *18,293* | *18,133* | *-0.9* |
| Gross income (c=a+b) | 78,668 | 85,613 | 8.8 | 48,684 | 52,595 | 8.0 |
| Operating expenses (d) | 48,998 | 51,255 | 4.6 | 29,855 | 31,276 | 4.8 |
| *of which: staff costs* | *28,289* | *29,925* | *5.8* | *17,360* | *18,532* | *6.7* |
| Operating profit (e=c-d) | 29,670 | 34,358 | 15.8 | 18,829 | 21,320 | 13.2 |
| Allocations to provisions and net value adjustments (f) | 9,096 | 9,967 | 9.6 | 5,022 | 5,916 | 17.8 |
| *of which: in respect of loans* | *6,715* | *7,039* | *4.8* | *3,830* | *4,007* | *4.6* |
| Ordinary profit (g=e-f) | 20,574 | 24,390 | 18.5 | 13,807 | 15,404 | 11.6 |
| Extraordinary profit (h) | 1,915 | 2,596 | 35.6 | 1,316 | 1,665 | 26.5 |
| Gross profit (i=g+h) | 22,488 | 26,986 | 20.0 | 15,123 | 17,069 | 12.9 |
| Taxes (l) | 7,438 | 8,714 | 17.2 | 4,382 | 4,962 | 13.2 |
| Profit from categories of assets undergoing disposal (after tax) (m) | 194 | 310 | 59.8 | 67 | 204 | 203.8 |
| Profit of minority interests (n) | 1,251 | 1,374 | 9.8 | 739 | 864 | 16.9 |
| Profit of parent company (o=i-l+m-n) | 13,993 | 17,208 | 23.0 | 10,069 | 11,446 | 13.7 |
| **Indicators** | | | | | | |
| Ratio of non-interest income to gross income | 48.0 | 47.4 | | 48.7 | 48.2 | |
| Cost-income ratio (2) | 62.3 | 59.9 | | 61.3 | 59.5 | |
| Value adjustments in respect of loans/Operating profit | 22.6 | 20.5 | | 20.3 | 18.8 | |
| ROE | 12.7 | 13.8 | | 14.6 | 15.6 | |

Source: Banking groups' consolidated supervisory reports.
(1) Five largest groups by total assets. – (2) Operating expense as a percentage of gross income (d/c).

Operating expenses increased by 4.6 per cent, but their ratio to gross income, which is an indicator of operating efficiency, improved, falling by more than two percentage points, to 59.9 per cent. Operating profit grew by 15.8 per cent. All of the improvement in operating profitability during the year came from the gain in efficiency.

An analysis of the contribution to profitability of the groups' Italian banking and financial components shows that they accounted for about three quarters of operating profit, in line with the proportion of exposures to customers resident in Italy. Compared with the foreign components, the domestic components contributed less to the diversification of income and had a higher incidence of costs: their ratio of non-interest income to gross income was about three percentage points lower than the overall figure and their cost-income ratio about one point higher.

Provisions and value adjustments increased by 9.6 per cent, partly owing to non-recurring items relating to the groups' foreign components. Provisions for loan impairment increased by 4.8 per cent and absorbed 20.5 per cent of operating profit (22.6 per cent in 2005).

Gross profit grew by 20 per cent; the incidence of taxes diminished from 33.1 to 32.3 per cent.

The operating profitability of Italy's five largest banking groups was low in 2006 compared with that of the other main European banking groups (British, German, French, Spanish and Dutch). The operating ROE (ratio of ordinary profit to equity) of all five Italian groups fell short of the European average (22 per cent), but their cost-income ratio was in line with the European standard (60 per cent).

*Capital adequacy.* – In 2006 the banking system's consolidated regulatory capital grew by about €17 billion, or 9.8 per cent, to €191.7 billion. Both core and supplementary capital elements contributed to the increase (Table 15.4).

Table 15.4

**Capital adequacy of Italian banks and banking groups** (1)
*(end-of-period data in millions of euros)*

| | Banking system | | Main banking groups (2) | |
|---|---|---|---|---|
| | 2005 | 2006 | 2005 | 2006 |
| Allocations to regulatory capital | 6,504 | 11,558 | 3,366 | 6,496 |
| Regulatory capital | 174,552 | 191,663 | 91,468 | 96,147 |
| Solvency ratio (%) | 10.6 | 10.7 | 10.0 | 9.8 |
| Tier 1 capital ratio (%) | 7.9 | 7.8 | 7.1 | 6.7 |
| Capital excesses | 43,962 | 49,670 | 18,841 | 18,374 |
| Capital shortfalls | 14 | 74 | – | – |
| Number of banks with shortfalls | 1 | 1 | – | – |

(1) Consolidated reports for banking groups and individual reports for banks not belonging to a group. Excludes the Italian branches of foreign banks. – (2) Five largest groups by total assets.

Set against an 8 per cent increase in risk-weighted assets, the banking system's solvency ratio rose by 0.1 points to 10.7 per cent; gross capital excesses rose from €44 billion to €49.7 billion. The tier 1 capital ratio declined by 0.1 points to 7.8 per cent.

For the five largest banking groups, the increase in capital did not fully offset that in risk assets. The overall capital ratio fell by 0.2 points to 9.8 per cent and the tier 1 capital ratio by 0.4 points to 6.7 per cent. Capital excesses decreased by €500 million to €18.4 billion. The increase in capital (5.1 per cent) was entirely due to the supplementary component, which grew by 15.4 per cent. Tier 1 capital remained unchanged: the contribution from the increase in self-financing was offset by the decline in the amount of innovative capital instruments and by larger deductions for goodwill in connection with some recent takeovers. As with the system as a whole, the amount of elements to be deducted from the sum of tier 1 and supplementary capital increased owing to larger deductions of equity interests in insurance companies.

*Quality of bank assets.* – The overall quality of banking groups' exposure improved in 2006 (Table 15.5).

Table 15.5

**Banking groups: exposures and value adjustments**
*(end-of-period data in millions of euros and percentages)*

| | Exposures (1) | *of which: % to residents* | Share of total exposures | | Cover ratio (2) |
|---|---|---|---|---|---|
| | 2006 | | 2005 | 2006 | 2006 |
| | | | **All groups** (3) | | |
| On-balance-sheet exposures to customers | 1,889,961 | 72.1 | 100.0 | 100.0 | 2.7 |
| Performing | 1,796,103 | 72.0 | 93.8 | 95.0 | 0.5 |
| Non-performing | 93,858 | 74.3 | 6.2 | 5.0 | 46.0 |
| *loans past due/overdraft ceilings breached* | *7,326* | *94.5* | *0.7* | *0.4* | *8.1* |
| *restructured loans* | *6,124* | *31.3* | *0.2* | *0.3* | *26.9* |
| *substandard loans* | *21,048* | *81.1* | *1.9* | *1.1* | *24.1* |
| *bad debts* | *59,361* | *73.9* | *3.4* | *3.1* | *60.4* |
| On-balance-sheet exposures to banks | 382,618 | 39.1 | | | 0.1 |
| Off-balance sheet exposures | 657,524 | 42.5 | | | 0.3 |
| *of which: to customers* | *452,838* | *52.6* | | | *0.4* |
| *to banks* | *204,686* | *20.3* | | | *0.1* |

Source: Banking groups' supervisory reports.
(1) Exposures are gross of value adjustments. – (2) Value adjustments as a percentage of total exposures. – (3) Includes Italian groups controlled by foreign banks.

On-balance-sheet exposures to customers grew over the year by 11.9 per cent to €1,890 billion, of which 72.1 per cent to customers resident in Italy.

Non-performing positions – comprising loans that are past due and overdraft ceilings that have been breached for more than 180 days, restructured loans, substandard positions and bad debts, corresponding to the Basel II aggregate of positions in default – fell from 6.2 to 5 per cent of total on-balance-sheet exposures to customers, thanks above all to the reduction in substandard positions and breaches of overdraft ceilings; the incidence of bad debts diminished from 3.4 to 3.1 per cent. Non-performing positions vis-à-vis residents in Italy accounted for 74.3 per cent of the total.

Securitizations and assignments of bad debts by the units operating in Italy totalled €3.4 billion, compared with €11.4 billion in 2005. In contrast with the past, the amount consisted almost entirely of assignments, which permit claims to be transferred definitively and removed from banks' balance sheets according to IAS/IFRS.

At the end of the year, value adjustments to non-performing exposures amounted to 46 per cent of the latter's face value; for bad debts the cover ratio was 60.4 per cent.

*Credit risk.* – In lending to manufacturing firms, the ratio of adjusted new bad debts recorded during the year to the stock of loans outstanding at the end of the previous year (default rate) fell by 0.2 percentage points to 0.9 per cent, according to Central Credit Register data. The overall ratio remained unchanged at 0.85 per cent, a historically low level.

At the end of 2006 the average probability of default by a firm within one year, weighted by the amount of credit drawn, was equal to 0.9 per cent, 0.2 points lower than a year earlier. The improvement, under way since 2002, involved all classes of firm; it was sharpest in the industrial sector and, geographically, in the North-West.

More than one third of banks' total lending is to the property sector. The default rate for consumer households continues to be low, while profits and capital appear capable of absorbing the effects of a significant drop in property prices.

If the real value of buildings were to fall by 20 per cent, as it did between 1992 and 1999, the potential losses deriving from the diminution in value of the liens would amount to about 4 per cent of total regulatory capital. Factoring in the potential losses connected with an increase in the probability of default by firms of the building sector (to almost 8 per cent, the high recorded in the middle of the 1990s), the total rises to about 6 per cent of regulatory capital. These estimates do not consider the possible indirect effects on banks of the reduction in household wealth due to the fall in property prices.

*Country risk and geographical concentration*. – The Italian banking system's exposure to developing countries and offshore centres (defined using BIS criteria) rose by 47.9 per cent in 2006 to €135 billion at the end of the year. Most of the increase was due to the inclusion of the HVB component of the UniCredit group; otherwise the increase would have been about 7 per cent.

The exposure represents a small portion of Italian banks' assets (4.8 per cent). Italian banks' share of total lending to developing countries is similarly small (less than 4 per cent), lower than those of the banks of other EU and non-EU industrial countries.

Lending to the countries of central and eastern Europe continued to expand vigorously last year. Italian banks' market share in the area is roughly 10 per cent. Their exposure to the countries of the Middle East and Asia also increased.

Exposures subject to value adjustments totalled approximately €14 billion at the end of 2006. The amount of minimum value adjustments fell further, to €430 million (0.2 per cent of regulatory capital). This modest amount reflects both the progress in terms of financial stability in the emerging economies and the reallocation of Italian banks' lending towards less risky countries. The prudential rules on country risk, which established minimum levels for value adjustments to non-guaranteed exposures to non-OECD countries, have been superseded since the beginning of 2007 by the Basel II regime.

*Emerging risks*. – The fora of international cooperation in the banking and financial sector are paying keen attention to some market developments that have seen the ascent of actors and instruments whose risk profiles are hard to assess. Hedge funds have a positive impact on the functioning of financial markets by contributing liquidity, facilitating price discovery and making possible more effective diversification of risk. However, their operations can create risks for financial stability. Alongside the activity of hedge funds, the increase in leveraged buy-outs and intensive use of instruments for credit risk transfer, such as credit default swaps, also have implications for financial stability.

Italian banks have a small direct exposure to hedge funds (loans to and investments in funds); for the 10 largest banking groups, it amounted to about 2 per cent of regulatory capital and 3 per cent of tier 1 capital at the end of 2006. The risks also appear limited in light of the fact that the loans are collateralized and the banks' investments are mainly in funds of hedge funds, which have a lower risk profile than pure, single-manager hedge funds. The exposure in the private equity sector is high.

The notional value of credit derivatives held by Italian banks rose by 13.4 per cent in 2006 and was equal to 9.7 per cent of traditional risk assets (loans and securities) at the end of the year. Banks use credit derivatives mainly for trading purposes rather than to hedge the risk in their own banking book. In recent years the notional value of contracts purchasing protection has been fairly close to that of contracts selling protection. At the end of 2006 the figures were €76 billion and €67 billion, respectively.

## *Non-bank intermediaries*

*Asset management companies.* – Asset management companies' total net profit for the year rose by 12.1 per cent to €785 million (Table 15.6). Loss-making companies numbered 49, about the same as in 2005; 27 of these were companies established in the last two years and specializing mainly in closed-end funds and hedge funds.

**Table 15.6**

**Asset management companies: income statement data**
*(millions of euros and percentages)*

| | 2005 | | 2006 | | Percentage change |
|---|---|---|---|---|---|
| | Amount | Percentage (1) | Amount | Percentage (1) | |
| Fee and commission income | 6,590 | 325.4 | 6,979 | 316.1 | 5.9 |
| Fee and commission expense | 4,565 | 225.4 | 4,771 | 216.1 | 4.5 |
| **Gross operating profit** | **2,025** | **100.0** | **2,208** | **100.0** | **9.0** |
| Administrative expenses (-) | 1,092 | 53.9 | 1,168 | 52.9 | 7.0 |
| *of which: staff costs (-)* | *460* | *22.7* | *482* | *21.8* | *4.8* |
| Other operating expenses (-) | 31 | 1.5 | 39 | 1.8 | 25.8 |
| **Total operating costs** (2) | **1,193** | **58.9** | **1,240** | **56.2** | **3.9** |
| Other operating income | 123 | 6.1 | 104 | 4.7 | -15.4 |
| **Net operating profit** | **955** | **47.2** | **1,072** | **48.6** | **12.3** |
| Result on ordinary activities | 171 | 8.4 | 192 | 8.7 | 12.3 |
| **Extraordinary income/expense** | **1,126** | **55.6** | **1,264** | **57.2** | **12.3** |
| Taxes (-) | 424 | 20.9 | 473 | 21.4 | 11.6 |
| **Net profit (loss) for the year** | **700** | **34.6** | **785** | **35.6** | **12.1** |

(1) Amount as a percentage of gross operating profit – (2) Includes value adjustments to tangible and intangible fixed assets.

The overall profitability of asset management companies was the outcome of different trends in the various business segments. Companies that manage traditional open-end funds, which account for roughly 90 per cent of the income statement aggregates, operate in a mature market characterized by broadly stable costs and slowing profits; they recorded a shift in the composition of their fee income to the benefit of fees from individual portfolio management services, which, however, offer very narrow margins.

Asset management companies that operate hedge funds and closed-end funds enjoyed faster growth in income, accompanied by a sharp increase in administrative expenses, due in part to the fact that most of these companies started up in the last four years.

At the end of 2006 the regulatory capital of asset management companies amounted to €1,540 million, compared with €1,390 million a year earlier. The minimum capital requirements stood at €361 million (€327 million at the end of 2005).

*Investment firms*. – The relatively moderate gain of 13.6 per cent in investment firms' operating profit reflected the weak growth in total income from investment services (5.3 per cent) due to the contraction of 5.5 per cent in income from the execution of orders for customers. The latter segment of activity came under greater pressure from larger intermediaries and foreign intermediaries, significantly compressing margins. Except for some fast-growing firms, the volume of trading also showed modest growth (about 3 per cent).

At the end of 2006 investment firms' regulatory capital totalled €674 million, compared with €685 million a year earlier. The growth in tier 1 capital was more than offset by the increase from €48 million to €140 million in the components to deduct from regulatory capital.

Investment firms' total capital requirements amounted to €139 million at the end of 2006 (€144 million at the end of 2005). The minimum capital needed in order to provide investment services is the principal capital requirement of investment firms: for 60 firms it is higher than both the capital required to cover "other risks" and the capital charges for credit and market risks.

*Financial companies.* – In 2006 financial companies entered in the register referred to in Article 107 of the Consolidated Law on Banking saw their net profit jump by 37.2 per cent to €1.3 billion. Net fee income and net interest income contributed to the growth, more than offsetting the slight increase in value adjustments for credit risks and in operating costs. Net profit grew by 38 per cent in the consumer credit sector, which has recorded a persistent expansion in the volume of new lending. The increase in net profit was smaller in leasing and factoring (7.3 and 20.5 per cent, respectively).

The growth in lending last year was achieved thanks in part to differentiated choices in the type of distribution channel used. More than half of all new loans were made through companies' branch networks. As to the other channels, retail outlets were preponderant in consumer credit (for the purchase of consumer goods), bank branches were used mainly by leasing and factoring companies, and networks of financial agents and credit brokers by leasing companies and intermediaries specialized in making loans secured by one fifth of salary.

Financial companies' regulatory capital amounted to €12.9 billion at the end of the year, rising by 23.5 per cent thanks mainly to capital increases subscribed by their shareholders.

Leasing, factoring and consumer credit companies' combined regulatory capital was equal to 7.7 per cent of their risk-weighted assets at the end of 2006, 0.4 percentage points lower than a year earlier; by type of company, the ratios were respectively 5.9, 9.7 and 5.4 per cent. Among securitization servicers, there were no cases of capital shortfalls with respect to the claims managed.

Financial companies' loan portfolios showed a decrease in new positions classified as bad debts, partly offset by a slight increase in those more than 120 days overdue. In leasing, overdue claims were equal to 4.1 per cent of new business (3.7 per cent in 2005); in factoring, where there is an appreciable volume of overdue claims on public sector counterparties, the ratio rose from 3.8 to 4.2 per cent. In consumer credit the ratio of new bad debts to new lending during the year rose from 1.6 to 1.9 per cent.

# 16. SUPERVISION

With the increasing integration of banking systems, the creation of cross-border banks of systemic importance, and the emergence of new risks for financial stability, closer cooperation between supervisors is needed in order to safeguard stability, guarantee equal competitive conditions, and limit the costs to banks.

With the new prudential regulations for banks and investment firms now in place, European supervisors are stepping up cooperation on cross-border groups in order to develop common operational solutions for the approval of internal models and the application of prudential controls (the second pillar of Basel II). They are also working to strengthen the tools for managing potentially systemic financial crises.

The principal changes to banking and financial legislation in Italy relate to the new prudential regulations governing banks and investment firms (Basel II), the coordination of the consolidated laws on banking and finance with the law on the protection of saving, and the Government's measures regarding bank-customer relations. The transposition of the Markets in Financial Instruments Directive 2004/39/EC (MiFID) is an important development in this connection. The general objectives of the various measures are to improve supervised banks' ability to manage and control their risk exposure, strengthen the governance of banks and securities issuers, extend the protection of savers and users of bank services, and enhance market transparency.

Under the new prudential rules, supervisors tend to look beyond structural controls and operational constraints in order to focus on the suitability of organizational arrangements, risk control and management, capital adequacy and the reconciliation of banks' autonomy with prudential objectives.

## THE REGULATORY FRAMEWORK

### *The international context*

*International cooperation*. – At the meetings of September 2006 and March 2007 the Financial Stability Forum focused on such factors of risk for global financial stability as the operations of hedge funds, the rapid increase in leveraged buy-outs financed by private equity, and the potential instruments for the transfer of credit risk, particularly in situations of stress. The Forum also looked at the recent difficulties of the US sub-prime mortgage market.

In view of the rapid expansion of hedge funds, at the request of the G7 ministers and central bank governors, the Forum updated its 2000 recommendations to banks and financial intermediaries to reinforce risk management procedures in the case of highly leveraged institutions. The new document invited supervisors to press core intermediaries to continue to strengthen their counterparty risk management systems; to work with these banks to improve their ability to cope with an erosion of market liquidity; and to assess how far the availability of more systematic data on banks' aggregate exposure to hedge funds could effectively complement existing supervisory measures. Hedge fund counterparties and investors should take action to increase market discipline, particularly by obtaining prompt and accurate evaluations of portfolio values and risk exposure. The global hedge fund industry needs to review and reinforce its business practices to meet the expectations of improvement of the authorities and the market.

In connection with the Basel II Accord, the Committee on Banking Supervision, after examining the results of the fifth quantitative impact study, confirmed the calibration of capital requirements set out in the 2004 document and stepped up its efforts to encourage efficient implementation of the new rules, particularly as regards banks with substantial cross-border business.

*European cooperation for financial stability.* – Within the European Union further progress was made in 2006 on the reference framework for financial stability and crisis management. In April the Economic and Financial Committee conducted an international financial crisis simulation at the European Central Bank in order to check the procedures set out in the Memorandum of Understanding on cooperation between central banks, supervisory authorities and finance ministries that came into force in July 2005. On the basis of the results the Ecofin Council called on the authorities involved to increase cooperation and ensure that the mechanisms for guaranteeing financial stability were consistent with market developments.

The ESCB's Banking Supervision Committee and the Committee of European Banking Supervisors (CEBS) drew up a set of joint recommendations for reinforcing cooperation and information exchange in the event of systemic crises with potential cross-border implications, affecting banks, financial markets and infrastructure.

The Commission has continued to examine regulatory activity and prudential supervision in Europe, as set out in its white paper on financial services strategy for 2005-2010.

In January this year the Inter-institutional Monitoring Group for the Lamfalussy Procedure – consisting of experts nominated by the European Commission, Parliament and Council – published a consultation document containing, among other things, a proposal to conduct further assessments of the work of the Level 3 committees and of the transposition of Community regulations.

The Banking Supervision Committee conducted a survey on the role of major European banks in the private equity market through the medium of leveraged buy-outs. The survey, which covered a sample of 30 European banks and 11 London branches of international banks, showed that, although the banks' exposure in relation to such operations was generally not large enough to generate systemic risks, there were nonetheless some areas of vulnerability. For instance, greater financial leverage and complex mechanisms of credit risk transfer require banks to evaluate counterparty risk carefully and institute adequate procedures for the assessment of the relative exposures.

*European Union regulations*. – The transposition of the new capital adequacy requirements (Basel II) was concluded in 2006 with the adoption, on 14 June, of Directive 2006/48/EC "relating to the taking up and pursuit of the business of credit institutions" and Directive 2006/49/EC "on the capital adequacy of investment firms and credit institutions". The two texts recast, respectively, Directive 2000/12/EC of 20 March 2000 and 93/6/EEC of 15 March 1993, which were repealed.

With regard to investment services, two provisions were issued to implement MiFID. These were Directive 2006/73/EC of 10 August regulating the organization and conduct of banks and contemporaneous Regulation 2006/1287/EC on record-keeping obligations for investment firms, transaction reporting and market transparency. The Commission has also issued Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on eligible assets for undertakings for collective investment in transferable securities (UCITS).

Another important step in the area of prudential supervision was the Commission's proposal of September 2006 for a directive on the valuation of acquisitions of large shareholdings in the financial sector, which should be passed in the summer of this year. The purpose is to establish clear and uniform rules for the valuation of takeover bids involving banks, investment firms and insurance companies.

In April this year the European Parliament adopted the legislative proposal for a directive on payment services. The Payment Services Directive is a step in the creation of the single euro payments area (SEPA); its aim is to create a harmonized legal framework for retail payment services within the European Union, thus enhancing transparency and increasing competition for more efficient protection of users. The Directive allows non-financial entities (commercial businesses or industrial enterprises, such as telephone companies and large retail outlets) to set up as payment institutions offering payment services within the European Union under an EU-wide "passport", in competition with banks and e-money issuers. These payment institutions will be allowed to provide all the payment services envisaged in the Directive (such as credit transfers and payments of funds and issues of credit and debit cards); to hold customer's liquid assets exclusively for the purpose of making payments; and to grant, from funds not held on behalf of customers, loans up to 1 year connected with payment services. The Directive also makes provision for a regulatory regime proportionate to the complexity and risk of the activity performed, with requirements for minimum start-up capital, organizational measures and capital adequacy.

*The supervision committees*. – The CEBS assigned priority to the convergence of supervisory practices and uniform application by member states of the new capital adequacy rules. The Committee was also engaged in implementing the recommendations of the Financial Services Committee, which include procedures for the mediation of disputes between authorities and delegation mechanisms.

Considerable emphasis was placed in 2006 on fostering cooperation between authorities engaged in the supervision of cross-border groups. Discussions and exchanges of experience were initiated between European supervisors in order to reduce the cost of applying the capital adequacy rules to members of banking groups located in different countries. The CESB Subgroup on Operational Networks comprises representatives of the home- and host-country authorities of the ten largest European groups, one of which is UniCredit. Its objective is to identify common problems and solutions by examining the effective machinery of cooperation, and aspects relating to the validation of advanced risk measurement systems and the implementation of the supervisory review process (the "second pillar"). The group has already completed a preliminary study of the functioning of the networks of supervisors and, more generally, of collaboration between home- and host-country authorities. It appears that some networks were created many years ago, at the time cross-border banking groups were founded, while others have been set up more recently in response to a need for better coordination among authorities to implement the new capital adequacy rules. A wide variety of approaches emerged, for instance as regards the composition of the networks, the procedures for information exchange, and the frequency of meetings. Some of the variations are due to differences in the organizational and operational structure of the banking groups subject to supervision and to the authorities' methods of supervision; exchanges of experience should lead gradually to greater uniformity of supervisory practices.

The Subgroup also began to look into some of the main issues raised by the validation of advanced internal rating models envisaged in Basel II and made a comparison of the methods adopted by different supervisors. Discussions covered the division of tasks between home- and host-country authorities within the networks; the calculation and validation of risk parameters for portfolios with a low proportion of defaults; and the estimation of the losses during an economic recession.

*Bilateral cooperation.* – In 2006 and early 2007 the Bank of Italy increased bilateral cooperation with the supervisory authorities of other countries, partly in connection with the growing internationalization of the country's banking system. Memorandums of Understanding were signed with the supervisory authorities of Poland and Serbia, where the market share of Italian banks is about 20 per cent. Meetings were also held with representatives of the supervisory authorities of Germany, Austria, Poland, France and the Netherlands with a view to enhanced cooperation and information exchange.

## Italian legislation

*Implementation of the law on the protection of saving.* – Legislative Decree 303/2006, implementing Article 43 of Law 262/2005 on the protection of saving, aligned the latter with the consolidated laws on banking and finance, eliminating several problems of interpretation and application and rationalizing the legislative framework. The decree sets aside the provision of Law 262/2005 requiring that acquisitions of significant holdings in banks should be authorized by the Bank of Italy and the Antitrust Authority in a single act and lays down instead that the two institutions shall, within the same deadline of sixty days, issue separate authorizations, each for the aspects within its province. The decree further provides that the Antitrust Authority may, at the request of the Bank of Italy, authorize agreements that are necessary for the operation of the payment system, as well as concentrations restricting competition, in order to guarantee the stability of banks. On 2 April the two authorities signed a Memorandum of Understanding on coordination and collaboration that also covers the exchange of information.

The rules on transparency of the Consolidated Law on Banking and the related monitoring by the Bank of Italy do not apply to the subscription and placement of financial products, including those issued by banks, or to operations and services, even of banks, that are "components" of financial products. These are now subject to the rules on transparency of the Consolidated Law on Finance and to the control of Consob.

The oversight of securities issues (Article 129 of the Consolidated Law on Banking) was radically revised in the interests of simplicity, liberalization and greater relevance to the objectives of supervision. Authorization is no longer required, although notice of issues must be sent to the Bank of Italy, which retains the faculty to demand periodical reports and data on outturns.

Other important provisions of Legislative Decree 303/2006, which will have an impact on the governance of listed banks, relate to the regulations on issuers contained in the Consolidated Law on Finance. The objective is to tighten controls and enhance the safeguards for minority shareholders of listed companies. Finally, the decree tackles the matter of conflicts of interest in the banking sector already covered by the law on the protection of saving, introducing improvements to the legislative framework.

The passage of Legislative Decree 51/2007 of 28 March gave effect to the enabling clause contained in the Law on the Protection of Savings relating to the transposition of Directive 2003/71/EC of 4 November 2003 on prospectuses and admission to trading. The new rules of the Consolidated Law on Finance grant a European "passport" to prospectuses that comply with the harmonized minimum requirements and have been approved by the competent authorities of a member state.

*Transposition of MiFID*. – Italian legislation is now being amended to incorporate MiFID. The new provisions, which come into effect on 1 November 2007, aim to foster the integration of European financial markets by extending the Directive to new services and financial instruments and promoting competition between trading venues (regulated markets, multilateral trading facilities and "systematic internalizers" of retail order flows).

MiFID includes advice among the investment services that banks and investment firms may provide. Whereas previously advice could be an incidental part of other investment services, such as placement, management, trading, and execution of orders, under the new rules it must be offered separately and explicitly to customers and may be charged on a stand-alone basis.

The Directive lays down information and conduct of business requirements for firms according to type of service (advice and individual portfolio management, on one side; trading and order collection, on the other), complexity of financial instruments, and customer category (retail, professional, or qualified investors), thereby regulating the matter flexibly, enhancing the transparency of investor relations and encouraging more informed investment decisions. The aspects of investor protection relating to the management of conflicts of interest and the principle of best execution of orders have generally been left to the decision of investment firms regarding the most suitable organizational solution, maximizing their freedom of action.

With a view to the adoption of MiFID, in March the Ministry for Economy and Finance issued a consultation document on the draft legislative decree amending the regulations on firms and markets contained in the Consolidated Law on Finance. As far as concerns supervision, the document retains the existing division of supervisory tasks according to objective. To reduce the costs to banks and to rationalize secondary legislation, a Memorandum of Understanding will be signed by the Bank of Italy and Consob, which will have joint regulatory powers to establish the organizational requirements.

*The new capital adequacy rules (Basel II).* – The transposition of the new rules on capital adequacy creates an organic system of regulation and supervision based on the effective risk exposure of banks and their ability to develop suitable risk management and control techniques and adopt appropriate organizational solutions for their characteristics and strategies. The process necessitated the adoption of a set of enabling acts by 31 December 2006, the deadline fixed by the European Union.

The Bank of Italy's circular letter 263 of 27 December 2006 containing "new provisions concerning the prudential supervision of banks" sets out the new framework. The provisions were drawn up after lengthy public consultation, partly with a view to reducing the costs for supervised intermediaries.

Since the EU regulations allow banks to retain the previous prudential regime for the whole of 2007, the provisions of the Bank of Italy's circular letter 229 of 21 April 1999 will remain in force until the end of the year. Exceptions to this are the provisions on own funds, which enter into force immediately. Their main innovations include raising the limit for innovative capital instruments from 15 to 20 per cent of Tier 1 capital and the opportunity to issue these instruments directly, without the need for a foreign vehicle.

The aim of new minimum capital requirements (the first pillar) is to tackle the typical risks of banking and finance, i.e. credit, counterparty, market, and operational risk. Various methodologies of calculation, with increasing degrees of complexity of risk management and measurement, are envisaged, while organizational and internal control requirements are tightened. Closer links are established between capital adequacy and organizational arrangements, and the organs of corporate governance are given a crucial role in risk management and control.

In the case of banking groups with branches in more than one member state, authorization to use advanced internal ratings-based approaches is granted by joint decision of the competent supervisors. If they fail to reach agreement, the decision of the authority responsible for consolidated supervision will be binding for the whole group.

The total capital requirement is the sum of the requirements for the single categories of risk. Provided the total requirement is met at the consolidated level, banks belonging to a group are eligible for a 25 per cent reduction on the total requirement applicable at solo level.

As regards the second pillar, the principle of proportionality is observed by separating banks into three categories according, generally, to their size and sophistication. The provisions of the capital accord lay down the stages of banks' internal assessment of capital adequacy, the frequency of reviews, the main risk exposures to be evaluated, including in some cases details of simplified methods of calculation. The supervisory authority is charged with reviewing the internal assessment process, checking that outcomes are consistent, preparing an overall evaluation of the bank and, where necessary, requiring appropriate corrections.

In the matter of disclosure requirements (third pillar) the provisions include tables summarizing the quantitative and qualitative information banks are required to provide. They set out the methods and frequency of disclosure and any exemptions, as well as the checks to which all information must be subject before release to the public.

As to investment firms, the EU directive ensures equality of treatment for those that perform the same activities by providing they should be subject to the same prudential regulations, with some exceptions. In January 2007 a consultation paper was issued on some specific aspects of the prudential treatment of investment firms to supplement the general recommendations contained in the 2006 consultation documents relating to banks, investment firms and other financial intermediaries. It is the intention of the Bank of Italy to take advantage of the option offered by Directive 2006/48/EC to adopt a different supervisory regime for investment firms. In particular, different capital adequacy requirements are established according to the nature and complexity of investment firms' activities and hence their risk exposure.

In April this year the Bank of Italy issued for consultation a draft of the prudential supervision instructions applying to financial intermediaries listed in the special register set up under Article 107 of the Consolidated Law on Banking. In their case too, the new instructions aim to create a supervisory regime based on three pillars, similar to that applying to banks but designed to reflect the different operational characteristics.

*Compliance*. – Following discussions at national and international level it emerged that stronger measures were needed to ensure banks' compliance with all the provisions governing their activity, in particular their relations with customers. The Bank of Italy issued a consultation paper on methods of managing and controlling compliance risk, i.e. the risk of incurring sanctions, financial loss or reputational damage as a result of breach of laws, regulations or internal rules.

The proposed regulations are designed to supplement the internal control systems of banks and they assign the latter broad powers to tackle this risk within their own organizational arrangements. Nonetheless, banks are required to create an ad hoc, independent function for compliance risk management, to endow it with sufficient resources, to assign a manager to oversee it, and to specify the official roles and responsibilities of all involved. General duties of direction and oversight are assigned to the board of directors and senior management.

The compliance function has a complementary role with respect to the risk management system required by the new prudential regulations. Its main purpose is preventive as it acts as a safeguard against risks that are not predominantly financial, but legal and reputational. Consob has also been called to contribute to the regulations for the part relating to investment services, in order to coordinate them with the provisions transposing MiFID.

*Regulatory simplification.* – In accordance with established international guidelines for better regulation, the Bank of Italy is revising supervisory rules to eliminate the constraints and costs relating to non-harmonized provisions and, more generally, to simplify and rationalize regulatory and supervisory activity. This process comprises the abolition of the information requirement for acquisitions of controlling shareholdings in banks and the adoption of simplified procedures for amendments to by-laws and the opening of bank branches. Amendments to by-laws are examined on the basis of a proposal approved by the board of directors and notified to the Bank of Italy; if there are no conflicts with the principles of sound and prudent management, authorization is granted on condition that the shareholders' meeting approve the project as examined. For the opening of new branches, the previous authorization procedure has been replaced by information requirements in a move to give banks freedom of decision in branching matters. However, the Bank of Italy may initiate administrative proceedings to prohibit a new opening if problems are detected.

In the case of securities issues by banks, the compulsory minimum maturity for certificates of deposit and savings certificates was abolished in order to boost the markets for short-term debt instruments, and especially the launch of the Short-Term European Paper market. The Bank of Italy initiated a broad review of supervisory provisions that will lead to the simplification and reduction of administrative proceedings, especially regarding authorizations.

*Permissible shareholdings of banks*. – The Bank of Italy submitted a proposal to the Interministerial Committee for Credit and Saving to review the supervisory instructions relating to permissible shareholdings of banks. The new rules would align national legislation with EU standards, simplifying the procedures for the acquisition of shareholdings in financial and insurance companies and considerably raising the limits on equity investment in non-financial corporations, in line with EU thresholds. The risks associated with the increased opportunities for acquiring shareholdings in industrial firms and the dangers of overlapping or conflict of interests will be countered by the more sophisticated risk measurement and control techniques developed by the banks and adopted by the supervisors, by the introduction of specific governance and transparency requirements, and by new regulations for connected lending in implementation of the recast Article 53 of the Consolidated Law on Banking.

*Covered bonds*. – The regulations governing banks' issues of covered bonds set out in Law 130/1999 of 30 April 1999 on the securitization of credits were given effect by a decree of the Minister for Economy and Finance and provisions issued by the banking supervisory authorities. The Bank of Italy issued the supervisory instructions on 15 May 2007. The regulations are designed to ensure the sound and prudent management of banks, taking account of the technical complexity of the issues and the large amounts involved, to safeguard other bank creditors not holding covered bonds, and to foster market confidence during the launch. Banks issuing such securities or selling the collateral assets must therefore have sufficient capital base and capacity to absorb risk. Other provisions concern the prudential limits on the transfer of bank assets, the organization and internal control of operations, and the supervisory reports on the operations to enable their control and reveal the risk exposure of banks and the banking system.

## CONTROL PROCESSES

### *Evolution*

Changes to the legislative and regulatory framework and increasing convergence of international supervisory practices have led to the progressive alignment of the guidelines for supervision and of the methods and procedures for performing controls.

According to the principle of means proportionate to objectives that informs much of the new regulatory framework, supervisory action should be more closely related to effective risk exposure, partly in order to minimize the costs for supervised intermediaries. The supervisory process leaves broad scope for independent choices, verifying only that banks maintain sufficient capital to cover their risk exposure and encouraging a drive for greater efficiency, to the benefit of the whole economy.

Under the new regulations governing the prudential control system the supervisory authority is charged with the supervisory review and evaluation process. This activity is based on dialogue with the supervised banks and includes a re-examination of their internal capital adequacy assessment process. As part of the review and evaluation process the supervisor analyzes the bank's and the group's risk exposure, taking account of internal risk control and mitigation mechanisms, and checks compliance with the body of prudential rules in order to perform an overall assessment of the subject and adopt corrective measures as needed. In accordance with the principle of proportionality, the supervisory review and evaluation process is correlated to the importance and characteristics of the subjects.

The Bank of Italy has initiated a review of the methods used to evaluate banks in order to improve the efficiency and effectiveness of controls and implement the principle of proportionality. In the future the models for analyzing individual banks will take account of the innovations introduced by the regulations and the EU guidelines, regarding the broader range of risks to be taken into consideration and the criteria for evaluating exposures and mitigating factors. In 2006 the Bank of Italy developed a method of analysis of interest rate risk on banks' portfolio that complies with the Basel Committee's recommendations and the new capital adequacy requirements. A review of the methods of analysis of banks' annual accounts is under way, partly as a result of the innovations of IAS/IFRS.

The models will be revised with a view to establishing a more structured and systematic link between risk analysis of individual banks, particularly those of systemic importance (micro-prudential analysis), and risk analysis for the financial system as a whole (macro-prudential analysis). The aim is to refine the Bank of Italy's assessments of the stability and vulnerability of the country's financial system and render overall supervisory activity more effective.

The information requirements associated with the new approaches are tackled in the project to align the banks' accounting supervisory reports with the common European format for accounting and prudential reports. The project aims to simplify and to limit the costs to banks. On-site inspections will also be subject to modifications; their scope and purpose will be more clearly defined, in line with the above principles, and there will be a wider range of assessments, differing according to bank size and sophistication. In the case of small and medium-sized or highly specialized banks, the main purpose of the inspection will be to examine the overall situation; for medium-to-large banks the inspection will look at certain areas of risk or specific aspects of management within the context of a long-term assessment programme. The effectiveness of measures adopted at the request of the supervisor will be assessed in the course of brief follow-up evaluations, and visits will be made to obtain specific information (in connection with various stages in the validation of advanced risk management systems) or examine aspects affecting the supervision of multiple banks.

The inspection process will be modified to focus on risk analysis and organizational arrangements, in compliance with the principle of proportionality, with close coordination of on-site and off-site inspections. Steps were recently taken to provide banks with a clearer and more organic description of inspection findings, fostering a constructive dialogue with the supervised institutions. In particular, administrative observations, which summarize the main areas examined and the conclusions reached, are now separated from reports of failure to comply with regulatory provisions; this allows a more objective and better documented description of any charges.

Assessments of the stability and efficiency of supervised banks increasingly focus on the choices made in matters of governance, which must ensure a transparent decision-making process and a satisfactory level of internal debate, given the wider options offered by the regulations in terms of management and control models.

The protection of users of banking and financial services is an important objective of supervision, partly because of the way reputational aspects affect the stability of banks. Inspections to assess compliance with the relative regulations are combined with frequent calls for fair-play between banks and transparency of conditions. A new survey of bank costs is being carried out, following that of December 2005.

### *Monitoring of banks' compliance with the new capital adequacy requirements*

The Bank of Italy approves banks' internal rating systems in several stages. Because of the complexity and organizational impact of these systems, banks may present projects for internal ratings even before making a formal application, thereby initiating a dialogue with the supervisory authority. Once approval has been granted, the Bank of Italy ensures that the requirements continue to be met. In the last two years there has been an increase in discussions with banks that had begun earlier to develop systems of internal assessment of capital adequacy with a view to the entry into force of the new regulations. In the second half of 2006 and the first part of 2007 complex concentrations involving some banking groups made it necessary to review the schedule for the original projects.

In the case of market risk, the regulations have long allowed banks to use internal models to calculate capital adequacy, as an alternative to the standardized method. Three Italian groups have been granted supervisory authorization to use internal systems for market risk. The Bank of Italy has made methodological, organizational and informational adjustments in order to extend this authorization process to credit and operational risk exposure. The procedure involves assessment of a wide range of information and the formulation of opinions on highly technical matters.

In the standardized approach to calculating capital requirements for credit risk, banks may use the ratings of external credit assessment institutions to determine the risk weights of their assets. Approval is granted subject to a thorough verification of compliance with requirements relating to the rating methodology (objectivity, independence, transparency, and regular review) and the consequent rating (credibility and transparency). Some applications have already been submitted.

Subsequent to consultations and cooperation initiated in 2005 and agreements with foreign supervisors, reports were prepared on Italian banking groups with important establishments abroad for which the Bank of Italy conducts consolidated supervision (UniCredit and Intesa Sanpaolo). During this stage, the networks of supervisors were active on two levels, one consisting in ordinary control of risks and of the overall business situation, and the other relating to the approval of internal systems for calculating capital requirements. On the first level, the Bank of Italy sought to ensure the circulation of information among the supervisors concerned, forwarding notes on its consolidated assessments of groups and working to acquire similar information on foreign subsidiaries from the host-country supervisor. The exchange of adequate information is particularly important for the supervisory review process set out in the second pillar. Regarding the approval of internal risk measurement methods, the Bank of Italy, as coordinator, called for a division of tasks based on the principle of subsidiarity and for the involvement of host-country supervisors in order to benefit from the better knowledge of institutions that comes with proximity.

As the practice of information exchange grows, the Bank of Italy became increasingly involved in collaboration and coordination processes as part of its role as supervisory authority for banking institutions, including systemically important ones, belonging to groups subject to consolidated supervision by foreign supervisors. Regular meetings and contacts were held with the French supervisor (regarding Banca Nazionale del Lavoro, part of the BNP Paribas group) and the Dutch authorities (regarding Antonveneta, a member of ABN AMRO).

Since the business of banks embraces multiple sectors, as do some of the problems encountered in the course of supervision, the Bank of Italy is involved in increasingly frequent contacts with other supervisors and leading technical bodies at national level, which are often regulated by specific agreements. This form of cooperation has developed in the field of supervision of financial conglomerates and banks with substantial business in the insurance sector and in that of accounting, mainly in connection with the numerous problems of interpretation raised by the application of IAS/IFRS to banks' financial accounts.

# PAYMENT SYSTEM AND FINANCIAL MARKET INFRASTRUCTURES AND SERVICES

## 17. THE PAYMENT SYSTEM

### *The integration of European payment services*

The creation of a single market for payment services (the Single Euro Payments Area, SEPA) is intended to enable consumers, corporates and public administrations to make payments and collections in euros by the same procedures and with the same rights and obligations in all the countries of the European Union. The project provides that by 1 January 2008 banks should be in a position to offer their customers services compliant with the SEPA schemes for credit transfers and direct debits and to issue payment cards in line with the principles established. By the end of 2010 a significant share of domestic payments should have migrated to the pan-European schemes.

The migration to SEPA involves a large majority of stakeholders in every country. In Italy, a National Committee for the migration began work in 2006. It is co-chaired by the Bank of Italy and the Italian Banking Association and comprises all the final users of payment services: corporates, consumers, merchants, and public administrations. Working groups comprising banks, the central bank and the other stakeholders have been formed to determine their respective needs and trace the path to the completion of the migration project. At the start of May 2007 the Committee approved the National Migration Plan specifying the Italian payment procedures that will migrate to the new SEPA schemes and a list of additional optional services that Italy intends to develop.

As in the other EU countries, the existing procedures for credit transfers need little adaptation to conform to the scheme drafted by the European Payments Council, so their migration to SEPA will take place in January 2008. For direct debits the situation is more problematic, owing to the relative lack of European standardization and the significant differences between the Italian procedure and the EPC's scheme.

As to debit cards, CoGeBan – the Convention for the Management of the Bancomat Trademark – is oriented towards international co-branding agreements in order to comply with SEPA standards starting in January 2008. At the same time, CoGeBan is working on the initiative of the Euro Alliance of Payment Schemes to create a European payment card scheme based on agreements between domestic schemes.

On 26 April 2007 the European Parliament approved the proposal for a directive on retail payment services within the single market. With the transposition of this Payment Services Directive, which is to be achieved before 1 November 2009, traditional financial intermediaries will be operating in competition with new "payment institutions" authorized to provide payment services. Consistent with SEPA, the Directive will help to institute shared standards for payment instruments, enhancing the comparability of the conditions applied to services.

## *Payment instruments*

The number of transactions made with non-cash instruments increased by 3 per cent in Italy last year to over 3.6 billion. By international standards, Italy still shows limited use of non-cash instruments. This produces substantial transaction costs and impedes the reduction of unit costs for banking services.

There were 62 non-cash transactions per capita in Italy in 2006, compared with more than 150 a year in the Eurosystem countries in 2004-05. The main non-cash instrument for retail purposes, payment cards, registered 22 transactions per capita in Italy in 2006, compared with 46 a year in the euro area in 2004-05. The gap is not due to differences in the diffusion of cards or POS terminals. With 1.2 cards per inhabitant and 18 POS terminals per thousand, Italy has come into line with the European averages (1.2 and 16, respectively, in the Eurosystem countries in 2005, the latest year for which data are available).

Among non-cash instruments, the use of cheques continued to decline and that of electronic payment and collection orders (automated credit transfers and direct debits) and payment cards continued to increase. The growth of transactions on POS terminals slowed, while Internet payments increased rapidly. Among bank instruments, the number of cheques fell by 2.4 per cent, while ordinary credit transfers and direct debits increased by 4.9 and 3.6 per cent respectively, more or less as in the previous three years. The decline in cheque use was sharper than in the rest of Europe, but the portion of transactions settled by cheque remains high in Italy (13 per cent), most notably among non-financial firms in the South (47 per cent).

Irregular use of cheques increased. The number of persons and of cheques reported to the interbank database of irregular cheques and payment cards rose by 10.7 and 9 per cent, respectively, and the amount involved by 12.5 per cent. The increase involved both cheques rejected for lack of funds (which accounted for 64 per cent of the cheques registered) and unauthorized cheques (36 per cent). The ratio of reported to regular cheques was 1.4 per mille by number and 2.7 per mille by amount. The average bad cheque was for just over €4,000. As in previous years, the reports were concentrated in the South (Table 17.1).

**Table 17.1**

**Interbank database on irregular cheques and payment cards: irregular cheques by geographical area** (1)

| | Persons banned from issuance | Unpaid cheques | | | | Average cheque amount |
|---|---|---|---|---|---|---|
| | No. | No. | % composition | Amount (millions of euros) | % composition | euros |
| North-West | 11,518 | 36,984 | 14.1 | 165.3 | 15.2 | 4,468 |
| North-East | 5,554 | 18,820 | 7.2 | 102.9 | 9.4 | 5,467 |
| Centre | 12,513 | 49,586 | 18.9 | 235.2 | 21.6 | 4,743 |
| South | 37,119 | 156,579 | 59.6 | 583.5 | 53.5 | 3,727 |
| Foreign | 192 | 860 | 0.3 | 3.4 | 0.3 | 3,953 |
| **Total** | **66,896** | **262,829** | **100.0** | **1,090.3** | **100.0** | **4,148** |

(1) At 31 December 2006.

According to ABI, handling time for cheques and credit transfers was essentially unchanged last year. As to charges to customers, the fee for credit transfers diminished especially for automated transfers (e.g. via Internet), which now account for more than 64 per cent of all bank credit transfers (Table 17.2).

Table 17.2

**Charges for domestic credit transfers**
*(in euros)*

| | Standing payment orders | Ordered at branch with current account debit | Ordered at branch and settled in cash | Ordered via Internet | Ordered via telephone | Payments via Freccia bank form |
|---|---|---|---|---|---|---|
| 2004 | 2.33 | 3.53 | 5.05 | 1.12 | 1.59 | 1.23 |
| 2005 | 2.37 | 3.42 | 5.05 | 1.10 | 1.53 | 1.30 |
| 2006 | 2.26 | 3.40 | 5.05 | 1.11 | 1.52 | 1.24 |

Source: ABI - PattiChiari (March 2005 - April 2006 - March 2007).

The number of credit and debit card purchases at POS terminals increased by 5.4 per cent, about half as much as in the previous four years. The number of credit cards rose to more than 31 million, with over 475 million transactions. The use of credit cards for Internet payments and for instalment payments (consumer credit) is increasing in Italy as elsewhere. Debit cards are the most popular payment instrument, with more than 37 million in circulation, accounting for over 770 million retail purchases last year. Cash withdrawals at ATMs increased even faster, by 5.9 per cent in number and 8.2 per cent in amount.

The diffusion of post-office payment instruments among customers proceeded faster than that of their bank counterparts. The number of post-office current accounts rose by 6 per cent over the year to about 4.8 million. The fastest-growing instruments were payment cards (debit and pre-paid) and automated credit transfers.

Among bank and post-office payment cards, the fastest growth was registered by general-purpose prepaid cards, which accounted for about 3 per cent of all transactions in 2006. The use of these instruments is boosted by the fact that they are accessible for people without bank accounts and that they limit the risk of fraud, especially online.

The diffusion of electronic money ("virtual" and "plastic") continued, with issues by banks, electronic money institutions and Poste Italiane. At the end of the year some 6 million instruments were in circulation, including those issued in Italy by foreign e-money institutions under the freedom to provide services. In March 2007, 36 schemes were in place, including five operated by e-money institutions. At the same date three such institutions were entered in the special register, while five EU e-money institutions were already operating or had notified the intention to operate in Italy under the freedom to provide services. The use of prepaid instruments increased by 70 per cent, above all for online payments (40 per cent of such transactions). Another significant use was for cash withdrawal.

Payment card fraud increased. To combat it, in addition to promoting smart card technology, CoGeBan took action to tighten security in its own schemes. The data of the interbank database of irregular cheques and payment cards recorded an increase in irregular transactions with payment cards. At the end of 2006 a total of 143,000 names of offenders were in the database, an increase of 9.5 per cent on the year. Nearly 95,000 names were entered during the year, or one half more than in 2005. Of these, 39 per cent were domiciled in the North, 19 per cent in the Centre and 42 per cent in the South.

## *The State treasury service*

The diffusion of ICT in the public sector has fostered the modernization of public payments and the completion of the electronic State treasury service. The Bank of Italy has rationalized procedures and initiated projects for more intensive use of ITC networks, for the complete dematerialization of expenditure documents, and for the full realization of the Computerized Public Administration Payment System. The evolution of the State treasury service has been accompanied by simplification and comprehensive review of the relevant secondary legislation, which dates to 1939 and was partly revised in 1972.

The further development of the electronic State treasury service was assisted last year by the start of projects for the computerization of local spending by central government entities and for the use of credit transfers for collecting revenues on behalf of the State.

The legal basis for the further modernization of the State treasury service is the Digital Administration Code, issued with Legislative Decree 82 of 7 March 2005 and amended by Legislative Decree 159 of 29 April 2006. The development of infrastructures and services based on open networks, such as the Internet, will provide access for the general public to State treasury payment services.

Public administrations are engaged in adopting SEPA standards for their collection and payment operations.

The General Government Payments Information System registered significant advances in the course of the year. Operated by the Bank of Italy as State treasurer, the System enables the Ministry of the Economy to monitor the public accounts constantly and provides local administrations with essential information for their budgeting. The System embraces regions, provinces, municipalities and mountain communities, unions of municipalities, consortia of local authorities, and universities and their departments, for a total of over 11,300 entities; 97 per cent of them already transmit coded data on receipts and payments through their treasurers. As of July 2007 public research institutions have joined the system. The inclusion of national health care bodies (local health agencies, hospitals, etc.) is scheduled for January 2008. Since November 2006 participants in the General Government Payments Information System have had access to processed data via a website that posts daily and monthly tables for each entity and for its sector.

## *Payment infrastructures*

In 2006 Italy completed the removal of barriers to the provision of retail payment support services by private sector entities (domestic and foreign). At the end of the year the Belgian company SWIFT was authorized to provide network services in Italy in competition with the Interbank Company for Automation (SIA).

A measure issued by the Bank of Italy on 11 November modified the rules of the retail clearing system (BI-COMP), allowing private Italian and foreign operators, in free competition as "assigned operators", to perform all activities preparatory to the calculation of the clearing balances and their settlement, which had previously been reserved to the Bank of Italy.

The introduction of uniform payment procedures in Europe and the investment for the creation of new IT platforms are prompting mergers among the operators of payment infrastructures, aimed at economies of scale and diversification. In Italy, the operators of the principal payment infrastructures were involved in consolidations. In October 2006 Società per Servizi Bancari (SSB) took over SIA, creating a company that can offer most of the services necessary to securities payment and settlement. The new company provides network services and databases in support of payment systems, operates the platforms for the Italian financial markets and for the European STEP2 clearing system, provides retail clearing services for payments to be settled in BI-COMP, and handles payment card transactions. It has a 57 per cent share of the Italian market in retail clearing services and 60 per cent of the domestic debit card market.

Authorization for the merger, granted in April 2007 by the Antitrust Authority, was conditional upon the creation of a separate unit for the provision of network services and on the adoption of measures ensuring equal treatment of all users. The new company became operational on 7 May 2007.

In early 2007 Seceti S.p.A. and the Central Credit Institute for Rural and Artisans' Banks (ICCREA), which provide retail payment services to cooperative banks and to mutual banks, respectively, concluded a cooperation agreement to combine their IT platforms and expand their service provision.

The concentration of various activities within a single technological infrastructure magnifies the possible repercussions of crises in operational structures. Thus mechanisms to guarantee business continuity through shared procedures for recovering lost data and resuming the activity of infrastructures become more important. In this framework, and in compliance with the Bank of Italy's guidelines on business continuity, in 2006 the main Italian payment infrastructure operators developed internal procedures and structures for crisis management.

### *Private clearing and settlement systems*

Clearing and settlement systems run by private operators, generally controlled by banks, settle commercial transactions in competition with the central banks' systems. More than a third of the volume of payments in Europe is settled by the Euro Banking Association's Euro1 system, which nets interbank transactions among its members and is in competition with the TARGET gross settlement system. The services provided by private systems tend to be functionally specialized. The Continuous Linked Settlement system (CLS) for foreign exchange transactions, launched in September 2002 and including two Italian banks as direct participants, permits simultaneous payment versus payment settlement (PVP) for transactions in fifteen currencies.

Most of the private settlement systems in Europe are engaged in the exchange and settlement of retail payment instructions, an activity that is still conducted mainly at national level. Italy is one of the few EU member states in which the central bank directly operates the main clearing system (BI-COMP). In recent years and with a view to SEPA, private sector initiatives have emerged in Italy as well. Since the end of 2006 the Italian banks belonging to Euro1 have switched their retail credit transfers from BI-COMP to the EBA's STEP2 European clearing system.

### *Cash settlement*

The country's wholesale and retail clearing and settlement systems are operated by the Bank of Italy. In 2006 the flow of funds processed by these systems increased by 15 per cent to exceed €49,800 billion, equal to 33.8 times GDP (Table 17.3). The BI-REL real time gross settlement system handled 87.5 per cent of the payments by value. Payments channelled through the BI-COMP clearing system accounted for 6.8 per cent and the cash balances from the securities settlement system accounted for 5.7 per cent.

Table 17.3

**Funds handled by Italian clearing and settlement systems**
*(billions of euros)*

| | Clearing systems (1) | | | Gross settlement (2) (c) | Total amounts (3) | |
|---|---|---|---|---|---|---|
| | BI-COMP gross amounts (a) | Clearing balances | | | | |
| | | BI-COMP | Securities settlement and Express II (b) | | (d)=(a+b+c) | (d)/GDP |
| 2000 | 2,258 | 230 | 2,700 | 34,605 | 39,563 | 33.2 |
| 2001 | 2,449 | 266 | 2,252 | 34,980 | 39,681 | 31.8 |
| 2002 | 2,598 | 276 | 1,954 | 32,145 | 36,697 | 28.3 |
| 2003 | 2,839 | 291 | 2,116 | 30,873 | 35,828 | 26.8 |
| 2004 | 3,011 | 323 | 2,190 | 31,650 | 36,851 | 26.5 |
| 2005 | 3,181 | 376 | 2,531 | 37,656 | 43,368 | 30.5 |
| 2006 | 3,402 | 420 | 2,818 | 43,635 | 49,855 | 33.8 |

Sources: Based on SIA, Istat and Bank of Italy data. Rounding may cause discrepancies.
(1) Including transactions of the Bank of Italy, provincial treasury sections and Poste Italiane S.p.A. Since 30 November 1998 the cash balances from securities settlement have not been transmitted to BI-COMP for clearing but settled directly in BI-REL on a gross basis. Express II began operations on 8 December 2003, and the securities settlement procedure was terminated on 23 January 2004. – (2) Transactions net of the balances of auxiliary clearing systems. Includes incoming and outgoing cross-border payments net of transactions with the Bank of Italy. – (3) Does not include transactions settled on centralized accounts outside BI-REL.

*BI-REL.* – The Bank of Italy's real-time gross settlement system handled more than 51,000 transactions a day in 2006 with a value of over €195 billion, or 13 and 7 per cent respectively of the payments handled by TARGET, of which BI-REL is the Italian component. Both domestic and cross-border payments through BI-REL increased, by 15 and 17 per cent respectively. Interbank payments grew faster than customer payments (17 and 9 per cent). The growth in interbank transactions was fuelled by the increase from €22 billion to €25 billion a day in payment orders transmitted to BI-REL through the gross component of the Express II securities settlement system. There was a slight contraction in the volume of domestic trades on the screen-based interbank deposit market e-MID, which are settled automatically in BI-REL, together with an appreciable growth in trades with non-resident counterparties.

BI-REL also settles the balances from ancillary domestic systems and those deriving from the transactions of Italian banks in ancillary international systems. The former expanded significantly, increasing by more than 11 per cent compared with 2005, owing almost entirely to the increase in settlements of the net component of Express II (from €19.7 billion to over €22 billion a day). The daily volume of BI-REL settlements of Euro 1 and CLS balances came to about €2.2 billion.

Payments in BI-REL are highly concentrated. By value, the five most active banks settle more than 50 per cent of all transactions, and the top three alone (one large Italian bank and two branches of foreign banks) almost 35 per cent. These three banks accounted for most of the increase in the amounts handled in 2006; very active in securities custody and settlement for foreign customers, they made extensive use of interbank transactions, mostly cross-border, to balance their liquidity positions in connection with securities trading (for a daily average totalling more than €17 billion).

There was a slight increase in the turnover rate of the reserves held with the central bank. The total payments debited to the banks' accounts rose from 4.9 to 5.1 times the sum of compulsory reserves and intraday liquidity advances.

The use of intraday advances averaged nearly €5 billion, an increase of 8.6 per cent in absolute terms but stable at around 6 per cent in proportion to the value of payments settled. The value of collateral posted was broadly unchanged at €16.1 billion, reflecting more efficient use of lines of credit. The peak drawing on intraday liquidity in the course of the business day, which averaged €7.4 billion, coincided with the settlement of maturing e-MID transactions.

Drawings of intraday advances are highly concentrated at just a few banks. Over 80 per cent of drawings and 50 per cent of collateral were accounted for by the same three banks that were responsible for most of the increase in settlement flows.

The foreign assets posted as collateral for intraday advances, equal to 54 per cent of the total in 2006, were mainly mobilized via links between central securities depositories, even though utilization of the correspondent central banking model grew by 25 per cent compared with 2005. Following the inclusion of bank loans among eligible assets starting 1 January 2007, two Italian counterparties began to use loans as collateral. At the end of March the stock of bank loans pledged as security with the Bank of Italy amounted to about €4 billion, mostly in respect of monetary policy operations.

*BI-COMP.* – The volume of funds handled by the BI-COMP clearing system increased by 7 per cent to €3,400 billion. Growth was faster for the non-documentary transactions handled by the retail sub-system than for the paper-based payments exchanged in local clearing houses (8 per cent as against 4 per cent). Virtually all the volume was accounted for by just three types of payments: credit transfers (47 per cent), cheques (29 per cent), and bill collections (20 per cent). The clearing system handled nearly 2 billion transactions in 2006, an increase of 2.7 per cent compared with 2005. A reduction of more than 3 per cent in the number of cheques, which includes both truncated cheques and items presented to local clearing houses, was more than offset by the increase in POS debit card transactions (29 per cent), credit transfers (7 per cent), and collection orders (more than 3 per cent).

BI-COMP clearing balances amounted to €420 billion, an increase of 12 per cent compared with 2005. The ratio of balances to flows rose from 11.8 to 12.3 per cent. The three participants with the largest flows accounted for 27 per cent of total value.

In keeping with European retail payment developments, the Bank of Italy has decided to adapt the BI-COMP system to the SEPA requirements for settlement infrastructures.

In November 2006 the six large Italian banks that are shareholders in EBA began using their link to the pan-European STEP2 system to settle not only cross-border but also domestic credit transfers. In the first four months of 2007 a total of 6.5 million domestic credit transfers were transmitted to STEP2, equal to about 6 per cent of those handled in BI-COMP (and 7 per cent by value). On 6 November 2006 the Bank of Italy joined STEP2, for the purpose of acquiring an alternative to TARGET for executing the Bank's own cross-border credit transfers and offering the service also to domestic banks requesting it.

### *TARGET2, TARGET2-Securities and CCBM2*

*TARGET2.* – The new TARGET2 European payment system will be launched on 19 November 2007, responding to the banks' need for harmonized advanced services, especially for liquidity management. The new system is centralized, with a single platform shared by all the participating central banks.

*TARGET2-Securities and CCBM2.* – In July 2006 the Governing Council of the ECB announced that it would study the creation of a "TARGET2-Securities" system, to be owned and operated by the Eurosystem, for the settlement of securities transactions in central bank money. The project is designed to make post-trading services in the euro area more efficient and economical and to harmonize the securities settlement procedures, thus heightening competition. In March 2007 the Governing Council concluded that the project was feasible. It is to be carried out by the Bank of Italy and the central banks of France, Germany and Spain, making full use of synergies with TARGET2.

In parallel with the TARGET2-Securities project, the Governing Council stated its intention to review the current Eurosystem collateral handling procedures for credit operations, to increase efficiency and reduce costs for banks. The project, called "Collateral Central Bank Management" (CCBM2) will exploit synergies with TARGET2 and TARGET2-Securities to create a single technological platform for the management of both domestic and cross-border collateral.

# 18. SECURITIES TRADING AND SETTLEMENT SYSTEMS

## *The process of European financial market integration*

Stock exchange management companies, originally formed as cooperatives of exchange users, continued their trend towards conversion into for-profit operating companies and international consolidation in both Europe and the United States. Large intermediaries, exploiting the scope opened up by the EC's MiFID Directive on markets in financial instruments (Directive 39/2004), have reacted by forming alliances of their own to create alternative trading venues to regulated markets. This will heighten competition between exchanges and intermediaries and affect the process of price formation.

After the failure of the negotiations for a federal alliance among the leading European stock exchanges, the process of consolidation became worldwide, with the integration of Euronext and the New York Stock Exchange. The change in the control of Euronext under the new corporate structure also affects Italy's MTS S.p.A., whose capital is held by MBE Holding, a joint venture between Euronext (51 per cent) and Borsa Italiana (49 per cent). The Spanish stock exchange management company has been listed for trading on its own exchange.

One of the most significant initiatives undertaken by the intermediaries is the Turquoise project prepared by a consortium of seven large international brokerage operators to create a trading venue in competition with the European stock exchanges. The MiFID Directive lays down pre-trade and post-trade transparency requirements for the various venues (regulated markets, multilateral trading facilities and systematic internalizers) and obliges them to guarantee best execution for investors. To avoid the risk of a dispersion of liquidity, the solution envisaged is to concentrate in a single forum (the "consolidator") all the information from the various trading systems, plus more extensive cooperation and information interchange among oversight authorities. The extension of transparency requirements to bond trading is also being taken into consideration.

In the European bond market the activity of electronic trading platforms is growing, especially those that give institutional investors direct access. Increasingly, these screen-based exchanges offer integrated trading and post-trading services, thanks to central counterparties that guarantee more efficient management of default risk. Telephone trading is still prevalent in the interbank deposit market, where the only electronic platform in the euro area is e-MID, operated by e-MID S.p.A.

## *The wholesale market in government securities*

Turnover on the spot segment of MTS returned to growth in the second half of 2006 following three years of progressive contraction. The increase involved all types of security except CCTs. The fastest growth in trading was in BOTs. Turnover on the other spot markets operated by the MTS group diminished, in particular on EuroMTS.

Average daily spot turnover on MTS was €6.4 billion last year, an increase of 3.6 per cent compared with 2005. BOTs accounted for 24 per cent of trading (19 per cent in 2005), BTPs for 52 per cent and CTZs for 7 per cent (both the same as in 2005), and CCTs for 14 per cent (down from 19 per cent). Trading in 30-year BTPs increased, led by institutional investors, whose strategy was influenced by recent changes in accounting standards and regulatory provisions.

The average bid-ask spread widened slightly. The number of participants and the degree of concentration remained stable. There was a significant increase in recourse to the central counterparty. The spread widened by about 0.5 basis points to 4.3 basis points. The number of participants decreased by one to 118. The share of trading volume accounted for by the top five traders rose from 25 to 27 per cent, while that of the top 10 traders was unchanged at 46 per cent. Trades guaranteed by the two central counterparties, Cassa di Compensazione e Garanzia and LCH.Clearnet SA, accounted for a full 62 per cent of total trading volume in 2006, compared with just 21 per cent in 2005.

The repo segment of MTS, after contracting slightly in 2005, returned to growth with an increase of 15 per cent in trading volume.

BondVision, the MTS S.p.A. venue for trading between intermediaries and institutional customers, recorded further growth both in trading volume (up 28 per cent) and in the number of participants (from 273 to 295). The increase in business was due to greater interest on the part of institutional customers in electronic trading and to the growing number of instruments traded.

## *The interbank deposit market*

Turnover on e-MID, the interbank deposit market operated by e-MID S.p.A., increased by 11 per cent in 2006. The participation of foreign banks favoured the concentration of trading in the large-deal segment, which the major banks prefer because of the larger minimum lot. Both the number of banks and the degree of concentration of trading were stable. There was increased interest in the broken-date contracts now offered by e-MID.

Average daily volume was €24.2 billion (€21.8 billion in 2005), 88 per cent of it again being accounted for by overnight loans. In the first quarter of 2007 the average daily volume of funds transferred rose further to €26.9 billion.

Foreign banks accounted for about 46 per cent of the overall volume in 2006, compared with 41 per cent in 2005. The large-deal segment accounted for 56 per cent of the market, compared with 50 per cent in 2005, with average daily volume of €13 billion (€11 billion in 2005). In the dollar segment, the turnover was $1.50 billion a day ($1.56 billion in 2005).

The decline in trading in the overnight indexed swap segment (e-Mider) continued. The average daily volume came to €150 million, compared with €450 million in 2005. The decline can be ascribed to greater competition from other European electronic trading platforms, which attracted the business of large foreign intermediaries.

## *Central securities depositories*

The European clearing and settlement industry has seen major initiatives by the public sector that will affect the strategic choices of operators. The TARGET2-Securities project will have an impact on the activities of central securities depositories.

In October 2006 European stock exchanges, central counterparties and central securities depositories signed a Code of Conduct for the provision of guarantee and settlement services for transactions in shares, in response to the Commission's urging to stimulate competition between systems.

Italian post-trading entities extended the range of services offered and took measures to strengthen their technological infrastructure. An expansion of business brought a significant improvement in net operating profit, to €22 million for Monte Titoli (an increase of 26 per cent) and €14.3 million for Cassa di Compensazione e Garanzia (up 13 per cent).

*Central depository services.* – The financial instruments in custody with Monte Titoli increased by 9 per cent at market prices to €2.7 trillion. The number of issues handled by the depository rose by 6 per cent and securities transfer orders by 23 per cent. The Italian central depository remained third in Europe in value of securities handled, behind Euroclear and Clearstream.

*Securities settlement.* – The number of transactions entered daily into the net component of the Italian Express II settlement system operated by Monte Titoli increased by more than 8 per cent in 2006 to 103,000, while their value decreased by 7 per cent to €165 billion. About 69 per cent of the transactions came from Italian regulated markets; those guaranteed by the central counterparties – Cassa di Compensazione e Garanzia and LCH.Clearnet SA – increased their share of the total from 17.3 to 32.6 per cent. The portion of transactions settled on the day specified in the contract remained extremely high (98.8 per cent by value).

The share handled by the daytime cycle increased, confirming the trend recorded in 2005, and that handled by the overnight cycle fell from 84.6 to 80.9 per cent of transaction value.

The number of participants in the net component of Express II remained practically stable. The concentration of business at a few members increased further. There was greater recourse to the system's automatic activation of intraday credit from the Bank of Italy.

The results of gross settlement improved. The number of transactions handled and their value both increased. The time to settlement of transactions transmitted from the net system was reduced. The percentage of transactions not settled at the end of the day remained unchanged.

*Clearing and guarantee services.* – The activities of Cassa di Compensazione e Garanzia in the equity and bond markets continued to expand. In the cash segment of the equity markets it handled 58.4 million contracts, up from 47.9 million in 2005, for an average daily value of about €4.5 billion (€3.7 billion in 2005). In the equity derivatives market (Idem), there was an increase both in the number of contracts (from 25.8 million to 31.6 million) and in value (which grew by 29 per cent to €1.2 billion).

In the spot and repo markets for government securities, Cassa di Compensazione e Garanzia recorded an increase both in the number of participants and in the turnover. The value of repos traded came to €3,921 billion compared with €1,680 billion in 2005; in the spot segment turnover rose from €128 billion to €471 billion.

The strong performance of the markets resulted in another increase in 2006 in the initial margins posted with Cassa di Compensazione e Garanzia. The collateral required rose to a daily average of €2.2 billion from €1.8 billion in 2005. Participants posted excess collateral, bringing the daily average daily to €2.9 billion.

The activities of Cassa di Compensazione e Garanzia include forcible execution of contracts that are not settled for lack of securities (buy-ins) or for lack of liquidity (sell-outs) to guarantee the successful completion of transactions when they reach the expiry date set by the market. The buy-in procedure was executed 51 times in 2006 for a total value of €22 million; there were no sell-outs.

# THE GOVERNOR'S CONCLUDING REMARKS

I wish to pay grateful and affectionate tribute to the members of the Directorate who left the Bank in 2006 after decades of dedicated, rigorous and judicious work. They accompanied me in my first steps in this institution, providing the support of their loyalty and experience.

Vincenzo Desario, who was appointed Director General in 1994, served the Bank in the exercise of highly sensitive functions, notably in the area of banking supervision. He led the Bank on an interim basis after the resignation of Antonio Fazio. He stamped his mark indelibly on the Bank's approach to prudential supervision, principles of internal organization and daily administrative practices. The Board of Directors has named him Honorary Director General.

Pierluigi Ciocca, who had been Deputy Director General since 1995, gave the Bank the benefit of his profound, original thinking and his vast economic and legal knowledge. He promoted the study of law and economics, inspired research for many years and helped to refine the analysis of the functions of central banking.

In 2006 the Directorate acquired new members with expertise and experience, some of it gained abroad. Fabrizio Saccomanni, who as Vice President of the European Bank for Reconstruction and Development was in charge of risk management at that institution for three years, has been Director General since October. Ignazio Visco, Central Manager for Economic Research and previously Chief Economist of the OECD for five years, and Giovanni Carosio, formerly Central Manager for Banking and Financial Supervision, joined Antonio Finocchiaro as Deputy Directors General in December. The Directorate's new membership combines valuable experience in the international arena with intimate knowledge of the Bank, analytical and research skills with specialization in the area of regulation and central banking.

The Bank's new Statute was approved last year. It modifies the operations of the Bank's decision-making bodies: the Board of Directors, the Board of Auditors and the Directorate. It establishes the principle of collegiality for measures that have external significance.

The Bank intends to renew itself, and has already begun to do so. The reorganization taking place affects the functions of the Head Office, the branch network and the representative offices abroad; it provides for the full integration of the Italian Foreign Exchange Office. The aim is to reduce bureaucratic procedures, simplify and rationalize working practices, thus fostering individual responsibility, reallocate resources from the Bank's internal administration to its institutional functions, and tap into new recruitment channels, as with the forthcoming competitive examination for economists that is open to applicants from abroad.

We are on the point of implementing the reorganization of the activities of economic research and international relations, with the objective of structuring their tasks better according to particular needs: to contribute to setting the common monetary policy by monitoring and forecasting short-term economic developments and analyzing monetary strategy and transmission mechanisms; to study the fundamental problems of Italian economic development; to carry out research on the world economy and cooperate with international organizations; to refine economic statistical methodology and disseminate economic and financial statistics. The plan for the reorganization of the supervisory departments is being finalized, to give greater weight to the macroeconomic analysis of risk, the quality of regulation and consumer protection. There will be more interaction between research and supervision, and off-site and on-site supervision will be more closely integrated and have more methods in common. Measures affecting the other functions will follow in due course.

The Bank of Italy is also reviewing the principles and procedures for managing its own portfolio of financial assets. The aim is to increase transparency and separate the investment of its own resources more clearly from its other institutional activities.

The Bank of Italy has recently introduced numerous innovations in its operating procedures. Since the beginning of 2007 banks have been permitted to include bank loans among eligible collateral for Eurosystem financing operations. Since mid-April the Bank has conducted new very-short-term borrowing transactions on behalf of the Ministry for the Economy and Finance, making treasury management easier and more predictable. On behalf of the same Ministry, it has launched the General Government Transactions Information System, which will enable government entities to evaluate their cash flows in real time and facilitate the adoption of electronic payment procedures. The project for the development of the new TARGET2 platform for settling large-value payments, which is being carried out in conjunction with the Bank of France and the Bundesbank, has reached an advanced stage. TARGET2, which will come into operation in November, centralizes the technical infrastructure of the European payment system, reducing the cost of cross-border interbank transactions. It will allow the ever-growing number of banks with a presence in more than one European country to operate with a single account in central bank money and curb the cost of treasury operations.

The branch network will be reorganized on a regional basis in forms that are more appropriate for the present day and without abandoning the Bank's nationwide presence. Reducing the tasks of self-administration and increasing those with greater technical content will give branch staff new opportunities for learning and professional growth.

Wide-ranging discussions with the trade unions on the organizational changes have been under way for several months. I hope that broad consensus will be reached before long on action to strengthen the Bank's role and prestige and an agreement concluded on the necessary measures to assist the workers involved.

The Bank's expanding international commitments, the reform of its governance and the new operational initiatives have posed important challenges. The staff have faced them with their customary professionalism and dedication, born of a tradition that has cultivated the spirit of public service, a sense of identification with the institution and merit-based selection in recruitment and promotions. I wish to express my gratitude to all the members of staff.

The principles of Community law, primary legislation and the provisions of the Bank's Statute protect the absolute autonomy of the Bank in the performance of its institutional functions from possible influence by its shareholders. However, the criteria for share ownership appear obsolete and do not ensure a sufficiently broad distribution of shares. The new bill on the reform of the regulatory authorities goes in the right direction, being based on the principles of the independence of the Bank and of a balanced distribution of its share capital.

Credibility and independence are essential to the performance of our duties. The autonomy of the central bank, though protected by law, can be fragile unless it is supported not only by authoritative analysis but also by consequent action.

## *The world economy, finance and monetary policy*

The world economy grew by 5.4 per cent in 2006, the highest rate for more than thirty years. The slowdown in the United States was offset by continued strong expansion in China and the other emerging countries and by the recovery taking place in the euro area and Japan.

World trade continued to expand at a rate of over 7 per cent. Economic integration has been an important driving force of the uninterrupted growth of recent years. It is threatened by the resurgence of protectionist tendencies; the signs are visible, most notably in the stalled negotiations on the Doha Round of liberalization measures.

The persistent increase in current payments imbalances continues to pose a risk. The current account deficit of the United States reached 6.5 per cent of gross domestic product in 2006, the highest ratio ever recorded; with its counterpart in the growing surpluses of China and other Asian countries and oil producers, it has been financed easily thus far, but the share held by foreign authorities is rising.

The financial sector has made a fundamental contribution to economic growth in recent years by permitting unprecedented capital mobility and facilitating efficient capital allocation and by smoothly financing imbalances that in another era would have been disruptive. Financial innovation has enhanced market liquidity and reduced volatility.

The expansion in the markets and the continued process of financial innovation are also changing the pattern of risks.

The use of derivative instruments has grown further. Their notional value is now equal to ten times world GDP. Alongside instruments serving to hedge market risks, there has been a rapid expansion in those for the transfer of credit risk; the notional value of credit default swaps more than doubled in 2005 and doubled again in 2006. By making it possible to slice up credit risk and evaluate it precisely, allocating it and spreading it among a multitude of market participants, credit derivatives help to raise the productivity of the financial system, just as new production technologies boost that of the real economy. However, they can become a source of instability if intermediaries use them not to hedge existing risks, but to increase the volume of risks they assume.

In addition, credit derivatives can modify the modus operandi of the banks that use them. If lenders transfer part of the risk to others, the incentive to evaluate borrowers' creditworthiness can weaken. A sign of this is to be seen in the rise in sub-prime mortgage defaults in the United States, where the transfer of risk is commonplace.

Abundant liquidity and low interest rates have contributed to the vigorous growth of hedge funds and private equity funds. Their role in the functioning of the markets has been positive, but the scale of the phenomenon, the high leverage of hedge funds, the demand from investors and counterparties for greater transparency and the potential risks of instability require the attention of the market and regulators. Supervisors seek to limit systemic risk, relying on market discipline by pressing the intermediaries under their direct supervision to obtain the necessary information from hedge funds and satisfy themselves that procedures are in place for the best management of risk.

Risk premiums have now fallen for a broad spectrum of financial instruments and markets. Investors' perception of risk could suddenly change; an abrupt portfolio adjustment, whatever the cause, would have destabilizing effects on exchange rates and financial markets. Although it is more able than in the past to absorb small and medium-sized shocks, the financial system may have become more vulnerable to "extreme" events that have a low probability of occurring but potentially disruptive effects, due not least to the system's increasing complexity and the growing interdependence between markets.

The development of new instruments and the emergence of new types of intermediary also pose unprecedented challenges for monetary policy. More than ever before, the financial markets are a source of information on trends in economic activity and the expectations of economic agents; central banks' actions are reflected more rapidly in the prices of financial assets. At the same time, the money and credit aggregates are being increasingly affected by the conduct of non-bank intermediaries; financial innovation is complicating the interpretation of the behaviour of monetary aggregates.

From December 2005 onwards the Governing Council of the European Central Bank has gradually moved towards a less accommodating monetary policy stance; it has raised official interest rates by 1.75 percentage points since then. At a time of strengthening economic activity, expanding employment and sharply rising energy and commodity prices, our decisions have kept inflation expectations firmly anchored to the objective of price stability. For the first time a powerful oil shock had no repercussions on inflation.

Money and credit continue to grow strongly. Despite the impact of financial innovation on the velocity of circulation, monetary aggregates remain a fundamental element in the strategy of the Eurosystem.

In nominal effective terms, the euro appreciated by almost 5 per cent in 2006. One factor in the strength of the single European currency has been the improved economic outlook for the area, in the face of fears of a slowdown in the United States.

Monetary policy has remained conducive to growth. Real short-term interest rates are still below the average for the area over the last twenty years. Long-term rates have risen, but by less than in comparable phases of past cycles. The gradualness and careful communication of monetary policy decisions have helped maintain stable conditions in the money and financial markets.

Consumer price inflation in the euro area was 2.2 per cent in 2006, just over half the rate recorded in the early nineties. A similar reduction occurred in the industrial countries as a whole, while in the emerging economies inflation fell from 60 per cent to 5 per cent. This remarkable achievement is attributable to the independence of central banks and the clarity of their statutory objectives, and also to the increase in competition triggered by the opening-up of markets.

## *To strengthen growth in Italy*

The Italian economy has been recovering since the middle of 2005. Growth strengthened during 2006, to an average of nearly 2 per cent, a result that had not been achieved for five years. A similar rate of growth is expected in 2007, despite the slowdown in the first quarter. The recovery has been fuelled by investment and the growth in demand abroad, especially in Germany. Employment has risen substantially, but still largely in the number of temporary jobs.

The Italian economy may have shaken off economic stagnation, but its rate of growth is still one of the lowest in the euro area. In the first half of this decade labour productivity fell in every sector, and especially in industry. The disparity in relation to the rest of the euro area indicates slowness in the adaptation of Italian industry to the changes in the technological and competitive environment.

The recent improvements in productivity and exports, though still modest and largely cyclical, may nevertheless suggest that a process of restructuring has begun.

### *The restructuring of the industrial sector*

A survey of more than 4,000 firms carried out in recent months by researchers at the Bank provides initial indications that this is indeed happening. More than half of the industrial firms in the sample have changed strategy in the last five years. The 12 per cent of firms that have shifted their product range towards new sectors earned higher than average profits in 2006. One firm in five, almost double the ratio compared with the beginning of the decade, is adopting some form of internationalization, ranging from cooperation with foreign partners, the preferred solution for small firms, to the outsourcing of manufacturing or marketing. In all the firms the importance of investment in product development, design, brands, and distribution and customer-service networks has increased. Among medium-sized and large companies the use of new technologies for integrated corporate management is becoming more prevalent and the proportion of better-educated staff is rising; corporate profits have benefited as a result. Profits are also inversely correlated with the age of company leaders, a fact of great significance in the country of family capitalism: firms that have tackled generational changeover report higher average profits.

Our survey, the many case studies accompanying it and data from other research bodies paint a picture of change, owing partly to a more severe winnowing of firms. According to the Chambers of Commerce, the number of manufacturing firms deleted from the registers has exceeded new registrations by more than 50,000 over the last five years. Confronted with the dual shock of globalization and technological change, the economy is beginning to react.

It would be wrong to conclude that the crisis of productivity and competitiveness of the last few years is now behind us. Productivity in industry, which fell by 3 percentage points between 2001 and 2005, rose by just over 1 point last year; in Germany, France and Spain it increased by between 3 and 6 per cent. The divergence of trends in unit labour costs has become more pronounced. We still have a long road ahead of us.

Company size remains crucial. Companies must achieve sufficient scale to support the high fixed costs of continuous innovation and an active presence in distant markets; even more than in manufacturing plant, scale matters in developing products, fostering brand recognition and standing, and organizing production. Field surveys reveal obstacles to growth. In our study, 40 per cent of the firms that considered themselves to be too small missed out on opportunities to expand by means of acquisition or merger over the past decade.

## *A gap to close*

The transformation of the economy is being hampered by an institutional framework that still has major shortcomings, although it must be recognized that progress has been made. The reduction of unemployment, though important, is the only area in which Italy is in step with the timetable envisaged in the Lisbon Agenda. Italy is behind schedule as regards raising the employment rate, especially for women and older workers, education, vocational training, reducing the risk of poverty, innovation, and compliance with environmental constraints; in many cases the lag is greater than the average for the Union as a whole.

Last year I pointed to areas where structural measures are of particular importance for the growth of the economy and its enterprises. I would like to revisit some of those issues in the light of developments since then.

Education continues to head the list of fields where change is most necessary. The low international ranking of the Italian school system has a geographical aspect that deserves attention. The disparity in levels of scholastic achievement between North and South is significant even in primary school and tends to widen thereafter. One of every five 15-year-olds in the South is "knowledge poor", which is the prelude to economic poverty; the disparity is even larger if the South's higher drop-out rate is taken into account. Such a marked geographical difference shows that the problem lies not only in the rules but also in their practical application.

The recruitment of teachers, their distribution between regions and different types of school, and their career paths are governed by mechanisms that feature, at different stages, both precariousness and irremovability. Mobility bears little relationship to educational need, merit or capability. Every year more than 150,000 of Italy's 800,000 teachers change assignments in an arduous progression towards their desired position. Another negative factor is the delay in developing an effective school assessment system, which the experience of other countries suggests is an indispensable complement to school autonomy. Changing the Italian school system must begin with a recognition of the vicious circles that penalize it, demoralize teachers and betray the mission of public education. It is here that the problems originate, and not in a shortage of resources for education per student, which in Italy are actually above the European average.

For an advanced economy, an even more direct and immediate contribution to growth comes from the university system. Some important reforms enacted in the past, ranging from financial autonomy to the evaluation of the quality of research, have still not been completed. Priority in the allocation of public resources should be given to financing scholarships for worthy and less well-off students. Universities should be able to compete for students and public funding on the basis of the quality of their teaching and research staff, selected for their academic standing and paid accordingly.

The degree of competition in the domestic market in both public and private services affects the growth of firms competing in the international arena. In the countries where the legal and regulatory obstacles to competition in energy, telecommunications, transport and professional services are greater, manufacturing industry grows more slowly. Until a short time ago Italy was – and in some respects still is – among the countries where regulation is most unfavourable to consumers. To date, liberalization in the energy sector has been halting. Although the price of electricity for industrial users in Italy has risen only very slowly in recent years, excluding taxes it is still among the highest in Europe, about 20 per cent above the average. Action to liberalize the market for services, which has been initiated, is essential to regain competitiveness and growth. This objective should also be pursued because of the effects it will have on consumers' welfare, not least in terms of income distribution. In 2005 more than 15 per cent of the monthly consumer spending of the poorest 20 per cent of the Italian population went for goods and services now the subject of liberalization measures: €140 out of a total of €940, half of which was for energy in various forms.

The shortcomings are particularly prevalent in local public services, notably urban public transport and the collection and disposal of waste. The succession of rules enacted in the nineties were designed to separate the management of services, to be awarded by competitive mechanisms, from activities that are natural monopolies, and assigning regulatory powers to local government. These guidelines have been frequently disregarded. The results in terms of the cost and quality of services have been disappointing, with geographical differences depending on the administrative capabilities of local authorities.

Liberalization has progressed in other fields. In professional services, where Italian regulations had been the most restrictive among the advanced economies, the initiatives undertaken in 2006 have brought the level of regulation close to the middle of the international range. Action in the retail sector needs to be continued, by establishing not only in law but also in practice the principle that sales outlets should not be rationed geographically except on sound environmental grounds and by guaranteeing the full application of this principle at regional and local level.

The failings of the Italian civil justice system are documented in international studies and demonstrated by the inconvenience suffered by individuals and firms. An international comparison of the length of legal proceedings is unforgiving. To take just one example: labour disputes take an average of more than two years to pass through the lower courts in Italy, compared with a year in France and less than six months in Germany. The slowness of justice is due not so much to lack of resources as to organizational weaknesses and defects in the system of incentives. Here too there is a specific Southern problem; an ordinary civil case in lower court takes three times as long in Messina as in Turin, averaging 1,500 days against 500. The universal application of information technology would make proceedings speedier and more efficient and the operation of the various offices transparent; it would also supply the basic information that is indispensable for effective reorganization.

Information is vital if inefficiencies are to be eliminated. The quality of the services supplied must become the yardstick for evaluating government departments and the activity of their managers. The objectives must be clear and verifiable. Differentiating earnings partly on the basis of individual productivity, evaluated uniformly and transparently, would help attain them. This is provided for in the Memorandum of Understanding concluded between the Government and the trade unions last January.

Infrastructure represents an unresolved problem. The experience of recent years, after the amendment of Title V of the Constitution, has shown that concurrent decision-making between central and regional government is laborious and frequently ineffective. In the general interest, consideration should be given to the possibility that in certain cases it would be advisable, once a certain time has elapsed, to relieve the central government of the obligation to obtain the assent of the regional and local authorities. It must be possible to allow local needs to be expressed without for ever blocking public works that are necessary to the modernization of the country.

## *Sustainable public finances*

According to Government estimates, net borrowing will come to 2.3 per cent of GDP in 2007, half a percentage point better than the target set at the end of last year. The primary surplus will rise to 2.6 per cent.

To ensure the sustainability of the public finances, deficit reduction must continue, with incisive action on the size and composition of the budget.

At the end of 2006 Italy's public debt reached €1,575 billion, or nearly €27,000 per person. For thirty years, from 1964 to 1994, its ratio to GDP rose steadily, from 32 per cent to 121 per cent. It then declined by 18 points by 2004, turning upwards again since then. Without asset disposals and the restructuring of liabilities, the ratio of debt to GDP would be approximately the same today as in 1994.

The accumulation of debt has not helped Italy to grow. It has not endowed the country with adequate infrastructure.

High debt constrains public policies; it requires higher taxes and reduces the resources available for investment and welfare expenditure. With interest rates rising, albeit by very little so far, interest payments are again tending to increase. They are already equal to the amount spent on public education and to two thirds of that spent on health care.

In 2005 there were 42 persons aged 60 or more for every 100 of working age. By 2020 they will have risen to 53 and by 2040 to 83. These trends will affect spending on pensions, health care and social assistance. The choice we face is whether to reduce the debt burden in the next ten years, before the aging of the population becomes more pronounced, or to wait, but in this case accepting major changes in the support that society will be able to provide to its weakest members.

The recent improvement in the public finances is due to the sharp increase in revenue. According to the Government's estimates, the ratio of tax and social security contributions to GDP will rise further this year. It is higher than the European average and close to the peak levels of the last few decades. Among the large European countries, France alone has a higher ratio. Because of tax evasion, which remains high despite signs of a recovery in tax receipts, the difference between Italy and the rest of Europe is greater in terms of the burden on honest taxpayers. The statutory tax rates on both labour and capital are high; the corporate income tax rate is only lower than that in Germany, where the Government recently announced a cut of 9 percentage points. An excessive level of taxation and the variability and complexity of tax rules discourage investment in physical and human capital and raise the cost of compliance.

Only by permanently reducing current expenditure can the deficit be curbed and the debt lowered without increasing the tax burden. Since 2000 primary current expenditure has risen by an average of one percentage point more per year than GDP. Its ratio to GDP has reached 40 per cent, comparable to the highest post-war levels.

The expenditure mechanisms need to be changed. In 2006 primary current expenditure still grew by 3.6 per cent, compared with the Government's budget forecast of 1.1 per cent. There is scope for saving in all the major items of the budget; the revision of expenditure programmes that the Government has commenced goes in the right direction. Redistributive policies also need to be subject to a cost-benefit analysis.

A lasting adjustment requires action on the pension system. Life expectancy continues to rise and the number of Italians of working age to diminish; meanwhile, the employment rate is the lowest in the euro area. It is necessary to raise the average effective retirement age over time, not least in order to maintain an adequate level of benefit. The architecture of the system introduced in 1995 must be applied. Close correlation between an individual's pension contributions and benefits reduces the distortions in levies and disparities of treatment between different categories of worker, and permits flexibility in the choice of retirement age. Rigorous and prompt application of the adjustment mechanisms envisaged by the current legislation is essential.

But it will not be possible to return the system to a sustainable path and at the same time guarantee workers adequate pensions without a rapid and resolute launch of supplementary pension provision, which is still underdeveloped. The returns on investments in supplementary pension plans are likely to be better than those on severance pay funds, and further advantages derive from the additional contributions from employers and favourable tax treatment. The decision to bring forward the introduction of implied consent for the assignment of accruing severance pay to supplementary pension funds to 2007 and the new forms of flexibility in the use of accumulated savings move in the right direction. However, in many cases enrolment in supplementary funds is being discouraged by the excessive fees charged to savers; little of the benefit of the economies of scale generated by the growth of pension fund assets has materialized so far. Competition must increase; fees are insufficiently transparent and the restrictions on portability are excessive. The limits on the transferability of employers' contributions need to be reconsidered. Information must be improved: if workers are not fully acquainted with the facts of the public pension that they will receive in the future, they are not in a position to make informed decisions. Supplementary pension plans need to be extended to public employees as soon as possible.

Without prejudice to the stability of the public finances, and given that overall contributions to the public pension system equal 33 per cent of wages, by far the highest rate among the major European countries, thought should also be given to permitting individual employees to make voluntary allocations of a limited portion of their public pension contributions to supplementary pension schemes.

## *The financial industry and the capital markets*

Italian open-end investment funds, which had 17 per cent of Italian households' savings under management in 1999, now have barely 7 per cent. The outflow of resources, which is still influenced by tax disparities, has gathered pace lately, and in the last three years amounted to almost €100 billion. The presence of foreign funds has grown as a result of distribution agreements with Italian banks, while Italian banking groups have moved part of their operations abroad.

Asset management strategies are still subordinated in large part to those of the controlling companies. Reducing the conflict of interest inherent in the cross-shareholdings with banks and insurance companies and the consolidation of asset management companies are vital for the growth of the industry. As I have already had occasion to remark, an open architecture and a clear separation between companies and between owners benefit bank shareholders and fund clients alike.

The presence of private equity in Italy is growing, although the volume of transactions remains far below that of the other main European countries. Between 2003 and 2006 the number of Italian management companies rose from 26 to 49 and funds' financial resources from €3 billion to €6 billion. Above all, the growth is among companies not belonging to banking or insurance groups; in 2006 they accounted for more than half the total resources invested.

Intermediaries specializing in the provision of equity capital can foster the growth of small and medium-sized enterprises, contribute to strengthening management, facilitate listing on the stock exchange and accompany generational changeover. Family ownership is a pillar of Italian capitalism; the entrepreneur's sense of identification with his enterprise is a driving force of growth. Precisely for this reason it is important to have the means of facilitating a changeover when this is necessary. When family owners lose their taste for creative risk, when the wealth invested in the business begins to be seen only as a source of rents or private benefits of control, the immobility of ownership may hold back the growth of the business and set it on a downward path. It is at this juncture that firms have the greatest need of these intermediaries. The potential benefit to all from a changing of the guard is then at its highest, as sometimes is the resistance of the owners.

There is a close link between the spread of specialized intermediaries and the growth of the stock exchange. More than a third of the Italian companies that listed between 1995 and 2006 were assisted by private equity firms, thus increasing access to the stock market in Italy, which until now has remained restricted mainly to large firms and has a much lower market capitalization than its counterparts in the other industrial countries.

In a rapidly evolving international context, the strategies that Borsa Italiana intends to pursue remain to be defined: its shareholders need to provide clarification. Consolidation between companies managing the international markets is under way; the integration of technical infrastructures has accelerated sharply. This offers excellent growth prospects for those who participate, but raises questions as to the long-term fate of those who remain on the sidelines.

Simple ownership structures increase firms' ability to attract equity investment. An appropriate system of corporate governance satisfies a need for fairness in the treatment of shareholders' property rights, but also criteria of efficiency. Less-than-transparent systems make it difficult for minority shareholders to provide a stimulus, accentuate the self-referential nature of management and protect the private benefits of the controlling group.

Italian listed companies frequently use complex organizational structures. Compared with other methods of separating ownership from control, a pyramid structure may make it more difficult to evaluate intra-group transactions adequately and increase the group's opaqueness. The complexity of the leading groups has declined in Italy in the last few years. Between 1990 and 2006 the average number of listed companies per group fell from 6.8 to 2.5, the number of layers of control diminished, and the control leverage decreased. Although changes in tax law and in the rules on group transparency played a part, this reduction in complexity was mainly due to market pressure. It is above all the application of the rules on intra-group transactions and the protection of minority shareholders that still needs to be strengthened. In the same period the market value of listed companies controlled under shareholders' agreements rose from 18 to 22 per cent of the total and their number from 5 to 11 per cent.

## *Banks*

A year ago Italy's two largest banks ranked seventh and eighteenth in Europe in terms of stock market capitalization. The top three cooperative banks held 49 per cent of the category's assets in Italy. Today, if the operations announced by their boards of directors go ahead, the two leading Italian banks will climb to third and eleventh place, and the three largest cooperative banks will account for 73 per cent of the assets of that category.

What is happening in Italy is part of the process of banking consolidation that has been under way in Europe for several years. Most of the mergers have originated within individual countries; in some cases they have subsequently evolved into cross-border operations. Where the outcome has been successful, the resulting banks enjoy considerable economies of scale, benefit from greater risk diversification, and are highly capitalized.

The lead time before the synergy underlying a merger or acquisition must translate into greater shareholder value and more efficient customer service has been drastically reduced, however. The advent of the single currency, the growth of the financial services industry, and globalization itself have created a European and world market in bank ownership and control. Neither size nor nationalistic defences can safeguard those banks which, although sound, do not constantly seek to increase their value; the market therefore needs to see the fruits of consolidation very soon after the more complex stages of the operation have been completed. Concentration of the supply of banking services must not lead to a lessening of competition: customers must reap the full benefits of economies of scale.

Crucially, the governance, corporate structure and organizational arrangements the new banking groups adopt must ensure that they are soundly and prudently managed.

In many instances, the banks created by consolidation have introduced new forms of corporate governance, opting for the two-tier system; the activities of the new groups are coordinated by their operational holding company. The two-tier system of governance is effective if it is adopted in a way that ensures a clear division of responsibilities between the various corporate bodies. Overlapping responsibilities are detrimental to efficient decision-making and are considered by shareholders to destroy value; clear lines of responsibility also safeguard stability.

Particular attention must be paid to internal controls where a group holding company is formed or its scope is expanded to embrace the entity created by the consolidation. New banking groups must take prompt measures to ensure centralized risk management, particularly with regard to the most vulnerable lines of business. Special emphasis must be placed on reputational risk. Risk assessment models must be adopted and control functions put in place without delay.

The acquisition of large corporate shareholdings has become part of the strategy of the leading banking groups. For the banks, this means assuming new types of risk and may give rise to conflicts of interest. By law, such holdings have long been restricted in order to safeguard the stability of credit intermediaries. Developments in risk management techniques and in supervisory best practices now make rigid limits ineffective. Some time ago the Bank submitted a proposal to the Interministerial Committee for Credit and Savings that would allow to reduce administrative constraints by raising the limits on banks' permissible shareholdings; this is rendered possible by a supervisory system based on precise assessment of all the risks, adequate capital to cover them, the control of conflicts of interest by means of governance and transparency safeguards, and in the future more effective regulation of connected lending.

Assessment of the merit of individual mergers is left to the market and the banks' shareholders, who must be assured full information and adequate opportunities to be heard. They in turn have a duty, particularly in this regard, to be especially active in ensuring that the objective of mergers and acquisitions is to increase value and then in verifying that management decisions are consistent with that aim. This role should be performed in particular by institutional investors, given their fiduciary responsibility towards those who have entrusted them with their savings, and by banking foundations, which manage funds in the interest of the community. The latter's responsibility is all the more delicate and important for being less clearly defined in formal terms.

The present limits on non-financial corporations' shareholdings in banks and the associated prohibition on their acquisition of controlling interests will also be reviewed in the light of the forthcoming Community legislation.

Conditions are now ripe for reform of the legislation governing cooperative banks, to which it is hoped they will make a constructive contribution. A regulatory structure originally designed for small banks is in some respects no longer adequate to cope with the increasingly broad and fragmented ownership that has emerged as a result of consolidation. The legislative proposals to raise the limits on individual shareholdings, strengthen the role of institutional investors and broaden the mechanisms for proxy voting, without destroying the cooperative nature of such banks, are to be welcomed.

In 2006 the capital adequacy ratio of Italy's banking system rose to 10.7 per cent, although that of the leading groups declined slightly. In 2008 all Italian banks will adopt the criteria of the Basel II Accord. Depending on the composition of risk, this may lead to reduced capital requirements; it will certainly result in greater variability between banks. In order to guarantee leeway, the Bank of Italy is working to ensure that banks' capital ratios, in relation to the degree of risk and the accuracy of risk management methods, remain well above the minimum requirement. Discussions with the banking groups that plan to adopt internal systems for calculating their capital requirements have intensified of late.

In recent years cost reductions have contributed to the improvement in the operational efficiency of the leading Italian banking groups, which is now on a par with the average for the major European banks. Despite the progress that has been made, return on equity is lower, however, mainly owing to heavier loan losses; although favourable economic conditions are contributing to an improvement, the quality of Italian banks' assets is still lower than that of the other leading European banks.

The exposure of Italian banks to hedge funds represents less than 3 per cent of their capital. Their exposure to private equity funds is larger; together with loans to the companies in which these funds invest, it amounts to 13 per cent of their capital.

Exposures are concentrated among the large banks. In the credit derivatives market the banking system is on average a net buyer of protection.

The integration of the European markets brings new challenges for supervisors. The coordination bodies created by the Lamfalussy procedure have helped to harmonize regulation and strengthen cooperation among the authorities of the various countries. In 2006 we took part in coordinated simulations of critical events, so as to be ready to cope with episodes of instability having international effects. The convergence of supervisory practices must be carried further, to make the system less cumbersome, reduce the costs for banks and ensure equal competitive conditions.

To simplify the rules while protecting stability and to keep watch over banks' reputations by increasing the safeguards for customers have been our principles in regulating the banking system.

In 2006 and the early months of 2007 the Bank of Italy abolished the requirement to give advance notice of the intention to acquire control of a bank, repealed the rules on maturity transformation and the limits on banks' medium and long-term lending to firms, simplified the procedures for opening new branches, issued regulations for banks' covered bonds to create a broad and reliable market, and launched a review of all the supervisory legislation with a view to drastically reducing the number of authorizations.

Public confidence remains essential for the soundness of banks. The Bank of Italy verifies compliance with the rules on the transparency of banking and financial transactions and services; the extensive checks it makes at intermediaries help to improve the standard of their dealings with customers. In addition to ensuring contractual correctness, the information banks give to customers must be clear and simple. In order to strengthen the real protection of savers and firms, we plan to review all the legislation on transparency and reduce the bureaucratic formalities.

We have launched a new survey on the cost of bank current accounts, among other things to ascertain the importance of structural factors such as the impact of taxation and the excessive use of cash.

The recently approved European directive on retail payment services opens the market to new operators, such as large retailers and mobile phone companies; it increases competition, reduces costs, broadens the supply of services and lays the foundations for an integrated payment system in Europe. The Bank of Italy will support an extensive application of the directive, which it is to be hoped will soon be transposed by Parliament.

* * *

Italy has transformed its banking system, begun to put its public finances in order and started to grow again.

I have already reported on the progress made by the banking system. The role we played in this regard was neutral, not detached. We indicated the objective, not the actors: to aim for growth, abandoning the parochialism of the past and accepting the challenge of the market. This was where the transformation originated, not in the plans of the authorities. It is now essential that shareholders, households and enterprises clearly discern the benefits, in the shape of stronger banks ready to offer a wider range of services at lower cost. Finally, the conflicts of interest that are ever present in the land of cross-shareholdings have to be resolved. The Bank will follow all of these developments closely.

A modern financial system does not tolerate the mixing of politics and banking. Let the separation be clear-cut, and both will be strengthened.

For the public finances once again to foster growth and not hamper it, their adjustment must involve less current spending, more investment and lower taxes, and above all it must continue; we have ceased to accumulate debt, we have not begun to reduce it.

We must tackle the structural weaknesses of our economy with greater determination. Household consumption, eroded by the extraction of rents and held in check by uncertainty about the outcome of reforms deeply affecting people's lives, must regain its vigour.

Never dealing with the problem of pensions definitively has a cost in terms of lost growth and lower consumption.

These are attainable objectives if we all, each according to his own role and without tarrying to lament lost opportunities but drawing strength from awareness of the progress already made, can rediscover that sense of the common good that is essential to the enduring development of the country.

# THE BANK OF ITALY’S ANNUAL ACCOUNTS

# 19. MANAGEMENT REPORT AND ANNUAL ACCOUNTS

The Bank of Italy's results for the year are presented using a new explanatory format to assist comprehension and interpretation. The layouts of the balance sheet and the income statement have also been revised to make the aggregates they contain easier to evaluate. The annual accounts are accompanied by a report on operations giving an overview of the events that influenced the Bank's business and had an impact on the accounts. The report on operations is an addition to the instruments traditionally used by the Bank to report on its activity: the Annual Report, the *Bollettino di Vigilanza*, and periodic and occasional testimony before Parliament by the Bank's highest officers. Since 2006 the Bank has presented a report to Parliament and the Government on its activity, pursuant to Law 262 of 28 December 2005 (the Law on Savings).

In February the Bank's balance sheet was sent to the European Central Bank for consolidation with the other Eurosystem central banks.

The draft annual accounts have been transmitted to the Minister for the Economy and Finance.

The annual accounts for the year ended 31 December 2006 closed with a net profit of €134 million.

## MANAGEMENT REPORT

### *The Bank's new institutional structure*

Implementing Article 19 of the Law on Savings, the Bank's Statute was amended and the Bank's governance redesigned.

Measures of an institutional nature having external significance are adopted by the Directorate on a collegial basis. To permit this decision-making system to function better, the number of members of the Directorate was increased from four to five. Other amendments update the rules for appointing, re-appointing and removing the Governor, and introduce a fixed term with limits of reappointment for the decision-making and control bodies (the Directorate, the Board of Directors and the Board of Auditors).

The Board of Directors is charged with the general administration, management oversight and internal control of the Bank. The Board of Auditors, whose oversight of observance of the law is confirmed, is now formally entrusted with accounting control. Independent external auditors audit the accounts, as required by the Statute of the European System of Central Banks.

The Directorate has been expressly assigned the task of submitting the draft annual accounts to the Board of Directors, which after approving them submits them to the Board of Auditors and the shareholders' meeting for final approval.

The Code of Conduct for members of the Directorate was issued during the year. The Code establishes ethical standards based on the principles of independence, impartiality, fairness and transparency, all fundamental values for the Bank.

Further information on the matters mentioned above is to be found on the Bank's website (www.bancaditalia.it), where the Bank's organization chart and branch structure are also available.

### *Strategic and operational planning*

The Bank has launched a plan for the reorganization of the Head Office, the branch network and the representative offices abroad and the incorporation of the Italian Foreign Exchange Office (UIC) into the Bank. The aim is to strengthen the Bank's institutional action, rationalize its nationwide presence on a regional basis and enhance and make better use of the staff's expertise.

*As part of the reorganization plan, a first measure reconfiguring the economic research function at the Head Office was submitted to the Board of Directors for approval in April 2007. The objective* *is to achieve greater integration and coordination of the activities currently performed by the Bank's organizational units and thus improve their capacity to respond to developments in the international and domestic context. The new Economic Research and International Relations Functional Area will be composed of four departments whose tasks correspond to the distinct contributions of the Bank in the fields of euro-area monetary policy-making, national economic policy analysis, analysis of international economic and financial policy and national statistics.*

The planning instruments that the Bank has been using for some time – the Multi-Year Plan and sectoral operational plans – will be adapted to support the proposed reorganization.

*The projects for priority implementation in the three years 2007-09 have been identified under the guidelines established by the Directorate. Those with international implications include the redesigning of the Supervisory Instructions and associated models of analysis and evaluation of intermediaries on the basis of the new Basel capital rules and, in the field of payment systems, measures to increase the efficiency and harmonization of payment services in the euro area. In particular, the Bank of Italy, together with the central banks of Germany and France, is developing the single platform of the Target2 gross settlement system. Further harmonization concerns the creation of the Single European Payments Area (SEPA) for retail payments.*

Together with the planning instruments, the procedures for expenditure budgeting and control provide informational and operational support to ensure observance of the principles of economic efficiency, functionality and transparency of resource management and adequate coordination of the different processes within the Bank.

The operating expenses connected with realizing the projects and performing current activities are covered by income from the investment of own funds, other uses of resources, and charges for services that the Bank provides.

A substantial portion of expenditures for goods and services derives from the use of advanced IT technologies to provide services to the community and intermediaries, the decisions made at European level entrusting banknote production to the Bank, and security measures for managing banknote circulation.

The principle that the action of the national central banks and European Central Bank must be carried out making efficient use of resources was confirmed in "The mission of the Eurosystem", a document published in 2005. The document stresses the need to exploit synergies between central banks and to avoid overlapping activities (the document is available on the ECB's website, www.ecb.int).

After an initial phase in which convergence concerned institutional functions, the national central banks have also begun to discuss the corporate aspects of the activities they perform, studying homogeneous rules and methods to make the costs incurred comparable.

## *Human, IT and logistical resources*

In the field of human resources, the objective of efficient management is coupled with that of enhancing the value of existing staff.

At 31 December 2006 the Bank had 7,548 employees: 3,724 assigned to the Head Office, 3,667 in the branch network, 20 working at the representative offices abroad and 137 seconded to other national and international authorities, entities and institutions. Managers and officers made up, respectively, 7.96 and 17.34 per cent of total personnel. The staffs' average age was 47.8 years. About one third of all employees were women.

Table 19.1

**Composition of the Bank's staff**

| | At 31 December 2005 | | | | | At 31 December 2006 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Men | Women | **Total** | At branches | At Head Office (1) | Men | Women | **Total** | At branches | At Head Office (1) |
| Managers | 544 | 111 | **655** | 226 | 429 | 489 | 112 | **601** | 202 | 399 |
| Officers | 934 | 391 | **1,325** | 452 | 873 | 909 | 400 | **1,309** | 435 | 874 |
| Coadjutors | 808 | 456 | **1,264** | 672 | 592 | 755 | 453 | **1,208** | 625 | 583 |
| Other | 3,288 | 1,425 | **4,713** | 2,600 | 2,113 | 3,055 | 1,375 | **4,430** | 2,405 | 2,025 |
| **Total** | **5,574** | **2,383** | **7,957** | **3,950** | **4,007** | **5,208** | **2,340** | **7,548** | **3,667** | **3,881** |

(1) Includes personnel assigned to representative offices abroad and seconded to other organizations.

The number of staff declined by 409 in 2006 (and by 1,852 over the last ten years). Last year there were 610 departures, for the most part among clerical workers, and 201 entries. Hiring was targeted to meet needs for specialized skills and for ongoing generational turnover.

Bank personnel took part in numerous working groups established at European and international level to study problems of common interest and propose organizational and operational solutions.

Among activities to promote the staff's professional development, training programmes were run again in 2006 to improve technical and specialized, computer, language and managerial skills. The programmes, which make increasing use of distance training methods, involved 4,789 employees, with an average of just over 29 hours of training time per participant.

The reorganization plan will create new opportunities for professional development, in terms both of strengthening and consolidating skills and of expanding and diversifying work experience.

IT is of key importance for the Bank in the institutional activities it performs as central bank and supervisory authority and in the payment system. Spending on IT in 2006 fell under two major headings: management of the existing stock of applications and hardware, to guarantee high standards of security, and development of new information systems and infrastructure, to meet growing external and internal demand.

Several important projects were completed, including that aimed at making bank loans eligible as collateral in monetary policy operations and the project that introduced the economic approach in the Bank's accounting as of 1 January 2007. The economic approach involves the daily calculation and booking of the accruals related to financial instruments denominated in foreign currency. The new TARGET2 gross settlement system, which will improve the efficiency and security of payments in the euro area, is nearing completion. In the field of the State treasury service, which uses electronic procedures, the General Government Transaction Information System, operated by the Bank, provides an efficient means of monitoring central and local public finances.

The investments made in central processing platforms have led to the creation of infrastructure with high levels of performance, security and business continuity.

Significant investments have been made in the most recent period for Internet services, document management and data availability for operations, analysis and research.

A share of overall IT expenditure goes to strengthening and maintaining the existing information systems. Corporate functions have increasingly benefited from new technologies.

At the end of the year the Bank's real estate had a book value of €3,615 million, of which €490 million referred to property in which staff severance pay and pension provisions have been invested.

The principal property management measures in 2006 concerned the logistical reorganization of the units operating in the Rome area, the upgrading of buildings and their safety features to regulatory standards, the strengthening of anti-crime security systems, and checks on the anti-seismic adequacy of the Bank's buildings. There were further disposals of buildings not used for institutional activities.

### *Note issue*

Within the Eurosystem the Bank participates in studying and testing new banknote security features and contributes to the drafting of common guidelines for the quality of the banknotes in circulation and measures against counterfeiting.

In 2006 the Bank of Italy produced 1.2 billion banknotes in 20, 50 and 100 euro denominations. It put 2.1 billion banknotes into circulation, for a total value of €85.8 billion. The return flow to the Bank amounted to 1.9 billion banknotes worth €69.1 billion; most of these banknotes were subjected to automatic selection at the Bank's branches.

Growing demand for banknotes, the need to replace worn notes and, from the end of this decade, the gradual issue of the second series of euro notes will lead to a significant increase in production levels in the coming years and have made it necessary to adopt some structural measures to expand the production capacity of the Printing Works.

Banknotes in circulation at the end of 2006 amounted to €119.7 billion (19.1 per cent of the Eurosystem total), up by 16.2 per cent from €103.0 billion at the end of 2005; the amount recorded in the accounts (€105.5 billion) represented the 16.8 per cent share of total Eurosystem circulation notionally assigned to the Bank of Italy.

## *Financial resources*

Ownership of the country's official reserves is assigned by law to the Bank of Italy. The reserves make it possible to service the Italian Republic's foreign currency debt and meet its commitments to international organizations such as the International Monetary Fund. In addition, since the nation's official reserves are an integral part of the Eurosystem's reserves, their overall level and proper management contribute to safeguarding the credibility of the European System of Central Banks.

To ensure that the institutional tasks are performed effectively, the foreign currency reserves are managed with the aim of guaranteeing high levels of liquidity and security, while maximizing the long-term expected yield.

At 31 December 2006 the gold and foreign currency reserves were worth €62.7 billion, compared with €60.4 billion a year earlier. The increase mainly reflected the 11 per cent rise in the price of gold. The decrease in the value of foreign currency reserves was due to the reduction in net assets vis-à-vis the IMF and the depreciation of the US dollar and Japanese yen against the euro, offset only in part by valuation gains on the pound sterling.

The reserves are invested essentially in bonds, deposits and securities reverse operations; a portion is invested on the international futures markets.

The UIC manages a portion of the foreign currency reserves in the name and on behalf of the Bank. At the end of 2006 it held reserves in dollars and yen worth €8.8 billion and €1.4 billion respectively.

Market risk is controlled using benchmarks that reflect medium/long-term preferences in terms of risk-return combinations determined on the basis of indicators such as value-at-risk and financial duration. The benchmarks, together with the leeway permitted to the units that manage the reserves, are approved by the Directorate.

Table 19.2

**Compositions of the reserves** (1)
*(millions of euros)*

| | 2006 | 2005 |
|---|---|---|
| US dollars | 14,759 | 15,500 |
| Pounds sterling | 6,363 | 6,069 |
| Japanese yen | 2,087 | 2,354 |
| Swiss francs | 822 | 495 |
| Other currencies | 1 | 1 |
| Gold | 38,050 | 34,279 |
| Net assets vis-à-vis the IMF (includes SDRs) | 640 | 1,660 |
| **Total** | **62,722** | **60,358** |

(1) The reserves are valued at market exchange rates and prices.

Credit risk is controlled by means of a prior evaluation of counterparties' soundness. In addition, ceilings are set for issuers, counterparties and financial instruments.

The Bank also holds a financial portfolio, whose composition reflects risk-return combinations defined over a long time horizon and with prudential criteria.

At the end of 2006 the book value of the portfolio was €86.7 billion, compared with €70.3 billion at the end of 2005; the increase was concentrated in the government securities component. If all listed financial instruments were valued at market prices, the value of the portfolio would be €89 billion.

The Board of Directors decides whether securities are to be booked as fixed assets or held for trading. The bulk of the portfolio (89 per cent) consists of securities held as fixed assets and thus valued at cost, in accordance with Eurosystem accounting policies.

The portfolio also includes investments of balance-sheet provisions and reserves and of severance pay and pension provisions for staff hired before 28 April 1993.

*The Bank also manages the investments of the defined-contribution pension fund for staff hired since 28 April 1993. Its investments and earmarked estate are included in the Bank's books. The fund constitutes a separate estate for administrative and accounting purposes. Investments are made observing benchmarks. At 31 December 2006 the fund's net assets amounted to €83 million. Returns on assets and exposure to risk are measured daily.*

The Bank's overall portfolio is invested mainly in debt instruments (Italian and other euro-area government securities and securities issued by the European Investment Bank) and shares (most of them listed in the euro area); investments in bank shares are excluded. Units of collective investment undertakings specialized in equity investment were purchased in the final part of 2006.

Investment management is subject to the prohibition of monetary financing of member states and public institutions of the euro area, so that securities of such issuers are not purchased at issue. In addition, operating methods are used that do not interfere in the formation of the prices of financial instruments.

**Table 19.3**

**Composition of the financial portfolio**
*(millions of euros)*

| | 2006 | 2005 |
|---|---|---|
| Government securities | 78,391 | 62,830 |
| Shares and participating interests | 7,783 | 6,988 |
| Convertible bonds and warrants | 47 | 48 |
| Other bonds | 337 | 339 |
| Units of collective investment undertakings | 100 | – |
| Securities repos | – | 110 |
| **Total** | **86,658** | **70,315** |

Exposure to market risk is monitored with various indicators, including value-at-risk and, for the bond component, duration according to yearly slots. Investments are chosen with a view to geographical and sectoral diversification. To this end, in 2006 further investments were made in securities of other euro-area countries and disposals were made of equities in some sectors.

The financial assets held by a central bank, and in particular the foreign currency reserves, determine a high exposure to market risks. For this reason, the Eurosystem's accounting policies are based on the prudence principle. In particular, valuation gains are not included in the income statement but stated in specific revaluation accounts; valuation losses not covered by previous gains are instead charged to income. Offering further protection for the stability of the Bank, the provision for general risks can be used to cover losses relating to the Bank's overall activity. Allocations to and withdrawals from this provision are decided by the Board of Directors.

### *Balance-sheet highlights*

The year-end balance-sheet total rose by €33,528 million (from €185,029 million in 2005 to €218,557 million). The increase in earning assets (securities denominated in euros and intra-Eurosystem claims connected with the operations of the TARGET settlement system) is related to the increase in banknotes in circulation, general government deposits and legal reserve deposits.

At the end of 2006 the revaluation accounts, in which unrealized capital gains on gold, securities and foreign currency are recorded, amounted to €23,446 million (€18, 629 million for gold, €4,346 million for euro-denominated securities and €471 million for foreign currency).

In 2006 profit before tax and the allocation to the provision for general risks came to €1,199 million (€1,688 million in 2005). The result reflects the fact that, pursuant to the Bank's Statute, the return on investments of the ordinary and extraordinary reserves (€566 million) is allocated to the reserves and therefore does not contribute to the formation of profit.

The decline of €489 million from the previous year was due to the results on trading and to a swing of €969 million in the result on revaluation differences on securities and foreign currency (from a gain of €614 million in 2005 to a loss of €355 million in 2006). By contrast, the profit on ordinary operations (net interest income and dividends) improved from €2,625 million to €3,241 million.

Following the allocation of €703 million made in 2005, a further allocation of €396 million was made by the Board of Directors to replenish the provision for general risks, from which withdrawals of €4 billion had been made in 2002-04 to cover substantial valuation losses.

After taxes for the year (€669 million), the net profit for 2006 amounted to €134 million, an increase of €84 million with respect to 2005.

### *Post-balance-sheet events*

On 1 January 2007 ECB Guideline 16/2006 entered in force, superseding the accounting rules set out in Guideline 10/2002. The main changes concern the treatment of options and the introduction of the "economic approach", which requires the daily calculation and booking of the accruals related to financial instruments denominated in foreign currency.

Table 19.4

**Summary of the annual accounts Reclassified** (1)

*(millions of euros)*

| | Balance-sheet aggregates | Income statement | | | |
|---|---|---|---|---|---|
| | | *Interest* | *Results and writedowns* | *Other components of income* | *Contribution to net profit* |
| ***2006 FINANCIAL YEAR*** | | | | | |
| Gold | 38,050 | | | | |
| Position in foreign currency | 24,672 | *1,041* | *-354* | | *687* |
| Financial portfolio | 87,643 | *3,000* | *131* | | *3,131* |
| Lending to euro-area banks | 20,957 | *536* | | | *536* |
| Net intra-Eurosystem claims | 15,910 | *746* | | | *746* |
| Banknotes in circulation | 105,519 | | | | |
| Deposits for minimum reserve system | 17,157 | *-504* | | | *-504* |
| General government deposits | 22,945 | *-1,172* | | | *-1,172* |
| Revalutation accounts | 23,446 | | | | |
| Capital, reserves and provisions | 31,095 | | | | |
| *Other income, net* | | *28* | | *79* | *107* |
| *Operating expense and other costs* | | | | *-1,768* | *-1,768* |
| *Prior-year income and expense* | | | | *2* | *2* |
| *Appropriation of investment income to reserves under Article 40 of the Statute* | | *-434* | *-132* | | *-566* |
| **GROSS PROFIT** | | ***3,241*** | ***-355*** | ***-1,687*** | ***1,199*** |
| *Allocation to the provision for general risks* | | | | *-396* | *-396* |
| *Taxes on income for the year and productive activities* | | | | *-669* | *-669* |
| **NET PROFIT** | | ***3,241*** | ***-355*** | ***-2,752*** | **134** |
| ***2006 FINANCIAL YEAR*** | | | | | |
| Gold | 34,279 | | | | |
| Position in foreign currency | 26,079 | *780* | *358* | | *1,138* |
| Financial portfolio | 71,300 | *2,539* | *659* | | *3,198* |
| Lending to euro-area banks | 21,277 | *430* | | | *430* |
| Net intra-Eurosystem claims | 6,715 | *590* | | | *590* |
| Banknotes in circulation | 94,934 | | | | |
| Deposits for minimum reserve system | 11,451 | *-333* | | | *-333* |
| General government deposits | 14,663 | *-975* | | | *-975* |
| Revalutation accounts | 20,600 | | | | |
| Capital, reserves and provisions | 30,524 | | | | |
| *Other income, net* | | *28* | | *57* | *85* |
| *Operating expense and other costs* | | | | *-1,664* | *-1,664* |
| *Prior-year income and expense* | | | | *56* | *56* |
| *Appropriation of investment income to reserves under Article 40 of the Statute* | | *-434* | *-403* | | *-837* |
| **GROSS PROFIT** | | ***2,625*** | ***614*** | ***-1,551*** | ***1,688*** |
| *Allocation to the provision for general risks* | | | | *-703* | *-703* |
| *Taxes on income for the year and productive activities* | | | | *-935* | *-935* |
| **NET PROFIT** | | ***2,625*** | ***614*** | ***-3,189*** | **50** |

(1) The balance-sheet data refer to the end of the year. The data are reclassified as follows: the position in foreign currency includes the securities and other assets denominated in foreign currency (Items 2 and 3 on the assets side) net of the corresponding liabilities (Items 6, 7 and 8 on the liabilities side); the financial portfolio includes bonds, shares, participating interests and other financial assets denominated in euros and foreign currency allocated to Items 6, 7, 8, 11.3 and 11.4. It also includes the participating interest in the ECB (Item 9.1) and the UIC endowment fund (Item 11.2); the intra-Eurosystem claims (Item 9.4 on the assets side) are shown net of the debt related to the adjustment of the circulation (Item 9.2 on the liabilities side); with reference to balance-sheet aggregates that include shares and participating interests, the column *Interest* includes dividends; net income from fees and commissions, the pooling of monetary income and other withdrawals from provisions are included under *Other income, net*.

The central banks of Bulgaria and Romania joined the ESCB at the start of the year and the percentage share of the ECB's capital subscribed by each national central bank was altered accordingly. The Bank of Italy's share decreased from 13.0516 to 12.5297 per cent. This led to a decrease in its interest from €726 million to €722 million and in the corresponding claim on the foreign currency reserves contributed to the ECB from €7,263 million to €7,218 million.

With Slovenia's adoption of the euro, its central bank joined the Eurosystem.

Considering only the Eurosystem national central banks, the Bank of Italy's percentage share of the ECB's capital declined from 18.2563 to 18.0260 per cent. This weighting is applied to financial relationships between the Bank of Italy and the other Eurosystem central banks, for example in the distribution of the ECB's net profit.

Transactions in dollar-denominated exchange-traded funds have begun to be used in the financial portfolio in which the reserves provided for in the Bank's Statute are invested; the exchange risk is hedged with foreign exchange forward transactions.

On 30 April 2007 the exchange rates of the US dollar, pound sterling and Japanese yen against the euro stood at $1.3605, £0.6827 and ¥162.82, all three having weakened with respect to the end of 2006 ($1.3170, £0.6715 and ¥156.93).

# BALANCE SHEET AND INCOME STATEMENT
## for the year ended 31 December 2006

## BALANCE SHEET

| ASSETS | Amounts in euros at 31 December 2006 | 2005 |
|---|---|---|
| **1 GOLD AND GOLD RECEIVABLES** | **38,049,713,505** | **34,279,174,572** |
| **2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY** | **19,482,921,483** | **21,626,458,133** |
| 2.1 Receivables from the IMF | 1,442,125,295 | 2,510,117,195 |
| 2.2 Securities (other than shares) | 14,066,133,147 | 14,920,468,682 |
| 2.3 Current accounts and deposits | 3,844,246,298 | 4,191,899,816 |
| 2.4 Reverse operations | 127,073,842 | – |
| 2.5 Other claims | 3,342,901 | 3,972,440 |
| **3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY** | **6,856,912,396** | **6,929,534,590** |
| 3.1 Financial counterparties | 6,856,912,396 | 6,929,534,590 |
| *3.1.1 Securities (other than shares)* | *2,279,590,337* | *3,244,517,458* |
| *3.1.2 Reverse operations* | – | – |
| *3.1.3 Other claims* | *4,577,322,059* | *3,685,017,132* |
| 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** | **20,956,791,709** | **21,276,759,750** |
| 5.1 Main refinancing operations | 20,568,371,845 | 21,072,514,723 |
| 5.2 Longer-term refinancing operations | 388,360,223 | 204,185,386 |
| 5.3 Fine-tuning reverse operations | – | – |
| 5.4 Structural reverse operations | – | – |
| 5.5 Marginal lending facility | – | – |
| 5.6 Credits related to marginal calls | 59,641 | 59,641 |
| **6 OTHER CLAIMS ON EURO-AREA BANKS** | **10,256,392** | **115,111,983** |
| **7 SECURITIES ISSUED BY EURO-AREA RESIDENTS** | **1,977,265,298** | **1,939,412,655** |
| **8 GENERAL GOVERNMENT DEBT** | **18,251,848,454** | **18,405,970,514** |
| **9 INTRA-EUROSYSTEM CLAIMS** | **30,845,236,993** | **15,541,738,332** |
| 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) | 22,856,174,907 | 7,552,676,246 |
| **10 ITEMS TO BE SETTLED** | **7,715,584** | **1,137,334** |
| **11 OTHER ASSETS** | **82,117,970,342** | **64,914,149,535** (1) |
| 11.1 Euro-area coins | 29,749,139 | 36,418,012 |
| 11.2 UIC endowment fund | 258,228,450 | 258,228,450 |
| 11.3 Financial assets related to investments of reserves and provisions | 32,763,192,064 | 29,531,670,162 |
| 11.4 Other financial assets | 33,699,788,659 | 20,362,109,201 |
| 11.5 Intangible fixed assets | 30,969,284 | 27,865,779 |
| 11.6 Tangible fixed assets | 3,856,918,157 | 3,989,568,125 |
| 11.7 Accrued income and prepaid expenses | 1,199,375,024 | 758,581,472 |
| 11.8 Deferred tax assets | 7,696,395,078 | 7,961,476,337 |
| 11.9 Sundry | 2,583,354,487 | 1,988,231,997 |
| **TOTAL** | **218,556,632,156** | **185,029,447,398** |
| **13 MEMORANDUM ACCOUNTS** | **277,230,077,095** | **267,831,272,348** |

(1) The amounts for 2005 have been reclassified in line with the changes to the layout.

**THE ACCOUNTANT GENERAL:** Anna Maria Tarantola

**THE GOVERNOR:** Mario Draghi

*Audited and found correct - 24 April 2007*

**THE BOARD OF AUDITORS:** Giuseppe Bruni, Enrico Nuzzo, Angelo Provasoli, Massimo Stipo, Gianfranco Zanda

## BALANCE SHEET

| LIABILITIES | Amounts in euros at 31 December | |
|---|---|---|
| | 2006 | 2005 |
| **1 BANKNOTES IN CIRCULATION** | **105,519,190,400** | **94,933,679,360** |
| **2 LIABILITIES TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS** | **17,158,916,950** | **11,452,935,348** |
| 2.1 Current accounts (covering the minimum reserve system) | 17,156,764,192 | 11,451,124,748 |
| 2.2 Deposit facility | 2,152,758 | 1,810,600 |
| 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 EURO-AREA RESIDENTS DENOMINATED IN EUROS** | **22,963,778,039** | **14,707,403,877** |
| 4.1 General government | 22,944,941,571 | 14,662,533,655 |
| *4.1.1 Treasury payments account* | *22,294,785,953* | *14,405,375,705* |
| *4.1.2 Sinking fund for the redemption of government securities* | *552,944,403* | *166,396,749* |
| *4.1.3 Other liabilities* | *97,211,215* | *90,761,201* |
| 4.2 Other counterparties | 18,836,468 | 44,870,222 |
| **5 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN EUROS** | **88,448,209** | **91,029,853** |
| 5.1 Current accounts (covering the minimum reserve system) | 56,943,430 | 49,667,292 |
| 5.2 Deposit facility | 31,504,779 | 41,362,561 |
| **6 LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY** | **–** | **–** |
| 6.1 Financial sector counterparts | – | – |
| 6.2 General government | – | – |
| 6.3 Other liabilities | – | – |
| **7 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY** | **866,140,753** | **1,627,000,102** |
| 7.1 Deposits and balances | 10,207,047 | 11,248,769 |
| 7.2 Other liabilities | 855,933,706 | 1,615,751,333 |
| **8 COUNTERPART OF SDRs ALLOCATED BY THE IMF** | **801,859,840** | **849,833,760** |
| **9 INTRA-EUROSYSTEM LIABILITIES** | **14,208,918,325** | **8,100,701,800** |
| 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 | 14,208,918,325 | 8,100,701,800 |
| 9.3 Other liabilities within the Eurosystem (net) | – | – |
| **10 ITEMS TO BE SETTLED** | **28,549,723** | **29,975,193** |
| **11 OTHER LIABILITIES** | **2,246,189,431** | **2,062,697,836** (1) |
| 11.1 Bank of Italy drafts | 712,604,755 | 614,082,157 |
| 11.2 Accrued expenses and deferred income | 70,650,030 | 51,313,428 |
| 11.3 Sundry | 1,462,934,646 | 1,397,302,251 |
| **12 PROVISIONS** | **6,392,202,181** | **6,753,370,840** |
| 12.1 Provisions for specific risks | 722,303,819 | 1,088,394,839 |
| 12.2 Sundry staff-related provisions | 5,669,898,362 | 5,664,976,001 |
| **13 REVALUATION ACCOUNTS** | **23,446,340,100** | **20,600,378,145** |
| **14 PROVISION FOR GENERAL RISKS** | **7,931,281,997** | **7,535,281,997** |
| **15 CAPITAL AND RESERVES** | **16,771,058,495** | **16,234,874,914** |
| 15.1 Capital | 156,000 | 156,000 |
| 15.2 Ordinary and extraordinary reserves | 11,229,489,963 | 10,693,306,382 |
| 15.3 Other reserves | 5,541,412,532 | 5,541,412,532 |
| **16 NET PROFITS FOR DISTRIBUTION** | **133,757,713** | **50,284,373** |
| **TOTAL** | **218,556,632,156** | **185,029,447,398** |
| **18 MEMORANDUM ACCOUNTS** | **277,230,077,095** | **267,831,272,348** |

(1) The amounts for 2005 have been reclassified in line with the changes to the layout.

**THE ACCOUNTANT GENERAL:** Anna Maria Tarantola **THE GOVERNOR:** Mario Draghi

*Audited and found correct - 24 April 2007*

**THE BOARD OF AUDITORS:** Giuseppe Bruni, Enrico Nuzzo, Angelo Provasoli, Massimo Stipo, Gianfranco Zanda

## INCOME STATEMENT

| | | Amounts in euros 2006 | 2005 (1) |
|---|---|---|---|
| 1.1 | Interest income | 4,532,871,215 | 3,415,756,685 |
| 1.2 | Interest expense | -1,964,597,977 | -1,424,252,480 |
| **1** | **Net interest income** | **2,568,273,238** | **1,991,504,205** |
| 2.1 | Profits and losses on financial operations | -22,829,793 | 471,821,309 |
| 2.2 | Writedowns of financial assets and positions | -338,088,738 | -118,681,241 |
| 2.3 | Transfers to/from the provision for general risks for exchange rate and price risks | -396,000,000 | -703,000,000 |
| **2** | **Net result of financial operations, writedowns and transfers to/from risk provisions** | **-756,918,531** | **-349,859,932** |
| 3.1 | Fee and commission income | 26,000,806 | 24,345,967 |
| 3.2 | Fee and commision expense | -21,746,321 | -24,024,244 |
| **3** | **Net income from fees and commissions** | **4,254,485** | **321,723** |
| **4** | **Income from participating interests** | **1,159,158** | **798,161** |
| **5** | **Net result of the pooling of monetary income** | **15,429,612** | **6,350,235** |
| 6.1 | Interest income | 807,169,960 | 757,309,399 |
| 6.2 | Dividends from equity shares and participating interests | 297,743,456 | 309,164,460 |
| 6.3 | Profits, losses and writedowns | 137,763,645 | 663,438,665 |
| 6.4 | Other components | 2,063 | – |
| **6** | **Net income from financial assets representing investments of reserves and provisions** | **1,242,679,124** | **1,729,912,524** |
| **7** | **Other withdrawals from provisions** | **6,289,483** | **4,407** |
| **8** | **Other income** | **52,436,053** | **51,044,958** |
| | **TOTAL NET INCOME** | **3,133,602,622** | **3,430,076,281** |
| **9** | **Appropriation of investment income to reserves provided for in the Statute** (2) | **-565,539,832** | **-836,722,624** |
| 10.1 | Staff wages and salaries and related costs (3) | -633,760,260 | -604,835,746 |
| 10.2 | Other staff costs | -44,798,525 | -42,604,292 |
| 10.3 | Trasfers to provisions for accrued expense and staff severance pay and pensions | -101,855,098 | -97,295,981 |
| 10.4 | Pensions and severance payments | -367,992,108 | -264,102,724 |
| 10.5 | Emoluments paid to head and branch office collegial bodies | -1,826,233 | -2,635,975 |
| 10.6 | Administrative costs | -402,894,351 | -378,148,321 |
| 10.7 | Depreciation of tangible and intangible fixed assets | -194,270,409 | -254,242,306 |
| 10.8 | Banknote production services | – | – |
| 10.9 | Other costs | -20,198,814 | -20,213,731 |
| **10** | **Sundry expenses and charges** | **-1,767,595,798** | **-1,664,079,076** |
| **11** | **Other allocations to provisions** | **–** | **–** |
| 12.1 | Prior-year income | 6,043,939 | 59,280,441 |
| 12.2 | Prior-year expense | -3,837,577 | -3,767,677 |
| **12** | **Prior-year income and expense** | **2,206,362** | **55,512,764** |
| | **PROFIT BEFORE TAX** | **802,673,354** | **984,787,345** |
| **13** | **Taxes on income for the year and productive activities** | **-668,915,641** | **-934,502,972** |
| | **NET PROFIT FOR THE YEAR** | **133,757,713** | **50,284,373** |

(1) The amounts for 2005 have been reclassified in line with the changes to the layout. – (2) Made in accordance with Article 40 of the Statute. – (3) The average number of employees in 2006 was 7,868, compared with 8,027 in 2005.

| ALLOCATION OF THE NET PROFIT FOR THE YEAR | amounts in euros |
|---|---|
| **TO THE ORDINARY RESERVE** | **26,751,543** |
| **TO THE EXTRAORDINARY RESERVE** | **26,751,543** |
| **TO SHAREHOLDERS: 6% OF THE CAPITAL** | **9,360** |
| **AN ADDITIONAL 4% OF THE CAPITAL** | **6,240** |
| **TO THE STATE** | **80,239,027** |
| **TOTAL** | **133,757,713** |

**THE ACCOUNTANT GENERAL:** Anna Maria Tarantola **THE GOVERNOR:** Mario Draghi

*Audited and found correct - 24 April 2007*

**THE BOARD OF AUDITORS:** Giuseppe Bruni, Enrico Nuzzo, Angelo Provasoli, Massimo Stipo, Gianfranco Zanda

# NOTES TO THE ACCOUNTS

## *Legal basis, methods of preparation and layout of the annual accounts*

*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". This validity is recognized by Article 114 of Presidential Decree 917/1986 (Consolidated Income Tax Law) as amended by Legislative Decree 247/2005.

  The rules adopted by the ECB are contained in Guideline no. 10 of 5 December 2002 (now replaced by Guideline no. 16 of 10 November 2006), which contains provisions referring mainly to items of the annual accounts concerning the institutional activities of the ESCB and non-binding recommendations for the other items of the 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;

– the Bank's Statute (approved by a Presidential Decree of 12 December 2006), 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.

*Accounting policies*. – The accounting policies applied in preparing the annual accounts for 2006 are described below. Where provided for by law, they were agreed with the Board of Auditors.

*GOLD, FOREIGN CURRENCY ASSETS/LIABILITIES, SECURITIES*

*At the start of the Third Stage of EMU (1 January 1999) gold, foreign currency assets/liabilities and securities eligible for use in monetary policy operations were adjusted to the market prices and exchange rates obtaining at that date, with the resulting capital gains assigned to special revaluation accounts. These capital gains are included in the income statement on a pro rata basis in the event of disposals, redemptions and writedowns.*

*For gold, the capital gains still existing at 30 December 2002 were used in connection with the government bond conversion pursuant to Article 65.3 of Law 289/2002; the cost of gold, for tax purposes as well, is equal to the value stated in the accounts net of the pertinent revaluation account.*

*Gold and foreign currency assets/liabilities*

– *stocks, including those represented by foreign currency securities, are valued by applying, for each currency and for gold, the method of the "average-daily-net-cost", determined in the manner established by the ECB;*

– *for inclusion in the annual accounts gold and foreign currency assets/liabilities are valued on the basis of the year-end exchange rates and gold price communicated by the ECB; unrealized gains are included in the corresponding revaluation account, while unrealized losses are covered first by earlier unrealized gains and any amount in excess thereof is included in the income statement;*

– *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*

– *each type of security is valued by applying the method of the "average-daily-cost", determined in the manner established by the ECB.*

*In the case of bonds account is taken of 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 year-end valuation is effected:*

1) *for securities not held as fixed assets:*

   a) *listed shares and bonds, at the market price available at the end of the year; units of collective investment undertakings at the year-end value published by the management company. Unrealized gains are included in the corresponding revaluation accounts; unrealized losses are covered first by earlier unrealized gains for each type of securities and any amount in excess thereof is included in the income statement;*

   b) *unlisted bonds: at cost with account taken of any diminution in value corresponding to special situations relating 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 issuer are such as to cause the security's value to fall below cost;*

2) *for securities held as fixed assets: at cost, with account taken of special situations relating to the position of the issuer that cause the security's value to fall below cost. Foreign currency securities are translated at the historical exchange rate.*

*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 rate of 4 per cent established by the ECB. Land is not depreciated.*

*Plant and equipment*

– *are stated at cost, including improvement expenditure. They are depreciated on a straight line basis using the rates 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 Information Technology 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 euro-area 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, while 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". On the basis of the banknote allocation key the difference between the value of the banknotes allocated to each NCB and that of the banknotes it actually puts into circulation gives rise to remunerated intra-Eurosystem balances. From the year of the cash changeover and for the five subsequent years the intra-system balances arising from the allocation of euro banknotes will be adjusted in order to avoid significant changes in NCBs' relative income positions 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 reference period (from July 1999 to June 2001 for the Bank of Italy) and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments are reduced in annual steps for five years starting from the year of the cash changeover (1 January 2002 for Italy), 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 is to be 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 seigniorage income distributed by the ECB is 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 2006, as 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 is included under "Net claim/liability related to the allocation of euro banknotes within the Eurosystem".*

*PROVISIONS FOR RISKS*

*In determining the provisions for risks account is taken of the riskiness of the various sectors of the Bank's operations in an overall evaluation of adequacy. 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.*

*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.*

*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 provision for staff costs includes the estimated amount of costs that had accrued but not been paid at year-end;*
- *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 or who pay only a part of the contributions for retirement benefits, 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*

*Receivables are stated at their estimated realizable value, which coincides with their nominal value.*

*Deferred tax assets and liabilities are included in the financial statements on the basis of their presumable tax effect in future years. Deferred tax assets include those 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 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.*

*The other components are stated at their nominal value.*

*INTEREST RATE FUTURES DENOMINATED IN FOREIGN EXCHANGE*

*Initial margins in cash are recorded in the balance sheet among foreign currency claims, those in securities are recorded in the memorandum accounts. 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.*

*Changes to the layout of the accounts*. – The layouts of the balance sheet and income statement were updated in 2006.

A decree of the Ministry for the Economy and Finance dated 27 December 2006 altered the layout of the balance sheet as follows:

– more detail is now provided for "*Other assets*" by introducing two new sub-items: "*Other financial assets*" (11.4) and "*Deferred tax assets*" (11.8), which show amounts previously included in the "*Sundry*" sub-item. The first new sub-item includes securities held as fixed assets other than the investment of reserves and provisions; the second includes deferred tax assets . At the same time, in view of their analogous nature, "*Deferred charges*" have been included in "*Intangible fixed assets*" (11.5).
– the "*Cashier's department services*" sub-item of "*Other liabilities*" has been eliminated since the case no longer occurs.

The most important changes to the income statement compared with 2005 concern:

– the positive and negative components arising from the investment of reserves and provisions, which were previously included in "*Other income*" and "*Other costs*", are now shown net in a separate item "*Net income from financial assets relating to investments of reserves and provisions*";
– the "*appropriation of investment income to reserves provided for in the Statute*" is now shown separately from "*Sundry expenses and charges*";
– "*Prior-year income and expense*" are shown in a separate net item.

The items and sub-items of the balance sheet and income statement for 2005 have been reclassified in accordance with the changes to the layouts described above.

## *Comments*

On the balance sheet:

### Gold and assets and liabilities denominated in foreign currency

Includes the gold reserves, claims on and liabilities to the International Monetary Fund, securities and other net assets denominated in foreign currency, consisting mainly of current accounts, deposits and securities reverse operations.

| Gold and assets and liabilities denominated in foreign currency *(thousands of euros)* | 31.12.2006 | 31.12.2005 | Changes |
|---|---|---|---|
| **Gold (Item 1)** | **38,049,714** | **34,279,175** | **3,770,539** |
| **Assets and liabilities denominated in foreign currency** | **24,671,833** | **26,079,159** | **-1,407,326** |
| Assets denominated in foreign currency | 26,339,834 | 28,555,993 | -2,216,159 |
| *claims on non-euro-area residents (including the IMF) (Item 2)* | *19,482,922* | *21,626,458* | *-2,143,536* |
| *claims on euro-area residents (Item 3)* | *6,856,912* | *6,929,535* | *-72,623* |
| Liabilities denominated in foreign currency | 1,668,001 | 2,476,834 | -808,833 |
| *liabilities to non-euro-area residents (Item 7)* | *866,141* | *1,627,000* | *-760,859* |
| *counterparts of SDRs allocated by the IMF (Item 8)* | *801,860* | *849,834* | *-47,974* |

The changes were mainly due to the valuations at year-end.

More specifically, the increase in the value of gold – the quantity of which remained unchanged compared with 2005 (79 million ounces or 2,452 tons) – was entirely due to the rise in the metal's price. By contrast, the movements in exchange rates had a negative effect on the net position in foreign currency.

*The gold reserves are valued at the year-end market price in euros per fine ounce communicated by the ECB. This price was obtained by converting the dollar price of the London fixing on 29 December 2006 using that day's exchange rate of the euro against the dollar. Compared with end-2005, gold appreciated by 11 per cent (from 434,856 to 482,688 euros per ounce).*

*The exchange rates of the main currencies against the euro showed depreciations of the US dollar (from 1.197 to 1.3170), the yen (from 138.9 to 156.93) and the Swiss franc (from 1.5551 to 1.6069) and an appreciation of the pound sterling (from 0.6853 to 0.6715). There was also a depreciation of the SDR (from 1.2099 to 1.1416 euros per SDR). On the basis of these exchange rates there were unrealized losses covered by the corresponding revaluation accounts for dollars (€1,669 million) and SDRs (€127 million). The unrealized losses on yen, after reducing to zero the corresponding revaluation account of €13 million, were charged to the income statement (€258 million), together with those on Swiss francs (€29 million). By contrast, there were unrealized gains on pounds sterling (€126 million), which were entered in the corresponding revaluation account. After the above-mentioned movements, the revaluation accounts for gold and foreign currency amounted at the end of 2006 to €19,076 million, of which €18,629 million in respect of gold and €447 million in respect of the dollar and pound sterling (see the comment on Revaluation accounts).*

| Accounts with the International Monetary Fund *(thousands of euros)* | 2006 | 2005 | Changes |
|---|---|---|---|
| **Assets** | | | |
| **Receivables from the IMF (Sub-item 2.1)** | **1,442,125** | **2,510,117** | **-1,067,992** |
| *a)* Italy's net position vis-à-vis the IMF | 739,920 | 1,489,391 | -749,471 |
| *quota in the IMF* | *8,060,994* | *8,525,187* | *-464,193* |
| *IMF holdings* | *-7,321,074* | *-7,035,796* | *-285,278* |
| *b)* Participation in the PGRF | 496,007 | 827,287 | -331,280 |
| *c)* Special Drawing Rights | 206,198 | 193,439 | 12,759 |
| **Liabilities** | | | |
| **Counterpart of SDRs allocated by the IMF (Item 8)** | **801,860** | **849,834** | **-47,974** |

Net assets vis-à-vis the IMF diminished as a result not only of the valuation at the year-end exchange rate but also of:

– reimbursements by debtor countries that led to a reduction in Italy's net position vis-à-vis the Fund;

– the decline in Italy's participation in loans to support debt-reduction initiatives for the poorest countries (PRGF) following early redemptions.

**Securities denominated in foreign currency - stocks and movements**
*(thousands of euros)*

| | Stocks end-2005 | *Purchases, sales and redemptions* | *Gains and losses* | *Premiums and discounts* | *Other unrealized components* |
|---|---|---|---|---|---|
| Non-euro-area residents (Item 2) | **14,920,469** | *257,926* | *-33,314* | *202,485* | *127,676* |
| Euro-area residents (Item 3) | **3,244,518** | *-830,322* | *-776* | *79,375* | *36,403* |
| **Total** | **18,164,987** | ***-572,396*** | ***-34,090*** | ***281,860*** | ***164,079*** |

| | *Net revaluations* (1) | | *Writedowns* (2) | | Stocks end-2006 |
|---|---|---|---|---|---|
| | *price* | *exchange rate* | *price* | *exchange rate* | |
| Non-euro-area residents (Item 2) | *-167* | *-1,105,895* | *-44,138* | *-258,909* | **14,066,133** |
| Euro-area residents (Item 3) | *183* | *-248,574* | *-104* | *-1,113* | **2,279,590** |
| **Total** | ***16*** | ***-1,354,469*** | ***-44,242*** | ***-260,022*** | **16,345,723** |

(1) Increase/decrease in revaluation accounts. – (2) Entered in the income statement.

At the end of 2006 the portfolio of securities denominated in foreign currency consisted exclusively of bonds, for the most part issued by the US Treasury, the Japanese Government and international organizations.

Of the total portfolio 65 per cent consisted of securities denominated in US dollars, 21 per cent of securities denominated in pounds sterling, 12 per cent of securities denominated in yen and the remainder of securities denominated in Swiss francs.

The other foreign currency assets consisted mainly of time deposits (€7,118 million) and current accounts (€1,271 million), denominated primarily in US dollars and pounds sterling; on the liabilities side securities reverse operations were the most important component (€856 million).

### Monetary policy operations

Item 5 on the assets side and Item 2 on the liabilities side concern the operations carried out by the Bank of Italy in connection with the single monetary policy of the Eurosystem.

In 2006, as in the previous year, no use was made of *structural reverse operations*.

On the assets side the average stock of *main refinancing operations* declined from €19,527 million to €17,638 million, that of *longer-term refinancing operations* rose from €844 million to €1,102 million. On the liabilities side the deposits held by banks to fulfil their minimum reserve obligations averaged €17,544 million, compared with €15,902 million in 2005.

| **Monetary policy operations** *(thousands of euros)* | **31.12.2006** | **31.12.2005** | **Changes** |
|---|---|---|---|
| **Lending to euro-area banks (Item 5)** | | | |
| 5.1 Main refinancing operations | 20,568,372 | 21,072,515 | -504,143 |
| 5.2 Longer-term refinancing operations | 388,360 | 204,185 | 184,175 |
| 5.3 Fine-tuning reverse operations | – | – | – |
| 5.4 Structural reverse operations | – | – | – |
| 5.5 Marginal lending facility | – | – | – |
| 5.6 Credits related to margin calls | 60 | 60 | – |
| **Total** | **20,956,792** | **21,276,760** | **- 319,968** |
| **Liabilities to euro-area banks (Item 2)** | | | |
| 2.1 Current accounts (covering the minimum reserve system) | 17,156,764 | 11,451,125 | 5,705,639 |
| 2.2 Deposit facility | 2,153 | 1,810 | 343 |
| 2.3 Fixed-term deposits | – | – | – |
| 2.4 Fine-tuning reverse operations | – | – | – |
| 2.5 Deposits related to margin calls | – | – | – |
| **Total** | **17,158,917** | **11,452,935** | **5,705,982** |

## Other claims on euro-area banks

Item 6 on the assets side contracted by €105 million (from €115 million to €10 million) and consisted almost entirely of overnight deposits in connection with the Eurosystem Reserve Management Services (ERMS).

At the end of the year claims on financial counterparties in respect of repos involving securities denominated in euros unrelated to monetary policy had fallen to zero, from €109 million at the end of 2005. During the year repos totalling €21 million on average were carried out.

## Securities portfolio

In addition to the securities denominated in foreign currency included in Items 2 and 3 and discussed above, the Bank's portfolio comprises:

| **Securities portfolio** (*thousands of euros*) | **31.12.2006** | **31.12.2005** | **Changes** |
|---|---|---|---|
| *a)* securities related to investments of reserves and provisions | 32,763,192 | 29,531,670 | 3,231,522 |
| *b)* other securities denominated in euros | 53,895,210 | 40,673,800 | 13,221,410 |
| **Total** | **86,658,402** | **70,205,470** | **16,452,932** |
| *of which: held as fixed assets* | *76,741,091* | *61,255,295* | *15,485,796* |
| *not held as fixed assets* | *9,917,311* | *8,950,175* | *967,136* |

In more detail, the Bank's portfolio includes:

*a)* securities held as fixed assets and not held as fixed assets related to investments of reserves and provisions denominated in euros and to a very small extent in foreign currency.

At year-end 76 per cent of the portfolio consisted of bonds and the remainder of shares, participating interests and units of collective investment undertakings. Most of the investments in shares consisted of listed securities.

The controlling interests refer to Società italiana di iniziative edilizie e fondiarie S.p.A. (SIDIEF) and Società per la bonifica dei terreni ferraresi e per imprese agricole S.p.A.

The participating interests held as fixed assets also include shares of the Bank for International Settlements, which are denominated in SDRs, valued at cost and translated at historic exchange rates. The Bank's interest in the BIS is equal to 9.61 per cent of its capital.

*b)* other bond securities denominated in euros:

– not held as fixed assets and included in Item 7 (*Securities issued by euro-area residents*);

– held as fixed assets and included in Sub-item 11.4 (*Other financial assets*). The net purchases during the year mainly involved government securities issued by other euro-area countries; 69 per cent of the portfolio consisted of bonds issued by the Italian Government and the remainder of bonds issued by other euro-area countries;

– held as fixed assets and included in Item 8 (*General government debt*), assigned to the Bank following the bond conversion under Law 289/2002 and the termination of the mandatory management of stockpiling.

The government securities provided for in Law 289/2002 consist of BTPs issued at market conditions and received in 2002 to convert the 1 per cent government securities previously assigned to the Bank to convert the Treasury's current account in accordance with Law 483/1993. The reduction of €104 million corresponded to the annual accrued amount of the related discounts.

The securities deriving from the termination of the mandatory management of stockpiling consist of non-interest-bearing BTPs; the reduction of €50 million was due to the annual redemption of the securities falling due.

Another €34 million of claims deriving from the termination of the management of mandatory stockpiling, also included in Item 8, have not been converted into securities since the relevant legislation made the issue of such securities subject to approval by the State Audit Office of the accounts of the transactions that gave rise to the claims. Following legislation on this matter in 2006, the Bank is waiting for the Ministry for the Economy and Finance to decide how the amount is to be paid.

The bonds held as fixed assets referred to in points *a)* and *b)*, include securities whose book value (€37,848 million) was higher than the year-end valuation at market prices (€37,501 million). The securities in question – issued by the Italian Government, the governments of other euro-area countries and to a limited extent by international organizations – are recorded at cost in accordance with the accounting rules of the Eurosystem.

### Intra-Eurosystem claims and liabilities

These are shown in Item 9 on the assets and liabilities sides.

**Positions with the ECB and the other euro-area NCBs**
(*thousands of euros*)

| | 31.12.2006 | 31.12.2005 | Changes |
|---|---|---|---|
| 9.1 Participating interest in the ECB | 726,278 | 726,278 | – |
| 9.2 Claims deriving from the transfer of foreign reserves to the ECB | 7,262,784 | 7,262,784 | – |
| 9.4 Other claims within the Eurosystem (net) | 22,856,175 | 7,552,676 | 15,303,499 |
| **Total** | **30,845,237** | **15,541,738** | **15,303,499** |
| 9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem | 14,208,918 | 8,100,702 | 6,108,216 |
| **Total** | **14,208,918** | **8,100,702** | **6,108,216** |

On the assets side:

– at 31 December there was no change in either the *participating interest in the ECB* or in the *claims deriving from the transfer of foreign reserves to the ECB*;

*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 paid-up capital is equal to 13.0516 per cent; if only the Eurosystem central banks are considered, the Bank's share of the paid-up capital at 31 December 2006 was equal to 18.2563 per cent. At 1 January 2007 the foregoing percentages fell to 12.5297 and 18.0260 per cent respectively following the accession of Romania and Bulgaria to the European Union and Slovenia becoming part of the euro area.*

*At the start of the third stage of EMU, the Eurosystem NCBs transferred gold, foreign securities and foreign currencies to the ECB in proportion to the share of the ECB's capital subscribed for by each central bank; in exchange each NCB recorded an interest-earning claim denominated in euros (see the comment on the income statement* Net interest income*).*

– there was an increase in *Other claims within the Eurosystem (net),* which derive mainly from the operation of the TARGET system. The latter gave rise to a credit position that increased by €15,178 million (from €7,663 million to €22,841 million). The sub-item also includes a claim of €15 million in relation to the net result of the pooling of the monetary income for 2006, compared with €6 million in 2005 (see the comment on the income statement *Net interest income*).

As in 2005, the liabilities referred exclusively to the allocation of euro banknotes within the Eurosystem (see the section *Legal basis, methods of preparation and layout of the annual accounts*).

### Other assets

This Item consists mainly (81 per cent) of securities included in Sub-items 11.3 (*Financial assets relating to investments of reserves and provisions*) and 11.4 (*Other financial assets*) (see the *Securities portfolio* section of the comments). It also contains tangible and intangible fixed assets (5 per cent); deferred tax assets (9 per cent), primarily in connection with prior-year tax losses; and the UIC endowment fund, contributed entirely by the Bank (Sub-item 11.2).

**Other assets (Item 11)**
(*thousands of euros*)

| | | 31.12.2006 | 31.12.2005 | Changes |
|---|---|---|---|---|
| 11.1 | Euro-area coins | 29,749 | 36,418 | -6,669 |
| 11.2 | UIC endowment fund | 258,228 | 258,228 | – |
| 11.3 | Financial assets related to investments of reserves and provisions | 32,763,192 | 29,531,670 | 3,231,522 |
| 11.4 | Other financial assets | 33,699,789 | 20,362,109 | 13,337,680 |
| 11.5 | Intangible fixed assets | 30,969 | 27,865 | 3,104 |
| 11.6 | Tangible fixed assets | 3,856,918 | 3,989,568 | -132,650 |
| 11.7 | Accrued income and prepaid expenses | 1,199,375 | 758,582 | 440,793 |
| 11.8 | Deferred tax assets | 7,696,395 | 7,961,477 | -265,082 |
| 11.9 | Sundry | 2,583,355 | 1,988,232 | 595,123 |
| | *– other investments of severance pay and pension provisions* | *81,498* | *77,753* | *3,745* |
| | *– assets of the complementary pension fund* | *85,326* | *68,848* | *16,478* |
| | *– other* | *2,416,531* | *1,841,631* | *574,900* |
| **Total** | | **82,117,970** | **64,914,149** | **17,203,821** |

As of 2006 *Tangible fixed assets* (Sub-item 11.6) contains separate data on buildings and land, partly with a view to rendering the accounting data of the Eurosystem central banks increasingly homogeneous. Land, including that on which the Bank's buildings are located, is not depreciated.

In 2006 five buildings were sold in which severance pay and pension provisions had been invested.

The value of the buildings owned by the Bank at the end of the year was estimated to be €3,927 million for those used for its operations and €1,521 million for those related to investments of severance pay and pension provisions.

*Deferred tax assets* (Sub-item 11.8) decreased by €265 million as a consequence of:

– the offsetting of €275 million of the deferred tax assets deriving from the carry forward of the tax losses for 2002-04, which consequently fell from €7,937 million to €7,662 million;

– the increase of €10 million (from €24 million to €34 million) in the deferred tax assets deriving from other sources.

*The bulk of the deferred tax assets included in the balance sheet derive from the carry forward of the tax losses incurred in the years 2002-04. In particular, the loss for 2002 derived from the bond conversion under Law 289/2002, while those for 2003 and 2004 derived from unrealized losses. The rules governing the carry forward of these losses are laid down in Article 65 of Law 289/2002 as amended by Law 248/2005. The rules state that the losses may be offset with no time restriction up to 50 per cent of the corporate income tax liability each 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.*

*Among the other sources of the deferred tax assets, it is worth noting the allocations to the provision for staff costs and the depreciation not yet deducted for tax purposes (of which a part refers to the* *revaluation of buildings under Law 266/2005). The item also contains deferred tax liabilities in relation to corporate income tax deriving almost exclusively from accelerated depreciation.*

*Sundry* (Sub-item 11.9 on the assets side) includes the balance-sheet total of the defined-contribution supplementary pension fund for staff hired since 28 April 1993, which is matched on the liabilities side by an equal amount entered in Sub-item 11.3 of *Other liabilities*. The other components of the sub-item are mainly tax credits (and accrued interest) in respect of prior years and payments on account of corporate and personal income tax made in 2006.

**Banknotes in circulation**

Banknotes in circulation (Item 1 on the liabilities side), which represent the Bank of Italy's share (16.8 per cent) of the total Eurosystem note issue (see the section *Legal basis, methods of preparation and layout of the annual accounts*), increased by €10,585 million (from €94,934 million €105,519 million).

The banknotes actually in circulation, without taking account of the adjustments for their distribution within the Eurosystem, increased by €16,694 million (from €103,034 million €119,728 million). The average stock of banknotes rose from €92,412 million to €105,604 million, an increase of 14 per cent, compared with 11 per cent for the euro area.

**Liabilities to general government and other counterparties in euros**

Item 4 on the liabilities side refers mainly to the deposits held by the Treasury with the Bank of Italy. Among the accounts held with the Bank by non-general-government counterparties, that of the UIC is particularly significant.

Compared with 2005, the year-end balance increased both for the Treasury payments account and for the sinking fund for the redemption of government securities. By contrast, the average for the year of both accounts diminished: the former from €32,277 to €30,722 million and the latter from €3,788 million to €256 million.

The balance of the UIC's current account, included under *Other counterparties*, declined from €34 million to €18 million.

**Liabilities to non-euro-area residents denominated in euros**

These comprise the following sub-items:

- 5.1, which refers almost entirely to the correspondent accounts of Norodowy Bank Polski and Eesti Pank for their participation in the TARGET system;
- 5.2, which mainly refers to the accounts held by customers that use the Eurosystem Reserve Management Services (ERMS).

**Other liabilities**

Item 11 comprises the sub-items detailed below:

| **Other liabilities (Item 11)** *(thousands of euros)* | | **31.12.2006** | **31.12.2005** | **Changes** |
|---|---|---|---|---|
| 11.1 | Bank of Italy drafts | 712,605 | 614,082 | 98,523 |
| 11.2 | Accrued expenses and deferred income | 70,650 | 51,314 | 19,336 |
| 11.3 | Sundry | 1,462,934 | 1,397,302 | 65,632 |
| | *– lira banknotes not yet presented for conversion net of the payments on account to the Treasury* | *808,133* | *874,149* | *-66,016* |
| | *– liabilities of the complementary pension fund* | *85,326* | *68,848* | *16,478* |
| | *– other* | *569,475* | *454,305* | *115,170* |
| **Total** | | **2,246,189** | **2,062,698** | **183,491** |

The Sub-item *Sundry* (11.3) includes the lira banknotes not yet presented for conversion, excluding the two payments on account that the Bank of Italy has already made to the Treasury for the banknotes that will presumably not be presented within the legal time limit.

### Provisions and provision for general risks

Among the components of *provisions* (Item 12), the reduction in *Provisions for specific risks* (Sub-item 12.1) was due to the change in the tax provision, which was used to pay the taxes for 2005 and to which an allocation was made for the taxes for 2006. The increase in *Sundry staff-related provisions* (Sub-item 12.2) was the result of:

*a)* the allocation of €30 million to the severance pay and pension provisions, which rose from €5,541 million at the end of 2005 to €5,571 million at the end of 2006. Of this amount €4,583 million was for supplementary pensions and €988 million for severance pay;

*b)* the reduction in the provision for staff costs. Of the €25 million set aside in 2005 for the revision of wages and salaries €24 million was used following the renewal of labour contracts, while €1 million was included in the income statement under prior-year income.

| **Provisions (Item 12)** *(thousands of euros)* | | **Stocks end-2005** | ***Withdrawals*** | ***Allocations*** | **Stocks end-2006** |
|---|---|---|---|---|---|
| **12.1** | **Provisions for specific risks** | **1,088,395** | ***-770,775*** | ***404,684*** | **722,304** |
| | for insurance cover | 309,874 | – | – | 309,874 |
| | for taxation | 778,521 | *-770,775* | *404,684* | 412,430 |
| **12.2** | **Sundry staff-related provisions** | **5,664,976** | ***-96,933*** | ***101,855*** | **5,669,898** |
| | for staff severance pay and pensions | 5,541,101 (1) | *-70* (2) | *30,349* | 5,571,380 |
| | for staff costs | 120,300 | *-96,759* | *71,005* | 94,546 |
| | for severance pay of contract staff | 1,869 | *-60* | *171* | 1,980 |
| | for grants to BI pensioners and their surviving dependents | 1,706 | *-44* | *330* | 1,992 |
| **Total** | | **6,753,371** | ***-867,708*** | ***506,539*** | **6,392,202** |

(1) The figure was in excess by €11 million reabsorbed in 2006 in connection with the renewal of labour contracts. – (2) Transfer to the supplementary pension fund for newly hired staff who signed up to participate in the fund.

The *Provision for general risks* (Item 14) increased from €7,535 million to €7,931 million following the allocation of €396 million approved by the Board of Directors (€703 million in 2005).

The 2006 allocation is a further step in the replenishment of this fund. In 2002-04 approximately €4 billion had been withdrawn from risk provisions to cover unrealized losses.

### Revaluation accounts

These include the gains and losses deriving from the valuation at market prices of gold, assets and liabilities denominated in foreign currency and the securities portfolio (see the comments on *gold, assets and liabilities denominated in foreign currency and the securities portfolio*).

**Revaluation accounts (Item 13)**
*(thousands of euros)*

| | Stock 2005 | *Withdrawals* | *Allocations* | Stock 2006 |
|---|---|---|---|---|
| Exchange rate revaluations | 16,988,724 | | *2,087,409* | 19,076,133 |
| *of which: gold* | *14,858,282* | | *3,770,539* | *18,628,821* |
| Price revaluations | 3,601,400 | | *764,842* | 4,366,242 |
| Revaluations at 1 January 1999 | 10,254 | *-6,289* | | 3,965 |
| **Total** | **20,600,378** | ***-6,289*** | ***2,852,251*** | 23,446,340 |

### Capital and reserves

Item 15 is detailed below.

**Capital and reserves (Item 15)**
*(thousands of euros)*

| | 31.12.2006 | 31.12.2005 | Changes |
|---|---|---|---|
| **15.1 Capital** | **156** | **156** | – |
| **15.2 Reserves under Article 39 of the Statute** | **11,229,490** | **10,693,306** | **536,184** |
| Ordinary | 5,573,990 | 5,324,013 | 249,977 |
| Extraordinary | 5,655,500 | 5,369,293 | 286,207 |
| **15.3 Other reserves** | **5,541,413** | **5,541,413** | – |
| Revaluation reserves under Law 72/1983 | 673,460 | 673,460 | – |
| Revaluation reserves under Law 408/1990 | 660,533 | 660,533 | – |
| Revaluation reserves under Law 413/1991 | 16,922 | 16,922 | – |
| Revaluation reserves under Law 342/2000 | 866,534 | 866,534 | – |
| Revaluation reserves under Law 266/2005 | 1,518,920 | 1,518,920 | – |
| Fund for the renewal of tangible fixed assets | 1,805,044 | 1,805,044 | – |
| **Total** | **16,771,059** | **16,234,875** | **536,184** |

The movements of the ordinary and extraordinary reserves are detailed below:

**Movements in ordinary and extraordinary reserves (Sub-item 15.2)**
(*thousands of euros*)

| | Stocks end-2005 | *Allocation of 2005 profit under Art. 39 of the Statute* | *Distribution to shareholders under Art. 40 of the Statute* (1) | *2006 income earned under Art. 40 of the Statute* | Stocks end-2006 |
|---|---|---|---|---|---|
| Ordinary | 5,324,013 | *10,057* | *-24,945* | *264,865* | 5,573,990 |
| Extraordinary | 5,369,293 | *10,057* | *-24,525* | *300,675* | 5,655,500 |
| **Total** | **10,693,306** | ***20,114*** | ***-49,470*** | ***565,540*** | **11,229,490** |

(1) From the income earned in 2005.

The **income statement** shows a net profit for the year of €134 million, compared with €50 million in 2005.

### Net interest income

*Net Interest income* (Item 1) rose by €577 million (from €1,991 million to €2,568 million). It included the interest accrued on assets and liabilities, except for financial assets representing investments of reserves and provisions, which are shown in a separate item (see the comment on *Net income from financial assets related to investments of reserves and provisions*).

Interest income increased as a result of both a higher average rate of return and a larger average stock of interest-bearing assets denominated in euros. Interest expense also increased, but to a lesser extent and primarily owing to the rise in interest rates.

**Interest income (Sub-item 1.1)**
(*thousands of euros*)

| | 2006 | 2005 | Changes |
|---|---|---|---|
| On assets denominated in euros | 3,411,752 | 2,593,267 | 818,485 |
| *securities* | *1,893,105* | *1,470,370* | *422,735* |
| *lending operations* | *535,934* | *429,950* | *105,984* |
| *intra-ESCB balances* | *950,916* | *662,195* | *288,721* |
| *other* | *31,797* | *30,752* | *1,045* |
| On assets denominated in foreign currency | 1,121,119 | 822,490 | 298,629 |
| *securities and other assets denominated in foreign currency* | *1,069,767* | *746,308* | *323,459* |
| *receivables from the IMF* | *51,352* | *76,182* | *-24,830* |
| **Total** | **4,532,871** | **3,415,757** | **1,117,114** |

In particular, interest income on positions in euros showed increases in:

– interest earned on securities, as detailed below:

*a)* €825 million from the government securities received in the conversion under Law 289/2002;

*b)* €1,068 million (€646 million in 2005) from other government securities, partly held as fixed assets (Sub-item 11.4 on the assets side) and partly not held as fixed assets (Item 7); the increase was due above all to the expansion in the average size of the portfolio (from €20,244 million to €30,843 million);

– interest income from main refinancing operations (from €412 million to €504 million), owing to the rise in the applicable interest rates (on average from 2.11 to 2.86 per cent) since the reference aggregate contracted (on average from €19,527 million to €17,638 million). There was also an increase in interest from longer-term refinancing operations (from €18 million to €31 million) owing both to the rise in the applicable interest rates (on average from 2.12 to 2.84 per cent) and to the growth in the reference aggregate (on average from €844 million to €1,102 million).

– interest income from intra-Eurosystem claims in relation to the Bank's TARGET balances (from €532 million to €775 million) and that earned on the claims deriving from the transfer of foreign reserves to the ECB (from €130 million to €176 million). The increase reflects the rise in the applicable interest rates (on average from 2.02 to 2.78 per cent) and to the growth in the average TARGET balances (from €25,434 million to €26,893 million).

*The net position vis-à-vis the ECB in connection with the working of TARGET is remunerated at the marginal interest rate on main refinancing operations; the interest on the part in relation to the TARGET positions of Norodowy Bank Polski and Eesti Pank is computed on the basis of the interest rate applied to overnight deposits at the central banks, in the same way as the interest paid on the accounts held by other central banks not belonging to the euro area. The claims arising from the transfer of reserves to the ECB are remunerated on the basis of the latest available marginal interest rate applied to the main refinancing operations of the Eurosystem. This rate is reduced by 15 per cent since a part of the reserves transferred is in the form of gold, which bears no interest (see the comment on the balance sheet* Intra-Eurosystem claims and liabilities*).*

– sundry interest income, which included €29 million earned on tax credits (€28 million in 2005).

Among the items of interest income on foreign currency assets:

– income earned on foreign currency securities and other foreign currency assets increased, above all owing to the higher rates of return on dollar-denominated investments;

– income from accounts with the IMF declined, primarily owing to the contraction in Italy's net position vis-à-vis the IMF.

Among the components of interest expense for liabilities denominated in euros:

– the interest paid on the Treasury payment account increased owing to the rise in the average rate of return (from 2.77 to 3.79 per cent), which was only offset in part by the fall in the annual average balance (from €32,277 million to €30,722 million);

– the interest paid on the sinking fund for the redemption of government securities decreased, owing entirely to the fall in the average amount outstanding (from €3,788 million to €256 million) since the average rate of return rose from 2.09 to 2.54 per cent;

**Interest expense (Sub-item 1.2)**
(*thousands of euros*)

| | 2006 | 2005 | Changes |
|---|---|---|---|
| On liabilities denominated in euros | 1,884,193 | 1,382,267 | 501,926 |
| *Treasury payments account* | *1,165,408* | *895,384* | *270,024* |
| *sinking fund for the redemption of government securities* | *6,498* | *79,194* | *-72,696* |
| *current accounts (covering the minimum reserve system)* | *503,822* | *333,181* | *170,641* |
| *intra-ESCB balances* | *205,409* | *72,670* | *132,739* |
| *sundry* | *3,056* | *1,838* | *1,218* |
| On assets denominated in foreign currency | 80,405 | 41,985 | 38,420 |
| *counterpart of SDRs allocated by the IMF* | *30,090* | *21,813* | *8,277* |
| *sundry* | *50,315* | *20,172* | *30,143* |
| **Total** | **1,964,598** | **1,424,252** | **540,346** |

– the interest paid on current accounts (covering the minimum reserve system) increased, owing to the rise in the average rate of return (from 2.10 to 2.87 per cent) and the increase in the annual average amount of the above accounts (from €15,902 million to €17,544 million);

– there was an increase in the interest paid on intra-Eurosystem balances, which consisted exclusively of the balances related to the allocation of euro banknotes within the Eurosystem. The increase was due both to the higher average rate of return and the larger average value of the balances (see the comment on the balance sheet *Intra-Eurosystem claims and liabilities*).

– there was an increase of €1 million in other interest, which consisted mainly of that on accounts held with the Bank of Italy by non-euro-area correspondents (€1.5 million), that on overnight and fixed-term deposits (€0.7 million) and the UIC's current account (€0.6 million).

Among the interest paid on positions denominated in foreign currency there were increases in respect of the interest for the counterpart of SDRs allocated by the IMF and other interest, which was mainly for repos involving securities denominated in dollars; the increase was due to the higher average rate of return and, to a lesser extent, to the growth in the average stock of the liabilities in question.

**Net result of financial operations, writedowns and transfers to/from risk provisions**

The result for 2006 comprised:

– net losses on financial operations, as a consequence of:

*a)* losses on securities trading, due in part to the rise in interest rates on dollar securities, and a loss on futures;

*b)* profits on foreign exchange trading, primarily from sales of SDRs. The large profits recorded in 2005 were due to sales of dollars as part of a rebalancing of the foreign exchange reserves in favour of assets denominated in pounds sterling;

*c)* profits on other financial transactions, consisting of the fees periodically paid to the Bank for foreign securities loans under the automated securities lending programme introduced in 2006.

**Net result of financial operations writedowns and transfers to/from risk provisions (Item 2)**
*(thousands of euros)*

| | 2006 | 2005 | Changes (1) |
|---|---|---|---|
| Profits (+) and losses (-) on financial operations | -22,830 | 471,821 | -494,651 |
| *profits/losses on securities trading* | *-34,090* | *-4,838* | *-29,252* |
| *profits/losses on foreign exchange trading* | *18,107* | *481,210* | *-463,103* |
| *profits/losses on derivative contracts denominated in foreign currency* | *-7,517* | *-4,551* | *-2,966* |
| *profits/losses on other transactions denominated in foreign currency* | *670* | *–* | *670* |
| Writedowns (-) of financial assets and positions | -338,089 | -118,681 | - 219,408 |
| *foreign currencies* | *-287,236* | *-57,288* | *-229,948* |
| *foreign securities* | *-44,242* | *-56,751* | *12,509* |
| *euro securities* | *-6,611* | *-4,642* | *-1,969* |
| Transfers to (-) the provision for general risks for exchange rate and price changes | -396,000 | -703,000 | 307,000 |
| **Total** | **-756,919** | **-349,860** | **-407,059** |

(1) Negative changes indicate smaller profits or larger losses/writedowns; positive changes larger profits or smaller losses/writedowns. In the case of transfers the positive change indicates smaller allocations in 2006.

– writedowns of financial assets and positions, as a result of:

*a)* the valuation at year-end exchange rates of assets denominated in yen (€258 million) and Swiss francs (€29 million);

*b)* the valuation at market prices of foreign currency securities denominated primarily in dollars (€44 million) and of securities denominated in euros (€7 million);

– the transfer of €396 million to the provision for general risks.

### Net income from fees and commissions

The result (Item 3) increased by €4 million (from €0.3 million to €4.3 million); fee and commission income rose from €24 million to €26 million, while fee and commission expense fell from €24 million to €22 million.

*Fee and commission income* included fees for financial services on behalf of public-sector entities (€3 million); charges payable by the participants in the BI-Rel system (€6 million); the charges for Correspondent Central Banking Model services (€4 million); and those for the use of Central Credit Register information (€5 million) and substitute protest declarations (€3 million).

*Fee and commission expense* included €15 million payable to the UIC for the management of the foreign exchange reserves (€16 million in 2005).

### Income from participating interests

As in 2005, income from participating interests (Item 4) referred exclusively to the profits allocated to the Bank in respect of its interest in the UIC's endowment fund; the increase from €0.8 million to €1.2 million was due to that in the UIC's net income for the year. As in the previous year the ECB did not pay a dividend.

*In 2006, the Governing Council decided, as for 2005, to retain the full amount of the ECB's income on euro banknotes in circulation, which amounted to €1,319 million, of which the Bank of Italy's share was €241 million (€158 million in 2005). The amount in question has been transferred, together with other ECB income, to a provision for foreign exchange rate, interest rate and gold price risks. Following this allocation, the ECB broke even in 2006. Accordingly, for 2006 it will again not pay a dividend to the Eurosystem participating NCBs (see the section* Legal basis, methods of preparation and layout of the annual accounts*).*

### Net result of the pooling of monetary income

The net result of the pooling of monetary income (Item 5) amounted to €15 million, compared with €6 million in 2005.

*The result in 2006 was the difference between the monetary income pooled, €2,713 million, and that redistributed, €2,728 million. The pooled monetary income 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 relating to monetary policy operations denominated in euros; net intra-Eurosystem liabilities resulting from TARGET transactions; and net intra-Eurosystem liabilities relating 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 share. 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.*

### Net income from financial assets relating to investments of reserves and provisions

This item decreased owing to the smaller profits earned on the disposal of equity securities not held as fixed assets; income from interest-bearing securities increased, primarily owing to the higher rates of return.

**Net income from financial assets relating to investments of reserves and provisions (Item 6)**
(*thousands of euros*)

| | **2006** | **2005** | **Changes** |
|---|---|---|---|
| Interest income | 807,170 | 757,309 | 49,861 |
| *reserves pursuant to the Statute* | *263,121* | *249,242* | *13,879* |
| *other reserves and provisions* | *544,049* | *508,067* | *35,982* |
| Dividends | 297,743 | 309,165 | -11,422 |
| *reserves pursuant to the Statute* | *170,525* | *184,390* | *-13,865* |
| *other reserves and provisions* | *127,218* | *124,775* | *2,443* |
| Profits/losses from trading and disposals | 139,613 | 676,599 | -536,986 |
| *reserves pursuant to the Statute* | *133,226* | *410,906* | *-277,680* |
| *other reserves and provisions* | *6,387* | *265,693* | *-259,306* |
| Writedowns | -1,849 | -13,160 | 11,311 |
| *reserves pursuant to the Statute* | *-1,334* | *-7,815* | *6,481* |
| *other reserves and provisions* | *-515* | *-5,345* | *4,830* |
| Other components | 2 | – | 2 |
| *reserves pursuant to the Statute* | *2* | *–* | *2* |
| **Total** | **1,242,679** | **1,729,913** | **-487,234** |

## Other transfers from provisions and other income

In 2006 a total of €6 million was withdrawn from the securities and foreign exchange revaluation accounts created at the start of the third stage of EMU.

The item *Other income* is detailed below.

**Other income (Item 8)**
(*thousands of euros*)

| | 2006 | 2005 | Changes |
|---|---|---|---|
| Rental income from buildings | 21,440 | 20,901 | 539 |
| Procedures, studies and designs completed during the year | 10,036 | 9,856 | 180 |
| Other | 20,960 | 20,288 | 672 |
| **Total** | **52,436** | **51,045** | **1,391** |

## Appropriation of investment income to reserves provided for in the Statute

As provided for in Article 40 of the Statute, income earned on investments of the ordinary and extraordinary reserves is used to increase these reserves. The amount appropriated (Item 9) fell by €271 million (from €837 million to €566 million), primarily owing to the smaller profits earned on equity investments.

## Sundry expenses and charges

This item comprises:

**Sundry expenses and charges (Item 10)**
(*thousands of euros*)

| | 2006 | 2005 | Changes |
|---|---|---|---|
| Staff wages and salaries and related costs (1) | 633,760 | 604,836 | 28,924 |
| Other staff costs | 44,799 | 42,604 | 2,195 |
| Transfers to provisions for accrued expenses and staff severance pay and pensions | 101,855 | 97,296 | 4,559 |
| Pensions and severance payments | 367,992 | 264,103 | 103,889 |
| Emoluments paid to head and branch office collegial bodies | 1,826 | 2,636 | -810 |
| Administrative costs | 402,894 | 378,148 | 24,746 |
| Depreciation of tangible and intangible fixed assets | 194,271 | 254,242 | -59,971 |
| Other expenses | 20,199 | 20,214 | -15 |
| **Total** | **1,767,596** | **1,664,079** | **103,517** |

(1) The figure for 2005 does not include the provision of €25 million made in the same year for increases in wages and salaries in relation to the renewal of the Bank's labour contracts.

It is worth noting that:

– the increase in *pensions and severance payments* was primarily due to that in severance payments (from €70 million to €166 million) as a consequence of the larger number of terminations in 2006.

The breakdown of the Bank's staff is shown in the following table:

| The bank's staff | | | | |
|---|---|---|---|---|
| CARRIERE | Average number of persons in service | | Percentage composition | |
| | 2006 | 2005 | 2006 | 2005 |
| Managerial | 1,970 | 1,980 | 25.1 | 24.8 |
| Clerical | 4,704 | 4,810 | 60.0 | 60.2 |
| General services and security | 662 | 706 | 8.5 | 8.8 |
| Blue-collar | 498 | 497 | 6.4 | 6.2 |
| **Total payroll workers** | **7,834** | **7,993** | **100.0** | **100.0** |
| Contract workers | 34 | 34 | | |

– *administrative costs* increased by €25 million. Within this item security and banknote escort increased by €7 million (from €81 million to €88 million); equipment rentals by €5 million (from €18 million to €23 million); raw materials for the production of banknotes by €9 million (from €16 million to €25 million); and building maintenance by €4 million (from €60 million to €64 million). There was a small increase in software leasing and maintenance (from €24 million to €25 million) and systems assistance was unchanged at €22 million.

– there was a reduction in depreciation because the land on which the Bank's buildings stand ceased to be depreciable in 2006.

### Prior-year income and expense

*Prior-year income* (Sub-item 12.1) fell by €53 million (from €59 million to €6 million); in 2005 the amount included €53 million in connection with the decrease in the tax provision following the reduction in the risk inherent in tax disputes. *Prior-year expense* (Sub-item 12.2) amounted to €4 million, as in 2005.

### Taxes on income for the year and productive activities

Taxes for the year (Item 13) amounted to €669 million and comprised both the current taxes due to the tax authorities and the change in the deferred tax assets and liabilities (see the *deferred tax assets* sub-item in the comment on the balance sheet under *Other assets*).

More specifically, corporate income tax for the year amounted to €543 million (€779 million in 2005) and included €275.6 million of taxes for the current year, recorded in the tax provision and to be paid, and €275.6 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 net change in the remaining deferred tax components reduced the tax liability by €8 million.

The regional tax on productive activities (Irap) amounted to €126 million, the result of €128 million of tax for the year, recorded in the tax provision and to be paid, and a positive net change of €2 million in the deferred component.

## *Proposals of the Board of Directors*

Pursuant to Articles 38 and 39 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 2006 of €133,757,713:

| | euros |
|---|---|
| – 20 per cent to the ordinary reserve ............................................ | 26,751,543 |
| – an amount equal to 6 per cent of the share capital to shareholders | 9,360 |
| – 20 per cent to the extraordinary reserve ...................................... | 26,751,543 |
| – an additional amount equal to 4 per cent of the share capital to shareholders ........................................................................ | 6,240 |
| – the remaining amount to the State ............................................ | 80,239,027 |
| TOTAL ........................................ | 133,757,713 |

Pursuant to Article 40 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 €53,466,000, equal to 0.50 per cent (as in 2005) of the total reserves at 31 December 2005.

If these proposals are approved, the total dividend will be equal to €53,481,600 corresponding to €178,272 per share.

THE GOVERNOR

Mario Draghi

# 20. DOCUMENTATION ATTACHED TO THE ANNUAL ACCOUNTS

## REPORT OF THE BOARD OF AUDITORS

ON THE 113th FINANCIAL YEAR OF THE BANK OF ITALY
AND THE ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2006

*To the shareholders,*

The accounts for the year ended 31 December 2006 submitted for your approval show the following results:

| | | |
|---|---|---|
| Assets | € | 218,556,632,156 |
| Liabilities | € | 201,651,815,948 |
| Capital and reserves | € | 16,771,058,495 |
| Net profit for the year (as shown in the income statement) | € | 133,757,713 |

The memorandum accounts, shown on both sides of the balance sheet for an amount of €277,230,077,095, 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 annual accounts, which were also checked by external auditors, were compared with the accounting records and found to conform with them.

The annual accounts for 2006 have been drawn up using new balance-sheet and income statement layouts, with which we agree. A decree issued by the Minister for the Economy and Finance on 27 December 2006 approved the new layouts, which compared with the previous ones differ in the composition of the items *other assets* and *other liabilities*. The layout of the income statement has been updated to highlight some income items and intermediate results. The items/sub-items of the balance sheet and income statement for 2005 are reclassified to ensure comparability of the data.

The criteria for preparing the annual accounts and the valuation methods used have been updated compared with the previous year to take account of the purchase of units of collective investment undertakings not held as financial fixed assets and stated at the year-end value published by the management company, and of the fact that pursuant to the provisions now in force the land on which the Bank's buildings stand is no longer depreciable.

The criteria for preparing the annual accounts and the valuation methods used, with which 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 inclusion in the balance sheet of deferred tax assets arising from the carrying forward of tax losses for the years 2002-04 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. In relation to the result for the year, the deferred tax assets in question decrease by €275 million (from €7,937 million to €7,662 million).

The Board of Directors approved the transfer of €396 million to the provision for general risks, which had been used on a major scale in the three years 2002-04. The 2006 allocation continues the replenishment of the provision that began in the previous financial year.

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.

Pursuant to Article 39 of the Statute, the Board of Directors proposes the following allocation of the net profit of €133,757,713 for 2006:

| | | |
|---|---|---|
| – 20 per cent to the ordinary reserve........................................... | € | 26,751,543 |
| – an amount equal to 6 per cent of the share capital to shareholders........................................................................ | € | 9,360 |
| – 20 per cent to the extraordinary reserve .................................. | € | 26,751,543 |
| – an additional amount equal to 4 per cent of the share capital to shareholders ........................................................................ | € | 6,240 |
| – the remaining amount to the State............................................ | € | 80,239,027 |
| Total .................................. | € | 133,757,713 |

Pursuant to Article 40 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 €53,466,000, equal to 0.50 per cent of such reserves at 31 December 2005 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, until the entry into force of the Bank's new Statute, of the Board Committee and effected 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 maintaining close contact, in accordance with Articles 19 and 20 of the Bank's Statute, with the examiners at the main and local branches, whom we thank warmly.

We recommend that you approve the annual accounts for 2006 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 40 of the Statute.

At the end of our appointment, we thank you for the trust placed in us.

THE BOARD OF AUDITORS

Gianfranco Zanda (chairman)

Giuseppe Bruni

Enrico Nuzzo

Angelo Provasoli

Massimo Stipo

## 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*<br>Regional tax on productive activities |
| Irpef | – | *Imposta sul reddito delle persone fisiche*<br>Personal income tax |
| Ires | – | *Imposta sul reddito delle società*<br>Corporate income tax |
| ISAE | – | *Istituto di studi e analisi economica*<br>Institute for Economic Research and Analysis |
| Istat | – | *Istituto nazionale di statistica*<br>National Institute of Statistics |
| Isvap | – | *Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo*<br>Supervisory authority for the insurance industry |
| MTS | – | *Mercato telematico dei titoli di Stato*<br>Screen-based secondary market in government securities |
| QRBR | – | Quarterly Report on the Borrowing Requirement |
| SACE | – | *Istituto per i servizi assicurativi per il commercio estero*<br>Foreign Trade Insurance Services Agency |
| SIM | – | *Società di intermediazione mobiliare*<br>Italian investment firm |
| TARGET | – | Trans-European Automated Real-Time Gross Settlement Express<br>Transfer System |
| UIC | – | *Ufficio italiano dei cambi*<br>Italian Foreign Exchange Office |

# ADMINISTRATION OF THE BANK OF ITALY

AT 31 DECEMBER 2006

## DIRECTORATE

| | |
|---|---|
| Mario DRAGHI | Governor |
| Fabrizio SACCOMANNI | Director general |
| Antonio FINOCCHIARO | Deputy director general |
| Ignazio VISCO* | Deputy director general |
| Giovanni CAROSIO* | Deputy director general |

*Took office on 9 January 2007

## BOARD OF DIRECTORS

Paolo BLASI
Paolo DE FEO
Giampaolo de FERRA
Paolo Emilio FERRERI
Paolo LATERZA
Rinaldo MARSANO
Cesare MIRABELLI
Giovanni MONTANARI
Ignazio MUSU
Gavino PIRRI
Stefano POSSATI
Nicolò SCAVONE
Giordano ZUCCHI

## BOARD OF AUDITORS

Giuseppe BRUNI
Enrico NUZZO
Angelo PROVASOLI
Massimo STIPO
Gianfranco ZANDA

## ALTERNATE AUDITORS

Cesare BISONI
Dario VELO

## MANAGING DIRECTORS

| | |
|---|---|
| Giancarlo MORCALDO | advisory functions for economic matters |
| Mario MELONI | organization and logistics |
| Francesco Maria FRASCA | studies of economic institutions |
| Paolo PICCIALLI | secretary general |
| Anna Maria TARANTOLA | banking and financial supervision<br>(ad interim) accounting and control |
| Franco PASSACANTANDO | central banking and markets<br>(ad interim) payment system and treasury operations |
| Matilde Carla PANZERI | note issue |
| Alberto Mario CONTESSA** | advisory functions for information technology |
| Salvatore ROSSI** | economic research |

*Took office on 5 February 2007