BANCA D'ITALIA

EUROSISTEMA

Annual Report

Abridged Version

Ordinary Meeting of Shareholders

Rome, 31 May 2008

Financial Year 114th

114th FINANCIAL YEAR

2007

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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

The robust expansion of the world economy continued in 2007 with growth of 4.9 per cent, compared with 5 per cent in 2006. Although the pace slackened in the main industrial countries during the year, it remained strong in the emerging economies. Inflationary pressure was manifest everywhere, mainly owing to the acceleration of basic material prices.

In the United States output rose by 2.2 per cent. From the middle of 2006 onwards economic activity reflected the growing difficulties of the property market and consequent decline in residential investment. The fall in house prices triggered strong tensions on the markets for financial assets based on mortgage-backed securitizations. The property market remains weak, partly due to tighter lending requirements, and prices may fall further this year. In September the Federal Reserve changed the stance of monetary policy, lowering the federal funds target rate on several occasions for a total of 3.25 percentage points, despite continuing inflationary pressure. The expansionary action is comparable in scale to that of 2001 and is designed to curb the effects of the money and financial market turbulence on economic activity.

Japan recorded economic growth of 2.1 per cent, led by export demand; domestic demand slackened. In this situation, and with a rate of inflation close to nil, the Bank of Japan kept an accommodating monetary policy stance. Further measures were taken to strengthen the fiscal position and the budget deficit was reduced to 4.9 per cent of GDP, against 5.9 per cent in 2006.

In the European Union the rate of expansion slowed slightly, to 2.8 per cent. In the nine new member states that have not yet adopted the euro growth remained strong overall (6.2 per cent) despite marked divergences. In these countries, inflationary pressure increased and external deficits widened, but were easily financed thanks to large capital inflows, especially in the banking sector.

The main emerging economies (China, India, Brazil and Russia), which now account for 21 per cent of PPP-adjusted world output, continued to grow at a rate of almost 10 per cent; inflation rose. Capital inflows remained substantial and upward pressure on exchange rates were again countered by building up foreign currency reserves.

The United States

In 2007, GDP grew by 2.2 per cent, compared with 2.9 per cent in 2006 (Table 1.1). The economy stagnated in the fourth quarter owing to the financial market turbulence and housing market crisis. The fall in residential investment, which averaged 17 per cent over the year, subtracted 1 percentage point from GDP growth.

Table 1.1

Gross domestic product, demand and inflation in the leading industrial countries
(percentage changes)

	2003	2004	2005	2006	2007
United States					
GDP (1)	2.5	3.6	3.1	2.9	2.2
Domestic demand (1)	2.8	4.1	3.1	2.8	1.5
Inflation (2)	2.3	2.7	3.4	3.2	2.9
Canada					
GDP (1)	1.9	3.1	3.1	2.8	2.7
Domestic demand (1)	4.6	4.3	5.1	4.4	4.3
Inflation (2)	2.7	1.8	2.2	2.0	2.1
Japan					
GDP (1)	1.4	2.7	1.9	2.4	2.1
Domestic demand (1)	0.8	1.9	1.7	1.6	1.0
Inflation (2)	-0.3	..	-0.3	0.3	..
European Union					
GDP (1)	1.3	2.5	1.9	3.1	2.9
Domestic demand (1)	1.9	2.5	2.0	3.0	2.8
Inflation (2)	2.1	2.3	2.3	2.3	2.4
United Kingdom					
GDP (1)	2.8	3.3	1.8	2.9	3.0
Domestic demand (1)	2.8	3.8	1.6	2.8	3.7
Inflation (2)	1.4	1.3	2.0	2.3	2.3
Advanced economies					
GDP (3)	1.9	3.2	2.6	3.0	2.7
Memorandum item:					
World output (3)	3.6	4.9	4.4	5.0	4.9

Sources: IMF and national statistics.
(1) Volumes at chain-linked prices. – (2) Consumer price index. – (3) Volumes at constant prices.

Household consumption increased by 2.9 per cent, compared with 3.1 per cent in 2006, close to the growth in real disposable income. The personal saving rate, which had fallen by 2 percentage points over the four previous years, was unchanged at 0.4 per cent. Consumption may be affected in 2008 by the deterioration in households' balance sheets last year.

Non-residential investment rose by 4.7 per cent, against 6.6 per cent in 2006. The profits of non-financial corporations, which had grown rapidly for five years – at an average rate of 18 per cent, measured according to national accounts criteria – declined by 3.7 per cent. As a whole, this category of companies had no difficulty obtaining external finance; the default rate on corporate bonds, which was virtually nil, and the small proportion of financial charges in net operating profits indicate a sound balance-sheet situation. However, debt rose by around 6 percentage points of gross value added in 2007, to almost the same level as at the end of 2001 (90 per cent).

Employment grew by just over 1 per cent on average in 2007. Conditions on the labour market worsened progressively over the year, with the unemployment rate touching 5 per cent in December, compared with 4.4 per cent at the end of 2006. In the first four months of 2008 payroll employment fell by a total of 260,000 units.

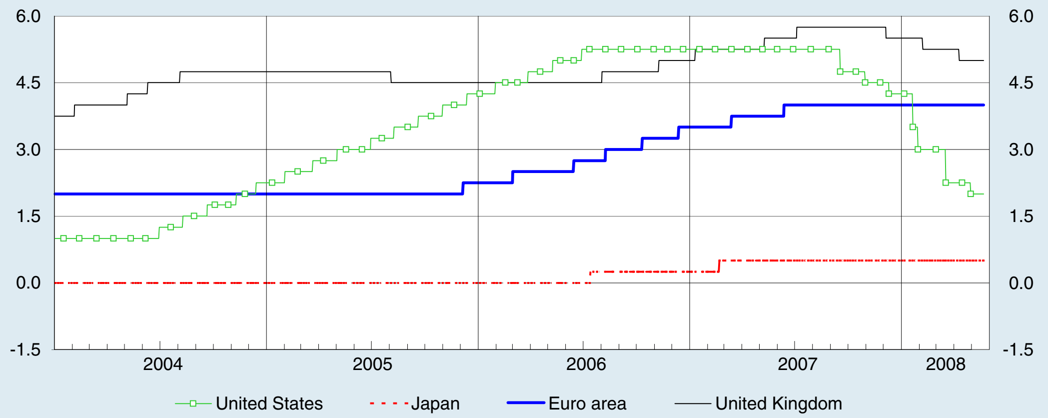
Early estimates indicate that economic activity, sustained mainly by inventory building, was again slack in the first quarter of 2008, with output increasing by 0.6 per cent on a yearly basis, as in the last quarter of 2007. Investment in residential building continued to decline at a rate of more than 25 per cent; non-residential investment fell by 2.5 per cent. Consumption slowed further.

Consumer prices increased by 2.9 per cent on average in 2007, with a sharp jump in August in response to the acceleration in food and energy prices. Excluding these, inflation was 2.3 per cent on average over the year. Medium and long-term inflation expectations inched up, both as reported in surveys and as deduced from the yield on index-linked government securities. Import prices accelerated sharply, reflecting the depreciation of the dollar.

The Federal Reserve left the federal funds target rate unchanged at 5.25 per cent until the summer of 2007, signalling the risk that inflationary pressures would necessitate a more restrictive monetary policy stance (Figure 1.1). From August, it sought to counter the financial turbulence and prevent it spreading to the money and interbank markets by intervening repeatedly to create liquidity, sometimes in collaboration with the other leading central banks. Despite rising inflation, the federal funds rate was cut three times between September and December, for a total of 1 percentage point, to 4.25 per cent. From the beginning of 2008 onwards, with the further slowdown in economic activity and partly in response to the tightening of borrowing conditions for households and firms, the Fed cut the target rate a further four times, to 2 per cent. Recent futures prices indicate that dealers foresee no further change in official rates before the end of the year.

Figure 1.1

Official interest rates (1)
(daily data; 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 main refinancing operations; for the United Kingdom, interest rate on commercial banks' reserves with the Bank of England and before 18 May 2006, the repo rate.

The federal budget deficit was reduced from 1.9 to 1.2 per cent of GDP in the 2006-07 financial year ending in September. The decrease was entirely structural: excluding the cyclical effect, the deficit fell to less than 1 per cent of GDP, from 1.8 per cent in 2006. The improvement in the federal accounts was due not only to the protracted rapid growth in revenue from personal income taxes, but also to the curbing of discretionary spending. In particular, non-defence spending, which had increased at an annual average rate of 6.1 per cent in 2005 and 2006, decreased by 0.7 per cent in 2007, while defence spending continued to rise at a rate of more than 5 per cent.

Fiscal policy is now significantly affected by the spreading credit market crisis. To counter the downturn in economic activity, in February 2008 the US Congress passed the Economic Stimulus Act introducing temporary tax cuts totalling $168 billion (equal to just over 1 per cent of GDP), most of which will come from the current budget. Some two thirds of the tax relief will benefit households, particularly large families on low incomes, and the rest, enterprises, mainly in the form of incentives raising tax deductible depreciation allowances on investments in machinery, made in 2008.

The housing market. – The fall in house prices that began in 2006 continued throughout last year. According to the Case-Shiller index covering the 10 main metropolitan areas, in the second half prices were 9 per cent lower than a year earlier, adjusted for changes in consumer prices, against 2 per cent according to the Office of Federal Housing Enterprise Oversight (OFHEO). The downturn sharpened at the beginning of 2008 and in February the Case-Shiller index recorded a year-on-year drop of 14 per cent. Downward pressure has begun to appear in other advanced countries as well.

In the US the decline in house prices has led to a marked increase in delinquencies on mortgage loans, mainly in the subprime sector, i.e. the market in loans granted against limited personal guarantees, which account for around 14 per cent of all outstanding mortgages. The increase in the delinquency rate on subprime mortgages, from 11.6 per cent at the end of 2005 to 17.3 per cent at the end of December 2007, was greater in the case of adjustable-rate mortgages, which represent around two thirds of the total, and for those granted more recently, partly because of the less rigorous criteria adopted by lenders. The fall in house prices made it harder to obtain a further loan against the value of the property, causing problems mainly for borrowers who had been banking on this to meet increased payments. This factor has had severe repercussions above all for home-owners taking out loans with a very low initial teaser rate that subsequently rises sharply, even without any change in market rates.

Housing demand slowed in 2007 and the number of new mortgages declined. Leading indicators of activity in the US housing market (such as building licence applications and new building starts) do not indicate any abatement of the crisis. The number of months needed to sell the backlog of new houses is rising steadily and this is expected to drive prices down further; the prices of futures contracts on the Case-Shiller index recorded in May this year point to a further fall of more than 10 per cent before the end of 2008.

The estimated difference between the observed and the equilibrium price/rent ratio, a measure of the overvaluation of houses based on the user cost of residential property, peaked at 23 per cent in the fourth quarter of 2006, before declining by 3 percentage points the following year. Fairly similar indications emerge if the observed value of the price/disposable income ratio is compared with its historical average. In the early 1980s, when residential property was overvalued by 20 per cent, it took five years to restore equilibrium values, but without the need for major adjustments in house prices. In the present phase the fall in prices has been more abrupt and therefore readjustment may be swifter.

Japan

Output grew by 2.1 per cent, compared with 2.4 per cent in 2006, reflecting the trend in domestic demand, which slowed before actually declining in the second half of the year. Investment demand was extremely slack, particularly in the case of residential investment, which fell by 9.5 per cent, partly in connection with the tightening of regulations for new buildings. Consumption decelerated sharply during the year owing to the decrease in nominal wages and still weak upturn in employment, from 0.4 to 0.5 per cent. Growth was led mainly by exports.

In the first quarter of this year GDP grew at an annualized rate of 3.3 per cent, thanks to the strengthening of household consumption and the sharp upturn in exports.

Consumer prices remained virtually stationary, as in 2006. Inflation increased from the last quarter of the year, following the rise in energy and food products, reaching 1.2 per cent on an annual basis in March 2008. Core inflation, which does not include fresh food prices, followed a similar pattern.

In February 2007, given the acceleration of growth, the Bank of Japan raised the target for the overnight rate by 25 basis points to 0.5 per cent. On the same occasion it also announced that it would make further gradual increases according to the future performance of the economy and the trend in prices. In the second half of the year, however, expectations of further increases faded as the international financial market turbulence spread and signs of cyclical weakening emerged. The monetary policy stance remained unchanged and the prices of eurodeposit futures indicate that dealers expect no change in reference rates before the end of 2008.

In the fiscal year that ended in March 2008 the budget deficit came down to 4.9 per cent of GDP, one point less than in 2006, mainly thanks to the large increase in tax revenues linked to high corporate profits. The improvement in the public finances is expected to come to a halt this year as the economy slows: the 2008 budget is based on the deficit remaining stationary. However, the medium-term objectives remain unchanged, with the primary deficit, currently running at -0.9 per cent of GDP, set to move into surplus in 2011. This could lead to a reversal of the upward trend in the public debt, standing at 164.9 per cent of GDP this year, two points higher than in 2006.

The European Union

Growth in the EU-27 decelerated slightly, from 3.1 per cent in 2006 to 2.8 per cent last year. Although euro-area output slowed in the second half of the year, it grew by 2.6 per cent on average during the year, compared with 2.8 per cent in 2006, much faster than the 1.5 per cent average recorded in the three years 2003-05.

In the United Kingdom economic activity expanded by 3 per cent, driven by the acceleration in consumption and the rapid increase in investment, while the export sector subtracted around half a percentage point from GDP growth. Inflation, measured by the harmonized consumer price index, remained well above the target of 2 per cent in the first half of the year, prompting the Bank of England to raise the reference rate for monetary policy on three separate occasions, for a total of 0.75 points, bringing it to 5.75 per cent. Subsequently, the rate of price increase slowed to 1.7 per cent in August. Starting in the last quarter of 2007, the heightened financial tensions and deteriorating economic situation led the Bank of England to lower the reference rate to 5 per cent, despite a resurgence of inflation to 3 per cent in April of this year. According to the Bank's latest forecasts inflation will continue to accelerate in the coming months in response to the rise in prices of energy products and imported goods, and will only fall back to the target rate of 2 per cent in 2010. In the fiscal year 2007-08 ending in March the public sector net borrowing requirement rose to around 2.6 per cent of GDP, compared with 2.3 per cent a year earlier. In the budget for the current year the cost of rescuing Northern Rock will temporarily increase the national debt by 1 per cent of GDP.

Despite marked differences, growth in the new EU member countries that have not yet adopted the euro remained strong overall at 6.2 per cent, compared with 6.6 per cent in 2006; the expansion was driven by domestic demand. Household consumption rose by 6.2 per cent on average, against 6.7 per cent in 2006, with a slowdown in the second half of the year, notably in the Baltic states and Hungary. Investment accelerated to 14.8 per cent, sustained by the expansion in credit; lending to households continued to increase at a rapid pace, particularly in the home mortgage segment.

The robust growth in domestic demand and the rise in food and energy prices increased inflationary pressures in almost all of these countries. Average consumer price inflation rose to 5.7 per cent, from 4.5 per cent in 2006. The rate of increase was considerably faster in the Baltic states and in Hungary, partly owing to the alignment of regulated prices and indirect taxes with average levels in the EU.

All the monetary authorities, except those of Estonia and Slovakia, sought to contain the expansion of credit and counter inflation by tightening monetary conditions. In the countries with flexible exchange rates (the Czech Republic, Hungary, Poland and Romania) reference rates were raised by between a minimum of 75 basis points (Hungary) and a maximum of 300 basis points (Romania). Bulgaria and Lithuania, which have adopted a currency board against the euro, and Latvia, which has a narrow fluctuation band (+/-1 per cent) around the central parity of the euro, raised the rates on standing facilities by 150, 60 and 100 basis points, respectively.

The current account deficits of almost all these countries widened further in 2007, to 11.8 per cent of GDP on average from 10.6 per cent in 2006, reflecting a higher import bill caused by large rises in commodity prices. The deficits were financed mainly by capital inflows, predominantly bank loans, which averaged 14.5 per cent of GDP. Inflows of foreign direct investment remained substantial (6 per cent of GDP), especially in Bulgaria where they amounted to 20.5 per cent.

Thanks among other things to the cyclical upturn, the budget deficits narrowed, except in Lithuania and Romania. Hungary, Poland and Slovakia introduced measures to curb expenditure. In April of this year Slovakia applied for an assessment of its economic convergence with a view to adopting the euro in January 2009.

The main emerging economies: China, India, Brazil and Russia

China. – In 2007 the economy grew by 11.9 per cent, up from 11.6 per cent in 2006, benefiting from the acceleration in both domestic demand and exports (Table 1.2).

Table 1.2

Main macroeconomic indicators for Brazil, China, India and Russia
(percentage changes, unless otherwise indicated)

	GDP		Consumer prices		Balance on current account (2)		Share of world GDP at PPP (3)	Per capita GDP at PPP (4)
	2002-06 (1)	2007	2002-06 (1)	2007	2002-06 (1)	2007	2007	2007
Brazil	3.3	5.4	8.1	3.6	0.8	0.3	2.8	9,080
China	10.1	11.9	1.5	4.8	5.1	11.1	10.8	5,292
India	7.6	9.2	4.5	6.4	0.1	-1.8	4.6	2,659
Russia	6.6	8.1	12.6	9.0	9.4	5.9	3.2	14,692
Memorandum item								
Emerging countries	*6.7*	*7.9*	*6.1*	*6.4*	*2.9*	*4.2*	*43.6*	*5,202*
Advanced countries	*2.5*	*2.7*	*2.0*	*2.2*	*-1.0*	*-1.2*	*56.4*	*37,115*

Source: IMF.
(1) Average annual values. – (2) As a percentage of GDP. – (3) Percentages. – (4) US dollars.

Investment continued to expand at a robust pace, contributing 4.6 percentage points to GDP growth. The largest increase was recorded in the sectors of raw-materials processing, machinery and real-estate services, while signs of a weakening appeared towards the end of the year in a few export-led sectors affected by the downturn in demand from the advanced economies.

Real consumption expenditure, amounting to around 50 per cent of GDP, contributed 4.7 per cent to the growth in output, driven by the acceleration in public sector consumption and the increase in employment. Some 10.4 million new jobs were created in urban areas while about twice that number of workers abandoned the countryside, leaving the unemployment rate unchanged at 4 per cent.

Consumer price inflation increased sharply in 2007, to 4.8 per cent from 1.5 per cent in 2006. It has continued to rise in 2008, reaching 8.5 per cent in April. This trend mainly reflects the acceleration in the prices of food products (12.3 per cent in 2007), which account for more than a third of households' expenditure, due not only to price hikes on international markets but also to a contraction in the supply of some products, notably meat, caused by internal factors. Excluding food prices, inflation remained moderate (1.8 per cent in March of this year).

The increase in inflation prompted the People's Bank of China (PBC) to tighten monetary conditions. In order to drain excess liquidity the PBC made substantial use of open-market operations in 2007 and on several occasions increased the reference rate on bank lending and the reserve requirement ratio. The latter was raised to 16.5 per cent in May of this year, from 9.5 per cent in January 2007. The liquidity surplus was boosted by a massive build-up of foreign currency reserves, which the PCB used to counter upward pressure on the renminbi generated by the large trade surplus and the substantial inflow of foreign direct investment.

In the first quarter of 2008 output growth slowed to 10.6 per cent due to the effect of bad weather on economic activity and the weakening of exports.

India. – Economic activity expanded rapidly for the fifth consecutive year, by 9.2 per cent, reflecting the strong performance of domestic demand. The main contribution to growth continued to come from the service sector.

Wholesale price inflation, which is the reference index for monetary policy, peaked at 6.5 per cent at the beginning of 2007, overshooting the tolerance threshold of 5 per cent. The monetary authorities introduced a series of restrictive measures, bringing the rate down gradually over the year to 3.6 per cent in December. Against the background of full industrial capacity utilization and abundant liquidity fed by capital inflows, the rise in the prices of oil and food products caused a resurgence of inflation at the beginning of 2008, leading to a 7.3 per cent increase in prices in April. In the same month the central bank raised the reserve requirement ratio on two occasions, for a total of 75 basis points, to 8.25 per cent.

Thanks to rapid economic growth, tax revenues continued to increase, overtaking the government's original forecasts. Part of the additional revenue was redistributed in the form of public subsidies to contain the effects of rising food and energy prices.

The protracted expansion of economic activity fostered further large inflows of capital in 2007. Foreign direct investment, which had been very modest up to 2005, rose to $23 billion, equal to 3.1 per cent of GDP. Overall, net inflows were more than sufficient to offset the current account deficit of 1.8 of GDP. The monetary authorities countered some of the resulting upward pressure on the rupee by a massive build-up of foreign currency reserves.

Brazil. – The Brazilian economy, which had been expanding strongly since 2004, grew by 5.4 per cent in 2007, driven by consumption and investment.

The growth in household consumption accelerated to 6.5 per cent, benefiting from the increase in employment and wages (7 per cent). The expansion in investment rose to 13.4 per cent, driven mainly by export-led sectors such as agri-food and energy.

Inflationary pressure increased in the second half of 2007, mainly in the sector of food products; however, the rise in consumer prices in the year as a whole (3.6 per cent) was below the monetary policy target rate. The central bank abandoned its accommodating monetary policy stance in the closing months of 2007 and in April of this year, with inflation accelerating, raised the reference rate to 11.75 per cent. The monetary tightening was preceded in March by the introduction of a tax on foreign investments in short-term fixed-interest securities in order to discourage inflows of capital, part of which are related to carry trade activity.

Russia. – Output expanded by 8.1 per cent in 2007, the fastest rate of the last five years, driven by substantial revenues from energy exports. Household consumption rose by 13 per cent, sustained by the robust performance of real wages, up by 16 per cent. Investment accelerated to 21 per cent, led by the energy industry.

The strong growth in domestic demand, together with the high rate of industrial capacity utilization and the rise in food prices triggered powerful inflationary pressures from the middle of 2007 onwards; in April of this year the consumer price index climbed to 14.3 per cent. The central bank tightened monetary conditions, raising the reference rate on two separate occasions by a total of 50 basis points, to 10.5 per cent, and the reserve requirement ratio by a total of 1.5 percentage points.

The trade surplus remained extremely large, amounting to $132 billion and 10.2 per cent of GDP. Upward pressure on the rouble was heightened by huge net capital inflows – totalling $80 billion, half of which in the banking sector – and was partly countered by a build-up of foreign exchange reserves.

2. THE FINANCIAL AND FOREIGN EXCHANGE MARKETS

The favourable phase of limited volatility, low risk premiums and rising asset prices on international financial markets came to an end last summer after five years. It had been characterized by a pronounced increase in financial leverage and by the search for high yields, both of which had benefited from abundant liquidity and low interest rates.

The US subprime mortgage crisis and losses on structured credit instruments linked to subprime mortgages generated strong strains in the interbank markets of the leading industrial countries; the central banks countered them with extraordinary measures, often coordinating their interventions. The sudden increase in uncertainty triggered portfolio reallocation towards safer assets, which caused the yields on government securities to diminish and simultaneously drove down the prices of both equities and high-risk corporate bonds. The decline of the dollar against the euro and, above all, against the yen accelerated from the summer onwards, partly owing to the reduction in interest rates in the United States. The repercussions on the emerging markets were limited, thanks to the good performance of the real economy and the structural lessening of the financial vulnerability of these countries.

The financial turbulence in the industrial countries

Conditions in the international financial markets remained mainly positive in the first half of 2007. Nevertheless, during that period the rise in delinquency and default rates on US subprime mortgages was reflected in a significant increase in the risk premiums for structured credit instruments linked to these mortgages, such as low-rated mortgage-backed securities and collateralized debt obligations.

The phase of turbulence began in the summer and spread rapidly from the United States to other industrial countries, particularly in Europe, where many intermediaries held securities linked to US subprime mortgages. Between June and July, following downgrades of many high-rated mortgage-backed securities and collateralized debt obligations, the tension heightened and spilled over to a wider range of structured products and credit derivatives. Demand for commercial paper collateralized by asset-backed securities collapsed, making it harder for some non-bank intermediaries to refinance their exposure to those markets.

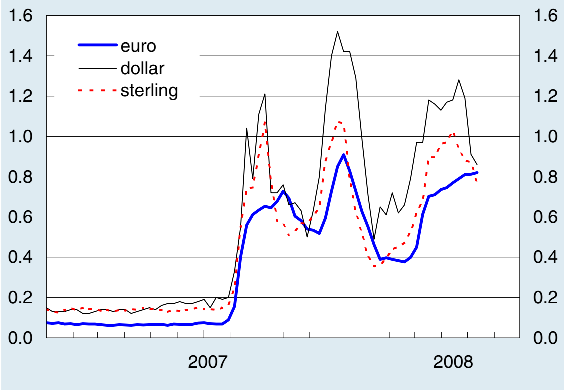
The scant liquidity of structured credit instruments and the difficulty of identifying and quantifying credit risk fuelled uncertainty as to the size and distribution of the losses and, in particular, fed worries that the banking system might be heavily exposed both directly and through related entities (conduits and structured investment vehicles). In August an unexpected increase in banks' demand for liquidity in order to meet their commitments vis-à-vis the above-mentioned entities and for precautionary reasons, together with the perception of higher counterparty risk, began to provoke strains in the interbank markets. Banks' reluctance to lend to each other was reflected in a sudden rise in deposit rates in the main currencies and the widening of interest rate spreads between unsecured and secured deposits (Figure 2.1). Investors grew more risk-averse, and this caused share prices to fall, corporate bond spreads to widen and government securities yields to decline; current and expected volatility rose sharply.

The tension subsided in the second half of September following the reduction in interest rates in the United States, but then mounted again in the last quarter of the year and the first few months of 2008. This was due in part to the huge amount of write-downs and losses on loans that financial intermediaries gradually announced or booked (about $340 billion up to mid-May 2008). Other factors were also at work, notwithstanding the strongly expansionary stance of monetary policy: the worsening of the real-estate market and the slowdown of the economy in the United States; the spread of the credit crisis to other sectors, including prime mortgages and commercial building; and the balance sheet problems of the companies that provide insurance against credit risk of some financial assets, including structured products, with the consequent fears of a rating downgrade for these insurers, which would extend to the instruments backed by them (including the bonds of many municipalities).

Figure 2.1

Spreads between 3-month unsecured and secured interest rates in dollars, euros and sterling (1)

(average weekly data; percentage points)



Source: Thomson Financial Datastream.
(1) Difference between the 3-month interbank rate on the Euromarket and the corresponding repo rate; up to the week ended 18 May 2008.

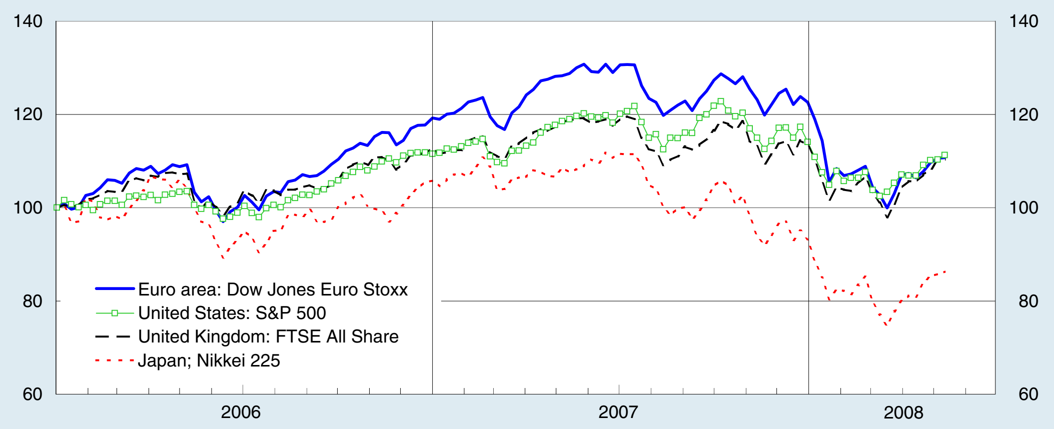
The most critical moment came in the middle of March 2008 with the liquidity crisis of the investment bank Bear Stearns; the potential systemic repercussions prompted the Federal Reserve to accentuate its rate cutting and to give Bear Stearns, technically ineligible for refinancing with the Fed, a 28-day loan through the bank JP Morgan Chase and then to approve the latter's proposal to acquire Bear Stearns within 90 days. The equity and high-risk corporate bond markets have staged a partial recovery since then, but conditions on the financial markets as a whole continue to be marked by high volatility.

On 21 May the main share indices showed declines from the highs recorded last summer of about 8 per cent in the United States and the United Kingdom, 16 per cent in the euro area and 21 per cent in Japan (Figure 2.2); share prices in the financial sector were down by almost 30 per cent in all four areas. The risk premiums on corporate bonds had more than doubled since mid-July 2007, those on high-yield securities increasing from 2.5 to 5.7 percentage points in the euro area and from 3.1 to 6.7 points in the United States and those on AAA-rated securities from 0.2 to 0.6 points and from 0.7 to 1.5 points respectively. Ten-year government bond yields, which had risen in all the areas in the first six months of last year, were down to 4.3 per cent in the euro area, 3.8 per cent in the United States, 1.6 per cent in Japan and 4.9 per cent in the United Kingdom, near or below the levels at the beginning of 2007. The stock of commercial paper collateralized by asset-backed securities outstanding in the United States has contracted by about €450 billion since last August, to €750 billion.

Figure 2.2

Stock market indices (1)

(average weekly data; first week of January 2006=100)



Source: Thomson Financial Datastream.
(1) Up to the week ended on 18 May 2008.

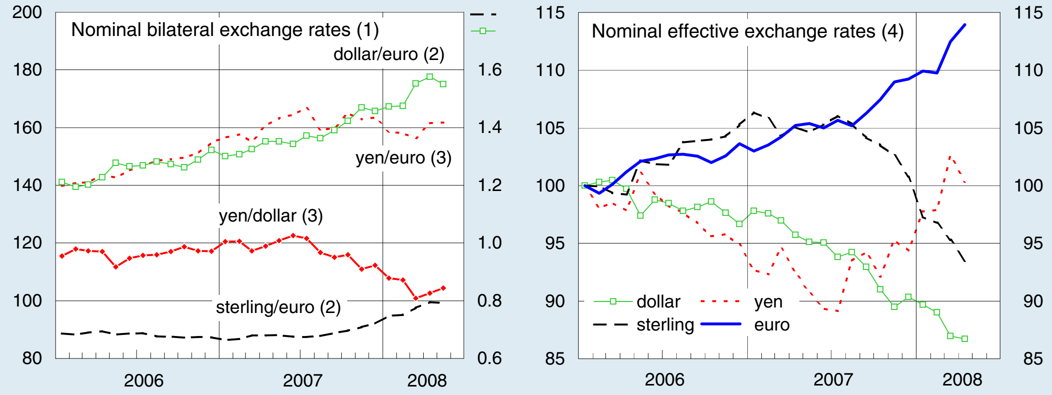
The main central banks have intervened repeatedly to relieve the pressures on the interbank markets by injecting liquidity into the system and taking steps to ensure the orderly functioning of the markets. These interventions have succeeded only partly in containing the pressure. Albeit with ups and downs, the spreads between the rates on unsecured and secured interbank deposits have remained far above the levels recorded before August. They currently stand at around 0.8 percentage points for three-month deposits in dollars, euros and sterling, compared with an average of about 0.1 points in the first half of 2007 (Figure 2.1).

The shortage of liquidity and the decline in capital ratios in the banking system are causing concern that the supply of credit to households and firms could contract significantly. Lending conditions have become more stringent since the third quarter of 2007 according to the bank lending surveys conducted by the Federal Reserve, the Eurosystem and the Bank of England. In the United States, lending to firms began to slow down in the first quarter of this year after a strong acceleration in the second half of 2007 due to the accumulation on banks' balance sheets of massive loans connected with leveraged buy-outs that the banking system was unable to sell on the market (see the boxes "Impact of the turmoil on financial intermediaries and credit", *Economic Bulletin* no. 47, January 2008, and "Bank lending in the United States", *Economic Bulletin* no. 48, April 2008). Gross issues of corporate bonds have contracted by 50 per cent since the middle of 2007 both in the United States, where the decline has been limited to banks and other financial companies, and in the euro area, where it has involved all sectors.

From the beginning of 2007 to 21 May 2008 the US dollar depreciated by 16 per cent against the euro; from the end of June 2007 onwards it also weakened against the yen by a total of 16 per cent (Figure 2.3). In addition, the dollar's downtrend against the renminbi accelerated, with a loss of 10 per cent from January 2007. The weakness of the dollar reflected expectations of a sharp slowdown of the economy and reductions of interest rates in the United States. Since 2002, when the phase of dollar weakness began, the US currency has depreciated by about 45 per cent against the euro and by 27 per cent in nominal effective terms. Since July 2005, when China made its exchange-rate regime more flexible, the dollar has depreciated by 16 per cent against the renminbi.

Figure 2.3

Exchange rates of the main currencies
(average monthly data)



Sources: Bank of Italy and ECB.
(1) Units of the first currency per unit of the second; the data for May 2008 are based only on the first 21 days of the month. – (2) Right-hand scale. – (3) Left-hand scale. – (4) Indices, January 2006 = 100. An increase indicates an appreciation.

Financial markets in the emerging countries

In mid-July financial markets in the emerging countries began to be affected by the turmoil that shook the advanced economies. The strains were transmitted mainly through portfolio reallocation towards less risky assets, since the direct exposure to losses on subprime mortgages and other US structured products was negligible.

The repercussions on the emerging countries' financial markets have been limited as a whole: risk premiums on bonds have increased but are still relatively low by historical standards, stock market indices are close to the levels where they stood before the onset of the turbulence, and international capital has continued to flow into the main areas, albeit more slowly than in the first half of 2007.

The resilience of these markets reflects not only the persistence of a favourable business cycle but also the improvement in fundamentals in the last decade. It is in sharp contrast with what occurred in the two previous decades, when shocks originating from the advanced countries tended to affect the emerging economies, causing price collapses and interruptions in capital flows.

However, financial conditions have deteriorated more markedly, especially since February of this year, in some countries that are more vulnerable because of their large and persistent current account deficits and heavy dependence on portfolio or bank capital inflows (Bulgaria, Romania, South Africa, Turkey and Ukraine).

The recommendations of the Financial Stability Forum

In the report it published this April the Financial Stability Forum – an organization established in 1999 by the finance ministers and central bank governors of the G7 countries that brings together governments, central banks and supervisory authorities having responsibility for financial stability – set out a series of recommendations intended to strengthen the stability of the financial system. Some proposals aim at correcting the vulnerabilities connected with the complexity of structured credit instruments and with the relationships between banks and bank-related entities that invest in such products. The report proposes action in five areas: prudential regulation, transparency of intermediaries, the role of rating agencies, supervisory activity and the responses of central banks.

As regards the strengthening of prudential rules for banks and of banks' risk controls, the report states that it is necessary not only to accelerate the implementation of the Basel II discipline but also to introduce greater safeguards against the risks associated with exposure to the structured credit market, taking into account the positions of affiliated companies in groups and of off-balance-sheet entities. The determination of capital requirements must also be aimed at averting procyclical dynamics in credit supply. Liquidity risk management practices need to be tightened; to this end, the supervisory authorities of the main countries will promptly issue the relevant guidelines and will check that they are actually applied by banks. In addition, measures must be taken to improve valuation models and stress-testing procedures for structured products, especially the more complex ones. Lastly, compensation systems need to be aligned with long-term profitability objectives.

A second set of proposals aims at enhancing transparency on the risks of structured products, on each stage of the securitization process, and on the risks for final holders; in particular, more information should be disclosed on the valuation methods adopted, especially in the absence of a sufficiently liquid secondary market.

The need for greater transparency also applies to rating agencies. The third set of proposals is directed towards improving the information these agencies disclose concerning the quality of the data and risk assessment models used for some products. The complexity of these investment instruments must be brought out with clarity, including by means of a different rating scale from that used for traditional instruments such as bonds. The use of such ratings must be only the first step in the process of risk assessment by investors, within a risk management model commensurate with their specific objectives. Further measures will have to be taken to resolve conflicts of interest in the assignment of ratings.

Supervisory activity needs to be strengthened, including through greater cooperation and more intensive and timely exchanges of information between the authorities of different countries.

The objective of the final set of proposals is to strengthen the authorities' ability to deal with stress in the markets, through more flexibility in the operations of central banks, and to manage the difficulties of banks. Here, again, the Financial Stability Forum underscores the importance of greater international coordination.

3. WORLD TRADE AND PAYMENTS BALANCES

Although the growth in demand in the advanced countries slowed, world trade in goods and services continued to expand rapidly in 2007 (6.8 per cent), led by the imports of the emerging countries, which accounted for 55 per cent of global trade growth.

Raw material prices continued to increase. Against a backdrop of sharply rising energy consumption by the emerging economies and stagnating global crude oil supplies, petroleum prices soared. The upward pressure on the prices of oil and other commodities intensified in the first few months of 2008. Sharp rises in food commodity prices affected consumer prices and the purchasing power of the poorest population groups, especially in the developing countries.

Notwithstanding the further rise in oil prices, the worsening of global balance-of-payments disequilibria was halted in 2007. Partly as a result of the depreciation of the dollar and the weakening of US domestic demand growth relative to that of the other leading economies, the US current account deficit narrowed to $739 billion, from $811 billion in 2006. The large surplus of the oil exporting countries stabilized at around $450 billion, while that of the Asian economies expanded further to exceed $700 billion, owing above all to the increase in China.

International trade and commodities prices

World trade in goods and services continued to expand rapidly in 2007, although its real growth rate came down from 9.2 to 6.8 per cent. The imports of the emerging economies again expanded sharply (12.8 per cent), while the growth of those of the advanced countries slowed from 7.4 to 4.2 per cent. The slowdown was due mainly to developments in the United States, where imports rose by just 1.9 per cent; those of the euro-area countries, including trade within the area, increased by 5.1 per cent.

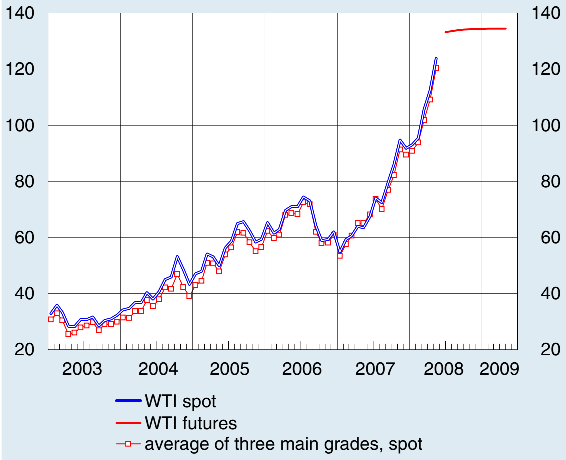
Since the turn of the decade, with domestic demand growing strongly and international economic integration increasing irreversibly, the difference between the rate of growth in imports by the emerging and the advanced economies has widened steadily, reaching almost 9 percentage points last year. As a result there has been an increase in the share of total world imports going to the emerging countries.

The price of crude oil rose sharply in 2007 and continued to do so in the first few months of 2008. In the first twenty days of May the average for the three main grades reached a peak of $120.20 a barrel, 84.7 per cent higher than twelve months earlier. The futures contracts traded on the NYMEX commodities exchange at the end of that period indicated that the WTI grade, then trading at $133 a barrel, would sell for $134.30 in December (Figure 3.1).

Figure 3.1

Oil: spot and futures prices (1)

(dollars per barrel)



Sources: IMF, Reuters and Thomson Financial Datastream.
(1) For spot prices, average monthly data; for May 2008, the first 21 days only. For futures, quotes at 21 May. The three main grades are Brent, Dubai and WTI.

Since the start of the present cyclical upswing in prices in April 2003, the price of oil has risen by 371.5 per cent in nominal terms. Deflated by the consumer price index in the main industrial countries, the cost of crude oil in the first twenty days of May was about the same as the historic peak of November 1979.

Last year, for the first time since 2002, the global supply of oil was not enough to meet the increased demand. Consumption in the industrial countries stagnated, but in the emerging economies (which account for 43 per cent of world consumption) it increased rapidly, by nearly 4 per cent. The relative price inelasticity of their energy demand presumably depended in part on public consumption subsidies in some countries, mainly in Asia and the Middle East.

The OPEC cartel adopted a more restrictive supply policy last year, and the other oil producers increased production capacity by less than had been forecast.

The rise in oil prices was accompanied by an across-the-board increase in the prices of other raw materials. The rise in food commodity prices accelerated and in April 2008 they were 45.6 per cent higher than a year earlier. Over the past three years structural factors on both the demand and the supply sides, partly related to the unbroken rise in energy prices, have spurred soaring prices for grains and oilseeds (see the box “The recent rise in food commodity prices”, Bank of Italy *Economic Bulletin* No. 48, April 2008). While the developing countries with abundant natural resources have been able to more than offset the costs of higher food commodity prices by increased revenue from raw materials exports, other developing countries that are heavily dependent on agricultural imports, mainly in Africa and Asia, have suffered a severe deterioration in their terms of trade.

In response to rising food commodity prices and the consequent danger of social tensions, some of the producer countries have recently introduced export restrictions and taxation in an effort to defuse pressures in domestic markets; these had the effect of increasing price volatility still further. Moreover, such measures tend to be counterproductive in the longer run as well, because they decrease competition and impede the global integration of farm product markets, thus weakening the market incentives to expand supply. Instead, these incentives need to be strengthened and broadened by cutting back the artificial price supports and import protection policies in place in most domestic farm product markets, first and foremost those in the leading industrial countries.

Although global economic activity showed signs of slowing in the closing months of 2007, the upward trend in raw materials and especially energy prices, which tend to be more cyclically reactive, did not cease in the early months of 2008. This contrasts with the pattern of previous cyclical downswings.

Balance-of-payments disequilibria

Though still large, the US deficit on current account diminished for the first time in five years in 2007, from 6.2 to 5.3 per cent of GDP (Table 3.1). The reduction stemmed principally from improvements in the balance on trade in services and in the income account, but it also reflected at least a modest narrowing of the trade deficit from $838 billion il 2006 to $815 billion. An increase of nearly 10 per cent in energy import expenses was more than offset by the positive trend in the balance on merchandise trade in volume terms. Imports slowed sharply in 2007 while exports grew rapidly (8 per cent) for the fourth consecutive year, outpacing world trade growth.

Again in 2007 the US deficit was financed mainly by private capital inflows, which amounted to $1,451 billion, about the same as in 2006. Starting in mid-year, however, with the onset of financial turmoil and the worsening of the prospects for US economic growth, the inflow was drastically reduced, to less than half that of the first part of the year. As they became more risk-averse, international investors reduced their purchases of corporate bonds, while the easing of monetary conditions discouraged short-term capital inflows. Foreign official investment remained substantial, at $413 billion compared to $440 billion in 2006.

According to IMF estimates, at the end of 2007 the ratio of the net debtor position to America's GDP was about the same as a year earlier (16.2 per cent).

Most of the increase in the current account surplus of the Asian economies was accounted for by China, which had a surplus of $372 billion, or 11.3 per cent of GDP, in 2007. As in previous years, the main factor was China's merchandise trade surplus, which rose by $85 billion to $262 billion, according to customs data. Exports increased in value by 25.7 per cent and imports by 20.8 per cent, compared with 27.2 and 19.9 per cent respectively in 2006. The slowdown in export growth, which emerged in the fourth quarter, mainly involved manufactures, while the slight acceleration in imports came in food and energy products.

After three years of strong expansion, the current account surplus of the main oil exporting countries stabilized last year at about 10 per cent of their GDP. The price-induced revenue gains from oil exports were offset by these countries' increased respending on imports of consumer and investment goods.

The countries running current account surpluses continued to amass foreign exchange reserves, using foreign exchange market interventions to counter the upward pressures on their currencies. China's reserves increased by $460 billion to nearly $1,550 billion at the end of 2007, approximately equal to the reserves of all the industrial countries combined. The reserves of the main oil exporters also expanded considerably, to nearly $1,070 billion. In recent years this very substantial accumulation by the commodity exporters and the countries whose currencies are pegged to the dollar has come to exceed the levels warranted by the need for liquid resources to cope with possible downward pressures on the currency. Accordingly, these countries have allocated a part of these resources to sovereign wealth funds.

Table 3.1

Current account of the balance of payments and foreign exchange reserve flows

	Current account balance (1)						Foreign exchange reserve flows		
	2005		2006		2007		2005	2006	2007 (2)
	billion dollars	% of GDP	billion dollars	% of GDP	billion dollars	% of GDP	billion dollars	billion dollars	billion dollars
United States	**-754.8**	**-6.1**	**-811.5**	**-6.2**	**-738.6**	**-5.3**	**-21.8**	**0.8**	**4.7**
Euro area	**21.4**	**0.2**	**-0.4**	..	**37.0**	**0.3**	**-27.3**	**12.3**	**18.6**
Japan	**165.8**	**3.6**	**170.4**	**3.9**	**211.0**	**4.8**	**0.4**	**45.4**	**73.1**
United Kingdom	**-55.9**	**-2.5**	**-93.6**	**-3.9**	**-115.3**	**-4.2**	**-1.5**	**2.2**	**8.3**
Canada	**23.4**	**2.0**	**20.8**	**1.6**	**12.8**	**0.9**	**-1.5**	**2.0**	**6.0**
Latin America	**35.0**	**1.4**	**45.4**	**1.5**	**16.4**	**0.5**	**34.8**	**55.1**	**134.6**
Asia	**236.6**	**4.6**	**361.4**	**6.1**	**518.8**	**7.3**	**235.0**	**382.3**	**690.4**
Newly industrialized Asian economies (NIEs) (3)	73.4	5.1	82.8	5.2	104.0	6.1	15.6	57.6	69.4
Hong Kong	*20.2*	*11.4*	*22.9*	*12.1*	*27.4*	*12.3*	*0.7*	*8.9*	*19.5*
Singapore	*22.3*	*18.6*	*29.8*	*21.8*	*39.0*	*24.3*	*3.6*	*20.1*	*26.7*
South Korea	*15.0*	*1.9*	*5.4*	*0.6*	*6.0*	*0.6*	*11.3*	*28.6*	*23.3*
Taiwan	*16.0*	*4.5*	*24.7*	*6.7*	*31.7*	*8.3*	….	….	….
ASEAN-4	12.6	1.8	38.5	4.8	54.8	5.8	7.0	38.9	62.9
Indonesia	*0.3*	*0.1*	*10.8*	*3.0*	*11.0*	*2.5*	*4.0*	*12.3*	*18.9*
Malaysia	*20.0*	*14.6*	*25.5*	*16.2*	*28.9*	*14.0*	*2.8*	*4.1*	*10.2*
Philippines	*2.4*	*2.0*	*5.0*	*4.5*	*6.4*	*4.4*	*-1.8*	*8.0*	*13.9*
Thailand	*-7.6*	*-4.3*	*2.2*	*1.1*	*14.9*	*6.1*	*2.0*	*14.6*	*19.9*
India	-10.3	-1.3	-9.7	-1.1	-11.9	-1.8	5.3	38.8	96.3
China	160.8	7.2	249.9	9.4	371.8	11.3	207.0	247.0	461.8
Central and Eastern Europe	**-61.3**	**-4.7**	**-90.9**	**-6.2**	**-121.5**	**-6.6**	**30.2**	**38.0**	**61.4**
Oil-exporting countries	**362.6**	**11.6**	**459.8**	**12.3**	**448.3**	**10.2**	**113.1**	**212.8**	**316.3**
OPEC (4)	234.2	18.2	309.4	19.7	313.6	17.1	45.4	81.0	132.7
Algeria	*21.2*	*20.6*	*29.0*	*25.2*	*30.6*	*23.2*	*13.1*	*21.6*	*32.4*
Indonesia	*0.3*	*0.1*	*10.8*	*3.0*	*11.0*	*2.5*	*-1.8*	*8.0*	*13.9*
Iran	*-1.0*	*-3.3*	*4.3*	*8.6*	*4.7*	*7.5*	….	….	….
Kuwait	*34.3*	*42.5*	*51.1*	*51.7*	*52.7*	*47.4*	*0.6*	*3.7*	*4.1*
Libya	*17.4*	*41.8*	*25.6*	*51.6*	*24.3*	*42.5*	*13.8*	*19.8*	*20.1*
Nigeria	*7.9*	*7.1*	*13.9*	*9.5*	*1.2*	*0.7*	*11.3*	*14.0*	*9.0*
Qatar	*14.1*	*33.2*	*16.1*	*30.6*	*23.4*	*34.6*	*1.1*	*0.8*	*4.1*
Saudi Arabia	*90.1*	*28.5*	*95.5*	*27.4*	*100.8*	*26.8*	*-0.8*	*1.0*	*6.2*
United Arab Emirates	*24.3*	*18.3*	*35.9*	*22.0*	*41.7*	*21.6*	*2.5*	*6.6*	*48.1*
Venezuela	*25.5*	*17.7*	*27.2*	*14.7*	*23.2*	*9.8*	*5.5*	*5.5*	*-5.2*
Mexico	-5.2	-0.7	-2.2	-0.3	-7.3	-0.8	9.9	2.2	10.8
Norway	49.2	16.3	58.3	17.3	63.7	16.3	2.7	9.9	4.0
Russia	84.4	11.0	94.4	9.5	78.3	5.9	55.1	119.7	168.8

Sources: IMF and national statistics.
(1) Owing to errors, omissions and differences in international statistics, in the last two years the world current account balance, instead of being nil, has turned significantly positive (according to IMF estimates, it went from $0.9 billion in 2005 to $81.5 billion in 2006 and $167.6 billion in 2007). – (2) For the United Arab Emirates, first eleven months. — (3) The flow of foreign exchange reserves does not include Taiwan. – (4) The OPEC aggregate does not include Angola, Ecuador and Iraq. The flow of foreign exchange reserves does not include Iran.

4. INTERNATIONAL ECONOMIC COOPERATION

Financial assistance disbursed by the International Monetary Fund continued to diminish in 2007 and in early 2008, and at the end of March outstanding loans to member countries were equal to 5.8 billion SDRs, down from 9.8 billion at the end of 2006. The main IMF debtor is now Turkey, accounting for 72.8 per cent of the total; other borrowers include the Dominican Republic, Liberia, Sudan and Ukraine. A sharp debate is under way on the reform of the IMF's sources of revenue, which have dried up owing to the drastic contraction in member countries' demand for credit.

Work continued during the year to strengthen crisis prevention and improve dialogue with systemically important countries, including emerging economies. Two major reforms were completed: that of "bilateral surveillance" and that of IMF quotas and voting rights. The financial market turmoil and the increased importance of sovereign wealth funds highlighted the need to intensify surveillance of the global financial system and to coordinate the IMF's preventive action with that of other international organizations, especially the Financial Stability Forum, the OECD and the World Bank.

As regards economic development and poverty reduction, the Millennium Development Goals now appear very difficult to achieve. Against the backdrop of a contraction in official development assistance in 2007, the World Bank has undertaken a revision of its own long-term strategy.

Reform of the IMF's surveillance function

On 15 June 2007 the Executive Board of the Fund adopted a "Decision on Bilateral Surveillance over Members' Policies" by a large majority, replacing the 1977 "Decision on Surveillance over Exchange Rate Policies". The new Decision reinterprets (without amending) Article IV of the Fund's Articles of Agreement, which specifies the purposes of surveillance, the forms and members' obligations.

The Decision adopts "external stability" as the organizing principle for bilateral surveillance, defining stability as a balance-of-payments position that does not cause disorderly exchange rate movements. The notion implies joint fulfilment of two conditions: no "fundamental misalignment" of real exchange rates, i.e. rates consistent with current account positions, adjusted for cyclical or contingent factors, that are near balance; and stable capital flows not subject to the risk of sudden reversal. The external stability of each country, it is felt, will contribute to that of the system as a whole, thus making it easier to achieve the "stable system of exchange rates" to which the members and the Fund are jointly pledged. At the same time, under Article IV, member countries are obliged to pursue policies directed to their own “internal stability” (sustainable, non-inflationary growth), which is the essential prerequisite for external stability.

As to the forms of surveillance of IMF member countries that belong to currency unions, the Decision establishes that the concepts of “external stability” and “fundamental misalignment” apply only to the union, not to its individual members. The latter must seek to maintain internal stability and thereby contribute to that of the union as such. Nevertheless, the IMF will continue to monitor national balance-of-payments positions and real exchange rates, because serious imbalances at national level could have repercussions on the union’s balance of payments.

The new Decision stresses the importance of exchange rates and that of deviations from a situation of equilibrium as warning signs of the risk of disorderly movements in nominal exchange rates, prices of other financial assets, or inflation rates. Significant as it is, this new approach has not yet been fully applied. On the one hand, the method for defining and estimating equilibrium exchange rates has been better specified, although these instruments still need fine-tuning; on the other, however, external communication on exchange rates remains complex and delicate and must be handled with great caution. In the absence of new obligations for member countries and specific power of the Fund to apply sanctions for violators, the effectiveness of the IMF’s action in this field still depends essentially on authoritative analysis, on correct communications with national policy-makers and with markets, and on peer pressure within the Executive Board.

Reform of voting power

On 28 April 2008 the 185 Governors of the IMF approved a resolution increasing the quotas of many countries, and hence their voting rights. The intention is to bring the distribution of voting power more closely into line with the changing relative size of the member economies and to provide for better representation of the poorest countries. A first step in this direction was taken at the end of 2006 at the annual meetings in Singapore, with increases in the quotas of China, Mexico, South Korea and Turkey, all of which were seriously underrepresented. The reform was completed this April with further increases in quotas and voting power for those and other countries, including a good number of emerging economies. This brought the protracted, complex talks initiated in 2001 to a close.

The reform institutes a new, “non-linear” voting power formula based on four factors, provides for an increase of 11.5 per cent in Fund capital (with respect to the pre-Singapore situation) distributed among the beneficiary countries on an ad hoc basis, and triples so-called basic votes. The quotas of 54 countries, including 41 non-advanced countries, were increased. Taking the increase in basic votes from 250 to 750 into account, there has been a shift in voting power of 2.7 percentage points from the advanced to other countries (Table 4.1). China now has the sixth-largest quota, behind the United States, Japan, Germany, France and the United Kingdom. The increased voting power of the emerging countries came mainly at the expense of the European Union countries, whose relative voting power was reduced by 1.6 points. The votes of the lowest-income countries increased by 1.1 points, 0.4 points for India alone. Italy’s quota was increased by 827 million SDRs (about €870 million), with a very slight decrease in relative voting power from 3.24 to 3.16 per cent of the total.

Table 4.1

Quotas and voting power in the IMF

COUNTRY	Quota *(millions of SDRs)*		Voting power *(per cent of total)*		
	Before reform	Increase	Before reform	After reform	Difference
Countries increasing relative voting power, of which:					**+5.42**
China	6,369	3,152	2.93	3.80	+0.88
South Korea	1,634	1,732	0.76	1.36	+0.60
India	4,158	1,663	1.92	2.34	+0.42
Brazil	3,036	1,214	1.40	1.72	+0.31
Mexico	2,586	1,040	1.20	1.47	+0.27
Spain	3,049	973	1.41	1.62	+0.22
Turkey	964	491	0.45	0.61	+0.15
Ireland	838	419	0.40	0.53	+0.13
Japan	13,313	2,317	6.11	6.23	+0.12
Poland	1,369	319	0.64	0.70	+0.06
Vietnam	329	132	0.16	0.21	+0.05
Malaysia	1,487	287	0.69	0.73	+0.04
Countries decreasing relative voting power, of which:					**-5.42**
France	10,739	–	4.93	4.29	-0.64
United Kingdom	10,739	–	4.93	4.29	-0.64
Saudi Arabia	6,986	–	3.21	2.80	-0.41
Canada	6,369	–	2.93	2.56	-0.37
Russia	5,945	–	2.73	2.39	-0.35
Netherlands	5,162	–	2.38	2.08	-0.30
United States	37,149	4,973	17.02	16.73	-0.29
Belgium	4,605	–	2.12	1.86	-0.26
Switzerland	3,459	–	1.60	1.40	-0.19
Australia	3,236	–	1.49	1.31	-0.18
Germany	13,008	1,557	5.97	5.80	-0.16
Sweden	2,396	–	1.11	0.98	-0.13
Italy	7,056	827	3.24	3.16	-0.09
Memorandum items:					
Advanced economies (1)	131,728	12,529	60.60	57.90	-2.70
EU-27	70,404	5,562	32.50	30.90	-1.60
Low-income countries (2)	16,468	1,828	8.30	9.40	1.10

Source: IMF.
(1) Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, New Zealand, Netherlands, Norway, Portugal, San Marino, Spain, Sweden, Switzerland, United Kingdom, United States. – (2) The 78 countries eligible for assistance through the IMF's Poverty Reduction and Growth Facility; includes India.

Other initiatives for financial stability

The financial market turmoil has spurred an intensified effort to strengthen IMF surveillance on financial stability, improve the Fund's crisis-prevention instruments and achieve more effective coordination with the Financial Stability Forum (FSF). In April 2008 the Group of Seven approved a new FSF report with recommendations for enhancing the resilience of markets and financial institutions. The Fund's International Monetary and Financial Committee (IMFC) also discussed the report, which addresses its recommendations in large part to national authorities but urges closer cooperation among international organizations in their respective spheres as well. In particular, it recommends that the IMF present regular reports on the risks to global financial stability to the half-yearly meetings of the FSF. In addition, the Fund's own surveillance reports should assess the state of implementation of the FSF's recommendations.

Sovereign wealth funds. – In October the IMFC, though acknowledging the positive effect of sovereign wealth funds in increasing international liquidity and fostering efficient resource allocation, underscored the danger of protectionist backlash in the countries in which the funds invest. The IMF is mandated to engage in a dialogue with the managers of these funds with a view to a voluntary code of conduct. The code, to be drafted with contributions from the sovereign funds themselves and from the OECD and the World Bank, will bear on three issues (governance, institutional arrangements and transparency). At the same time the OECD will develop a code of conduct on the treatment of foreign investors by the recipient countries.

Poverty reduction and development assistance

Poverty reduction. – Achievement of the Millennium Development Goals is still most uncertain. The prospects for the first goal (halving the percentage of the world population living on less than a dollar a day with respect to 1990) remain good, but progress on all the other goals is lagging far behind schedule. The picture has worsened in the last year because of the slowdown in world growth and above all the soaring prices of food commodities. An additional risk factor is climate change, whose impact on the poorest countries is especially dramatic owing to their greater geographical, economic and institutional vulnerability.

Development finance, the role of the World Bank, reform proposals. – Preliminary estimates by the OECD's Development Assistance Committee put official development assistance at $103.7 billion in 2007 (0.28 per cent of the donor countries' GDP), which was 8.4 per cent less than in 2006 in real terms. The reduction reflects the termination of some extraordinary debt cancellations (for Iraq and Nigeria in particular) that had swollen the official assistance figures in 2005 and 2006. Now that this effect has been played out, total assistance should begin to rise again over the next three years to reach the target of 0.35 per cent of the donors' GDP in 2010.

In the five years from 2002 through 2006 net multilateral assistance increased slightly in real terms from $22.5 billion to $23.8 billion, while its share of the total fell from 28 to 23 per cent. Over the same years, the net disbursements of the International Development Association – the World Bank's arm for grants and subsidized lending – declined from $7.5 billion to $6 billion, so its share of total multilateral aid fell from 34 to 25 per cent. The fifteenth replenishment of the IDA's resources, finalized in December, amounted to a record $41.6 billion, 30 per cent more than the fourteenth; $31.4 billion will be provided by donor countries and the rest will consist in transfers from other World Bank institutions. The large amount of resources pledged indicates a significant increase in operations on behalf of the lowest-income countries in 2009-2011. Britain, providing 14 per cent, has become the leading donor, surpassing the United States (12.2 per cent). Italy's share remains stable at 3.8 per cent.

In view of the lag as regards the Millennium Development Goals, the critical situation in sub-Saharan Africa, the impact of climate change, the increase in inequality within the major emerging countries, and the loss of competitiveness of its funding instruments because of narrower market spreads, the World Bank has undertaken a revision of its long-run strategy. The main changes will be: a) intensified action in favour of the poorest countries, first of all in Africa, which will require sufficient contributions for IDA and a relaunching of its role as coordinator in the increasingly fragmented system of global development assistance; b) greater involvement of the most vulnerable countries, for which new approaches and better coordination with other international organizations (such as the United Nations) are needed; c) renewed engagement for the middle-income countries, where there are still very extensive areas of poverty (in fact, 70 per cent of the population with less than two dollars a day lives in these countries); d) simplified loan access, products more closely in line with borrower countries' specific needs, and the revision of advisory services and their unbundling from financial services; and e) establishment of a suitable frame of reference for involving the World Bank in the field of global public goods.

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

5. MACROECONOMIC DEVELOPMENTS

Economic activity in the euro area continued to expand in 2007. Despite the strong appreciation of the euro, exports provided the main stimulus, aided by the sustained growth in world trade. The expansion gave renewed impetus to industrial production and capital investment at a time of favourable credit conditions for a large part of the year. By contrast, the growth in residential investment slowed sharply in response to the slower rise in house prices and in the number of house sales.

Household consumption, which had already been growing only moderately in previous years, weakened further, owing mainly to the sharp fall in spending in Germany at the beginning of the year in connection with the raising of the rate of value added tax, which had prompted German households to bring forward some of their purchases to the last few months of 2006.

Inflation slowed to an annual average of 2.1 per cent in 2007, compared with 2.2 per cent in the preceding two years. The picture deteriorated rapidly from the autumn onwards, however, with inflation rising by 1.5 percentage points to an average of 3.4 per cent in the first quarter of this year, driven by increases in the prices of energy and food commodities. The effects of the increases in official rates by the European Central Bank until mid-2007 and the appreciation of the euro helped counteract the spread of price rises to other sectors.

In the latter part of the year the acceleration in inflation and increased uncertainty caused by the international financial crisis contributed to a darkening of the economic outlook, which mainly affected household consumption. Business confidence deteriorated, despite a strengthening of firms' capacity to export. The economic fundamentals for this year are consistent with continued growth, but at a slower rate than in 2007. The €-coin indicator calculated by the Bank of Italy, which estimates GDP growth adjusted for short-term fluctuations, is now at its lowest level during the current expansion, which is consistent with growth being below potential. The strong acceleration in output recorded in the provisional data for the first quarter, which was particularly pronounced in Germany, may be partly transient. A fall in inflation from the high levels of the first few months of the year depends on the behaviour of commodity prices.

Economic developments in the euro area

The GDP of the euro area increased by 2.6 per cent in real terms in 2007, compared with 2.8 per cent in 2006 (Table 5.1). The rate of growth was higher than that in potential output, and for the first time since 2001 it was faster than in the

United States (2.2 per cent). The cumulative increase in industrial production over the year was 3.1 per cent (Figure 5.1). The growth in manufacturing output was rapid in Germany (5.6 per cent), more modest in France (2.6 per cent) and almost nil in Spain; in Italy production fell.

The factors contributing to the increase in GDP differed from one country to another: domestic demand in France and Spain, exports in Germany and Italy.

Table 5.1

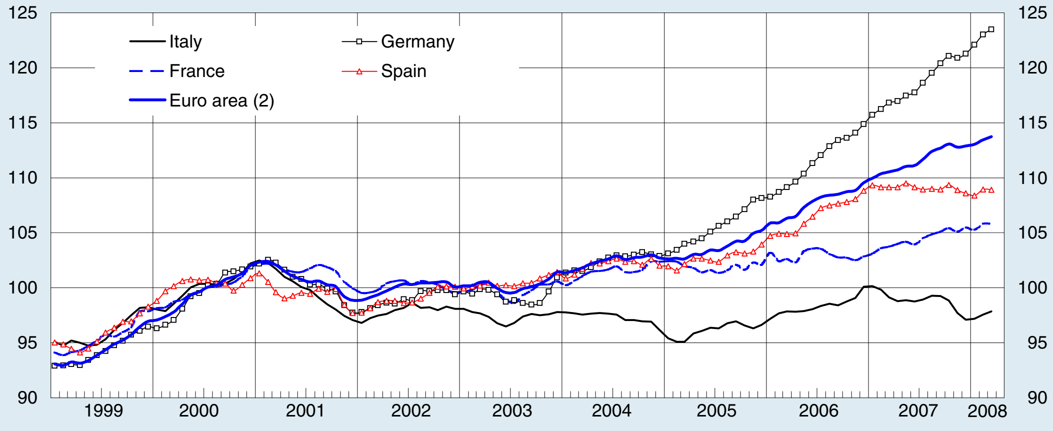
GDP, imports and the main components of demand in the major euro-area countries
(chain-linked volumes; seasonally adjusted data; percentage changes on previous period)

	2005	2006	2007	2007				2008
	Year	Year	Year	Q1	Q2	Q3	Q4	Q1
				GDP				
Germany (1)	0.8	2.9	2.5	0.6	0.2	0.7	0.3	1.5
France	1.9	2.2	2.2	0.6	0.6	0.7	0.3	0.6
Italy (1)	0.6	1.8	1.5	0.3	..	0.2	-0.4	0.4
Spain	3.6	3.9	3.8	1.0	0.9	0.7	0.8	0.3
Euro area (1) (2)	1.6	2.8	2.6	0.7	0.3	0.7	0.4	0.7
				Imports				
Germany	6.7	11.2	4.8	2.0	-2.0	3.2	-0.2	....
France	5.9	6.1	5.5	2.3	1.8	1.8	-1.1	1.9
Italy	2.2	5.9	4.4	1.3	-0.7	1.2	-1.0	....
Spain	7.7	8.3	6.6	1.0	1.7	3.3	-0.6	0.6
Euro area (2)	5.4	7.7	5.2	1.3	0.3	2.5	-0.3	....
				Exports				
Germany	7.1	12.5	7.8	-0.3	0.8	2.5	1.3	....
France	3.1	5.4	3.1	0.9	1.6	1.1	-0.2	3.1
Italy	1.0	6.2	5.0	1.5	-1.7	2.4	-1.3	....
Spain	2.6	5.1	5.3	-0.1	2.2	3.8	-0.7	-0.2
Euro area (2)	4.7	7.9	6.0	0.8	0.9	2.0	0.6	....
				Household consumption (3)				
Germany	-0.1	1.0	-0.4	-1.8	0.8	0.3	-0.8	....
France	2.6	2.3	2.4	0.8	0.8	0.6	0.6	0.2
Italy	0.9	1.1	1.5	1.1	0.1	0.2	-0.3	....
Spain	4.2	3.8	3.2	1.1	0.8	0.5	0.3	0.2
Euro area (2)	1.6	1.8	1.5	0.1	0.6	0.5	-0.1	....
				Gross fixed investment				
Germany	1.0	6.1	5.0	2.1	-1.4	0.6	1.1	....
France	4.4	4.8	4.9	1.2	0.6	1.0	1.1	1.1
Italy	0.7	2.5	1.2	-0.1	-0.6	-0.1	0.6	....
Spain	6.9	6.8	5.9	1.6	1.6	0.6	0.9	0.1
Euro area (2)	3.0	5.0	4.3	1.3	..	1.1	0.8	....
				National demand (4)				
Germany	0.3	1.9	1.0	1.9	-1.2	0.9	-0.4	....
France	2.6	2.4	2.8	1.0	0.6	0.9	0.1	0.4
Italy	0.8	1.8	1.3	0.3	0.3	-0.2	-0.3	....
Spain	5.1	4.8	4.3	1.3	0.8	0.8	0.7	0.5
Euro area (2)	1.8	2.6	2.2	0.9	0.1	0.9	..	....

Sources: Based on national statistics and Eurostat data.
(1) Preliminary estimates for the first quarter of 2008. – (2) The aggregate for the euro area relates to 15 countries. – (3) Consumption of resident households and of non-profit institutions serving households. – (4) Includes changes in stocks and valuables.

Figure 5.1

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 15 countries.

Thanks to the sustained growth in world demand, and despite the large real appreciation of the euro, exports of goods and services by euro-area countries, including trade flows within the area, increased by 6 per cent in volume terms. The growth in German exports was again higher than the average (7.8 per cent), benefiting from the improvement in the competitiveness of German industry brought about by the restructuring and internationalization that has been taking place since the end of the 1990s. There were also appreciable increases in the exports of France (3.1 per cent), Italy (5 per cent) and Spain (5.3 per cent). Germany is the only advanced economy to have increased its share of world trade in volume terms over the last fifteen years.

Imports of goods and services increased by 5.2 per cent, stimulated by substantial purchases of capital goods and the appreciation of the euro.

Gross fixed investment grew at a high rate of 4.3 per cent, consolidating the recovery that had begun in 2004. Contributory factors were the good outlook for demand, especially export demand, and the expansionary credit conditions that prevailed for much of the year. The high level of plant utilization stimulated spending on machinery, equipment and transport equipment, which rose by 4.8 per cent; investment in the construction sector continued to increase (3.7 per cent), despite the sharp and widespread slowdown in residential investment, whose rate of growth (2.6 per cent) was only half what it had been in 2006. The weakening of the real estate cycle was particularly pronounced in Spain, after the exceptionally large increases in housing investment over the last decade (3.1 per cent in 2007 compared with an annual average of 8.1 per cent between 1996 and 2006). In 2007 the area's propensity to invest, approximated by the ratio of total capital formation to GDP, was 22 per cent, higher than the peak reached in the cyclical expansion at the end of the 1990s.

The growth in investment in productive capital was higher than the average in Germany and Spain (7.6 and 8.1 per cent respectively) and in line with the average in France. In Italy, by contrast, investment net of construction stagnated, owing largely to the weakness of industrial activity.

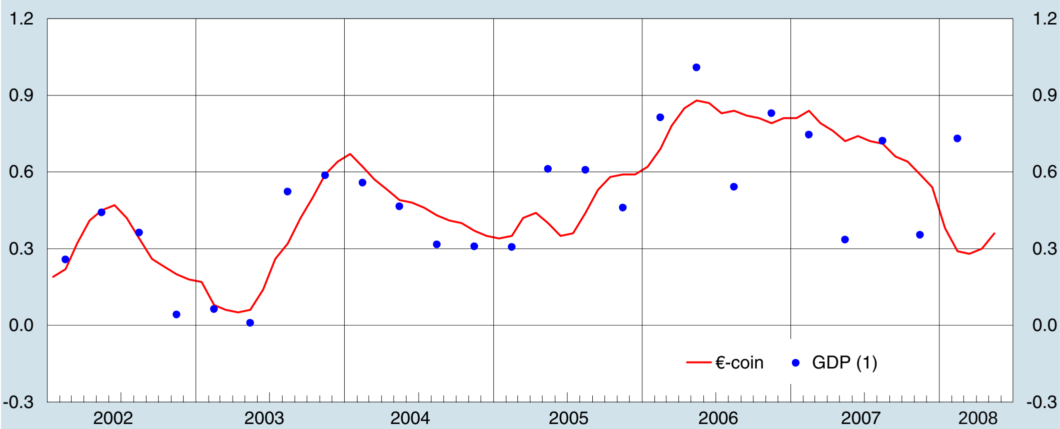
Household consumption in the euro area increased modestly, by 1.5 per cent, confirming an underlying feature of the current phase of the cycle. The smallness of the rise in purchasing power had its effect. In Germany the spending capacity of households was also reduced by the increase in VAT at the beginning of 2007, which caused consumption to contract by 0.4 per cent, having already stagnated since 2002. The pace of consumption was brisker in France and Spain (2.4 and 3.2 per cent respectively), as it had been over the last decade.

The sustained growth in GDP for 2007 as a whole conceals changes that occurred in the course of the year. Initially, the economic situation of the euro area was highly favourable, but conditions steadily deteriorated, especially from the summer onwards, owing to the shocks that buffeted the world economy. The acceleration in inflation, due to the rise in the prices of food and energy products, and pessimism about general and personal economic prospects brought on by uncertainty caused by the international financial crisis had a particularly strong effect on household consumption, which fell in the last few months of the year. Business confidence deteriorated, despite the strengthening of the ability to export.

The €-coin coincident indicator (http://eurocoin.bancaditalia.it), which estimates the quarterly growth in the area's GDP net of short-term fluctuations, tracked downwards during 2007, falling from rates of the order of 0.8 per cent in relation to the preceding quarter at the beginning of the year to about 0.5 per cent in December (Figure 5.2).

Figure 5.2

Coincident cyclical indicator (€-coin) and euro-area GDP
(three-month percentage changes)



Sources: Bank of Italy and Eurostat.
(1) The aggregate for the euro area relates to 15 countries.

On the basis of provisional data, GDP growth accelerated to 0.7 per cent in the first quarter of 2008, thanks largely to the vigorous increase of 1.5 per cent in Germany. Output in that country was boosted not only by export demand but also by exceptionally high investment, probably fostered by the expiry of tax incentives and by investment in construction; household consumption also increased, but at a modest rate. Growth was slower in France (0.6 per cent) and in Italy and Spain (0.4 and 0.3 per cent respectively).

In the same period, however, the cyclical indicators for the area continued to worsen. In May €-coin registered growth of about 0.4 per cent, slightly above the lowest figures recorded in the first few months of 2008; expressed at an annual rate, this would indicate growth of around 1.4 per cent net of short-term fluctuations, less than the estimate for potential growth, indicating the partly transient nature of the recent acceleration in GDP.

The balance of payments

The euro area's current account vis-à-vis the rest of the world, which had shown a small deficit in 2006, returned to surplus last year, reflecting an improvement in net exports of goods and services (Table 5.2). Net inflows on the financial account came to €102.8 billion; errors and omissions remained very large, amounting to an outflow of €143.3 billion. As in the recent past, it can be expected that when the final data are published part of the statistical discrepancy will be offset by a reduction in net inflows on the financial account.

Table 5.2

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

	2004	2005	2006	2007
Current account	**62.1**	**18.1**	**-1.3**	**26.4**
Goods	99.6	48.3	19.2	55.6
Services	32.5	37.4	42.3	51.5
Income	-10.2	5.4	15.1	3.0
Transfers	-59.8	-72.9	-77.9	-83.6
Capital account	**16.6**	**11.4**	**9.2**	**14.1**
Financial account	**-14.2**	**9.2**	**112.4**	**102.8**
Direct investment	-67.6	-216.4	-144.7	-94.8
Portfolio investment	70.7	131.4	266.3	253.9
Financial derivatives	-8.3	-18.2	2.4	-110.1
Other investment	-21.4	94.6	-10.3	58.9
of which: monetary financial institutions (2)	*-10.2*	*90.5*	*-25.4*	*80.1*
Change in official reserves (3)	12.4	17.8	-1.4	-5.2
Errors and omissions	**-64.5**	**-38.8**	**-120.3**	**-143.3**

Source: ECB.
(1) The aggregate for the euro area relates to 15 countries. – (2) Excluding the Eurosystem. – (3) A minus sign indicates an increase in reserves.

The increase in the trade surplus from 0.2 to 0.6 per cent of GDP reflected a larger slowdown in the value of imports than in that of exports and an improvement of 0.8 per cent in the terms of trade due to the appreciation of the euro against the US dollar.

Inflows and outflows of direct investment were large, giving rise to net outflows of €94.8 billion. Net inflows of portfolio investment declined to €253.9 billion. Gross flows also contracted, especially in the second half of the year, in connection with the strains in financial markets.

In 2007 the euro area's net external debtor position increased for the second year in succession, amounting to €1,343.6 billion at the end of December, equivalent to 15.1 per cent of GDP. About two thirds of the deterioration was due to value adjustments on stocks (variations in exchange rates and market prices), which reduced the value of portfolio assets and "other investment".

Prices and costs

Consumer prices. – Despite upward pressure towards the end of the year, consumer price inflation in the euro area declined slightly on an annual average basis in 2007, to 2.1 per cent. The decrease was ascribable to the slowdown in the prices of energy products by 5 percentage points in the first half (Table 5.3); a more pronounced fall was prevented by growing upward pressure on the prices of food products in connection with the prolonged rise in the prices of commodities.

Table 5.3

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

	Italy			Germany			France			Spain			Euro area		
	2006	2007	2008 Q1	2006	2007	2008 Q1	2006	2007	2008 Q1	2006	2007	2008 Q1	2006	2007	2008 Q1
Consumer prices (1)															
General index	2.2	2.0	3.3	1.8	2.3	3.1	1.9	1.6	3.3	3.6	2.8	4.5	2.2	2.1	3.4
Index excluding food and energy	1.6	1.8	2.2	0.7	1.9	1.6	1.4	1.6	1.8	2.8	2.5	2.4	1.4	1.9	1.8
Processed food	2.7	2.8	5.4	2.1	3.2	6.0	0.6	1.0	5.7	3.9	3.9	8.5	2.1	2.8	6.4
Non-food and non-energy	1.2	1.5	1.8	0.2	1.3	0.6	0.2	0.5	1.0	1.5	0.7	0.3	0.6	1.0	0.8
Services	*2.0*	*2.0*	*2.5*	*1.0*	*2.2*	*2.3*	*2.4*	*2.5*	*2.5*	*3.9*	*3.9*	*3.9*	*2.0*	*2.5*	*2.6*
Unprocessed food	1.6	3.2	3.9	3.2	2.4	2.2	2.6	2.2	3.8	3.9	4.3	4.6	2.8	3.0	3.5
Energy products	8.0	1.5	9.0	8.4	3.8	9.4	6.4	1.8	12.0	8.0	1.7	13.6	7.7	2.6	10.7
Producer prices (2)	**5.6**	**3.5**	**5.9**	**5.5**	**2.0**	**3.8**	**3.4**	**2.5**	**5.0**	**5.3**	**3.3**	**6.7**	**5.1**	**2.8**	**5.4**
GDP price deflator	**1.7**	**2.3**	**1.8**	**0.6**	**1.8**	....	**2.5**	**2.5**	**2.6**	**4.0**	**3.1**	**3.1**	**1.9**	....	....

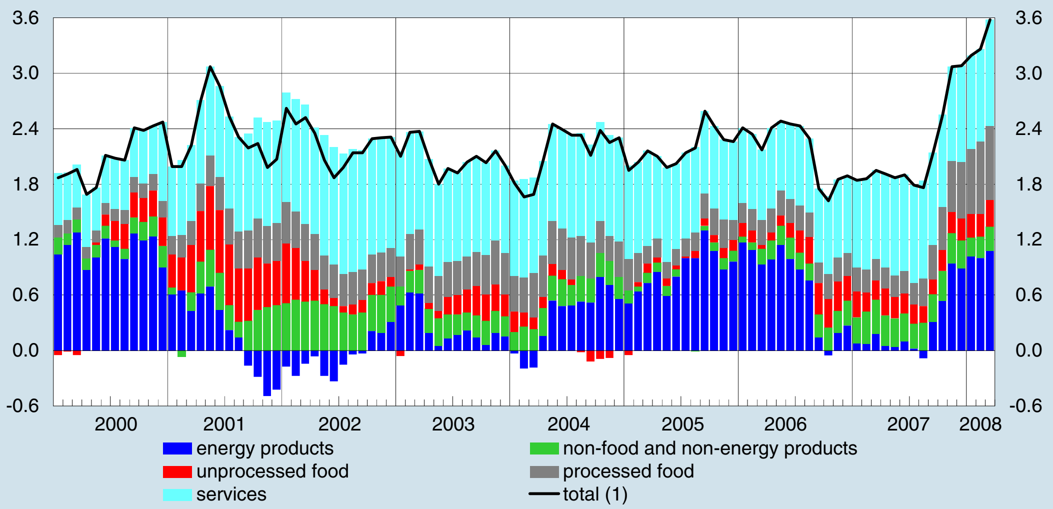
Source: Based on Eurostat data.
(1) Harmonized index of consumer prices. – (2) Producer price index for industrial products sold in the domestic market. The aggregate for the euro area relates to 15 countries.

The monetary policy stance of the ECB, wage restraint and the appreciation of the euro held the rise in consumer prices excluding food and energy down to 1.9 per cent; the acceleration of 0.5 percentage points in relation to 2006 was due almost entirely to the 3 percentage point increase in the rate of VAT in Germany in January 2007, which is estimated to have accounted for about 1.5 points of the rise in consumer prices in Germany and 0.4 points of that in the euro area.

Consumer price inflation was stable until the summer but began to accelerate in the fourth quarter, when it registered 2.9 per cent (compared with 1.9 per cent previously), propelled by rises in energy and food prices (Figure 5.3). In the first three months of this year it averaged 3.4 per cent, one of the highest rates since the launch of monetary union.

Figure 5.3

Contributions to inflation in the euro area
(percentage points)



Source: Based on Eurostat data.
(1) Twelve-month percentage change in the harmonized index of consumer prices.

The rise in the prices of processed food products accelerated from 2 per cent in the second quarter of 2007 to 4.5 per cent in the fourth. It continued to gather pace in the early months of 2008, reaching a twelve-month rate of 7 per cent in April. The rate of increase in fresh food prices remained more or less stable during the year; the consumer prices of meat increased only slightly, despite a steep rise in the cost of animal feed.

The rise in the consumer prices of food was due to large increases in the items "milk, cheese and eggs" and "bread and cereals", which followed the acceleration in world commodity prices after a lag of several months. The increases in the prices of milk and dairy produce were higher in Germany and Spain (twelve-month rates of increase of more than 15 per cent in the first quarter of 2008) than in Italy (7.4 per cent). In France the rise in food prices was lower than in the rest of the area; the strong presence of large distribution chains, which set delivery prices with suppliers at predetermined dates, delayed the effects of increases in the prices of agricultural raw materials.

Among the core components of inflation, the rise in the prices of goods other than food and energy remained low (an average of 1 per cent in 2007). In the first quarter of 2008 they rose at the same moderate rate as in the final quarter of 2006 before the change in VAT in Germany. In the services sector, by contrast, inflation was higher (2.5 per cent in 2007) and showed a further slight increase in the first quarter of this year, owing partly to rises in the prices of certain restaurant and transport services.

Producer prices and costs. – In 2007 producer price inflation fell to an annual average of 2.8 per cent, compared with 5.1 per cent in 2006, reflecting a slowdown in the rise in energy prices from 13.3 to 1.7 per cent, most of which occurred in the first half of the year. From the end of the summer onwards the rises in raw material prices propelled the increase in producer prices to a twelve-month rate of 4.4 per cent in December.

Excluding energy and food products, the rate of increase in producer prices steadily retreated to 2.1 per cent in December, aided by a slowdown in non-energy intermediate products, which benefited from the smallness of the rise in the prices of imported manufactures (1 per cent, compared with 3.5 per cent in 2006). The rise in the prices of goods for final consumption accelerated only slightly, from 1 per cent in 2006 to 1.3 per cent last year, thanks partly to the moderation of domestic costs.

Unit labour costs in the economy as a whole rose by a modest 1.2 per cent, but there were differences between sectors and countries. In industry they fell by 0.7 per cent owing to productivity gains of 3.1 per cent (Table 5.4), but in services they rose by 1.6 per cent as a result of a slight acceleration in labour costs per employee.

Table 5.4

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		of which: Value added (2)		of which: Employment (1)		Unit labour costs	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
					Industry excluding construction (3)					
Germany	3.8	1.7	6.3	4.0	5.3	5.3	-1.0	1.2	-2.3	-2.3
France	3.5	3.2	4.2	3.2	2.3	1.8	-1.8	-1.4	-0.7	..
Italy	2.6	2.4	0.1	-0.1	1.2	0.8	1.0	0.9	2.5	2.5
Spain	2.9	3.1	2.0	3.0	2.6	2.7	0.6	-0.3	1.0	0.1
Euro area (4)	3.4	2.4	4.2	3.1	3.8	3.6	-0.4	0.5	-0.8	-0.7
					Services (5)					
Germany	0.1	0.7	0.7	0.2	1.9	2.0	1.2	1.8	-0.6	0.5
France	2.9	2.9	1.0	0.4	2.1	1.9	1.1	1.5	1.9	2.6
Italy	2.5	1.6	0.1	0.7	2.1	1.8	2.1	1.1	2.5	0.9
Spain	2.6	3.6	0.1	0.6	4.1	4.2	4.0	3.6	2.5	3.0
Euro area (4)	1.8	2.3	0.4	0.7	2.5	2.7	2.1	2.0	1.4	1.6
					Total economy					
Germany	1.1	0.9	2.2	1.1	2.8	2.8	0.6	1.7	-1.1	-0.2
France	3.1	3.0	1.3	0.7	2.1	1.9	0.8	1.2	1.8	2.3
Italy	2.5	1.9	0.1	0.6	1.8	1.6	1.7	1.0	2.4	1.4
Spain	3.0	3.6	0.7	0.9	3.9	3.9	3.2	3.0	2.3	2.7
Euro area (4)	2.2	2.3	1.3	1.1	2.9	2.9	1.6	1.8	0.9	1.2

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) The aggregate for the euro area relates to 15 countries. – (5) Comprises “wholesale and retail trade, transport and communications”, “financial services and real-estate property” and “other services”.

Wage restraint and productivity gains enabled industrial firms in the euro area to increase their profit margins. According to national accounts data, in 2007 profits as a share of value added in industry rose in the largest countries, and most markedly in Germany, where they increased by about two percentage points. In services the more rapid increase in unit labour costs led to a slight narrowing of margins in France and Spain and no change in Germany; in Italy margins also remained by and large unchanged, despite an appreciable slowdown in unit labour costs.

The weakening of world economic activity and the appreciation of the euro led euro-area producers to hold down export prices. The increase in the prices of exported goods, as measured by the rise in their implicit price deflator, came to 1.3 per cent, less than that in the domestic producer prices of non-energy goods. The increases were particularly small in Germany and France (0.5 per cent). In Italy the export price deflator increased by more than the average for the euro area.

Inflation expectations. – Inflation expectations are still consistent with the definition of medium-term price stability, but the professional forecasters surveyed by Consensus Economics with regard to expectations about inflation in the euro area in 2008 have been revising their forecasts upwards since the final quarter of 2007, reaching an annual average of 3.1 per cent in May. Their expectations for 2009 are now 2.1 per cent. In keeping with forecasts from the major international organizations, they are based on an assumption that world economic growth will slow, leading to broad stability in the prices of oil and food commodities.

Employment

Driven by the continued expansion in economic activity, the growth in employment in the euro area accelerated from 1.6 per cent in 2006 to 1.8 per cent last year, leading to the creation of almost 2 million jobs.

On the basis of Eurostat data, the employment rate for the working-age population rose to 65.6 per cent, 1 percentage point higher than in the previous year; the proportion of part-time and fixed-term positions increased. The rise in the employment rate was greatest for women (from 56.8 to 57.8 per cent) and persons aged between 55 and 64 (from 41.8 to 43.4 per cent). Despite this progress, 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 0.8 percentage points to 7.4 per cent, its lowest level since the launch of monetary union; the participation rate rose further, from 70.6 per cent in 2006 to 70.9 per cent last year.

In Germany employment increased strongly, by 1.7 per cent compared with 0.6 per cent in 2006, thanks to a rise in permanent salaried employment. There was above-average growth in services (1.8 per cent), partly reflecting an increase in temporary contracts for workers who are then actually employed in industry. The unemployment rate fell substantially, from 9.8 to 8.4 per cent.

Employment measured in terms of standard labour units rose by 1.2 per cent in France and by 3.2 per cent in Spain. The unemployment rate in these two countries fell by 1 and 0.2 percentage points respectively (from 9.2 to 8.3 per cent and from 8.5 to 8.3 per cent). In Italy it decreased further to an annual average of 6.1 per cent.

6. BUDGETARY POLICIES

Euro-area general government net borrowing decreased from 1.3 per cent of GDP in 2006 to 0.6 per cent last year. The size of the improvement was basically as forecast in the stability programme updates submitted by member states in late 2006 and early 2007. The effect of the downward revision of the area-wide deficit for 2006 by 0.2 percentage points based on the new outturn from Italy was essentially offset by the faster-than-forecast economic growth of 2.6 instead of 2.1 per cent in 2007.

For the first time since 2001 all area countries recorded net borrowing below the threshold of 3 per cent of GDP. In Italy the deficit came down from 3.4 to 1.9 per cent and in Portugal from 3.9 to 2.6 per cent. Germany lowered its deficit significantly (by 1.6 percentage points), practically balancing the budget. In France net borrowing increased by 0.3 points to 2.7 per cent.

The area-wide primary surplus rose by 0.8 points to 2.3 per cent of GDP, while interest expenditure remained broadly unchanged at 3 per cent. The improvement in budgetary positions stemmed mainly from a reduction in the ratio of primary expenditure from 43.8 to 43.2 per cent of GDP, while revenue rose by 0.2 points to 45.6 per cent. Tax revenue and social security contributions rose from 41.3 per cent of GDP in 2006 to 41.5 per cent last year, mainly because of the increase in Italy.

The significant reduction in the primary expenditure ratio was due chiefly to social benefits in cash (down by 0.3 points) and staff compensation (down by 0.2 points). Revenue benefited from a rise in tax proceeds that was larger than had been expected considering the changes in the tax base, the effects of fiscal drag and discretionary measures. The latter had only a modest upward effect on revenue, as for the most part indirect tax increases (especially large in Germany) were offset by reductions in social security contributions (in Germany, France and the Netherlands) and in direct taxes (in France and Spain).

The European Commission estimates that the area's structural deficit fell from 1.2 per cent of GDP in 2006 to 0.7 per cent in 2007. The ratio of area-wide public debt to GDP fell again, as in 2006, from 68.5 to 66.4 per cent.

Stability programmes. – The latest stability programme updates indicate that the gradual reduction of budget deficits will be interrupted in 2008. Area-wide net borrowing, according to the programmes, is projected to rise to 0.9 per cent of GDP, from the 0.8 per cent estimated for 2007 (Table 6.1). In 2010, the last year covered in most of the programmes, the overall budgetary position is expected to be substantially in balance, with deficits only in France (1.2 per cent of GDP), Ireland (1 per cent), Italy (0.7 per cent) and Portugal (0.4 per cent).

Table 6.1

General government net borrowing and debt in the euro area (as a percentage of GDP)				
	2007	2008	2009	2010
Net borrowing				
National stability programme objectives	0.8	0.9	0.4	0.0
Outturn and forecasts:				
European Commission	0.6	1.0	1.1	–
IMF	0.6	1.1	1.1	–
Debt				
National stability programme objectives	66.7	65.1	63.3	61.2
Outturn and forecasts:				
European Commission	66.4	65.2	64.3	–
IMF	66.3	65.4	64.8	–

Sources: Based on European Commission (*Spring Forecasts*, April 2008), IMF (*World Economic Outlook*, April 2008), and the updates to national stability programmes submitted between October 2007 and April 2008.

In the Commission's assessment, budgetary trends as outlined in the stability programmes for Greece, France, Italy and Portugal do not provide a reasonable safety margin against excessive deficits in the event of unfavourable macroeconomic developments.

The EU Commission estimates for 2008-09. – The latest Commission forecasts indicate an increase in area-wide general government net borrowing from 0.6 per cent of GDP in 2007 to 1 per cent in 2008, with the balance worsening in two thirds of the countries. Net borrowing is forecast to increase in Germany (from near zero to 0.5 per cent of GDP) and in France (from 0.2 to 2.9 per cent), while in Spain the surplus will fall from 2.2 to 0.6 per cent. The budget position is expected to improve markedly in the Netherlands and in Greece (by 1 and 0.9 percentage points respectively).

Assuming unchanged budgetary policies, the Commission estimates a further slight increase in the euro-area deficit for 2009 to 1.1 per cent of GDP. In most countries, on this hypothesis, net borrowing would not change significantly. The balance would improve somewhat (by 0.2 points) in Germany, net borrowing would increase further in France to 3 per cent of GDP, and Spain's surplus would evaporate.

Overall, in the course of 2008 and 2009 the area's primary surplus is projected to diminish by 0.6 percentage points of GDP, reflecting declining revenues (0.5 points) and essentially stable expenditure. The Commission ascribes this trend to the worsening business cycle, tax cuts in some countries, and the decline in the GDP elasticity of revenue from the very high values of recent years to near its long-run average. In any case the Commission estimates a worsening of the structural budgetary balance in four fifths of the euro-area countries in 2008; and in 2009, in the absence of adjustment measures, the balance will worsen everywhere but Malta.

The quality of public finances. – In October 2007 the EU Council stressed the importance of budget rules and institutional arrangements in fostering the adjustment and consolidation of the public finances. The Council reaffirmed that countries with rapidly rising expenditure will have to set more ambitious medium-term budget targets in order to assure long-term sustainability, among other things in consideration of demographic trends. It called on the Commission to proceed in determining uniform standards for quantifying the implicit liabilities of social protection systems. Finally, the Council underscored that efforts to modernize the public administration in many member states can improve the quality of public services, ensure more efficient resource use and control public expenditure more effectively.

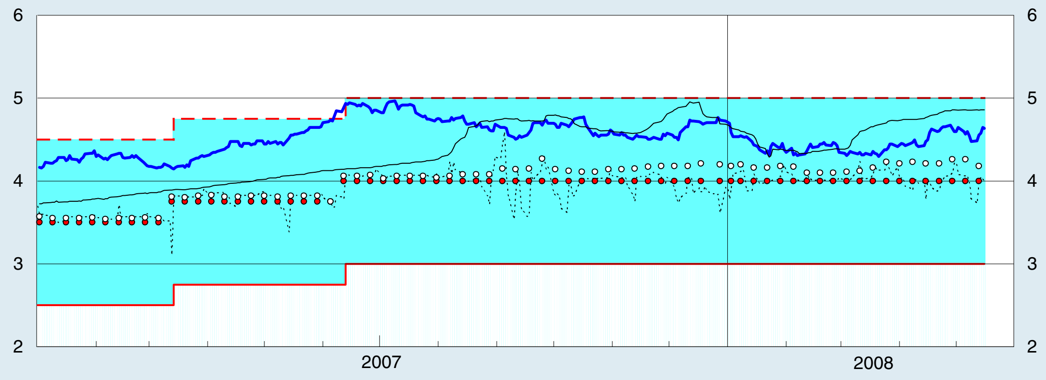
In March 2008 the Commission released a report summarizing the main findings of its Economic Policy Committee on the links between budgetary policies and long-term economic growth. It noted that setting the budgetary process in a medium-term framework can help countries to rationalize and upgrade public spending, enabling them to allocate resources to programmes that stimulate growth. The report pays special attention to issues involved in the construction of indicators of efficiency in the main areas of spending.

7. THE COMMON MONETARY POLICY

In the first half of 2007 the Governing Council of the European Central Bank continued the adjustment of monetary conditions begun at the end of 2005. The minimum bid rate on main refinancing operations was raised by 25 basis points in March and again in June, to 4 per cent (Figure 7.1). These actions were taken to counter the emergence of inflationary risks in a context of buoyant economic activity and rapid expansion of the money supply and credit.

Figure 7.1

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



Sources: ECB and Reuters.

Monetary policy had to cope with exceptional conditions starting in August, when the strains originating in the US mortgage market spread to the euro area and to other segments of the financial market. The increase in liquidity risk and uncertainty about counterparty solvency made banks reluctant to lend, driving interbank interest rates sharply up. Worries progressively spread that the mounting difficulties in fund-raising could produce tighter lending conditions, with repercussions on the outlook for economic growth. The macroeconomic situation was made even more complex from the autumn onwards by the abrupt pick-up in inflation due to sharp increases in energy and food prices.

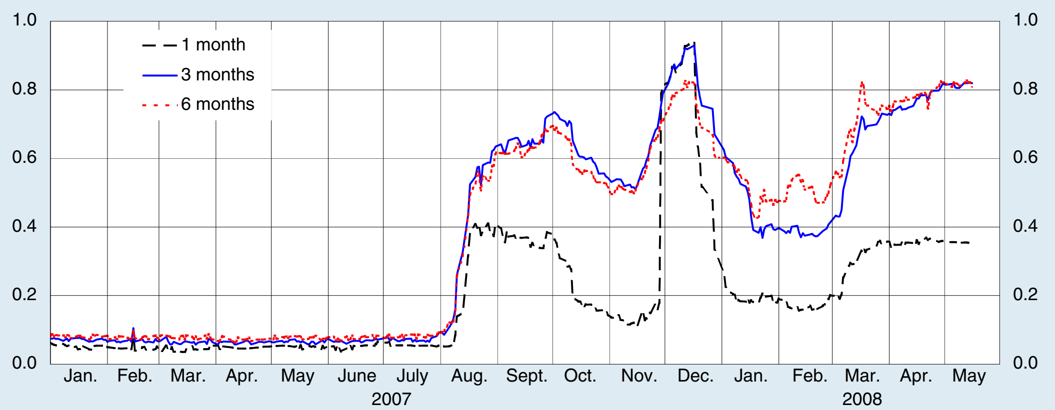
Against this background, the Governing Council confirmed its assessment of the risks to price stability and reaffirmed the importance of guaranteeing a solid anchor for inflation expectations, considering it also necessary to keep a close watch on developments on the financial markets. The Council judged the monetary policy stance appropriate to prevent the rise in the prices of raw materials from extending to wages and other prices and held the reference rate unchanged at 4 per cent from the second half of 2007 onwards. Simultaneously, the Eurosystem acted on its own and in concert with the other leading central banks to provide sufficient liquidity to the financial system and ensure the orderly functioning of the markets.

Interest rates and the exchange rate of the euro

Short-term interest rates. – Money-market rates rose gradually, in line with official rates, in the first half of 2007. The uptrend became more pronounced in August as the financial strains grew more acute. The three-month EURIBOR rate was close to 4.9 per cent at the end of the year, up from 4.3 per cent in July. The spread over the corresponding secured lending rate (EUREPO) – which can be interpreted as an indicator of the liquidity risk and, above all, the credit risk present in the interbank market, and which in the period preceding the crisis had not exceeded 10 basis points – hit 90 basis points towards the end of the year (Figure 7.2), despite the massive injections of liquidity by the Eurosystem. The spread remained wide in the first few months of 2008. Similar developments were recorded after the turmoil began for the other maturities, except the very-short-term, and for the equivalent spreads in dollars and sterling.

Figure 7.2

Spreads between EURIBOR and EUREPO rates by maturity
(daily data; percentages points)



Source: Reuters.

At the beginning of August the yield curve signalled that further increases in official rates were expected during the year (Figure 7.3). It later turned negative in slope as a result of a rise in rates on the short end, mainly due to the increase in the risk premium on the interbank market, and a decline in those at the long end, related to a revision of expectations concerning the macroeconomic picture and the monetary policy stance. However, the increase in risk premiums has made it harder to extract clear indications of expectations on official rates from the curve. The forward rates implied by swaps on the EONIA rate, which are not significantly affected by risk premiums, have displayed pronounced volatility in recent months, reflecting the high degree of uncertainty about the economic outlook. In mid-May they indicated expectations of unchanged official rates until the end of the year.

Figure 7.3

Rates on 3-month EURIBOR futures contracts (1)
(per cent)

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.

The real three-month rate rose in the first half of 2007 and then declined as a result of the larger increase in inflation expectations than in nominal interest rates; in mid-May of this year it stood at around 2 per cent, in line with the available estimates of a "neutral" level for the euro area.

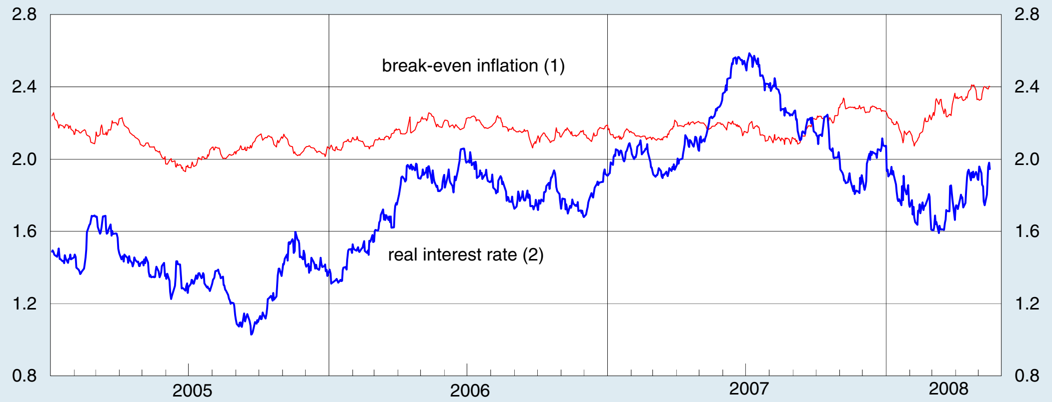
Long-term interest rates. – Measured on the basis of ten-year swap contracts, long-term rates also rose during the first half of 2007, to 5 per cent in June. During the rest of the year and in the first few months of 2008 they fluctuated downwards, to stand at 4.6 per cent in mid-May. In the latter period they were affected by portfolio shifts from riskier assets to fixed-income securities and by the downward revision of economic forecasts. The yield implied by the prices of Italian government securities indexed to euro-area consumer price inflation showed a similar pattern, reaching 1.9 per cent in May of this year (Figure 7.4).

The break-even inflation rate, i.e. the differential between nominal rates on Italian government securities and those on securities of equal maturity indexed to euro-area inflation, which provides a gauge of medium and long-term inflation expectations and the related risk premiums, held constant at 2.2 per cent in the first half of 2007. It rose during the remainder of the year and in the first few months of 2008 (to 2.4 per cent in mid-May) as a consequence of the surge in the prices of oil and food commodities.

Long-term inflation expectations implied by the prices of financial assets, net of risk premiums, are currently estimated at slightly above 2 per cent. Expectations over a horizon five to ten years ahead derived from zero-coupon inflation swaps, which are less influenced by the recent rise in inflation, provide similar indications. For the same horizon the Consensus Economics survey of forecasters in mid-April found inflation expectations of 2 per cent (compared with 1.9 per cent in the last three years). Finally, according to the Survey of Professional Forecasters conducted by the ECB in the same month, the average probability assigned by the respondents to inflation exceeding 2 per cent five years ahead is currently 50 per cent, about 5 percentage points higher than at the end of 2006. As a whole, these data indicate that long-term inflation expectations, though rising slightly, remain consistent with price stability.

Figure 7.4

Break-even inflation and the real long-term interest rate
(daily data; per cent)



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.

The exchange rate of the euro. – In 2007 the euro strengthened against the main international currencies. In nominal effective terms it appreciated by 5.4 per cent. The gains were especially large against the dollar and sterling: on 31 December the bilateral exchange rates were higher by about 12 and 9 per cent respectively than at the start of the year.

The appreciation of the euro against the dollar accelerated in the second half of the year and continued in the first few months of 2008, reflecting the differences between both cyclical conditions and the monetary policy stance in the United States and the euro area. In April the euro reached a historic high of close to $1.60. The rise of the dollar/euro exchange rate was accompanied by a significant increase in its volatility, owing to heightened uncertainty about the international economic situation and in particular the outlook for the US economy.

Money and credit

In 2007 the growth in the M3 money supply hit new highs since the beginning of stage three of Monetary Union. The twelve-month growth rate stood at 11.5 per cent at the end of the year, and then declined slightly in the early part of 2008. The expansion of the most liquid instruments, held for transaction purposes, slowed sharply; the growth rate of M1, which includes currency in circulation and overnight deposits, fell to 4 per cent at the end of year and diminished further in the first few months of 2008.

The rapid expansion of the money supply is partly ascribable to the relative flatness of the yield curve, which made short-term deposits more attractive than less liquid assets that are not part of the money supply, such as longer-term deposits and bonds. The slowdown in M1 reflected the widening of the yield differential between market instruments and overnight deposits. The tensions in the financial market significantly affected the composition of the money supply. The growth in money-market investment fund units/shares slowed in connection with worries about the value of the funds' assets. There was a further acceleration in deposits with agreed maturity up to two years, whose remuneration followed money market rates; at the end of the year this development explained about two thirds of the total growth in M3.

The strains on the financial markets have not had evident effects on the growth of credit so far. Lending to the private sector of the euro area continued to grow at a sustained pace (11.2 per cent in the twelve months ending in December). The slowdown in lending to households, particularly as regards loans for house purchases (which grew by 7.1 per cent), was counterbalanced by the further acceleration in lending to non-financial corporations, which expanded by 14.5 per cent; this acceleration, under way since 2004, continued even after the turmoil on the financial markets began. The dynamic of lending to firms is largely in line with the performance of the main economic determinants, including the good growth in gross fixed investment above all in sectors other than construction.

There is no sign that the persistence of the rapid growth in lending to the private sector has been substantially influenced so far by the reduction in securitization activity and the return of assets to banks' balance sheets in the wake of the financial turmoil. However, part of the growth in lending to large firms may have been due to their significant difficulties in raising funds on the bond market. This hypothesis is borne out by the responses of the intermediaries participating in the Eurosystem's Bank Lending Survey.

Although bank rates have risen, they do not denote particular strains in credit supply. In the second half of 2007 the rates on loans to non-financial companies and households continued to adjust to the rise in money-market rates, similarly to what has been observed in the past. Since last summer the rates on new corporate loans and those on new loans to households for house purchases have risen by a total of 30 and 5 basis points respectively.

However, the data on the volume of new business and on bank lending rates may not yet fully reflect the effects of the financial strains. According to banks' responses to the Bank Lending Survey, in the second half of 2007 and the first quarter of 2008 the market turbulence provoked a progressive tightening of standards for lending to non-financial companies, especially for the largest corporations and for the longest-term loans. Banks also reported an increase in spreads, notably on riskier loans, and as regards lending to households declared that they intended to reduce their loan-to-value ratios on mortgage loans. Lastly, banks reported difficulty in procuring funds on the wholesale bond market and the securitization market, partially offset by the favourable trend of less liquid deposits. The majority participating in the survey expect credit standards to continue to tighten in the coming months.

Monetary policy operations

On 9 August 2007 the financial turbulence began to impact significantly on the functioning of the euro-area money market. Intermediaries' acute uncertainty about their liquidity requirement and the increase in credit risk led to greater preference for liquidity and a reduction in trading.

The Eurosystem's operational arrangements proved adequate to cope with the exceptional situation, making it possible to react promptly and decisively as soon as the crisis arose. Repeated liquidity fine-tuning operations were carried out, adjustments were made to the distribution of the supply of funds during the compulsory reserve maintenance period, and the average maturity of open-market operations was lengthened.

The ECB accommodated the change in the liquidity demand profile of the banks, which preferred to move up compliance with the reserve requirement to the initial part of each maintenance period; the excess liquidity was reabsorbed during the subsequent part. The average daily amount of reserves held in excess of the requirements remained broadly stable over the year as a whole, at low levels and in line with those of 2006.

In the face of strong pressures on one- to twelve-month interest rates, the supply of liquidity with a maturity of more than one week was increased both through supplemental longer-term refinancing operations, with the customary three-month maturity, and with a six-month refinancing operation, carried out for the first time in April of this year. These operations, accompanied by a reduction in the amounts allotted in main refinancing operations, lengthened the average maturity of refinancing.

The average daily volume of liquidity injected into the market by means of longer-term (three-month) refinancing operations rose from about €116 billion in 2006 to €142 billion in 2007, before the start of the crisis, and to €245 billion subsequently. The ratio of bid amounts to allotments remained close to the levels of 2006 (1.5) until August and then rose to 2.1 for the rest of the year. The average daily liquidity provided through main refinancing operations amounted to €264 billion (€307 billion in 2006), with a slight decrease in the first half of the year and a sharp drop (to €220 billion) in the period of financial turmoil. The strong demand for liquidity at tenders was reflected in a widening of the spread between the weighted average allotment rate and the minimum bid rate; it averaged 17 basis points after the onset of the turbulence, compared with 7 in the period preceding it.

The interventions by the Eurosystem in the initial phases of the crisis quickly eased the strains in the very-short-term segment of the money market; the overnight interest rate (EONIA) trended back into line with the minimum bid rate on main refinancing operations, albeit with a sharp and persistent increase in its volatility.

For maturities of one month and beyond, the spreads between the interest rates on unsecured and secured deposits remained persistently large, reaching their maximum in December (around 90 basis points) when the reluctance of banks to lend was accentuated by the impending close of the financial year. In that period the ECB carried out a main refinancing operation with a maturity of two weeks, rather than the usual one week, so as to cover the end of the year, and guaranteed that all bids submitted would be accepted at the weighted average rate of the previous main refinancing operation. In the same period a coordinated action was begun with the Federal Reserve, enabling the Eurosystem to offer counterparties financing in dollars. The strains on the intermediate maturities, after abating temporarily, grew more acute again from the beginning of this March in connection with the crisis of the US investment bank Bear Stearns and the difficulties of other banking institutions: in the middle of May the spreads between unsecured and secured loans for maturities of between three and six months were slightly narrower than they had been at the end of 2007.

THE ITALIAN ECONOMY

8. DEMAND, SUPPLY AND PRICES

In 2007 the Italian economy grew at a slower rate than the average in the rest of the euro area (1.5 as against 2.8 per cent), the pattern since the mid-1990s. Services accounted for almost all of the expansion, while industrial activity contracted from the beginning of the year, contrary to the trend in the other main European countries. A less unfavourable picture of the Italian industrial cycle in 2007 emerges based on the indicators for turnover and orders, which appear more clearly to capture the effects of the progressive internationalization and shift in the composition of output towards higher-quality goods, which industrial production statistics can only partly take into account.

The rate of inflation in 2007 averaged 1.8 per cent, as measured by the index of consumer prices for the entire resident population. The average result masks divergent trends over the year. After falling below 2 per cent in the first nine months, inflation rose sharply in the fourth quarter, as in the rest of the euro area, driven by the surge in food and energy prices. The moderation of domestic costs, in particular the lack of wage pressures and the appreciation of the euro, helped curb the increase in the prices of the other components.

The solid performance of exports, fuelled by the expansion of outlet markets and the enhanced competitiveness of Italian firms involved in the ongoing restructuring process, provided the main contribution to growth. By contrast, domestic demand failed to strengthen sufficiently. The growth in household expenditure remained low, reflecting primarily the protracted weakness of disposable income, which since 1991 has grown in real terms at an annual average rate of just 0.3 per cent (compared with 1 per cent in Germany and 2.2 per cent in France). In 2007 the uncertainty engendered by the effects of the crisis in the international financial markets and the erosion of purchasing power associated with the acceleration in prices in the fourth quarter also had a large impact. In addition, the boost provided by capital gains, which in the early 2000s had been very substantial for housing wealth, weakened.

Investment in residential building slowed. Accumulation in machinery, equipment and transport equipment stagnated, reflecting the progressive weakening of economic activity, which was only partly offset by the favourable financing conditions prevailing for most of the year.

Since the final part of 2007 the economic situation has deteriorated: the rate of inflation has risen, driven by persistent increases in the prices of food and energy commodities; confidence among households and firms has eroded, in response to the uncertain world economic outlook. Based on the most recent indicators, the acceleration in GDP recorded in the first quarter of 2008, which offsets the equivalent decline in the previous quarter, appears to be partly temporary.

Households' consumption

In 2007 Italian households' expenditure increased by 1.4 per cent in real terms (Table 8.1); although rising slightly, the rate of growth was around half the average recorded during the upswing of the second half of the 1990s. The largest contribution to the increase came from spending on services, which rose by 2.1 per cent. Purchases of semi-durable and especially of durable goods also sustained household expenditure. By contrast, spending on non-durable goods fell by 0.3 per cent, owing in part to the stagnation of food purchases, which in the second half of the year were held down by the pass-through of the price increases for the corresponding raw materials.

Table 8.1

Sources and uses of income

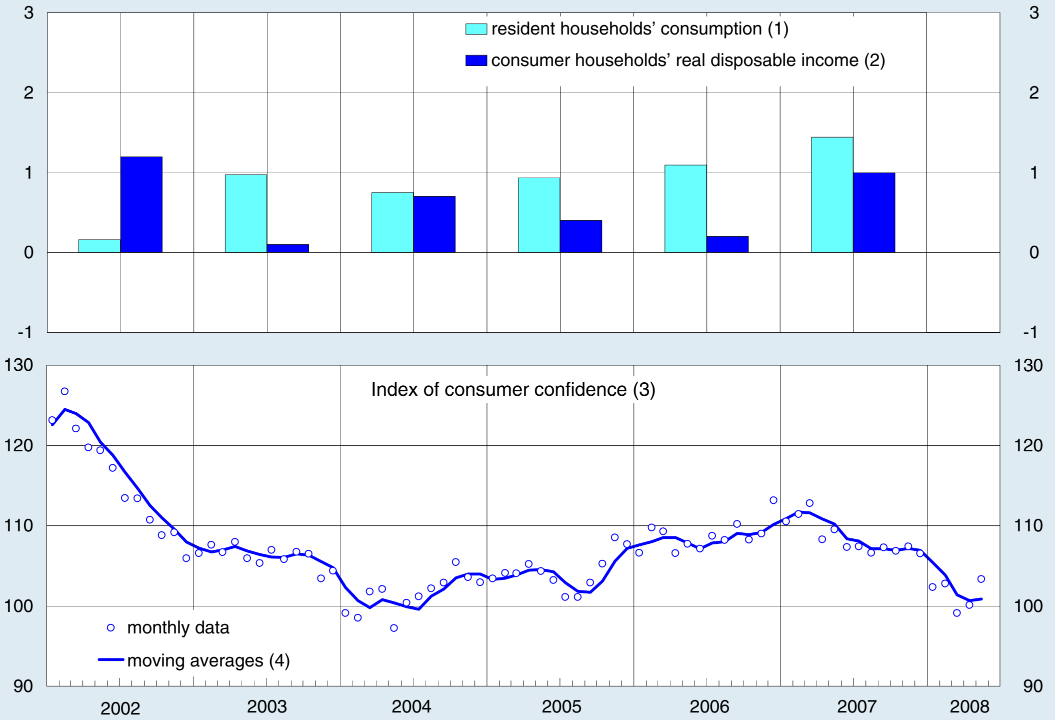
	As a percentage of GDP in 2007 (volumes at previous-year prices)	2006			2007		
		Percentage changes		Contribution to GDP growth (chain-linked volumes)	Percentage changes		Contribution to GDP growth (chain-linked volumes)
		Chain-linked volumes	Deflators		Chain-linked volumes	Deflators	
Sources							
GDP	100.0	1.8	1.7	–	1.5	2.3	–
Imports of goods *fob* and services (1)	29.5	5.9	7.6	-1.5	4.4	2.3	-1.3
of which: goods	*23.7*	*5.5*	*8.9*	*-1.1*	*3.6*	*2.6*	*-0.8*
Uses							
National demand	100.7	1.8	2.6	1.8	1.3	1.9	1.3
Consumption of resident households	58.7	1.1	2.7	0.6	1.4	2.2	0.8
Consumption of general government and non-profit institutions serving households	20.6	0.9	2.0	0.2	1.3	0.4	0.3
Gross fixed investment	21.0	2.5	2.6	0.5	1.2	2.6	0.3
machinery, equipment and transport equipment	*9.1*	*3.4*	*2.1*	*0.3*	*-0.1*	*1.6*	*..*
intangible assets	*0.9*	*3.9*	*0.9*	*..*	*2.6*	*1.9*	*..*
construction	*11.0*	*1.5*	*3.2*	*0.2*	*2.2*	*3.5*	*0.2*
Change in stocks and valuables (2)	–	–	–	0.4	–	–	..
Exports of goods *fob* and services (3)	28.8	6.2	4.5	1.6	5.0	3.6	1.4
of which: goods	*23.4*	*5.6*	*5.2*	*1.2*	*5.6*	*4.2*	*1.3*
Net exports	–	–	–	0.1	–	–	0.1

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

The large increases in food and energy commodity prices and the effects of the financial crisis that began last summer gave rise to growing pessimism in households' assessments of their own and the general economic situation (Figure 8.1). This led to increased caution in spending, which declined in the fourth quarter.

Figure 8.1

Consumption, real income and consumer confidence in Italy
(growth rates and indices)



Sources: Based on Istat and ISAE data.
(1) Chain-linked volumes; percentage changes on previous year. – (2) Deflated using the resident household's consumption deflator. – (3) Indices, 1980=100; seasonally adjusted data. – (4) For the three months ending in the reference month.

In 2007 as a whole, growth in consumption was affected by the persistent weakness of households' disposable income, which grew by just 1 per cent in real terms (3.2 per cent at current prices), following the stagnation of the previous two years (Table 8.2). Counting the erosion of purchasing power of net financial assets due to the rise in expected inflation, the increase in real disposable income falls to 0.6 per cent.

The rise in taxes on personal income and wealth (8.6 per cent, in line with the previous year, compared with an average of 1.9 per cent in the first half of the decade), and that in social contributions (5 per cent) subtracted 2.6 percentage points from the growth in disposable income at current prices; they were only partially offset (1.5 percentage points) by the acceleration in social benefits (5.2 per cent).

Again in nominal terms, total wages and salaries (net of employee social security contributions) rose by 3.4 per cent, compared with 5.5 per cent in 2006, reflecting the slowdown both in standard employee labour units and in per capita earnings; the increase in the latter (2 per cent) was lower than that of the consumer price deflator (2.2 per cent). By contrast, income from self-employment net of social contributions accelerated to growth of 1.2 per cent, from 0.1 per cent in 2006, on the strength of the growth in per capita income, notwithstanding a slight contraction in self-employed labour units.

The growth in net property income gained pace. The substantial increase in the dividends received and in the other profits distributed by firms (4.2 per cent as against 1.5 per cent in 2006) was accompanied by an increase of 5.4 per cent in gross operating profit, which for households consists primarily in property rental income. Net interest income grew by 7.6 per cent, compared with 9.6 per cent in 2006. Against the backdrop of higher yields, the growth in interest income decreased from 17.4 to 13.4 per cent, reflecting a decline in the accumulation of financial wealth; the more marked slowdown in interest expense (from 68.5 per cent to 38.3 per cent) reflected the more moderate growth in loans for house purchases and, to a lesser extent, in consumer credit.

Table 8.2

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

	2004	2005	2006	2007
		Percentage changes		
Earnings net of social contributions charged to workers	4.1	4.8	5.5	3.4
Income from salaried employment per standard labour unit	3.5	3.1	2.5	2.0
Total social contributions (1)	0.4	0.1	0.8	-0.1
Standard employee labour units	0.3	1.5	2.1	1.5
Income from self-employment net of social contributions (2)	2.8	-3.4	0.1	1.2
Income from self-employment per standard labour unit	2.9	0.8	-0.3	3.0
Total social contributions (1)	-0.7	-1.1	-0.3	-1.3
Standard self-employed labour units	0.5	-3.1	0.7	-0.4
Net property income (3)	3.1	5.3	4.4	5.7
Social benefits and other net transfers	2.8	2.7	3.5	5.4
of which: net social benefits	3.6	3.2	4.5	5.2
Current taxes on income and wealth (–)	3.1	2.9	8.7	8.6
Households' gross disposable income (4)	**3.4**	**2.7**	**2.9**	**3.2**
at chain-linked prices (5)	0.7	0.4	0.2	1.0
at chain-linked prices, adjusted for expected inflation (6)	0.8	0.1	0.8	0.6
at chain-linked prices, adjusted for past inflation (7)	1.2	0.5	0.3	0.6
Private sector gross disposable income	**3.7**	**2.4**	**1.3**	**2.7**
at chain-linked prices (5)	1.0	0.2	-1.4	0.5
at chain-linked prices, adjusted for expected inflation (6)	0.9	-0.1	-1.0	0.4
at chain-linked prices, adjusted for past inflation (7)	1.2	0.2	-1.4	0.5
		Percentages		
Households' average propensity to save (4) (8)	**12.7**	**12.3**	**11.5**	**11.2**
calculated on income adjusted for expected inflation	10.4	9.7	9.5	8.7
calculated on income adjusted for past inflation	10.1	9.7	9.1	8.3
Private sector average propensity to save (8)	**26.0**	**25.5**	**23.6**	**22.9**
calculated on income adjusted for expected inflation	26.6	26.1	24.0	23.3
calculated on income adjusted for past inflation	26.7	26.1	24.1	23.4

Source: Based on Istat data.
(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 propensity to save fell to 11.2 per cent (8.7 per cent when measured with reference to income adjusted for expected monetary erosion), confirming a trend under way since the mid-1980s and only briefly interrupted in the early 2000s.

At the end of 2007 household wealth was around eight times gross disposable income, a far higher ratio than in Germany and almost the same as that of France. The marked increase in wealth since the mid-1990s probably supported consumption.

In the private sector as a whole (households and enterprises) gross disposable income grew by 2.7 per cent at current prices; if measured in real terms the increase of 0.5 per cent only partially made up for the previous year's decline of 1.4 per cent (Table 8.3). Whereas the sector's propensity to save fell to 22.9 per cent, that of the economy as a whole recorded a slight increase of 0.2 percentage points to 20 per cent, reflecting the growth in general government saving, which rose for the second consecutive year (to 2.3 per cent of national income, against an average of -0.1 per cent in the first half of the decade).

Investment

In 2007 the growth in gross fixed investment was half that of the previous year (1.2 as against 2.5 per cent). Except for non-residential building, the slowdown involved all categories of capital asset and especially machinery, equipment and transport equipment (Table 8.3).

Table 8.3

Fixed investment in Italy

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

	% composition in 2007 (volumes at previous-year prices)	Percentage change			As a percentage of GDP (1) (volumes at previous-year prices)	
		2005	2006	200	2000	2007
Construction	52.5	0.5	1.5	2.2	9.3	11.0
residential	*21.8*	*5.8*	*5.0*	*3.5*	*3.8*	*4.6*
other	25.5	*-3.0*	*-2.0*	*1.5*	*4.7*	*5.4*
property transfer costs	*5.1*	*-1.3*	*5.5*	*0.5*	*0.8*	*1.1*
Machinery and equipment	33.4	2.2	3.4	-0.3	7.6	7.0
Transport equipment	10.0	-2.9	3.4	0.8	2.3	2.1
Intangible assets	4.1	-0.1	3.9	2.6	0.9	0.9
Total gross fixed investment	**100.0**	**0.7**	**2.5**	**1.2**	**20.1**	**21.0**
Total excluding residential buildings	–	-0.6	1.8	0.6	16.4	16.4
Total excluding construction	–	0.9	3.5	0.2	10.8	10.0
Total net fixed investment (2)	**–**	**-3.3**	**3.7**	**-0.6**	**5.6**	**5.3**

Source: Istat, *National Accounts*.
(1) Rounding may cause discrepancies in totals. – (2) Net of depreciation.

Against the background of a contraction in industrial activity, the gradual decrease in the plant capacity utilization rate held down investment in machinery and equipment, which fell by 0.3 per cent, compared with an average annual increase of 3.1 per cent in the previous three years. Beginning in the second half of the year, investment was also affected by the deterioration in expectations for demand and the heightened uncertainty over the global economic outlook, which led to a steep decline in business confidence. Despite favourable financial conditions for most of the year, business investment may also have been affected by firms' modest operating profits and self-financing capacity, which remained at the low levels of 2006.

Investment in construction increased by 2.2 per cent; the slight improvement with respect to 2006 was driven by the non-residential sector, which after two years of decline returned to growth (1.5 per cent). Residential construction slowed to growth of 3.5 per cent, reflecting the weakening of the real estate cycle. Overall, last year housing transactions declined for the first time since 2001 (-4.6 per cent), albeit in conditions that remained favourable for the taking out of mortgage loans.

Table 8.4

Gross fixed investment of the firms in the Bank of Italy sample according to size, capacity utilization and change in turnover
(percentage changes at 2007 prices, unless otherwise indicated) (1)

	Total	Number of employees				Capacity utilization (2) (3)		Change in turnover (2)	
		from 20 to 49	from 50 to 199	from 200 to 499	500 or more	High	Low	High	Low
Industry excluding construction									
of which: Manufacturing									
realized investment in 2007	*3.7*	*6.5*	*6.3*	*1.2*	*0.5*	*0.3*	*6.0*	*6.5*	*0.6*
realization rate (4)	*106.1*	*113.8*	*108.0*	*106.9*	*98.3*	*103.0*	*104.6*	*106.4*	*105.8*
plans for 2008	*6.5*	*-2.7*	*-0.5*	*7.5*	*20.8*	*10.4*	*9.3*	*9.9*	*2.2*
Realized investment in 2007	5.4	5.9	5.9	2.0	6.3	3.4	7.9	6.2	4.8
Realization rate (4)	98.8	112.5	106.5	101.3	88.3	99.4	91.3	105.1	94.2
Plans for 2008	5.8	-2.2	-0.3	6.6	13.4	8.3	7.8	9.4	2.8
Services (5)									
Realized investment in 2007	-0.2	0.9	-4.0	-4.1	2.4	....	....	3.4	-2.6
Plans for 2008	3.2	-5.7	-0.5	2.7	7.9	....	....	3.7	2.8
Total									
Realized investment in 2007	2.6	3.6	1.4	-1.2	4.2	3.4	7.9	4.9	0.9
Plans for 2008	4.5	-3.7	-0.4	5.0	10.4	8.3	7.8	6.7	2.8

Source: Banca d'Italia, *Survey of Industrial and Service Firms*.
(1) Robust 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 2007. – (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 2006 for 2007, both at current prices. – (5) Private sector non-financial services.

According to the survey conducted at the beginning of this year by the branches of the Bank of Italy on a sample of 4,063 firms with 20 or more employees in industry excluding construction and private non-financial services, gross fixed investment increased in real terms in line with the expectations expressed in last year's survey (Table 8.4). The more positive results of the survey compared with national accounts data may be partly due to the exclusion from the sample of firms that have ceased doing business. Results appear very divergent across sectors: a 5.4 per cent rise for industry excluding construction contrasted with stagnation in the service sector, where investment decreased by 0.2 per cent. Gross fixed capital formation in industry benefited from the strong increase recorded in the energy sector and in mining and quarrying (12.1 per cent despite a realization rate of the original investment plans of just 81 per cent) and, to a lesser extent, from that of manufacturing enterprises (3.7 per cent).

The favourable investment plans for this year are concentrated in large firms; excluding companies with 200 or more employees, expectations point to a slight contraction. In addition to good expectations for demand, the expansion plans of the medium-sized/large companies could also reflect the implementation of investments originally scheduled for 2007 and not yet realized. Overall, the outlook is better for manufacturing firms, particularly those in the transport equipment sector. In industry, plans are more optimistic among companies for which exports account for more than one third of turnover and those in the North-West of the country (Table 8.5).

Table 8.5

Gross fixed investment of the firms in the Bank of Italy sample according to proportion of turnover exported and administrative headquarters
(percentage changes at 2007 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 2007	*3.7*	*5.4*	*2.9*	*3.3*	*5.3*	*3.9* (*7.2*)	*6.7* (*9.1*)	*-2.0* (*0.3*)	*1.7* (*-9.2*)
realization rate (3)	*106.1*	*110.8*	*108.1*	*106.8*	*99.7*	*105.9*	*105.7*	*107.2*	*107.6*
plans for 2008	*6.5*	*-4.8*	*3.9*	*12.8*	*7.2*	*11.8* (*8.2*)	*2.4* (*7.4*)	*-2.6* (*1.8*)	*-2.3* (*7.9*)
Realized investment in 2007	5.4	8.9	4.8	3.0	5.4	3.7 (7.6)	7.8 (9.8)	7.8 (7.0)	3.1 (-3.9)
Realization rate (3)	98.8	86.8	105.0	106.2	99.6	101.5	103.7	86.5	105.2
Plans for 2008	5.8	-0.7	4.9	12.8	7.3	10.6 (7.4)	0.9 (4.8)	2.8 (1.0)	-1.4 (10.9)
Services (4)									
Realized investment in 2007 (5)	-0.2	-0.3	-0.6	.. ..	.. ..	-5.1 (-6.7)	0.8 (3.4)	7.5 (8.1)	-0.2 (-0.9)
Plans for 2008 (5)	3.2	3.3	5.0	.. ..	.. ..	2.9 (5.5)	-0.5 (1.1)	6.5 (2.2)	0.3 (4.2)
Total									
Realized investment in 2007	2.6	2.9	2.1	0.9	7.4	-0.7 (-0.4)	4.7 (7.0)	7.6 (7.6)	1.4 (-2.6)
Plans for 2008	4.5	1.7	4.9	8.3	4.4	7.3 (6.5)	0.3 (3.2)	5.0 (1.7)	-0.5 (7.8)

Source: Banca d'Italia, *Survey of Industrial and Service Firms*.
(1) Robust 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 2006 for 2007, 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 national accounts data, exports of goods and services increased by 5 per cent in real terms in 2007 (Table 8.1). Although lower than in 2006 (6.2 per cent), the rate of increase was above the average for the five years 2001-05, confirming signs of recovery in Italian industry's export capacity. However, there was still a gap of 1.5 percentage points in relation to world trade in 2007, also due to the further worsening of price competitiveness following a temporary recovery in 2005. On the basis of producer prices, between the end of 2005 and the beginning of 2008, Italian industry's loss of competitiveness amounted to 6.3 percentage points, almost double that of Germany and France. In Italy the nominal appreciation of the euro was accompanied by a faster increase in producer prices than in the other countries.

According to the foreign trade indices recently revised by Istat, in 2007 the volume of goods exports alone grew by 5 per cent (5.5 per cent in 2006; Table 8.6), benefiting primarily from the strong increase in demand from Spain, the smaller EU economies and the main energy-exporting countries, whose spending capacity was strengthened by abundant oil revenues.

Table 8.6

Exports and imports *cif-fob* by main countries and areas: indices of average unit values (AUVs) and volumes (1)
(percentage composition in the year and percentage changes on previous years; indices, 2005=100)

	Exports						Imports					
	2006			2007			2006			2007		
	% 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-27 countries	**61.2**	**4.6**	**6.0**	**60.8**	**4.9**	**4.4**	**57.6**	**5.5**	**4.6**	**57.7**	**3.1**	**3.3**
of which: euro area of 13	*45.5*	*4.6*	*5.4*	*45.1*	*4.7*	*4.4*	*46.4*	*5.8*	*3.9*	*46.4*	*3.2*	*2.9*
of which: France	*11.8*	*4.3*	*1.9*	*11.6*	*4.5*	*3.6*	*9.3*	*6.2*	*-0.2*	*9.1*	*2.9*	*1.4*
Germany	*13.2*	*4.5*	*6.6*	*13.0*	*4.6*	*3.7*	*16.8*	*6.5*	*3.6*	*17.1*	*2.4*	*5.9*
Spain	*7.4*	*5.6*	*3.3*	*7.5*	*4.7*	*6.9*	*4.3*	*5.4*	*7.7*	*4.3*	*5.5*	*1.7*
United Kingdom	*6.1*	*4.0*	*-1.4*	*5.9*	*4.3*	*1.9*	*3.6*	*4.7*	*-3.5*	*3.3*	*2.6*	*-3.4*
Non-EU countries	**38.8**	**6.0**	**4.7**	**39.2**	**5.0**	**5.8**	**42.4**	**14.7**	**3.9**	**42.3**	**2.1**	**3.9**
of which: China	*1.7*	*7.0*	*15.4*	*1.7*	*7.8*	*2.9*	*5.1*	*5.5*	*20.1*	*5.8*	*3.4*	*17.5*
DAEs (4)	*2.9*	*4.5*	*2.4*	*2.8*	*4.4*	*-0.5*	*2.4*	*2.4*	*2.5*	*2.3*	*0.8*	*-3.0*
Japan	*1.4*	*2.7*	*-3.7*	*1.2*	*5.2*	*-8.2*	*1.5*	*0.7*	*8.7*	*1.4*	*1.6*	*-3.0*
Russia	*2.3*	*5.6*	*18.6*	*2.6*	*6.6*	*17.8*	*3.9*	*27.6*	*-9.4*	*3.8*	*-0.8*	*6.6*
United States	*7.4*	*7.3*	*-4.4*	*6.7*	*1.3*	*-1.9*	*3.0*	*6.9*	*-6.7*	*3.0*	*2.4*	*1.1*
Total	**100.0**	**5.1**	**5.5**	**100.0**	**4.9**	**5.0**	**100.0**	**9.6**	**4.0**	**100.0**	**2.6**	**3.5**

Source: Based on Istat data.
(1) For 2007 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 2007 are calculated on the basis of data deflated for AUVs. – (3) Dynamic Asian economies: Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand.

Exports grew more strongly in the sectors of refined petroleum products, transport equipment, and mechanical machinery and equipment, while they declined in traditional sectors such as textiles and leather.

Italian exports' share of the world markets grew at current prices by about 0.1 percentage points to 3.7 per cent, thanks to the large increase in exports in euros (10.1 per cent in 2007) and the appreciation of the single currency, which further increased their value in dollars with respect to total world exports.

Imports. – On the basis of national accounts data, imports of goods and services grew by 4.4 per cent last year in real terms. Given that the increase in exports was only slightly greater, net exports made a negligible contribution to GDP growth.

According to foreign trade data, the volume of imported goods grew by 3.5 per cent, slowing slightly in part as a consequence of the weakness of industrial production. The increase was greater in the sectors with a positive export performance. Imports from China expanded strongly again (17.5 per cent in volume) and China became the third largest supplier of goods to Italy, accounting for almost 6 per cent of the total at current prices. Imports of crude oil and natural gas, which make up the preponderant part of Italy's purchases of energy products, grew in volume by 1 per cent and accounted for around 13 per cent of total imports at current prices.

Supply

Italy's GDP grew by 1.5 per cent in real terms in 2007 (1.8 per cent in 2006), again underperforming the rest of the euro area. The cumulative gap in growth since the middle of the 1990s with respect to the rest of the area widened to about 14 percentage points, equally ascribable to industry excluding construction and to services.

GDP growth in 2007 was almost entirely driven by the service sector, with a barely positive contribution from industry and nil from agriculture. Most of the increase of 1.8 per cent in value added in services came from the acceleration in monetary and financial intermediation, which had already grown rapidly in the previous two years, transport and communications, and distribution. Expansion in the construction sector continued (1.6 per cent), although not at the same rate as in the five years 2000-05.

The rate of growth of value added in industry excluding construction fell by a third to 0.8 per cent, weakening progressively over the year. The still considerable increase in some of the sectors driving the recent expansion (basic metals and metal products, mechanical machinery and equipment, and transport equipment) was accompanied by a contraction in sectors accounting for a large part of industry (electrical and electronic equipment, paper and food products). Among the sectors of traditional specialization, there was further decline in leather and textiles; the concomitant increase in the clothing sector could point to the repositioning of Italian firms towards higher quality products in order to face growing international competition.

The expansionary phase of Italian industrial production recorded in recent years was shorter than in the rest of the area, in particular Germany; it began in early 2005, with a lag of more than a year, and was interrupted at the end of 2006, in contrast with developments in the other main European countries. In addition, the industrial expansion in Italy was less broadly based: sectors accounting for about one third of aggregate activity continued to decline or at best remained stationary; in Germany, only two sectors, representing 4 per cent of total production, did not participate in the expansion.

In Italy, the recovery was led by export-oriented sectors, such as machinery and equipment, metal products, and transport equipment. The support of foreign demand was, however, sharply less in volume terms than in Germany; this helps to explain the greater intensity of German expansion. Italian exports began to slow in the second half of 2006, removing a crucial stimulus to domestic industrial production, which has shown a declining trend since early 2007. The cumulative growth gap that first emerged in 2004 vis-à-vis German manufacturing increased to 22 percentage points in the first quarter of 2008.

This picture, based on official industrial production data, could nevertheless overestimate the difficulties of Italian industry. Other business indicators describe a less unfavourable situation: the trend in orders, turnover and exports at current prices for the two years 2005-06, showed brisker expansion, lasting up to the first half of 2007. Starting in 2005, the strength of the recovery in Italian exports, in value rather than volume terms, was similar to that of Germany, indeed with a greater increase in 2007 as a whole. These different indications could reflect not only the internationalization of firms but also a shift in the composition of Italian output, in particular towards goods with higher value added, only partly captured by the industrial production index.

On the basis of preliminary estimates released by Istat, in the first quarter of 2008, GDP grew by 0.4 per cent, recouping the fall of the same amount recorded in the previous quarter. This result reflected a slight rise in industrial activity from the low levels recorded in the final part of 2007 as well as an expansion in services. The economic picture that emerges from the most recent indicators is that of lower growth rates for the remaining part of this year.

Prices and costs

Consumer prices. – Consumer price inflation in Italy, measured by the index of consumer prices for the entire resident population, fell from an average of 2.1 per cent in 2006 to 1.8 per cent last year, the lowest level since 2000. For the first time in the decade, the increase in the harmonized index in Italy was smaller than that for the euro area as a whole (2 and 2.1 per cent respectively.

However, in the fourth quarter of 2007, in Italy as in the rest of the area, inflation abruptly picked up, rising to a twelve-month rate of 2.6 per cent in December, from 1.6 per cent in August. The increase, due to the acceleration of energy and food prices, continued in 2008. In April the twelve-month rate stood at 3.3 per cent.

The average annual increase in the prices of goods other than food and energy held at 1.2 per cent in 2007, reflecting the moderation of domestic costs and the competitive pressure brought to bear on domestic producers by the appreciation of the euro. By contrast, that in the prices of unregulated services rose from 2.4 to 2.6 per cent, driven up in part by the restaurant component, which was affected by the sharp increases in food prices (Table 8.7).

Table 8.7

Consumer prices (1)

	Percentage changes on previous year		Percentage weights	Contributions to average inflation (percentage points)
	2006	2007	2007	2007
Overall index	**2.1**	**1.8**	**100.0**	–
Overall index net of food and energy	**1.6**	**1.6**	**72.4**	**1.20**
Unregulated goods and services	**1.9**	**2.1**	**81.5**	**1.71**
Unprocessed food	1.4	3.4	6.7	0.23
of which: milk	*0.9*	*2.5*	*0.7*	*0.02*
meat	*2.8*	*4.0*	*2.8*	*0.11*
Processed food	1.9	2.4	10.6	0.25
of which: bread	*1.6*	*5.7*	*1.2*	*0.07*
pasta and rice	*1.5*	*5.5*	*1.3*	*0.07*
milk products	*0.4*	*2.0*	*1.5*	*0.03*
Non-food and non-energy products	1.2	1.2	27.5	0.33
of which: computers	*-12.9*	*-8.7*	*0.3*	*-0.03*
telephones	*-14.9*	*-15.2*	*0.4*	*-0.07*
Services	2.4	2.6	32.2	0.84
of which: air transport	*1.3*	*-4.4*	*0.6*	*-0.03*
medical and dental services	*2.5*	*2.9*	*2.9*	*-0.15*
financial services	*1.7*	*-1.0*	*0.9*	*-0.01*
restaurants	*2.4*	*3.0*	*8.2*	*0.25*
Energy products	6.0	0.6	4.6	0.03
Regulated goods and services	**2.8**	**0.6**	**18.5**	**0.11**
Medical products	-3.7	-5.2	2.7	-0.14
Tobacco products	6.3	4.2	2.1	0.09
Public services and utilities	4.1	0.9	10.8	0.10
of which: gas	*9.3*	*0.1*	*2.3*	..
electricity	*12.6*	*4.8*	*1.4*	*0.07*
refuse collection	*4.9*	*9.2*	*0.7*	*0.07*

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

A contribution to curbing average inflation in 2007 came from the moderate rise in regulated prices (0.6 per cent). This was a result both of the slowdown in gas and electricity tariffs and of the decrease of 5.2 per cent in the prices of medical products. The latter reflected the discounts imposed on pharmaceutical companies by the Italian Drug Agency; these discounts are taken into account by the price index for the entire resident population but not by the harmonized index.

Since the end of the summer the consumer prices of food products, especially those of milk and milk products, bread, pasta and rice, have accelerated appreciably (from a twelve-month increase of 2.4 per cent in August to 5.5 per cent this April), reflecting pronounced price hikes in the stages upstream of distribution, triggered in turn by the rise in the prices of agricultural commodities on the international markets. The responsiveness of the producer prices of food products to movements in commodity prices, historically low up to mid-2007, appears to have increased since last summer.

Among the factors explaining the low correlation between commodity prices and producer price inflation in the past are the low incidence of raw materials on the cost of producing processed foods and, especially for dairy products, the EU's Common Agricultural Policy, which significantly influenced the relation between prices in the euro area and international prices. The swifter adjustment of prices since mid-2007 suggests that producers deemed the increases in input prices to be permanent and accordingly passed them on to consumers.

The jump in the prices of energy and food, which are essential goods, has had a greater impact on the purchasing power of less-well-off households, representing a larger share of their outlays.

Producer prices and costs. – In 2007 the producer prices of industrial products sold on the domestic market rose by an average of 3.5 per cent, compared with 5.6 per cent in 2006. The slowdown, concentrated in the first half of the year, was due to the deceleration from 16 to 3.3 per cent in the energy component. Excluding energy and food products, producer price inflation remained essentially unchanged (3.3 per cent).

The producer prices of non-food and non-energy products for final consumption rose by 1.6 per cent, as in 2006, benefiting from the moderate pace of the costs of imported inputs in the first half of the year.

Unit labour costs in industry rose again by 2.5 per cent, reflecting the stagnation of productivity and the increase in earnings per employee. In services, a sharp slowdown in compensation per employee, due to the delay in renewing important collective bargaining agreements, caused a temporary deceleration in unit labour costs, which rose by 0.9 per cent, compared with 2.5 per cent in 2006.

Inflation expectations. – The short-term inflation outlook for Italy depends on the evolution of food and energy commodity prices in the coming months. The professional forecasters surveyed in May by Consensus Economics expect a temporary pick-up in inflation in the second half of this year: after rising to an average of 3 per cent for 2008, consumer price inflation is forecast to fall back to 2.3 per cent in 2009.

Firms' pricing policies are likely to remain moderate. According to the quarterly survey conducted in March by the Bank of Italy in collaboration with *Il Sole 24 Ore*, firms expect to raise selling prices by 1.7 per cent during the next twelve months, in line with their responses in the previous survey.

9. THE LABOUR MARKET

Employment growth continued in 2007, although not as fast as in 2006. It was sustained by the expansion in output and fostered by enduring wage moderation. The unemployment rate fell further, reaching the same level as in the early 1980s. Most of the rise in the number of persons in employment concerned foreigners; there was an increase in the proportion of fixed-term and part-time workers. The already large disparities in employment rates between the South and the Centre and North widened.

Labour productivity growth was very slow, hampering economic growth and limiting the rise in unit wages. According to recent statistics on student performance, one of the factors that affect productive efficiency in the long term, Italy continues to lag behind other countries. The PISA tests run by the OECD in 2006 indicate that the knowledge and skills of Italian secondary school students are poor by international standards.

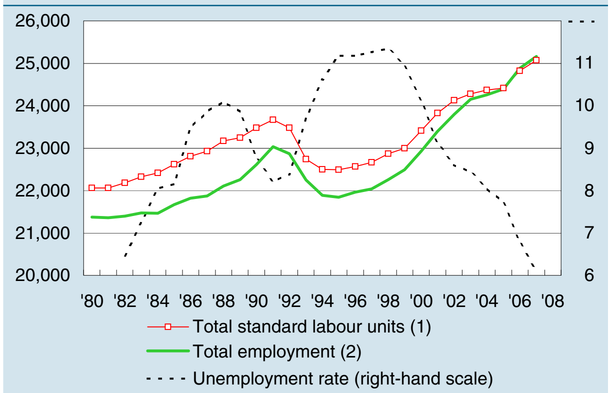
According to the Bank of Italy's Survey of Household Income and Wealth, although per capita earnings increased only moderately in 2005-06, net household income grew at an annual rate of 2.1 per cent in real terms, spurred by the rise in employment. The degree of household income inequality was virtually unchanged with respect to 2004 and remains wider than in other countries, partly reflecting large disparities in income between households in the South and those in the Centre and North.

Total employment and its composition

In 2007 the number of persons employed in Italy increased by around 1 per cent, both as recorded in the national accounts, i.e. including non-resident unregistered workers, and according to the labour force survey (Figure 9.1). The employment rate for persons aged 15-64 rose by 0.3 points to 58.7 per cent (Table 9.1), with a particularly sharp increase for the 55-64 year-old group, whose employment rate rose by 1.3 points to 33.8 per cent, continuing the trend under way since 1999.

Figure 9.1

Employment and unemployment
(thousands and percentages)



Sources: 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).

Table 9.1

Structure of employment in Italy, 2007
(thousands of persons and percentages)

	Centre - North		South		Italy	
	Thousands of persons (1)	Percentage change 2007-06 (2)	Thousands of persons (1)	Percentage change 2007-06 (2)	Thousands of persons (1)	Percentage change 2007-06 (2)
Employees	**12,394**	**2.1**	**4,773**	**-0.1**	**17,167**	**1.5**
Permanent	10,971	1.9	3,928	0.1	14,898	1.4
full-time	*9,444*	*1.4*	*3,535*	*-0.7*	*12,979*	*0.8*
part-time	*1,526*	*5.1*	*393*	*8.3*	*1,919*	*5.7*
Fixed-term and temporary	1,423	4.1	846	-1.1	2,269	2.1
full-time	*1,097*	*2.9*	*669*	*-1.7*	*1,766*	*1.1*
part-time	*326*	*8.5*	*176*	*1.2*	*502*	*5.8*
Self-employed	**4,312**	**-0.5**	**1,743**	**0.2**	**6,055**	**-0.3**
Entrepreneurs, professionals and self-employed workers	3,588	-0.5	1,508	0.1	5,096	-0.3
Family workers	311	-0.1	110	-2.8	421	-0.8
Cooperative members	33	30.2	14	4.4	48	21.2
Contingent workers	304	-4.6	88	3.3	392	-2.9
Occasional workers	76	4.7	22	8.3	98	5.5
Full-time	*3,767*	*-0.1*	*1,546*	*0.5*	*5,313*	*0.1*
Part-time	*545*	*-3.2*	*197*	*-2.3*	*742*	*-3.0*
Total employment	**16,706**	**1.4**	**6,516**	**..**	**23,222**	**1.0**
women	*6,976*	*1.7*	*2,189*	*0.1*	*9,165*	*1.3*
men	*9,730*	*1.3*	*4,327*	*-0.1*	*14,057*	*0.8*
Unemployed	**698**	**-8.6**	**808**	**-11.2**	**1,506**	**-10.0**
women	*400*	*-9.3*	*384*	*-11.1*	*784*	*-10.2*
men	*299*	*-7.7*	*424*	*-11.2*	*722*	*-9.8*
Labour force	**17,404**	**1.0**	**7,324**	**-1.4**	**24,728**	**0.3**
women	*7,376*	*1.0*	*2,573*	*-1.7*	*9,949*	*0.3*
men	*10,028*	*1.0*	*4,751*	*-1.2*	*14,779*	*0.3*
Participation rate (age 15-64)	**68.1**	**0.1**	**52.4**	**-0.8**	**62.5**	**-0.2**
women	*58.5*	*0.1*	*36.6*	*-0.7*	*50.7*	*-0.2*
men	*77.7*	*0.1*	*68.4*	*-0.9*	*74.4*	*-0.2*
Employment rate (age 15-64)	**65.4**	**0.4**	**46.5**	**-0.1**	**58.7**	**0.3**
women	*55.3*	*0.5*	*31.1*	*..*	*46.6*	*0.3*
men	*75.3*	*0.3*	*62.2*	*-0.1*	*70.7*	*0.2*
Unemployment rate	**4.0**	**-0.4**	**11.0**	**-1.2**	**6.1**	**-0.7**
women	*5.4*	*-0.6*	*14.9*	*-1.6*	*7.9*	*-0.9*
men	*3.0*	*-0.3*	*8.9*	*-1.0*	*4.9*	*-0.5*
Youth unemployment rate	**13.7**	**-0.7**	**32.3**	**-1.9**	**20.3**	**-1.3**
women	*16.2*	*-1.0*	*38.3*	*-2.2*	*23.3*	*-1.9*
men	*11.8*	*-0.5*	*28.9*	*-1.5*	*18.2*	*-0.9*

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.

As in 2006, women's employment grew faster than male employment (1.3 as against 0.8 per cent), resuming a long-term trend that had broken off briefly between 2003 and 2005. The female employment rate rose by 0.3 points to 46.6 per cent, that for men by 0.2 points to 70.7 per cent. The total increase over ten years amounted to 8.1 percentage points for women and 4.6 points for men.

A substantial share of additional employment in 2007 (154,000 jobs, equal to over 65 per cent) again involved foreigners officially resident in Italy. Their share of total average employment rose from 5.9 per cent in 2006 to 6.4 per cent and is particularly large in the Centre and North, in the hotel and restaurant sector, in construction, and in services to households, where foreign workers occupy the lowest paid positions.

Employment increased only among payroll positions, with the number of self-employed workers recording a small decline (Table 9.1). Although the latter's share of total employment in Italy is one of the highest among the industrialized countries (around 16 points above the euro-area average), it has declined progressively since 1997, from 29.1 to 26.1 per cent.

Four fifths of the growth in payroll employment concerned permanent positions, up by 1.4 per cent and 206,000 jobs. Temporary employment increased faster, however, rising by 2.1 per cent (47,000 jobs) to 13.2 per cent of all payroll jobs. The number of part-time jobs increased by 5.8 per cent to 14.1 per cent of the total. This form of work is uncommon among men, accounting for only 4.4 per cent in 2007, but concerned 27.2 per cent of working women, some 5 percentage points more than ten years earlier.

Unemployment and the labour supply

The number of job-seekers diminished by 167,000 on average in 2007 to a total of 1,506,000 (Table 9.1). The unemployment rate continued to decline, falling from 6.8 to 6.1 per cent, a level close to that recorded in the early 1980s (Figure 9.1). Both men and women in all age groups benefited, with the unemployment rate falling to 7.9 per cent for women and 4.9 per cent for men. In the Centre and North the total unemployment rate is now extremely low by European standards, but it remains high in the South, where part of the reduction of recent years may be due to discouragement.

The reduction in the unemployment rate was facilitated by the small rise in the labour force, which increased by just 0.3 per cent and 66,000 persons. The 0.6 per cent rise in the resident population of working age (15-64 years) was again due entirely to the foreign component, up by 11.6 per cent. The participation rate of 15-64 year-olds decreased by 0.2 points to 62.5 per cent, mainly in the South and among 15-24 year-olds.

Labour input by sector

Labour input to the economy, measured in standard labour units by the national accounts, continued to grow steadily in all the main sectors in 2007 (1.0 per cent), although less rapidly than in 2006 (Table 9.2). In agriculture, after the previous year's unexpected upturn, standard labour units decreased sharply, resuming a persistent downward trend. In the last ten years the sector's share of total employment fell by around 2 points, to 5.3 per cent. Employment in construction, which had slowed in 2006, resumed growth at a rate close to the average recorded during the phase of expansion under way since 1999. The recovery in output in industry excluding construction in the last two years led to an annual increase in employment of 1 per cent, recouping part of the 3-point decline accumulated between 1998 and 2005. The sector's share of total employment contracted by 2 points over the decade, to 20.3 per cent, although remaining high by international standards.

Table 9.2

Labour input in the Italian economy by sector
(standard labour units; percentages and percentage changes)

	Total				Employees			
	Percentage		Percentage change		Percentage		Percentage change	
	1997	2007	2007/ 1997	2007/ 2006	1997	2007	2007/ 1997	2007/ 2006
Agriculture, forestry, fishing	**7.2**	**5.3**	**-18.6**	**-2.9**	**3.3**	**2.8**	**-2.9**	**-0.4**
Industry excl. construction	**22.4**	**20.3**	**0.2**	**0.9**	**26.8**	**23.8**	**1.3**	**1.0**
of which: manufacturing	*21.5*	*19.6*	*0.9*	*1.1*	*25.6*	*22.9*	*2.2*	*1.2*
Construction	**6.8**	**7.8**	**26.8**	**2.4**	**5.8**	**6.8**	**34.2**	**2.4**
Services	**63.6**	**66.6**	**15.9**	**1.1**	**64.1**	**66.6**	**18.9**	**1.7**
Wholesale/retail trade and repairs	*14.7*	*14.2*	*7.0*	*-0.1*	*9.3*	*10.0*	*23.7*	*0.9*
Hotels and restaurants	*5.2*	*5.9*	*26.7*	*1.9*	*4.5*	*5.5*	*37.2*	*2.6*
Transport, storage and communications	*6.3*	*6.6*	*15.2*	*1.5*	*7.1*	*7.3*	*17.4*	*2.0*
Monetary and financial intermediation	*2.6*	*2.5*	*6.6*	*2.7*	*3.3*	*3.0*	*4.1*	*1.9*
Business services (1)	*8.6*	*11.8*	*50.6*	*3.0*	*6.6*	*9.3*	*62.1*	*5.0*
General government (2)	*6.5*	*5.4*	*-6.7*	*-0.2*	*9.3*	*7.6*	*-6.7*	*-0.2*
Education	*6.8*	*6.4*	*3.5*	*0.2*	*9.0*	*8.0*	*1.1*	..
Healthcare	*5.9*	*6.0*	*13.2*	*-0.2*	*7.0*	*7.1*	*16.6*	*0.4*
Other public, social and personal services	*3.8*	*4.2*	*21.9*	*0.4*	*3.4*	*3.9*	*31.2*	*1.7*
Domestic services for households and live-in help	*3.2*	*3.6*	*23.4*	*4.1*	*4.6*	*5.0*	*23.4*	*4.1*
Total	**100.0**	**100.0**	**10.6**	**1.0**	**100.0**	**100.0**	**14.4**	**1.5**
of which: public sector (3)	*15.5*	*14.5*	*3.6*	*-0.1*	*22.3*	*20.2*	*3.6*	*-0.1*

Source: Istat, national accounts.
(1) Includes real-estate services, leasing, IT, research and other professional and business services. – (2) Includes defence and compulsory social insurance. – (3) Public employees in general government, education, healthcare and other public, social and personal services, excluding national service conscripts.

In the services sector the increment of 1.1 per cent in labour input involved all branches except wholesale and retail trade and general government. Growth was modest in social services as well.

The number of public employees, measured in standard labour units, was down 0.1 per cent compared with 2006. In 2007 they totalled 3.6 million full-time equivalent workers, 0.7 per cent more than in 1992 when policies to curb expenditure had brought the sector's expansion to a halt. Public employment declined by around 120,000 jobs between 1992 and 1998, and has risen by 150,000 since then. Public sector employees, not including contingent workers, represented 14.5 per cent of total employment, against 15.4 per cent in 1992.

Unregistered employment continued to account for a large proportion of labour input. In 2005, the last year for which estimates are available, it amounted to 12.1 per cent of the total (2,951,000 standard labour units).

Education standards in Italy according to the PISA and IEA-PIRLS tests

In December 2007 the OECD released the results of the third Programme for International Student Assessment, conducted in the spring of 2006. PISA tests the knowledge and skills of 15-year-olds in reading comprehension, mathematics and science. As in previous editions, the average test scores of Italian students were well below the averages for the OECD countries. The gap is equivalent to the skills acquired in a semester of school for science and reading and a year for mathematics. The proportion of students not attaining the minimum level of skills deemed necessary for participation in an advanced society is 50.9 per cent for reading comprehension (more than 6 points higher than in 2003), 32.8 per cent for mathematics and 25.3 per cent for science. These figures compare with OECD averages of 42.8, 21.3 and 23.2 per cent.

There are significant geographical disparities in levels of achievement, both in average values and the proportion of students not attaining the minimum level of competence. In particular, the average gap between the North and the South of Italy is equivalent to the knowledge acquired in nearly 2 years of education. In the southern regions about two thirds of students are below the minimum in reading comprehension, almost one in two in mathematics and close to four out of ten in science.

The worrying situation depicted by the PISA survey contrasts with the results of the PIRLS (Progress in International Reading Literacy Study) and IEA (International Association for the Evaluation of Educational Achievement) surveys, which assess the reading attainment of 9 and 10 year-olds. The results put Italy towards the top of the ranking, eighth out of 40. The country's average scores are better than in the 2001 survey, mainly due to the contribution of the South. Although differences of methodology do not permit full comparison with the PISA tests, these studies suggest that Italian schools obtain good results through primary school but generally unsatisfactory ones thereafter.

The problems facing Italian schools are examined in the White Paper on Schools published in September 2007 by the Ministry for the Economy and the Ministry of Education. The Paper identifies several lines of action to improve education standards, including the need for a system for transfers and assignments of teachers that takes account of more than just the latter's requirements; improvements in teacher recruitment criteria; the adoption of a programming model that allocates public funds according to the actual size of the student population at regional level; and the creation of a more objective system of learning assessment than the present method based exclusively on the marks given by teachers.

Earnings and labour costs

Actual earnings per full-time equivalent worker for the entire economy rose by 2.1 per cent in 2007, compared with 3 per cent in 2006 (Table 9.3). The slowdown reflected growth of just 1 per cent in earnings in the public sector compared with an average of 4 per cent in the four previous years; major contracts renewed at the end of last year make provision for pay increases in 2008. In the private sector, too, actual per capita compensation grew moderately, by 2.4 per cent against 3 per cent in 2006, owing to delays in renewing the labour contracts of certain sectors, such as those for wholesale and retail trade, which expired in December 2006 and has not yet been renegotiated, and metal-working, which was signed at the beginning of this year, seven months late.

Table 9.3

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 labour costs per standard employee labour unit (6)	Real earnings per standard employee labour unit (7)
				Industry excluding construction					
1996-2000	1.1	-0.3	1.4	3.5	2.5	1.1	62.6	0.5	1.0
2001-2005	-0.5	-0.4	-0.1	3.1	3.1	3.2	63.1	1.1	0.6
2001	-0.2	-0.6	0.4	3.1	3.2	2.8	60.8	0.1	0.3
2002	-0.3	0.7	-1.0	2.7	2.5	3.5	61.7	0.6	0.2
2003	-2.7	..	-2.6	2.6	2.8	5.6	64.1	1.1	-0.1
2004	0.9	-1.0	1.9	3.9	4.0	2.0	64.2	2.2	1.7
2005	-0.4	-1.0	0.7	3.1	2.7	2.0	64.7	1.4	1.1
2006	1.2	1.0	0.1	3.4	2.6	2.5	65.6	1.6	1.3
2007	0.8	0.9	-0.1	2.8	2.4	2.5	65.2	-0.8	0.9
				Construction					
1996-2000	1.0	1.0	..	3.3	2.1	2.1	71.8	-0.1	0.9
2001-2005	2.8	3.3	-0.5	2.6	2.9	3.4	67.7	-1.9	0.2
2001	5.6	6.2	-0.5	2.7	1.8	2.4	69.4	-3.1	-0.1
2002	2.3	2.1	0.2	2.0	3.0	2.8	68.4	-1.3	-0.5
2003	2.3	2.7	-0.4	2.5	3.9	4.3	67.9	-1.2	-0.2
2004	1.5	1.6	-0.1	3.8	3.9	4.0	66.6	-2.0	1.5
2005	2.3	4.1	-1.7	2.3	1.8	3.6	66.4	-2.0	0.3
2006	1.5	0.8	0.7	2.9	2.2	1.4	65.8	-0.2	0.8
2007	1.6	2.4	-0.8	3.6	3.9	4.7	65.6	-1.1	1.7
				Private services (8) (9)					
1996-2000	3.1	2.2	0.9	3.2	2.0	1.1	69.7	-0.3	0.7
2001-2005	1.3	1.6	-0.2	2.6	2.6	2.9	68.1	0.2	0.2
2001	3.2	2.4	0.7	3.0	2.7	1.9	67.0	-0.5	0.2
2002	0.6	2.6	-2.0	1.7	1.8	3.9	67.7	-0.9	-0.8
2003	-0.2	1.8	-2.0	2.0	2.3	4.4	68.1	-1.4	-0.7
2004	1.6	0.7	0.9	2.9	3.1	2.2	68.5	1.4	0.7
2005	1.7	0.4	1.3	3.4	3.3	2.1	69.3	2.5	1.3
2006	2.7	2.3	0.3	2.9	2.5	2.2	71.5	3.5	0.8
2007	2.3	1.5	0.8	1.9	1.9	1.1	71.2	0.4	0.1
				Private sector (9)					
1996-2000	2.2	0.9	1.3	3.4	2.3	1.0	69.5	0.3	0.9
2001-2005	0.8	0.9	-0.1	2.8	2.8	2.9	68.4	0.4	0.3
2001	2.0	1.8	0.2	2.9	2.7	2.5	67.2	-0.6	0.1
2002	0.3	1.5	-1.2	2.1	2.2	3.5	67.7	-0.4	-0.3
2003	-1.0	0.9	-1.8	2.5	2.9	4.8	68.7	-0.4	-0.2
2004	1.8	0.3	1.5	3.2	3.3	1.7	68.8	1.7	1.0
2005	0.8	0.1	0.8	3.0	2.8	2.0	69.5	1.8	1.0
2006	2.0	1.7	0.2	3.0	2.4	2.2	71.1	2.5	0.9
2007	1.7	1.1	0.6	2.4	2.3	1.7	70.6	..	0.6
				Total economy (9)					
1996-2000	1.9	0.8	1.1	3.5	2.7	1.5	72.5	0.3	1.0
2001-2005	0.9	0.8	..	3.2	3.2	3.2	71.8	0.6	0.8
2001	1.9	1.8	0.1	3.5	3.2	3.0	70.5	-0.3	0.7
2002	0.4	1.3	-0.9	2.6	2.7	3.6	71.1	..	0.1
2003	-0.7	0.6	-1.3	3.2	3.7	5.1	72.2	0.2	0.5
2004	2.0	0.4	1.6	3.4	3.3	1.7	72.2	1.6	1.2
2005	0.8	0.2	0.7	3.4	3.2	2.5	72.8	1.5	1.4
2006	1.8	1.7	0.1	3.0	2.5	2.4	74.1	1.9	0.9
2007	1.6	1.0	0.6	2.1	1.9	1.4	73.6	-0.2	0.2

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.

The growth in real earnings continued to be generally moderate, a trend that has characterized the Italian labour market since the beginning of the 1990s. Real earnings per standard labour unit in the entire economy rose by 7.7 per cent between 1992 and 2007, i.e. by less than half a percentage point a year. For the period as a whole minimum contractual earnings have risen more slowly than consumer prices, despite outpacing them slightly since 2000. The increase in average earnings, small as it was, was due to pay rises granted at company level and to changes in the composition of the workforce.

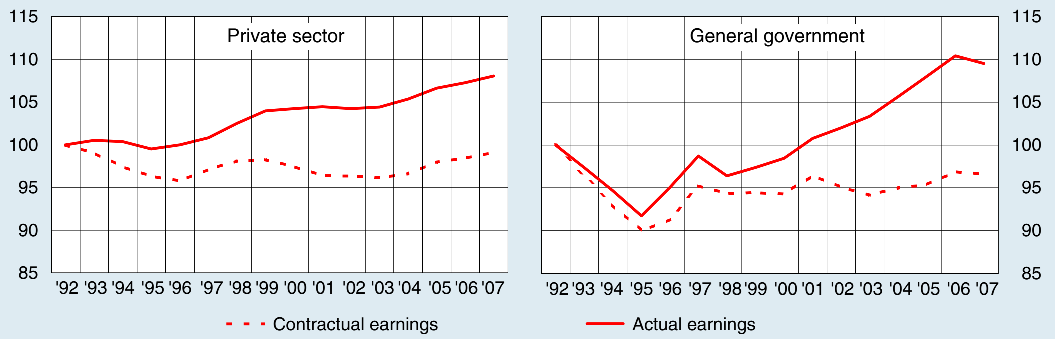
As expected, the agreements of 1992-93 decreeing that national contracts should safeguard only the purchasing power of minimum wages have widened the gap between actual and contractual earnings. Had labour productivity continued to grow at the same rate as in the decades prior to those agreements, the company-level bargaining and the pay rises granted outside industry-wide contracts would presumably have widened the gap between overall earnings and minimum wages even more substantially, causing greater wage dispersion among firms and geographical areas. In the present decade, with productivity stagnating there is little margin for company-level wage increases, which have therefore failed to spread.

Whereas public sector wages grew at a slower rate than consumer prices and wages in the private sector during the 1990s, since 2000 the pace has accelerated, more than recouping the lag accumulated earlier (Figure 9.2). The faster increase in actual earnings in the public sector can be put down to changes in the composition of employees by age and grade and to second-level pay rises and to increases for management, which are not included in the index of contractual earnings.

Figure 9.2

Real earnings per standard employee labour unit

(index, 1992=100)



Sources: Based on Istat, national accounts and survey of contractual earnings.

Unit labour costs including employers' social security contributions increased slightly less than earnings in 2007, increasing by 1.9 per cent in the entire economy and by 2.3 per cent in the private sector.

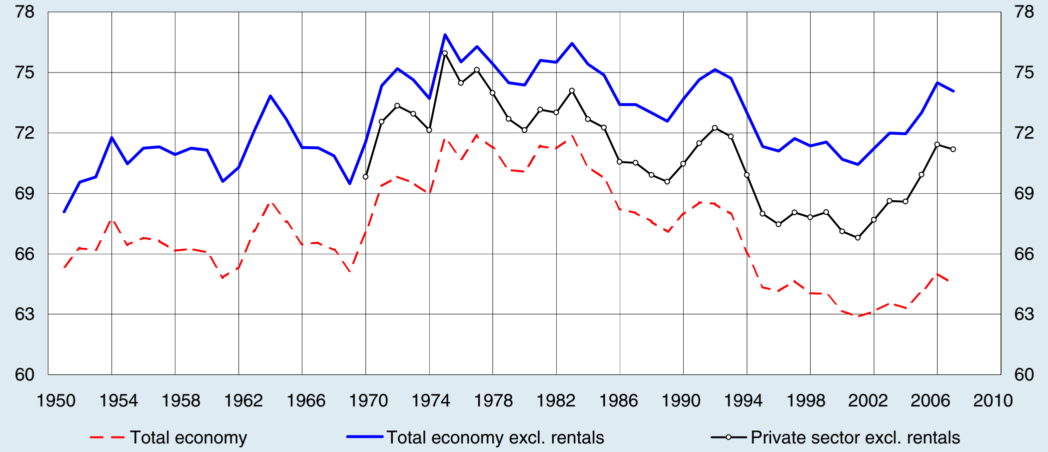
Last year firms were granted a reduction in the tax base for IRAP (regional tax on productive activities); officially, this does not affect the cost of labour or, consequently, the data in question, but it could be said to do so by allowing firms to deduct from the tax base €5,000 per employee and the contributions paid for permanent employees.

Although the rise in earnings and labour costs has been moderate compared with that in the cost of living this decade, it has outpaced labour productivity, which has continued to stagnate. This has led to an increase in labour's share of value added, which had declined throughout the 1990s. Imputing to self-employed workers the average payroll earnings in the relevant sector, labour's share of value added in the entire economy rose from 62.9 per cent in 2001 to 64.5 per cent in 2007 (Figure 9.3)

Figure 9.3

Labour's share of value added at factor cost (1)

(percentage)



Sources: Istat, national accounts; Prometeia.
(1) Calculated by imputing to self-employed workers the average per capita compensation for the sector.

Excluding rental of residential and non-residential buildings, which has risen steadily as a share of value added from the beginning of the 1980s, labour's share increased more sharply, from 70.4 per cent in 2001 to 74.2 per cent in 2007. In the private sector alone, excluding rentals, it rose from 66.9 to 71.5 per cent, nearly regaining the levels of the early 1990s. In the sectors most affected by privatizations, labour's share of value added settled at fairly low levels, while in manufacturing it grew very sharply. Company financial reports, however, indicate a less pronounced recovery.

The standstill in productivity also caused a progressive decline in the cost competitiveness of Italian goods. Unit labour costs in the private sector, excluding rentals, rose by 1.7 per cent in 2007, less than the 2.2 per cent recorded in 2006. In industry excluding construction they increased by 2.5 per cent, the same as in the previous year. In this sector the average growth in unit labour costs was around 2 per cent between 1997 and 2007, compared with a rise of 1 per cent in Spain and a decline of the same amount in France and Germany.

Labour market regulation

In July 2007 the Government and the social partners signed a Memorandum of Understanding on Social Security, Labour and Competitiveness for Equity and Sustainable Growth, the main lines of which were subsequently incorporated in Law 247 of 24 December 2007. The memorandum, in addition to providing for some amendments to the regulations on pensions, set out three main lines of action on social shock absorbers and the labour market: more generous income support measures; action to combat unstable employment, including a re-drafting of some forms of contract envisaged by Law 30/2003; and the introduction of incentives to increase productivity.

The provision on social shock absorbers includes an increase in the amount and the duration of ordinary unemployment benefits. A proposal for broader reform for universal entitlement, overcoming the segmentation of income protection, is incorporated in an enabling act. Regarding the labour market, Law 247/2007 sets a 36-month limit on the rolling over of fixed-term contracts, with the possibility of one further renewal to be signed at the provincial labour offices with the assistance of a trade union representative. Although the general framework of Law 30/2003 has not been altered, staff leasing and job-on-call contracts are abolished, with some exceptions in the latter case for specific sectors. Firms and workers have been granted some tax relief regarding wage increases based on productivity and results. Finally, the additional contribution on overtime pay, due in different amounts according to firm size, sector and number of hours of work, has also been abolished.

On 21 May 2008 the Government decided to introduce experimentally, from 1 July to 31 December, a 10 per cent substitute tax on earnings from overtime and bonuses linked to efficiency and company profitability. The measure will affect only private sector employees with annual payroll earnings not exceeding €30,000. The substitute tax is only applicable up to €3,000 in overtime earnings.

Personal distribution of earnings and household income

According to the Bank of Italy's two-yearly Survey on Household Income and Wealth, monthly per capita real earnings of payroll employees increased, net of tax and social security contributions, by 0.7 per cent a year between 2004 and 2006, down from around 1 per cent in the previous two years (Table 9.4). The increase was a little larger for men. Earnings rose more on average in the South than in the Centre and North (1 and 0.7 per cent), in contrast to the previous two-year period. Both the inequality indexes and the share of low-paid workers decreased slightly.

An approximate measure of the economic wellbeing of individuals is obtained by calculating the overall income received by a household, net of taxes and social security contributions, and adjusting it according to the scale of equivalence used by Eurostat to take account of household size and the economies of scale of cohabitation.

In 2005-06 the total "equivalent" disposable income of Italian households, sustained by the rise in employment, increased by 2.1 per cent annually in real terms, about the same as in the previous two years (Table 9.5). The result does not change when the imputed rents of home-owners are excluded.

From 2004 to 2006 the equivalent income of self-employed workers' households increased at an annual rate of 2.5 per cent in real terms; the rate for blue-collar households was 2.6 per cent, and for pensioners 2.7 per cent. Income growth was greatest for households of managers (6.9 per cent) and much lower for those of white-collar workers (0.7 per cent).

Table 9.4

Monthly net real earnings (1)
(euros at 2006 prices; absolute and percentage values)

	1995	1998	2000	2002	2004	2006
	Total payroll employees					
Average earnings	**1,320**	**1,292**	**1,310**	**1,338**	**1,364**	**1,384**
Men	*1,446*	*1,401*	*1,430*	*1,451*	*1,479*	*1,507*
Women	*1,129*	*1,133*	*1,134*	*1,176*	*1,199*	*1,218*
Centre and North	*1,348*	*1,343*	*1,362*	*1,387*	*1,419*	*1,439*
South	*1,252*	*1,170*	*1,177*	*1,212*	*1,214*	*1,238*
Gini index (2)	0.234	0.241	0.240	0.251	0.242	0.233
Interdecile ratio (3)	2.8	3.1	3.1	2.9	3.0	2.8
Percentage of low-paid workers (4)	13.7	18.3	16.9	17.8	18.1	16.3
Men	*8.2*	*13.0*	*11.2*	*10.6*	*12.0*	*10.0*
Women	*22.0*	*25.9*	*25.4*	*28.0*	*26.7*	*24.7*
Centre and North	*11.4*	*14.4*	*13.3*	*14.9*	*15.5*	*13.8*
South	*19.2*	*27.6*	*26.5*	*24.9*	*25.1*	*22.8*
	Full-time payroll employees					
Average earnings	**1,360**	**1,358**	**1,377**	**1,410**	**1,423**	**1,453**
Men	*1,456*	*1,439*	*1,458*	*1,480*	*1,498*	*1,529*
Women	*1,197*	*1,224*	*1,236*	*1,292*	*1,294*	*1,330*
Centre and North	*1,393*	*1,403*	*1,422*	*1,458*	*1,482*	*1,514*
South	*1,282*	*1,248*	*1,255*	*1,288*	*1,261*	*1,293*
Gini index (2)	0.220	0.216	0.217	0.228	0.225	0.212
Interdecile ratio (3)	2.4	2.6	2.4	2.6	2.5	2.4
Percentage of low-paid workers (4)	9.7	12.2	10.6	11.3	12.7	10.0
Men	*7.5*	*9.8*	*9.0*	*8.0*	*10.4*	*8.2*
Women	*13.5*	*16.1*	*13.4*	*16.9*	*16.4*	*12.7*
Centre and North	*7.0*	*8.6*	*7.4*	*8.6*	*9.7*	*7.2*
South	*16.3*	*20.9*	*19.3*	*18.4*	*20.6*	*17.1*

Source: Bank of Italy, Survey of Household Income and Wealth, *Historical Database* (version 5.0, February 2008).
(1) Main payroll employment (excluding second jobs). Earnings are deflated with the cost of living index and are net of taxes and social security contributions. Values in lire until 1998 are converted at the conversion rate of 1936.27 lire to the euro. – (2) The Gini concentration index ranges from 0 (perfect equality) to 1 (maximum inequality). – (3) Ratio of the top 9th decile to the bottom 1st decile of earnings. – (4) Percentages. The OECD defines "low paid" as less than 2/3 of the median earnings of full-time workers.

Since 1995 households of self-employed workers have recorded the most sustained growth in income, amounting to 3.4 per cent annually in real terms, followed by managers (2.3 per cent) and pensioners (1.8 per cent). For households headed by blue- and white-collar workers the average annual increase in income has been smaller: 0.7 and 0.6 per cent respectively.

The Gini concentration index of equivalent household income declined from 34.3 per cent in 2004 to 33.8 per cent in 2006, still one of the highest among the advanced countries and similar to levels in the other countries of southern Europe, in Ireland and in the United Kingdom. One of the causes is the uneven distribution of work among Italian households, combined with the weaker redistributive effect of social transfers compared with other European states. The low employment rate in the South of Italy, particularly among women, causes wider income gaps both within the area and vis-à-vis the Centre and North, contributing greatly to the overall inequality measured by the index. The index for households residing in the Centre and North is much lower, comparable with the rest of continental Europe.

Table 9.5

Real disposable equivalent household income (1)
(euros at 2006 prices)

(2)	1995	1998	2000	2002	2004	2006
Average equivalent income	15,839	16,926	17,130	17,531	18,301	19,063
Centre and North	*18,396*	*19,950*	*19,975*	*20,651*	*21,630*	*22,302*
South	*11,368*	*11,615*	*12,111*	*11,979*	*12,297*	*13,120*
Blue collar worker, apprentice, shop assistant	*12,581*	*12,636*	*12,774*	*12,929*	*12,859*	*13,524*
Office worker, junior manager, teacher	*18,766*	*18,278*	*18,949*	*19,198*	*19,680*	*19,965*
Senior manager	*31,925*	*33,362*	*32,871*	*38,309*	*36,041*	*41,171*
Self-employed worker	*18,632*	*22,828*	*21,078*	*21,946*	*25,601*	*26,887*
Pensioner	*14,312*	*15,644*	*16,312*	*16,258*	*16,485*	*17,388*
Non-employed non-retired worker	*4,969*	*6,740*	*6,881*	*6,273*	*9,382*	*7,404*
1 member	*14,968*	*17,449*	*17,468*	*17,082*	*20,959*	*22,024*
2 members	*17,772*	*19,566*	*19,610*	*19,925*	*20,881*	*21,150*
3 members	*17,817*	*18,533*	*18,739*	*20,152*	*19,083*	*19,518*
4 members	*15,113*	*15,781*	*16,018*	*16,326*	*17,441*	*18,013*
5 or more members	*12,920*	*13,119*	*13,211*	*12,811*	*12,415*	*14,853*
Owner occupied accommodation	*17,572*	*18,744*	*18,865*	*19,238*	*20,241*	*21,074*
Rented accommodation	*12,209*	*12,978*	*13,063*	*13,330*	*13,838*	*14,010*
Gini index (3)	0.337	0.348	0.335	0.330	0.343	0.338
Centre and North	*0.299*	*0.314*	*0.293*	*0.292*	*0.306*	*0.305*
South	*0.357*	*0.350*	*0.357*	*0.329*	*0.334*	*0.324*
Interdecile ratio (4)	4.7	4.8	4.6	4.4	4.5	4.4

Source: Bank of Italy, Survey of Household Income and Wealth, *Historical Database* (version 5.0, February 2008).
(1) Total household incomes (including imputed rents of accommodation used by owners) net of direct taxes, divided by the national accounts deflator of national household consumption and adjusted for the purpose of comparison using the modified OECD scale of equivalence (which assigns a value of 1 to the first adult member, 0.7 to every other member over 13 years of age and 0.5 to every member aged 13 and under). All observations are weighted by the number of people, except those used to calculate the percentage of low-income households, which are weighted by household. Values in lire until 1998 are converted at the conversion rate of 1936.27 lire to the euro. – (2) Employment status of the head of the household, i.e. the person with the highest earnings or pension. – (3) The Gini concentration index ranges from 0 (perfect equality) to 1 (maximum inequality). – (4) Ratio of the top 9th decile to the bottom 1st decile of disposable income.

The percentage of low-income households – i.e. those with less than half the median equivalent disposable income – was stable at 12 per cent. The number of people living in such households fell from 15 to 14.3 per cent of the total, a value in line with the average for 1995-2006. The proportion of low-income households continued to be higher among large families, those living in rented housing and those resident in the South.

10. THE PRODUCTIVE STRUCTURE AND STRUCTURAL POLICIES

In the two-year period 2006-07, Italian gross domestic product grew by 1.6 per cent on average, at double the rate recorded in the preceding five-year period. Labour productivity, which fell in the first half of the decade, continued on the slightly upward path begun in 2004. Merchandise exports increased sharply.

Data on the demographics of firms and the slight increase in average company size suggest parts of the Italian productive system are being restructured, leading to marked differences in performance between firms operating in the same sector. Those that increased their value added and productivity the most were the ones with the greatest capacity to make important innovations in company strategy, employing a better qualified workforce, updating product ranges, investing in their brand, and internationalizing production and supplier networks.

Some of the economic policy measures designed to facilitate the reorganization of the productive system put more emphasis on reducing production costs and encouraging innovation. The legislative framework for business activities has improved as regards bankruptcy rules and company law. Although there have not yet been any major changes in the pattern of Italian business ownership and control, the new laws are beginning to have effect, with a move towards less centralized structures that are more open to foreign investors.

The efficiency of services that face no international competition and of government departments remains problematic. In some public utility sectors, the market power of the former monopolies is still strong. In local services, liberalization processes set in motion in the 1990s have achieved little: there is still a high degree of fragmentation, there have been only limited improvements in the quality of service, and no significant separation between regulators and providers has been achieved.

Legislative production remains substantial, with frequent and uncoordinated changes to the rules and often inconsistent interpretation of laws. The civil justice system still has some highly critical areas and litigation can be excessively lengthy, making the laws uncertain and ineffective. Above all, poorly organized resources and significantly more disputes than in other leading European countries are the main problems.

Sectoral dynamics

The Italian productive system weakened across the board in 2001-05. In manufacturing industry, which recorded negative growth rates overall in both value added (–0.8 per cent on average over the year) and labour productivity (–0.5 per cent), the deterioration was most marked in the transport equipment sector, affected by the difficulties of the leading Italian company, and in other traditional sectors (leather and footwear, textiles and clothing, and wood).

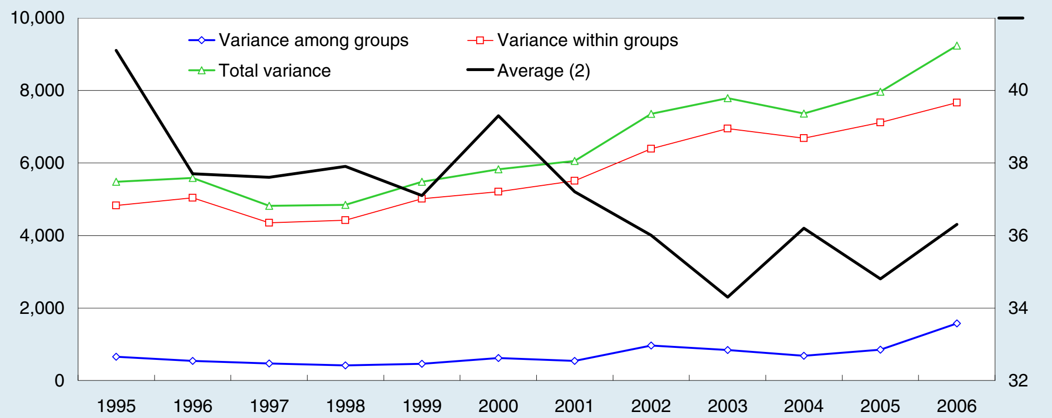
In the two-year period 2006-07, there was an improvement in almost all sectors, with the significant exception of manufactured wood products and leather and footwear. Value added in the services sector returned to the growth rates of the second half of the 1990s, increasing by 1.9 per cent on an annual basis, while in manufacturing industry it grew by 1.1 per cent. Productivity, which resumed growth in the services sector, remained stationary in manufacturing. The acceleration in value added was particularly sharp in the machinery and equipment sector (4.3 per cent), where there was a strong recovery in productivity (2.7 per cent), and in the transport equipment sector (2.7 per cent).

Although the cost of labour per employee rose moderately, productivity trends since 2000 have caused a significant reduction in average profits. The decline was particularly marked in manufacturing, where the share of profits returned to the modest levels of the second half of the 1970s. According to national accounts data, the share of the gross operating profit in value added fell by seven percentage points, from 45 per cent in 2000 to 38 per cent in 2006, levelling off in 2007. The fall in profits has apparently affected all sectors of manufacturing, particularly traditional industries and transport equipment.

This difficult period was reflected in a substantial increase in profit dispersion among firms. In 2002-06 dispersion increased on average by 50 per cent in comparison with the second half of the 1990s (Figure 10.1). Since the increase was only marginally affected by variables such as sector, geographical location and size of the firm, marked performance differences among firms would appear to be a feature of the present stage in the reorganization of the Italian productive system.

Figure 10.1

Breakdown of variance of firms' gross operating profit (1)



Source: Cerved archive of business enterprises.
(1) A firm's gross operating profit is calculated as the ratio of gross operating income to value added. The sum of the square of the deviation (total variance) of firms' gross operating profit is divided into the deviation of each observation from the group average (variance within the groups) and the deviation of the group average from the general average (variance among groups). The groups are: 3-digit sectors in the Ateco 1991 classification, the 103 Italian provinces and ten size classes calculated on the basis of turnover. – (2) Right-hand scale.

Firms

According to Istat data on firm demographics, between 2000 and 2004 the number of firms in Italy increased by about 33,000 overall: there was a fall in the number of trading companies (73,000) and industrial firms excluding construction (33,000), especially in the traditional sectors. There was, however, an increase in the number of firms working in construction (39,000) and in other services (99,000), amongst which notably post and telecommunication services, computer technology, and research and development.

Chamber of Commerce data are not perfectly comparable with Istat data because they do not exclude start-ups and closures due to mergers and split-offs and to simple changes of address, but they indicate for recent years a trend towards a reduction in the growth rate of the number of firms (0.75 per cent in 2007, down from 1.2 per cent in 2006 and 1.6 per cent in 2005). This is almost entirely due to an acceleration in closures (11.4 per cent in 2007, up from 7.9 per cent in 2006 and 1.3 per cent in 2005) which in absolute terms – 390,000 – are now at the highest level since 1993, a seriously critical year for the Italian economy.

The apparent paradox of an acceleration in closures during a recovery in production suggests that the productive system is undergoing a process of "creative destruction", in which less productive firms are being expelled and production quotas reallocated to better existing or emerging companies. Further support for this explanation comes from the albeit small increase in average company size and the greater frequency of closures in sectors more exposed to competition from developing countries and among smaller and less capitalized firms.

According to an empirical study conducted by the Bank of Italy on the sample of manufacturing firms (Invind), in 2000-06 average annual growth rates of value added and labour productivity, geographical location and sector being equal, were higher the larger the firm and the smaller its share of workers out of the total labour force. The growth and efficiency of firms benefited from drastic changes in company strategy, in particular from the renewal of product ranges, greater investment in brands and the beginnings of internationalization. A firm's success seems to depend increasingly on activities, apart from the physical production of goods, connected with creating the product and the brand, marketing, and after-sales service. These "service" activities allow firms to go beyond mere price competition by supplying a differentiated product with its own characteristics. Since these activities have high fixed costs, in particular those of setting up an integrated and digitalized internal organization, firms need to be sufficiently large to meet them: according to the latest Invind survey in 2007, only 34 per cent of manufacturing companies with 20-49 employees engaged in such activities directly or through outsourcing, as against 70 per cent of firms with over 500 employees.

Increasing competitive pressure from emerging countries on national and international markets and the regulation of the exchange rate with the adoption of the euro are among the main factors driving the restructuring of the Italian productive system by bringing about a clear reallocation of resources within sectors in favour of more efficient firms and far-reaching changes in company strategies.

Incentives policies

According to the European Union, on average among the EU-25 countries, outlays on policies supporting industry and services (excluding the transport sector) totalled 0.4 per cent of GDP in 2004-06, one tenth of a point less than in the previous three-year period. In 2006, spending on support policies went from 0.7 per cent of GDP in Germany (€16 billion, one third of the EU-25 total; Table 10.1) down to 0.25 per cent in the Netherlands and the United Kingdom; the figure for Italy was 0.3 per cent.

Table 10.1

State incentives for horizontal and sectoral objectives in 2006
(percentage shares of total unless otherwise indicated)

	Horizontal objectives								Sectoral aid (1)	Total incentives (millions of €)
	Total	*Environment and energy saving*	*Regional development*	*Research and development*	*SMEs*	*Vocational training*	*Employment incentives*	*Other horizontal objectives*		
EU-25	85	*29*	*19*	*14*	*11*	*1*	*7*	*4*	15	47,903
of which:										
Austria	51	*20*	*7*	*10*	*12*	*..*	*1*	*1*	49	1,551
Belgium	98	*20*	*18*	*20*	*31*	*3*	*3*	*3*	2	884
Czech Republic	100	*3*	*44*	*27*	*18*	*2*	*6*	*–*	..	584
Denmark	96	*34*	*..*	*7*	*..*	*..*	*51*	*3*	4	1,021
Finland	97	*36*	*12*	*27*	*6*	*..*	*7*	*7*	3	590
France	97	*1*	*19*	*23*	*26*	*1*	*19*	*8*	3	7,382
Germany	85	*50*	*19*	*11*	*3*	*..*	*..*	*1*	15	16,003
Greece	90	*6*	*65*	*2*	*8*	*–*	*5*	*5*	10	319
Hungary	52	*2*	*25*	*7*	*4*	*1*	*6*	*7*	48	833
Ireland	80	*1*	*25*	*14*	*16*	*3*	*7*	*15*	20	491
Italy	96	*3*	*21*	*19*	*33*	*6*	*7*	*6*	4	3,843
Luxembourg	100	*6*	*16*	*29*	*33*	*–*	*–*	*16*	..	45
Netherlands	97	*68*	*2*	*21*	*1*	*..*	*1*	*5*	3	1,270
Poland	85	*1*	*33*	*3*	*7*	*4*	*37*	*..*	15	1,230
Portugal	14	*..*	*3*	*..*	*5*	*3*	*3*	*..*	86	1,418
Slovakia	95	*..*	*76*	*2*	*10*	*4*	*1*	*1*	5	199
Slovenia	88	*3*	*31*	*13*	*20*	*1*	*11*	*8*	12	147
Spain	72	*5*	*29*	*15*	*9*	*1*	*4*	*9*	28	3,861
Sweden	99	*86*	*5*	*4*	*..*	*–*	*..*	*4*	1	2,890
United Kingdom	90	*35*	*19*	*18*	*5*	*4*	*1*	*8*	10	3,096

Source: European Commission, *State Aid Scoreboard,* 2007.
(1) Incentives for specific sectors granted under measures for which there were no horizontal objectives and incentives for improvement and restructuring.

European countries differ above all in the choice of intervention area. Italy favours supporting small and medium-sized firms and regional development; only small incentives are available for environmental protection and energy saving, which are predominant in the spending of Nordic and central European countries. Research and development incentives in EU-25 account for 14 per cent of total outlays: nevertheless, the overall level of spending on R&D investments (1.8 per cent of GDP in 2005) has not only remained stationary over time, but is still far from the 2010 objective of 3 per cent set by the Lisbon Strategy. Italy spends 1.1 per cent of GDP on R&D, the same as ten years ago, and lags behind not only Sweden and Finland, which have already met the 3 per cent goal, but also Germany and France (2.5 per cent and 2.1 per cent).

Most European countries have adopted the European Commission and Council's recommendations to direct incentives towards horizontal-type objectives at the expense of policies supporting "national champions" and sectors in decline. Horizontal objectives are pursued mostly by means of automatic instruments, which are preferable, according to the European Commission and the OECD, to selective aid because they are easier to monitor and less open to fraud and opportunistic behaviour. In Italy these limitations were taken into consideration in the reform described in the *Industria 2015* project, implemented by the 2007 Finance Law.

Public services: energy, telecommunications and local public services

Energy. – In 2007 Italy's gross energy requirement was 194.5 million tonnes of oil equivalent (MTOE), a reduction of 0.9 per cent compared with 2006. Following significant increases in the period 2003-05, last year energy intensity (the relationship between overall demand for energy and GDP) fell again – to 151.3 tonnes of oil equivalent/million euros from 154.9 in 2006 – benefiting from the mild temperatures recorded over the year. Net imports fell from 86.9 per cent of total requirements in 2006 to 85.3 per cent, mainly due to significant exploitation of the reserves of natural gas restocked during 2006.

Numerous studies carried out at EU and national levels have shown that the liberalization of the energy sector in Italy, as in the rest of the area, has not yet been fully completed. In many countries, the main operator (often the former domestic monopolist) continues to wield strong market power; the required legal and functional separation of production and transmission under current European legislation does not seem to have stopped integrated companies from blocking the entry of new competitors into the market. In September 2007, the European Commission presented a set of legislative proposals to accelerate the liberalization process, centred on unbundling the ownership of the distribution grid management from the ownership of production and supply. The separation requirement would apply to all EU operators, preventing a producer in one country from controlling the grid in another, and this is extended to all non-EU operators deciding to enter the European market.

In Italy, in the electricity sector, a form of ownership separation of the production network of the former vertically integrated monopolist (Enel) has already been implemented, giving grid ownership and management to the subsidiary company Terna. On the basis of the Commission's proposal, Enel should transfer its own participation (5.1 per cent) in Terna. The impact of the proposal would be greater in the gas sector, where ENI is both owner and network manager through its subsidiary Snam Rete Gas, of which it owns more than 50 per cent.

The Commission's proposals include measures promoting the integration of EU-countries' grids, which would benefit the Italian electricity and gas markets. In both sectors, the grid and the links with other countries seem seriously underdeveloped, generating income for integrated firms, creating entry barriers to foreign operators and reducing liquidity on domestic wholesale markets.

Telecommunications. – In 2007 the telecommunications market in Italy generated business worth €44.2 billion. The year-on-year increase (0.4 per cent) was less than in 2006 (2.1 per cent) due to decreased investment in equipment and infrastructure and the continued fall in fixed network services. There was a further increase in the number of active mobile phone users (2.2 per cent) and lines (10.8 per cent), mainly because of the fall in prices (–15.5 per cent) but also as a result of new legislation. For the number of lines per head of population, Italy, at 148 per cent, is in second place in Europe, after Luxembourg.

Local public services. – The liberalization in the local public services sector that began in the 1990s with the aim of encouraging operators to consolidate, ensuring the separation of service providers and regulators, and covering costs through tariffs, has encountered many obstacles that have greatly limited its effectiveness, although to different degrees in different sectors. Increased concentration and the emergence of a small group of large operators have come about not so much as the result of the competitive procurement process envisaged by the reform to select the most innovative and efficient providers, but more frequently as a result of mergers. The level of fragmentation remains high. There has been no significant separation between providers and regulators: producers are still mainly public and are often "in-house". The principle of fully covering costs is rarely applied. There have been limited improvements in service quality, with significant geographical disparities.

Some large operators of national importance are emerging: the largest are multi-service companies listed on the stock exchange; institutional investors often contribute to the capital. An analysis based on interviews with the leading firms in the sector has highlighted differences in their characteristics and development: some 30 per cent of the sample, representing 67 per cent of production value, originally worked in the energy sector and thanks to high profits and efficiency have grown significantly in sectors associated with production and exploitation of the network; others, representing around 20 per cent of production value, grew out of the federation of several municipal enterprises and benefit from economies of scale and scope, especially those at the end of the productive process.The reform has been hampered by the uncertainty of the legislative framework. Significant regulatory powers have been assigned at the local level, underestimating the importance of economies of scale, possession of the necessary technical skills and separation of the regulator from the providers and local government departments.

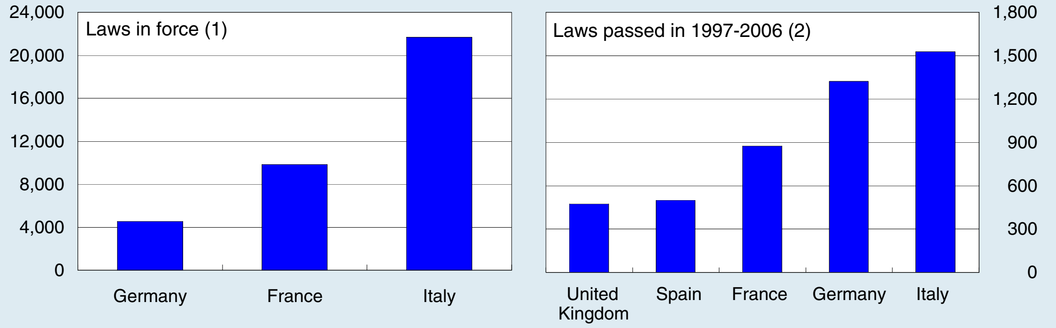
Development of the legal framework

Quality of the legislative process and simplification. – A system of regulation imposing excessive and unjustified bureaucratic costs limits the capacity of firms to grow and compete. An international comparison shows that the proportion of Italian companies' costs associated with administrative formalities is still high. On 19 February 2008, a unified registration form for new companies (*Comunicazione Unica*) was introduced on a trial basis by the Chamber of Commerce, as provided for by the "Bersani Law" (Law 40/2007). This procedure will apply throughout Italy and for all types of company from August 2008. According to the World Bank indicators, the *Comunicazione*

Unica will allow companies to save more than 50 per cent of the time usually spent on starting-up a business. An inflated and unclear legal framework generates uncertainty among operators, increases the costs of learning and applying rules, and encourages litigation. Studies on the state of the legislation and the process of legislating point to an excessive production of laws and too frequent and uncoordinated amendments of rules.The number of regulations with the force of law is 21,691 in Italy (2007), 9,837 in France (2006), and 4,547 in Germany (2007). In the ten years 1997-2006, the production of laws in Italy was almost double that of France and almost three times that of Spain (Figure 10.2). Our analysis of 12 consolidated laws passed in Italy in the period 1990-2005 shows that on average more than 10 per cent of the articles in those laws were changed each year.

Figure 10.2

Legislative production in selected European countries



(1) Sources: Italy (for 2007): Presidenza del Consiglio dei Ministri, *Relazione al Parlamento dell'11.12.07 sull'attuazione dell'art. 14, comma 12, della legge 246/2005 (the "fewer laws" article)*; France (for 2006): *Conseil d'État, Rapport public annuel,* 1991, 2000 and 2006; Annual report of the *Osservatorio sulla Legislazione della Camera dei deputati* (2007); Germany (for 2007): Ministry of Justice, *Pressemitteilungen* of 9 October 2007. – (2) Annual report of the *Osservatorio sulla Legislazione della Camera dei deputati* (2001-2007).

In recent years, some major initiatives have been launched to reorganize the legislation and to reduce the volume of laws in force. The work of interpreting and applying the law makes an important contribution to establishing a clear and consistent legislative framework. The Italian legal system differs from the two main legal systems of continental Europe (those of France and Germany) for the considerable variations in the direction of judicial decisions and for the extremely large number of cases reaching the Court of Cassation, Italy's supreme court of appeal, every year.

The civil justice system. – The excessive length of proceedings harms the working of the economy. In 2006, on the basis of Ministry of Justice data, it was estimated that, on average, 966 days were necessary to conclude an ordinary, first level, court case, compared with 918 days in 2005. An international comparison does not seem to indicate any lack of resources to explain such inefficiency, but it does reveal problems with the organization and use of resources.

On the assumption that professional skill and incentives for magistrates are important in determining productivity and efficiency, the judicial system has been the object of various reforms in recent years. Important innovations have been introduced especially as regards the training of judges. Further progress could be achieved through a system of career advancement that takes greater account of efficiency.

The solution to the inefficiencies of the civil justice system in Italy is not only to make changes in its structure. There are still significant organizational shortcomings. In fact, reorganization measures put into effect by some judicial and public prosecutors' offices have proved particularly effective. Disseminating these successful initiatives could help considerably to improve the performance of the justice system.

The Ministry of Justice has launched a project, financed by the European Social Fund, to disseminate best practices. The project is based on the successful experience of the Bolzano Public Prosecutor's Office and proposes to put it into practice in other public prosecutors' and judicial offices.

The use of IT can play an essential role in reducing the length of proceedings; good results could be obtained with the computerized civil proceedings system (PCT).

Litigation rates in Italy are significantly higher than in the major European countries. The quality of substantive and procedural legislation, the incentives for parties and lawyers, and the costs of accessing justice are some of the factors that can influence this tendency. An international comparison shows that Italy has a high number of lawyers in relation to the population.

The possibility of bringing class actions for damages to protect consumers has been introduced (Law 244/2007) and should enter into force on 29 June 2008. While, in general, class actions help to improve market efficiency by resolving the problems raised by the action and allowing externalities to be internalized, the way in which this instrument has been incorporated into the Italian system risks compromising its effectiveness.

Bankruptcy law. – In recent years, major reforms have been made to the law governing bankruptcy proceedings (Law 80/2005 and Legislative Decree 5/2006) to ensure they are managed more efficiently and to encourage earlier recognition of ailing companies. The shortcomings in applying the reform led the government to introduce further legislation in 2007.

The new regulations, contained in Legislative Decree 169/2007, removed some of the problems that had emerged. Although the range of subjects allowed to declare bankruptcy has been extended, access to bankruptcy proceedings is nevertheless still denied to a large number of small-sized enterprises and debtors who are not in business. An international comparison shows that Italy is one of the few major countries not to have any procedures allowing the cancellation of any remaining debts in order to make a fresh start. The chance to make a fresh start can have positive effects in terms of encouraging people in business to take risks and can foster the development of innovative business initiatives with higher risk profiles.

Company law and governance

In recent years, while the basic ownership and control structure of Italian companies has remained unchanged, there are signs of a move towards less centralized structures that are more open to foreign investors, mainly as a result of innovations introduced into Italian company law.

The survey of industrial firms conducted by the Bank of Italy (Invind) found that while unlisted companies continue to have a highly concentrated ownership structure (the proportion held by the first shareholder is stable at around 66 per cent) and a small number of shareholders, those shareholders include a larger proportion of foreign companies (up from 7.9 per cent in 1992 to 13.1 per cent in 2007) and finance companies (up from 0.1 per cent to 4.8 per cent in the same period, in general with large shareholdings). These trends are accompanied, on the one hand, by a reduction in pyramid structures (which external investors generally consider to be a sign of non-transparent operations within groups) and, on the other, by greater use of shareholders' agreements and statutory clauses limiting the transfer of control.

The performance of unlisted family-controlled industrial firms (70.9 per cent of the total) showed signs of weakness. Despite a reduction in the average age of their owners, the growth in turnover and productivity between 2003 and 2007 was below that of other firms.

In recent years, the concentration of ownership has diminished among listed companies, especially in the case of banks, where the share of the first shareholder, weighted for capitalization, fell from 18.8 per cent in 2003 to 12.2 per cent in 2007. Ownership of non-finance companies remains highly concentrated (44 per cent), even in comparison with other countries in continental Europe.

There was significant growth in the proportion of foreign institutional investors in non-finance companies (up from 1.1 per cent in 2003 to 5.3 per cent in 2007; Table 10.2). They included hedge funds and pension funds "active" in governance (with large shareholdings in some companies), which are increasingly playing a role in the governance of listed companies in Italy as well. Foreign participation in banks, which declined, consisted instead of a very small proportion of institutional investors.

The improved institutional structure will probably ensure a better level of protection for investors. There is evidence that the control premium, an indicator of the risk of expropriation for minority shareholders, declined significantly in the period 1992-2007.

The regulations adopted recently concerning the representation of minorities on the board of directors and the board of auditors and the limits on interlocking should reinforce the rights of minority shareholders and make it easier for them to play an active role. Information requirements and principles governing procedures for the approval of related parties transactions are currently being enacted and should provide more efficient protection against expropriations to the detriment of minority shareholders.

11. THE SOUTHERN ECONOMY AND REGIONAL POLICIES

In the last decade southern Italy's GDP has grown in real terms at about the same pace as that of the rest of the country. The gain in employment has been smaller in the South, where one fifth of work is unreported and migration from the South to the North has picked up again. The economic and social indicators of the quality of life of the southern population do not show any significant narrowing of the gap with more highly developed areas. Although less so than in the mid-1990s, lags persist in the ease of access to credit and the cost of loans, reflecting the greater fragility of the southern economy.

The South is home to one third of the population but accounts for one quarter of GDP. A lasting increase in Italy's low growth rate cannot be achieved without overcoming the underutilization of the South's resources. In the last ten years regional policy in support of the South has drawn on a substantial volume of financial resources, comparable to that of the extraordinary intervention discontinued in 1992. Launched in the second half of the 1990s in the new context of EU territorial cohesion policies, its hallmarks have been: the construction of an extensive, detailed database; the modernization of intervention procedures, now focused on assessment of results and greater responsibilities for local authorities; and the attention paid to the provision of essential public services for the population and firms.

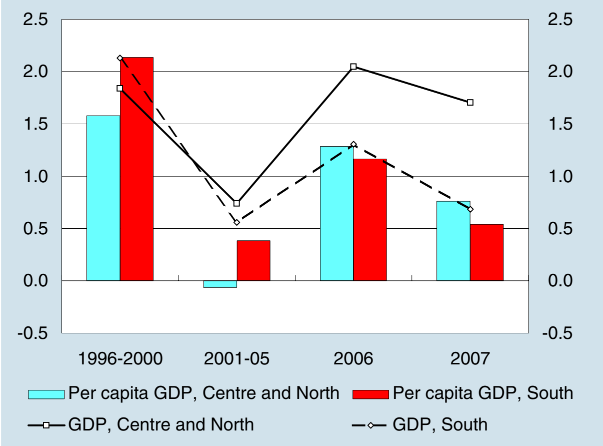
Ten years since its inception, the overall results have fallen short of the objectives both in terms of economic and social development, as gauged by the performance of the firms that benefited from incentives. Several of the most innovative aspects of the new regional policy have proved difficult to implement: notwithstanding the progress made, information gaps have hindered evaluation of the effects of support measures; "reward" mechanisms have failed as a whole to produce sufficiently virtuous behaviour by local government.

The effectiveness of regional policy has also been affected by the acute forms that the structural lags in the Italian economy display in the South, as well as by the differing territorial effects of national economic policies. The quality of basic public services, such as justice and education, is markedly lower in the South. The southern regions have proved less able to translate national deregulation measures into actual liberalizations, and they have been less inclined to promote the restructuring of the local public services sector. In several areas, criminal activities continue to exert a pervasive influence on economic relations. Flexibility in the use and remuneration of labour has increased but not enough, considering the persistent imbalance in the southern labour market.

Growth

Figure 11.1

GDP growth rates (1)



Sources: Istat, Conti economic territoriali, for 1996 to 2006; Svimez estimates for 2007.
1) Chain-linked prices. Average annual growth rates for the periods 1996-2000 and 2001-05.

Between 1995 and 2007 real GDP grew at almost the same average rate in the South and in the Centre and North, by 1.3 and 1.4 per cent respectively. While growth was slightly higher in the South in the second half of the 1990s (2.1 per cent as against 1.8 per cent), in subsequent years it was greater in the Centre and North, in the context of a general slowdown in productive activity (Figure 11.1). The gap appears to have widened in the last two years. According to Svimez estimates, in 2007 the South recorded growth of 0.7 per cent, compared with 1.7 per cent in the Centre and North.

The ratio of the per capita GDP of the South to that of the Centre and North rose from 54.7 per cent in 1995 to 57.5 per cent in 2007. In the same period the population of the Centre and North increased by 0.6 per cent per year, while that of the South remained stable (+0.1 per cent). Between 1995 and 2007 per capita GDP growth in the South outpaced that in the Centre and North by just under half a percentage point (1.2 as against 0.8).

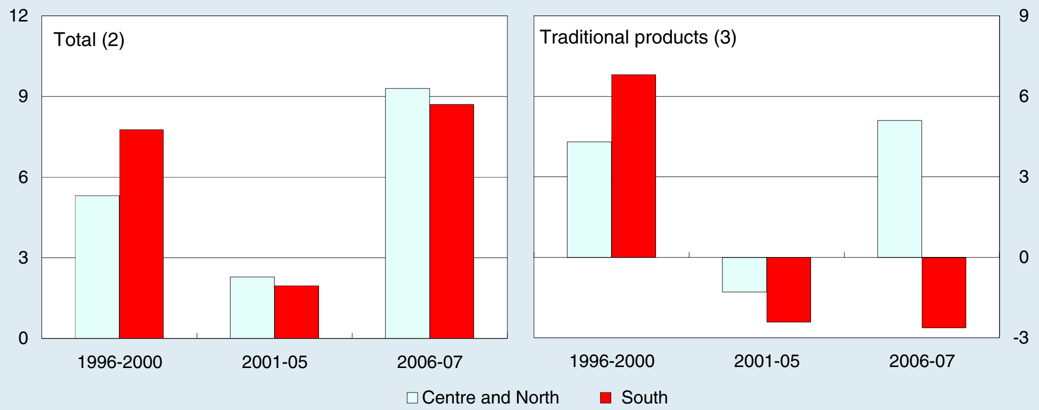
The growth gap compared with the Centre and North is accompanied by a net total inflow of public resources to the South, which reflects the broad correlation between tax revenue and income levels and that between many expenditure items (net of interest payments) and the size of the population. The financial resources generated in the southern regions (tax, duties and contributions) are significantly less than those spent on services (healthcare and social assistance), transfers to households (pensions) and to firms, purchases of goods and services, investments and the remuneration of public employees. According to a reconstruction using the database of the Ministry for Economic Development, between 1996 and 2006 the net inflow of public resources to the South was equal to between 10 and 15 per cent of the area's GDP; that was lower than the average for the period between 1970 and 1992, which on the basis of previous reconstructions can be estimated at just under 20 per cent.

Foreign trade

In the second half of the 1990s, the average annual rate of growth in exports at current prices, excluding oil products, was higher in the South than in the Centre and North (7.8 and 5.3 per cent respectively; Figure 11.2). Southern export growth was also stronger in the traditional sectors (textiles and clothing, leather products, footwear, and other manufactures, which include furniture). In the early 2000s this trend was inverted. Between 2000 and 2005 exports expanded slightly more rapidly in the Centre and North. The intensification of competition from the newly industrialized countries had a stronger impact on the traditional sectors of the South than in the rest of the country, reflecting the greater incidence of medium-low quality products in their product mix. Exports of traditional products declined annually by 2.4 per cent in the South and 1.3 per cent in the Centre and North. In the two years 2006-07 the recovery in exports, which was nationwide, included traditional goods in the Centre and North but not in the South.

Figure 11.2

Growth rates of exports (1)



Source: Istat.
1) At current prices. Average growth rates for the periods 1996-2000, 2001-05 and 2006-07. – (2) Excluding oil products and, to make the data comparable over time, ship's stores. – (3) Including textiles and clothing, leather products, footwear and other manufactures (including furniture).

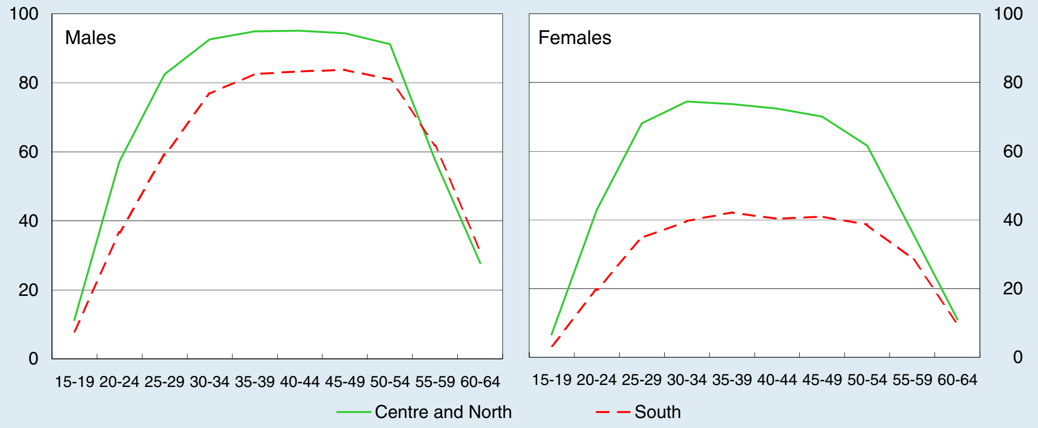
Employment, its composition and the unemployment rates

According to Istat's labour force survey, in 2007 employment in the South remained basically stable at the previous year's level, in contrast with a significant expansion in the Centre and North (1.4 per cent). While in the Centre and North the employment rate of persons aged between 15 and 64 rose by 0.4 percentage points to 65.4 per cent, in the South it declined by 0.1 points, to 46.5 per cent.

Last year's developments are part of a longer-term trend: between 1996 and 2007 employment increased by 18.5 per cent (2.5 million persons) in the Centre and North, where it was buoyed by substantial immigration, and only by 8.2 per cent (0.5 million) in the South. In the same period, the employment rate of the population of working age in the southern regions grew by barely three percentage points, compared with an increase of over eight points in the rest of Italy. The gap widened in particular for women (Figure 11.3): in 2007 the female employment rate was 31.1 per cent in the South, compared with 55.3 per cent in the Centre and North (in 1995 the gap had been 17.1 percentage points).

Figure 11.3

Rate of employment of persons aged between 15 and 64 years in 2007



Source: Based on Istat, labour force survey.

In addition to its lower employment rate, the South also has lower levels of private-sector employment. The proportion of fixed-term work is higher; unreported work is more widespread.

After widening the second half of the 1990s, the differential between the rates of unemployment in the two areas began to narrow again during this decade, thanks in part to the large migratory flows from the South to the Centre and North. In 1999 the two areas showed a differential of almost 13 percentage points (18.8 in the South and 5.9 in the Centre and North). In 2007 the unemployment rate in the South fell by 1.2 points to 11 per cent, that in the Centre and North by 0.4 points to 4 per cent.

Population and migratory flows

Between 1995 and 2007, principally following the measures taken to regularize the status of foreign immigrants, the resident population in the Centre and North increased by 2.2 million inhabitants (as against 96,000 in the South).

The influx from abroad has been accompanied by substantial internal migration. Transfers of residence from the South to the Centre and North (including changes of legal residence by foreigners) consistently surpass flows in the opposite direction; after falling to historic low levels in 1994, the numbers rose until 2000 and then dropped back in subsequent years, albeit to consistently high levels. Most internal migrants are between 25 and 35 years of age and move for work-related reasons, with a growing proportion of highly-educated persons. In addition to the flows registered from changes of legal residence, there are other workers who move but still maintain legal residence in their region of origin: according to the labour force survey, last year on average almost 120,000 more people worked in the Centre and North while legally residing in the South than vice versa.

Wages and the cost of living

According to the Bank of Italy's Survey on Household Income and Wealth (SHIW), the negative difference between earnings in the South and those in the Centre and North, net of taxes and social contributions, was about 15 per cent in 2006 among workers with the same individual characteristics. Based on data from the National Social Security Institute (INPS), which do not enable educational levels to be taken into account, for workers of the same gender, age and country of origin the difference in gross wages is of the order of 20 per cent.

The high levels of unemployment and unreported work suggest that labour costs in the South, while lower than in the Centre and North, do not permit equilibrium between labour demand and supply, given the persistent lag in the area's productivity. Where there are inadequate wage flexibility mechanisms, migration helps bring demand and supply back into balance. For a resident of the South, the negative pay differential and the lower likelihood of finding employment translate into incentives to look for work in the Centre and North. The higher cost of living in the more advanced regions of Italy works in the opposite direction.

No exhaustive comparative estimates are available of regional differences in the cost of living for all households. Partial indications can, however, be obtained for major expenditure items (rent, food products, clothing and furniture). According to the Survey on Household Income and Wealth, in 2006 average rents in the Centre and North were approximately 30 per cent higher than those in the South, for dwellings with comparable characteristics and similarly-sized municipalities of residence. Recent Istat estimates, referring exclusively to regional capitals, indicate that the prices of food, clothing and home furnishings are all higher in the Centre and North, by around 10, 3 and 18 per cent respectively.

Bank credit

In 2007 credit in the South expanded at a high rate (9.2 per cent), even though it showed a sharper deceleration compared with the other areas in the country. In particular, the growth in loans to businesses declined from 18.1 to 10.1 per cent, reflecting the stabilization of credit flows to the services sector at high levels. By contrast, loans to manufacturing firms and especially to the construction sector continued to expand more rapidly in the South than in the other regions. Between 2003 and 2007 lending to firms in the South increased by 10.7 per cent per year, compared with 8.2 per cent for lending to firms in the Centre and North. The differentials in the growth rates between the two areas were wide in all sectors and involved both small and larger companies.

In 2007 the increase in short-term interest rates was smaller in the South than in the Centre and North; the credit cost differential between the two areas narrowed by 0.2 percentage points from the previous year, to 1.3 points (in the mid-1990s it stood at 2.5 points). When the average interest rate for firms in the South is calculated using the sectoral and size composition of the loans granted to firms in the Centre and North, the differential in 2007 is less than one percentage point. The remaining cost differential reflects the greater riskiness of firms in the South, which can be attributed to the external diseconomies that weigh on productive activity in the area.

Public services

The quality of public services in the South is generally lower than in the rest of Italy, and this has serious repercussions on the standard of living of the populations and the functioning of the economy. The lags in the southern regions concern both the services for which the regulatory, organizational, and spending responsibilities fall primarily on the national government, such as education and civil justice, and those which are subject to greater local decentralization.

Civil justice. – The resolution of legal disputes in southern courts requires significantly more time than in the Centre and North. In 2005 first-level proceedings in the South lasted 1,124 days for ordinary civil trials and 1,011 days for labour, pension and social assistance disputes or 42.6 and 74.1 per cent longer than in the courts of the Centre and the North.

The level of litigiousness, measured by the number of proceedings initiated in any given year per inhabitant, is significantly higher in the South. In 2005 the number of new ordinary civil trials and labour and pension cases that opened in the South was 2.4 for every 100 inhabitants compared with 1.2 in the Centre and North.

The territorial distribution of court judges with respect to the population is weighted in favour of the regions of the South. Data from the Ministry of Justice and the Magistrates' Governing Council for 2005 show that the ratio between the number of judges assigned to the civil sector and population resident in the South is 28.2 per cent higher than that of the Centre and North. The higher presence of judges in the South reflects the greater number of pending trials: the number of new civil proceedings that opened in the courts in relation to the number of judges assigned to the civil sector was relatively uniform throughout the country in 2005, with only slightly more judges in the South than in the other areas. However, due to a backlog of disputes judges in the South now find themselves having to clear a heavier caseload than their peers in the Centre and North, with potentially adverse effects on the length of proceedings.

Healthcare. – The decentralization under way in the healthcare sector has led to the emergence of new organizational and management models in the regions, which are associated with varying levels of spending efficiency and quality. Several indicators show that expenditure is less efficient and less able to meet the demand for healthcare services in the South than the Centre and North. There is a higher incidence of inappropriate hospital care in the South. Advanced medical services are less readily available. The numbers of patients electing to receive treatment in hospitals outside their region of residence is higher than in the rest of the country.

Local public services. – Albeit to varying degrees in the different sectors, local public services in the South display elements of backwardness compared with the Centre and North, as regards both the quality of the services and the efficiency of firms. The implementation of liberalization measures and the modernization of the sector, a process that began in the 1990s, has proved less effective in the South. The recent development of national operators, generally multi-service and listed on the stock exchange, has been limited exclusively to the Centre and North.

Available indicators show that, on the whole, the population of the South receives lower-quality services than people living in the Centre and North. Moreover, services in the South show greater lags in achieving the environmental policy targets that characterize local public service regulations.

The greatest delays in implementing reform and the most glaring shortcomings compared with the rest of the country are found in waste collection and disposal services. Regional authorities, which by law are assigned vital tasks in planning the waste cycle and building infrastructures, have been placed under special administration in Calabria, Campania, Puglia and Sicily.

Regional policies and instruments

General government capital expenditure. – Total spending by general government in the South is based on ordinary and additional resources. The latter are drawn from the national Fund for Underutilized Areas, 85 per cent of which has been reserved to the South since 2003. This national fund is allocated under the Finance Law and distributed among the various programmes by the Interministerial Committee for Economic Planning. Extra resources also come from the European Structural Funds (with the related national co-financing), which are determined at EU level. These extra resources meet the additionality criterion established by the Community for regional policies in the Union; 30 per cent of ordinary resources must, instead, be allocated to the South. At the start of this decade a target was set of 45 per cent of total general government capital expenditure to be allocated to the South.

Between 1998 and 2006 actual accumulative expenditure in the South amounted to €181 billion (an annual average of approximately 6.5 per cent of the area's GDP, just under €1,000 per inhabitant), of which €88 billion was financed by additional funds. In the same period the Centre and North received around €300 billion (3.4 per cent of the area GDP and around €900 per inhabitant on an annual average basis). The order of magnitude of the additional capital expenditure that poured into the South is similar to that of the extraordinary intervention in the period from the early 1950s to the early 1990s, which ranged between 0.5 and 1 per cent of national GDP. The estimates for 2007 indicate that general government capital expenditure in the South amounted to approximately €22 billion or 35.3 per cent of the national total.

The South stands out for the relatively high proportion of transfers it receives compared with direct investment (43.8 and 56.2 per cent, as against 35.2 and 64.8 per cent in the Centre and North); this reflects larger allocations for policies to provide incentives to local enterprises.

The instruments. – Regional policy is composed of a wide range of instruments for intervention, designed both to offset the disadvantages of location (capital grants, employment and tax incentives that are subject to automatic, assessment or negotiating procedures), and to execute government investment (public works, services to businesses and persons), including through the use of incentive and "outcome-based" mechanisms, which were subject to a broad review in 2007. Tools for intervention include negotiated planning, aimed at promoting local enterprise systems and characterized by a mix of incentives to offset location disadvantages.

The negotiated planning instruments called territorial pacts are agreements aimed at promoting local development and entered into by local government and employers' associations in bordering municipalities belonging to the underutilized areas. These instruments use public funds mainly for providing incentives to economic agents and to a lesser extent for local infrastructures. Comparing trends in employment and local enterprise units in the municipalities that entered into a territorial pact with those in municipalities with similar socio-economic characteristics that did not, it can be seen that participation had no significant effects on the growth of employment and of local units in the period from 1996 to 2004.

Studies on important investment incentives (Law 488/1992 and Law 388/2000), under which the South's share of the total amounts granted between 2003 and 2006 was equal to 82.6 and 98.4 per cent respectively, indicate that their effectiveness is limited.

The new planning cycle for regional development policy

The national strategic framework. – In July 2007 the European Commission approved the Italian proposal for a National Strategic Reference Framework (NSRF), which defines the additional resources that regional policy can draw on in the period from 2007 to 2013.

The resources of the European Social Fund (ESF) and the European Regional Development Fund (ERDF) are allocated with reference to three objectives: the Convergence Objective, covering several regions of the South (Basilicata in the phasing-out stage, Calabria, Campania, Puglia and Sicily); the Regional Competitiveness and Employment Objective, covering the regions of the Centre and North and the other regions of the South (Abruzzo, Molise and Sardinia in the phasing-in stage); the European Territorial Cooperation Objective, covering several Italian cities with the aim of boosting tourism. The three objectives are assigned 72.1, 26 and 1.8 per cent of the resources respectively, including co-financing allocated at national level. The regions of the South receive €47 billion (as against €12.3 for the Centre and North), to which are added the allocations from the Fund for Underutilized Areas (€53.8 billion, of which approximately €3 are for service provision objectives).

Service objectives. – The previous planning cycle introduced an "outcome-based" mechanism, which allocated additional resources to local administrations that had met certain objectives. Partly to bolster the supervision of this mechanism, a broad set of indicators was identified; those specifically used in the "outcome-based" system referred above all to innovations in local government procedures. The 2007-2013 National Strategic Reference Framework strengthens this mechanism and changes the logic behind it by taking into account actual performance in four service areas:

education, child care and assistance for the elderly, urban waste management and water services. All the regions of the South take part in the mechanism while the Ministry of Education participates in the education service objective only.

Measuring the actual performance of key public services based on objective indicators, and not on the declarations of the local governments involved, is an important new departure aimed at promoting an administrative approach that is more interested in results than in formal procedures. In many of the areas considered, it is nevertheless necessary that ordinary policy be reformed and redirected towards results. Possible distortions can derive from the temptation to consider only the aspects measured by the indicators to the detriment of others. An important contribution to the effectiveness of the initiative can come from an adequate knowledge of the "outcome-based" mechanism by the people directly concerned.

12. THE BALANCE OF PAYMENTS AND THE NET INTERNATIONAL INVESTMENT POSITION

Italy's current account deficit declined slightly in 2007 from the peak recorded in 2006 (Table 12.1), falling to €37.4 billion or 2.4 per cent of GDP. This result was due to the sharp improvement in the merchandise trade balance and in particular to the substantial increase in the surplus on non-energy products as a consequence of the expansion in exports. After growing constantly in the preceding years, the energy deficit contracted a little, reflecting the increase in exports of refined oil products and the appreciation of the euro. The deficit on services widened considerably (from €1.3 billion to €7 billion), owing

Table 12.1

Balance of payments
(billions of euros)

	2003	2004	2005	2006	2007
Current account	**-17.4**	**-13.1**	**-23.6**	**-38.5**	**-37.4**
Goods	9.9	8.9	0.5	-10.2	2.9
Non-energy products (1)	*35.3*	*36.9*	*37.5*	*37.5*	*47.7*
Energy products (1)	*-25.4*	*-28.0*	*-37.0*	*-47.7*	*-44.7*
Services	-2.4	1.2	-0.5	-1.3	-7.0
Income	-17.8	-14.8	-13.6	-13.6	-19.7
Transfers	-7.1	-8.3	-10.0	-13.5	-13.7
of which: EU institutions	*-6.3*	*-6.5*	*-8.1*	*-8.3*	*-8.0*
Capital account	**2.3**	**1.7**	**1.0**	**1.9**	**2.7**
Intangible assets	-0.1	..	0.1	-0.1	-0.1
Transfers	2.3	1.7	0.9	2.0	2.7
of which: EU institutions	*3.6*	*2.8*	*3.4*	*3.8*	*3.7*
Financial account	**17.3**	**9.0**	**20.9**	**25.4**	**26.1**
Direct investment	6.5	-2.0	-17.6	-2.3	-37.0
Outward	*-8.0*	*-15.5*	*-33.6*	*-33.5*	*-66.3*
Inward	*14.5*	*13.5*	*16.1*	*31.3*	*29.4*
Portfolio investment	3.4	26.4	43.4	44.3	18.1
Equities	-16.0	0.5	-16.0	-8.8	-0.3
Debt securities	19.4	25.9	59.3	53.1	18.4
Financial derivatives	-4.8	1.8	2.3	-0.4	0.4
Other investment	13.7	-19.6	-8.1	-16.7	46.1
of which: Monetary Financial Institutions (2)	*40.6*	*-10.0*	*27.0*	*44.0*	*83.0*
Change in official reserves (3)	-1.4	2.3	0.8	0.4	-1.5
Errors and omissions	**-2.2**	**2.4**	**1.7**	**11.2**	**8.6**

(1) Based on Istat foreign trade data. – (2) Excluding the Bank of Italy. – (3) A minus sign indicates an increase in the reserves.

to the large increase in purchases abroad of transport and travel services and, above all, business services, particularly technical and professional services. The deficit on income also increased, rising from €13.6 billion to €19.7 billion as a consequence of the increase in the deficit on investment income. This was due to the yields of Italian debt and equity securities rising faster than those of the securities included in Italy's foreign assets. The deficit on transfers remained basically unchanged (€13.7 billion).

The overall deficit of €34.7 billion on current and capital account was offset by a net inflow of €26.1 billion on financial account, so that the "errors and omissions" item again showed a large positive balance (€8.6 billion). The surplus on portfolio investment contracted sharply from €44.3 billion to €18.1 billion. Influenced by two major transactions carried out by Italian firms, direct investment gave rise to a net outflow of €37 billion, compared with €2.3 billion in 2006. After recording deficits for three years, the "other investment" item showed a surplus of €46.1 billion, owing in part to the growth of banks' fund-raising abroad. The official reserves increased by €1.5 billion.

Italy's net external debt increased from €67.1 billion to €80 billion and from 4.5 to 5.2 per cent of GDP. The change includes the value adjustments to stocks, which resulted in a modest reduction in the debt. The appreciation of the euro reduced the value of assets but the market value of the long-term securities on the liabilities side also decreased, in connection with the increase in interest rates.

In Italy, as in most other European countries, the statistics on foreign trade and financial movements have traditionally been based on the observation of the corresponding payments. As long as international payments were concentrated in the resident banking system, banks' reporting of the value and nature of transactions for their customers ensured the quality of the data and permitted a census-type coverage of the universe. In the last few years the effectiveness of this data-collection system has diminished, owing to the enormous increase in international transactions and the reduced correspondence between the residence of the contracting parties and the place where the payment is settled, and it is likely to diminish further with the creation of the single payment area. For this reason several European countries have recently changed their method of collecting data, with the introduction of sample trade surveys carried out in firms. In Italy, where sample surveys have been used for some time to gather data on international tourism, transport services and the stocks of most financial assets, a start was made in 2007 on the switch to a widespread system of sample surveys for the collection of balance-of-payments data by the Ufficio Italiano dei Cambi. Following the merger of the UIC into the Bank of Italy, in 2008 the latter began to receive data from a sample of about 7,000 firms. The first results will be released later this year.

The current and capital accounts

Trade in goods. – Following a *fob-fob* deficit on merchandise trade in 2006, last year saw a surplus of €2.9 billion (0.2 per cent of GDP). The surplus on non-energy products increased significantly, rising from €37.5 billion to €47.7 billion and from 2.5 to 3.1 per cent of GDP. The energy deficit decreased by €3 billion (from €47.7 billion to €44.7 billion), benefiting from the rapid increase in exports of refined petroleum products and the appreciation of the euro, which attenuated the effects of the rise in oil prices. The energy deficit nonetheless began to increase again in the latter part of 2007 as a result of the further surge in oil prices and there was a deterioration of about €3 billion in the second half of the year.

Despite the slowdown in world trade and the appreciation of the euro, the value of merchandise exports continued to show strong growth (10.1 per cent) that was only a little less than in 2006 (11.1 per cent). By contrast, the slowdown in the expansion of the value of imports was significant (from 14.8 to 6 per cent); it was accentuated by the appreciation of the euro.

Data on the geographical distribution of trade in goods indicate that the balance improved in 2007 vis-à-vis both the EU-27 countries and the rest of the world.

Among the main euro-area countries, only the balance with Germany worsened slightly; this reflected an increase in the deficit on transport equipment, a sector in which German exports have recorded exceptional growth in recent years. By contrast, there was an increase in the surplus with France and above all Spain, countries in which demand remained lively.

The deficit with the rest of the world contracted significantly owing to the strong growth in sales to the energy-exporting countries. The deficits with the Middle Eastern OPEC countries contracted by €3.2 billion to €15.3 billion. The improvement in the balance with these countries benefited from the rapid growth in exports of mechanical and electrical machinery, whereas the value of imports of crude oil remained unchanged compared with 2006. The deficit with Russia also contracted thanks to the strong growth in exports, especially of clothing and mechanical machinery. By contrast, the deficit with China increased, owing to the faster growth in imports than exports; the deterioration mainly concerned basic metals and metal products and the consumer component of the electrical machinery and mechanical machinery and equipment sectors.

Excluding refined oil products, the surplus on manufactures on a *cif-fob* basis rose by about €8 billion to €45.8 billion (3 per cent of GDP). The main contribution continued to come from the mechanical machinery and equipment sector, which saw its surplus grow by €5 billion. Other contributions to the improvement in the balance on merchandise trade came from the decrease in the deficit on electrical equipment, precision instruments and transport equipment. There were also improvements in the traditional sectors: leather and leather products, textiles and clothing (in the latter case for the first time since 2001).

Trade in services. – The deficit on services grew for the third successive year and rose to €7 billion (0.5 per cent of GDP). “Other business services” (technical and professional services, merchanting and operating leasing) were mainly responsible for the deterioration, with a deficit that rose by €3.3 billion. Transport services and foreign travel also contributed to the increase in the deficit, albeit to a lesser extent (respectively €1.8 billion and €0.8 billion).

The small decrease in the surplus on foreign travel was mainly due to the business component, where outflows rose sharply. By contrast, the surplus on tourism (the main component of travel for personal reasons) increased slightly.

As regards receipts, the increase mainly concerned the spending in Italy of tourists from EU countries, especially Spain and recent additions to the Union; the spending of German tourists was slightly down. As for the spending of Italians abroad, it increased most in non-EU destinations.

The increase in the deficit on other business services, the main item of Italy's purchases of services abroad, was due to the much faster growth in imports than exports (respectively 15.4 and 4.3 per cent). The deterioration was due above all to the balance on technical and professional services, which swung from a surplus of €0.3 billion in 2006 to a deficit of €1.8 billion in 2007 as a consequence of the large increase in purchases abroad.

The deficit on transport services expanded. In addition to a sharp increase in the deficit on air transport services, there was also a larger deficit on maritime transport services. The worsening of the deficit on air transport services was due to the rapid growth of 16.5 per cent in Italian passengers' spending with foreign carriers and the contraction of 5.9 per cent in Italian carriers' receipts.

Income. – After remaining stable in 2006, the deficit on income grew by €6.1 billion to €19.7 billion. The increase was primarily due to the growth from €13.3 billion to €19.6 billion in the deficit on investment income, the balance of receipts and outlays, which register the nominal yields on financial assets but not capital gains, and in particular to the increase from €5.6 billion to €11.5 billion in the outflow of income from portfolio investment. The deterioration was primarily due to the market yields on debt and equity securities issued by residents; these rose more during the year than those on foreign assets held by Italian investors that refer to the US markets. The performance of this differential explains most of the movements in the balance of this item; another factor was the depreciation of the dollar, which reduced the value of receipts when translated into euros. Net income from direct investment increased by €0.7 billion to €2.6 billion, partly as a result of an increase in income from shares. By contrast, the deficit on other investment income grew from €8.4 billion to €10.7 billion, primarily because of the increase in the banks' debtor position on the Euromarket and the consequent growth in interest payments.

Transfers. – The deficit of €13.7 billion on current transfers was close to that recorded in 2006 following a slight increase in the deficit on private transfers (from €5.3 billion to €6.8 billion) and a decrease in that on public transfers (from €8 billion to €6.9 billion). Among the latter, the deficit vis-à-vis the European Union declined from €8.3 billion to €8 billion. Including capital transfers with the European Union, regularly in surplus, since 2001 Italy's transactions with the EU institutions have been in deficit by close to 0.3 per cent of GDP. The balance on private transfers worsened, primarily as a result of the increase in the deficit on workers' remittances from €4.3 billion to €5.8 billion.

Investment

Direct investment. – The large increase in the net outflow of direct investment was mainly due to two operations: Enel's acquisition of Endesa and the reorganization of the equity holdings within the Unicredit banking group. Excluding these two operations, Italian direct investment abroad was in line with the recent past. Although slightly down on 2006, the inflow of direct investment remained at a level close to that of the preceding years.

As in 2006, direct investment abroad by non-banks was well in excess of that of the banking sector. The former amounted to €46 billion, nearly twice the already exceptional result recorded the previous year (€27.2 billion). The growth was due entirely to the increase recorded by the energy sector (from €3 billion to €27.6 billion), since Enel's acquisition was accompanied by others by Eni. The slight decrease in direct investment abroad by manufacturing industry (from €10.7 billion to €9.2 billion) was due to the mechanical machinery sector.

The inflow of direct investment into the banking sector declined in 2007 while that into non-banking sectors remained almost unchanged at €24 billion. The growth in inward direct investment in the transport and communications sector in relation to an acquisition in the telephony market offset the reductions in the food sector and banking and insurance services.

Portfolio investment and financial derivatives. – The net inflow for these items fell from €43.9 billion to €18.5 billion. The turbulence that developed on international financial markets came on top of a trend that was already under way, marked by the downsizing of foreign equity portfolios and a slowdown in the diversification towards foreign debt securities.

Transactions in equities gave rise to a net outflow of €0.3 billion, down from €8.8 billion in 2006. Non-residents reduced their portfolio of Italian shares by about €11.3 billion, while Italian investors reduced their portfolio of foreign shares by €11 billion.

After running at a particularly high level for two years, the net inflow of foreign investment in debt securities fell significantly in 2007. Following the large decline recorded in 2006, Italian investment in foreign debt securities amounted to €11.7 billion, down from €30.8 billion in 2006. Non-residents' investment in Italian debt securities recorded a substantial contraction for the second successive year, falling to €30.1 billion, from €84 billion in 2006.

Other investment. – This item swung from a deficit of €16.7 billion to a surplus of €46.1 billion. The large increase in inflows was primarily due to the rise from €44 billion to €83 billion in the borrowings of banks, which continued to raise substantial funds abroad until the outbreak of turbulence on international financial markets.

The official reserves. – Transactions during the year increased the official reserves by €1.5 billion. The year-end stock rose from €57.5 billion to €64.1 billion, owing in part to the €6.7 billion revaluation gain on the gold reserves from €38.1 billion to €44.8 billion, which compensated for the losses due to exchange rate adjustments in connection with the appreciation of the euro against the main reserve currencies.

The net international investment position

Italy's year-end net external debt rose from €67.1 billion to €80 billion and from 4.5 to 5.2 per cent of GDP (Table 12.2). Of the net capital inflow of €26.1 billion on the financial account, corresponding to the increase in borrowing to finance the current and capital account deficits, only about half was reflected in increased external debt since another part was offset by adjustments to the value of the stock. Taken together, these reduced net debt, above all thanks to the adjustments to market prices (€35.1 billion), which outweighed the losses deriving from exchange rate adjustments (€21.9 billion).

Table 12.2

Net international investment position (1)
(billions of euros)

	Stocks at end-2006 (2)	January-December 2007					Stocks at end-2007 (2)
		Flows (3)	Value adjustments			Change in stocks	
			Total	Exchange rate (4)	Other		
	(a)	(b)	(c)=(d)+(e)	(d)	(e)	(f)=(b)+(c)	(a)+(f)
				Resident non-banks			
Assets	1,317.1	47.3	-29.8	-30.7	0.9	17.5	1,334.6
Direct investment	243.8	47.3	-0.1	-4.8	4.7	47.2	290.9
Portfolio investment	785.7	-17.3	-28.9	-25.1	-3.8	-46.2	739.5
of which: equities	*387.3*	*-19.4*	*-2.4*	*-8.5*	*6.1*	*-21.8*	*365.5*
Other investment	273.5	19.2	-0.8	-0.8	..	18.4	291.9
Derivatives	14.1	-1.9	..	..	..	-1.9	12.2
Liabilities	1,251.2	20.9	-27.7	-5.3	-22.4	-6.9	1,244.3
Direct investment	198.6	24.8	-1.3	..	-1.2	23.5	222.1
Portfolio investment	875.7	-2.9	-25.9	-4.7	-21.2	-28.9	846.9
of which: equities	*37.9*	*-0.8*	*-1.4*	*..*	*-1.4*	*-2.2*	*35.8*
Other investment	148.9	-4.1	-0.5	-0.5	..	-4.6	144.3
Derivatives	28.0	3.0	..	..	..	3.0	31.1
Net position	**65.9**	**26.4**	**-2.1**	**-25.4**	**23.3**	**24.3**	**90.3**
				Resident banks			
Assets	397.8	69.1	-10.7	-3.9	-6.8	58.4	456.2
Liabilities	637.9	140.5	-21.4	-9.8	-11.6	119.1	757.0
Net position	**-240.2**	**-71.5**	**10.7**	**5.9**	**4.9**	**-60.7**	**-300.9**
				Central bank			
Assets	108.1	18.1	4.5	-2.4	6.9	22.6	130.7
Liabilities	1.0	-0.8	-0.1	-0.1	..	-0.9	0.1
Net position	**107.2**	**18.9**	**4.5**	**-2.4**	**6.9**	**23.4**	**130.6**
Total net position	**-67.1**	**-26.1**	**13.2**	**-21.9**	**35.1**	**-12.9**	**-80.0**

(1) Rounding may cause discrepancies in totals. – (2) At end-of-period prices and exchange rates. – (3) At the prices and exchange rates obtaining on the transaction date. – (4) Calculated on the basis of the currency composition.

As regards total liabilities, the adjustment mainly concerned the reduction of €24.5 billion in the market value of debt securities as a consequence of the increase in the interest rates on those at long term. As regards total assets, there were significant losses as a consequence of exchange rate adjustments, accompanied by limited price gains. The large appreciation of the euro against the dollar in 2007 produced a sizable reduction in the value of the assets of the non-bank sector (€30.7 billion).

13. THE PUBLIC FINANCES

General government net borrowing diminished by 1.5 percentage points to 1.9 per cent of GDP in 2007, below the 3 per cent limit for the first time in five years. In May 2008 the European Commission recommended abrogating the excessive deficit procedure against Italy initiated in 2005.

The result for 2007 can be ascribed chiefly to the rise of 1.2 percentage points in the ratio of tax and social security contribution receipts to GDP, bringing this fiscal ratio to a level near its 1997 peak and more than 2 points above the average for the other euro-area countries. The ratio of primary current expenditure to GDP declined slightly; it remains near the peaks recorded in 1993 and 2005.

As in 2006, the improvement in net borrowing was considerably greater than the official forecasts, in spite of additional expenditure decided during the year. The structural primary surplus (i.e. the cyclically adjusted balance net of temporary measures) rose to nearly 3 per cent of GDP; in 2005 it had been practically nil. The general government borrowing requirement declined from 3.7 to 2.2 per cent of GDP, and the ratio of public debt to GDP fell 2.5 points to 104 per cent.

In September 2007, in the light of the favourable projections for the public finances, the budget for 2008 provided for a 0.4-point increase in the deficit. The net borrowing target for 2008 was kept at 2.2 per cent of GDP, as in the Economic and Financial Planning Document released in June.

In part because of worsening growth prospects, in March 2008 the Combined Report on the Economy and Public Finance revised the net borrowing forecast for 2008 upward to 2.4 per cent of GDP. The Report estimates that structural net borrowing will increase by 0.6 percentage points compared with 2007.

In the early months of 2008 the general government borrowing requirement was less than in the same period of 2007, in part reflecting some transitory factors. Personal income tax receipts expanded strongly; VAT receipts recorded a sharp slowdown. The effects of the cyclical deterioration expected in 2008 will not feed through completely until 2009, owing in part to the lags implicit in the company tax payment procedure.

For 2009 the Combined Report projects net borrowing on a current legislation basis at 2.1 per cent of GDP, in a context of gradual recovery in economic activity. The estimates of the European Commission, which also factor in the costs implied in established practices, put the deficit at 2.4 per cent. In the medium-term planning framework, budgetary balance is slated for 2011. Achieving this objective while reducing the fiscal burden requires a sharp deceleration in spending.

Budgetary policy for 2007: objectives and forecasts

The objectives and the official forecasts for net borrowing in 2007 were revised repeatedly, reflecting more favourable current-legislation projections on the one hand – in connection with higher growth forecasts, the better-than-expected budget results for 2006, and strongly expanding tax receipts – and increased expenditure decided during the year on the other.

The Government's Economic and Financial Planning Document (EFPD) in July 2006 had set a net borrowing target of 2.8 per cent of GDP for 2007 and a primary surplus of 2.1 per cent, based on economic growth of 1.2 per cent (Table 13.1). To attain these objectives, a budget adjustment of 1.3 per cent of GDP was estimated to be necessary.

Table 13.1

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

	General government				*Memorandum items*	
	Net borrowing	General primary surplus	Interest payments	Debt	Real GDP growth rate (%)	Nominal GDP
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 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)	....	....	....	....	1.3	....
as a percentage of GDP	*2.8*	*2.2*	*5.0*	*106.9*		
Estimates released in 2007						
Combined Report on the Economy and the 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*		
Economic and Financial Planning Document (June 2007) (1)	38.3	35.5	73.8	....	2.0	1,541.1
as a percentage of GDP	*2.5*	*2.3*	*4.8*	*105.1*		
EFPD update (September 2007) (2)	36.4	38.2	74.5	....	1.9	1,543.8
as a percentage of GDP	*2.4*	*2.5*	*4.8*	*105.0*		
Stability Programme (November 2007)	....	....	....	....	1.9	....
as a percentage of GDP	*2.4*	*2.5*	*4.8*	*105.0*		
Outturn (3)	29.2	47.5	76.7	1,596.7	1.5	1,535.5
as a percentage of GDP	*1.9*	*3.1*	*5.0*	*104.0*		

(1) Includes the effects of Legislative Decree 81/2007. – (2) Includes the effects of Legislative Decree 159/2007. – (3) Sources: Istat; for the debt, Bank of Italy.

The Forecasting and Planning Report issued in September 2006 maintained the net borrowing objective but diminished the magnitude of the adjustment by 1 percentage point in view of the strong performance of revenue and a modest improvement in the economic outlook. The Stability Programme update in December confirmed both the macroeconomic forecasts and the budget deficit target.

The Combined Report on the Economy and Public Finance released in March 2007 revised the net borrowing estimate down by half a point to 2.3 per cent of GDP.

The improvement stemmed from higher forecast growth (now put at 2 per cent) and larger-than-expected receipts, which together increased projected revenue on a current legislation basis by over €9 billion. Estimated expenditure was increased by €1.8 billion.

The June EFPD raised the revenue projection still further, by another €2.2 billion. However, the deficit projection worsened by 0.2 points to 2.5 per cent of GDP, reflecting increased expenditure to spur economic growth and sustain the neediest population groups. These measures were passed, together with the EFPD, and estimated at 0.4 per cent of GDP (see the box "The measures decided at the end of June and September", *Economic Bulletin* No. 46, October 2007).

In the autumn, the Forecasting and Planning Report and the EFPD update reduced projected net borrowing by half a percentage point of GDP; compared with the July estimates, expected revenue was about €6 billion higher and primary current expenditure €2 billion lower. The Government decided to use these resources for infrastructural investment and for economic growth and social measures. Including the effects of these additional measures (0.5 percentage points), net borrowing was estimated at 2.4 per cent of GDP. This estimate was confirmed in the Stability Programme update in November.

In February 2008 Istat reported net borrowing in 2007 at 1.9 per cent of GDP.

Net borrowing

The decline of 1.5 percentage points brought general government net borrowing down from 3.4 per cent in 2006 to the levels recorded in 1999 and 2000 (net, for 2000, of the extraordinary proceeds of UMTS licence sales; Table 13.2). Considering this result and its own forecasts in April 2008, the European Commission recommended that the EU Council terminate the excessive deficit procedure initiated in 2005.

Table 13.2

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

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Revenue	46.2	46.4	45.4	45.0	44.5	45.1	44.5	44.2	45.9	47.2
Expenditure (2) (3)	49.0	48.1	47.4	48.1	47.4	48.6	48.0	48.4	49.3	49.1
of which: interest payments	*7.9*	*6.6*	*6.3*	*6.3*	*5.5*	*5.1*	*4.7*	*4.5*	*4.6*	*5.0*
Primary surplus	-5.1	-4.9	-4.3	-3.2	-2.7	-1.6	-1.2	-0.3	-1.3	-3.1
Net borrowing	2.8	1.7	2.0	3.1	2.9	3.5	3.5	4.2	3.4	1.9
Borrowing requirement net of privatization receipts	3.3	3.4	3.5	5.0	3.1	4.2	4.2	5.2	3.7	2.2
Debt	114.9	113.7	109.2	108.8	105.7	104.4	103.8	105.8	106.5	104.0

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.

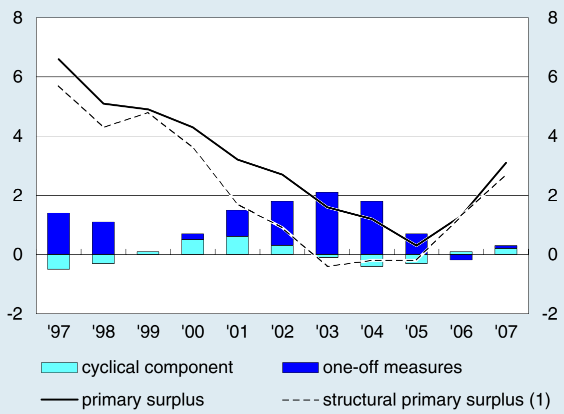
The deficit reduction was achieved despite the spending increases decided in June and September (amounting to 0.9 points of GDP) and the abolition in December of the advance payment by tax collection agents (0.3 points).

Applying the methodology adopted by the Bank of Italy (see the section "Net borrowing in 2006" of Chapter 11 of last year's Annual Report), the structural deficit in 2007 (cyclically adjusted and net of temporary measures) was reduced by about 1 percentage point of GDP and came to just over 2 per cent. The primary surplus increased by 1.3 points to nearly 3 per cent, continuing the significant improvement that began in 2006 (Figure 13.1).

The reduction in the structural budget deficit in 2006 and 2007 is estimated at 2.5 points, considerably more than the adjustment of 1.6 points that the Government had committed to in 2005 under the excessive deficit procedure.

Figure 13.1

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



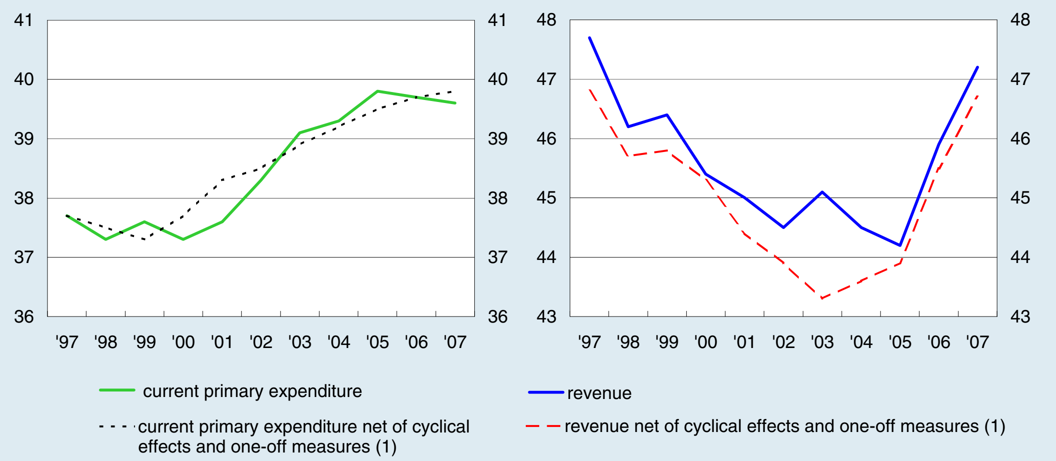
(1) Adjusted for the effects of the economic cycle and one-off measures; as a percentage of trend GDP.

The impact of the economic cycle on the budget balance was negative by 0.3 points of GDP in 2005; it turned positive in 2006 and came to more than 0.2 points in 2007. Temporary measures, which had improved the balance by nearly one percentage point in 2005, have been substantially neutral in the past two years. In 2007 the revenue produced by the payment to INPS of the accruing severance pay of workers not choosing to join private pension plans (€5.5 billion) and by other measures taken in previous years (€1.6 billion) was largely offset by the additional expenditure due to the Government's abolition of the advance payment due from tax collection agents (€4.9 billion). The Combined Report on the Economy and Public Finance released in March 2008, using the cyclical adjustment methodology and the standards for identifying temporary measures agreed at European level, estimated the structural adjustment achieved over the two years at 2.9 percentage points of GDP.

As in 2006, the improvement in the budget balance essentially reflected a structural increase in revenue (Figure 13.2).

Figure 13.2

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



(1) As a percentage of trend GDP.

Revenue and expenditure

Revenue. – General government revenue increased by 6.5 per cent in 2007 to €724.2 billion, and from 45.9 to 47.2 per cent of GDP (Table 13.3).

Table 13.3

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

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Direct taxes	14.3	14.9	14.4	14.7	13.9	13.4	13.3	13.3	14.4	15.2
Indirect taxes	15.1	14.9	14.7	14.2	14.3	14.0	14.0	14.2	14.9	14.7
Capital taxes	0.4	0.1	0.1	0.1	0.2	1.3	0.6	0.1	0.0	0.0
Tax revenue	**29.7**	**29.9**	**29.2**	**29.0**	**28.4**	**28.7**	**28.0**	**27.6**	**29.3**	**29.9**
Social security contributions	12.6	12.5	12.4	12.3	12.5	12.6	12.6	12.8	12.8	13.3
Tax revenue and social security contributions	**42.3**	**42.4**	**41.6**	**41.3**	**40.8**	**41.4**	**40.6**	**40.5**	**42.1**	**43.3**
Other current revenue	3.6	3.6	3.4	3.5	3.5	3.4	3.6	3.5	3.5	3.6
Other capital revenue	0.3	0.4	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Total revenue	**46.2**	**46.4**	**45.4**	**45.0**	**44.5**	**45.1**	**44.5**	**44.2**	**45.9**	**47.2**

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

The ratio of tax and social security contribution receipts to GDP rose by 1.2 points to 43.3 per cent. About one percentage point of the increase was due to discretionary measures, including those to broaden tax bases and fight tax evasion and avoidance. This evaluation takes account on the one hand of the lapsing of some temporary measures from previous years and on the other of the decision by many firms to defer until the time of settlement of the year's tax liability in 2008 the utilization of the IRAP relief on labour costs introduced in the Finance Law for 2007. Cyclical factors, determined using the macroeconomic variables that best proxy for the main tax bases, apparently had no significant overall effect on the fiscal ratio in 2007. The part of the rise in the indicator not due to cyclical developments or policy measures may have reflected changes in the composition of tax bases and in taxpayers' degree of compliance with tax law.

Essentially, the rise in the fiscal ratio derives from sharp increases in direct tax receipts (0.8 percentage points of GDP), reflecting discretionary measures and the improvement in company performance in 2006, and in social security contributions (0.5 points, two thirds of it consisting in the transfer to INPS of severance pay accruals for workers in firms with 50 or more employees not assigned to private pension funds).

Actual social security contributions increased by 8 per cent (€14.8 billion). Significant factors were the above-mentioned transfer to INPS (€5.5 billion) and increases in contribution rates under the Finance Law for 2007 (officially estimated at €4.4 billion).

In what follows, receipts entered in the State budget accounts on a cash basis are analysed tax by tax. IRAP and local personal income tax surcharges are considered under local government.

Corporate income tax receipts increased by 28 per cent (€11 billion), reflecting the expansion of economic activity in 2006, the adjustment of sector studies, the measures against tax evasion and avoidance enacted starting in the summer of 2006, and tax increases to offset the reduction in VAT receipts produced by the European Court of Justice decision of September 2006 on deductibility for company cars.

As for households, personal income tax receipts rose by 5.7 per cent (€8.1 billion). The share collected from employees and pensioners grew by 2.6 per cent; it is estimated that in the absence of discretionary measures it would have risen by 4.5 per cent. Part of the difference may reflect the personal income tax reform enacted with the Finance Law for 2007.

Self-assessed personal income tax payments by the self-employed and small enterprises increased by 18.8 per cent, reflecting the same factors that drove corporate income tax receipts. The effects of the personal income tax reform on this segment will not be felt until 2008. Assigning the tax settlement payment to the year in which the income was earned (that preceding the payment), the increase in 2006 came to over 10 per cent, compared with 3.9 per cent in 2005 and 0.1 per cent in 2004.

The tax wedge on labour diminished in 2007, when it is calculated using the tax rates in effect during the year (for IRAP, social security contributions, personal income tax and local and regional surcharges) for an employee with average income as measured in the national accounts. Depending on city of residence, the reduction ranged between 0.3 and 0.7 per cent of the cost of labour for workers with no dependents.

Between 1999 and 2007, the portion of the tax wedge borne by employers was reduced by an amount that can be estimated at between 2.4 and 2.8 percentage points of the total labour costs, depending on region. The component charged to workers was reduced only for workers with family dependents, for whom income tax cuts more than offset fiscal drag. With a spouse and two dependent children the reduction amounted to between 1.2 and 2 points, depending on city of residence (considering only regional capitals).

Receipts from taxes on households' savings income increased by 12.3 per cent (€1.5 billion), reflecting the ongoing rise in interest rates. They were affected, for the second consecutive year, by the bunching of postal savings certificate redemptions. The change in the composition of the revenue reflected some variations in households' portfolio choices in 2006. Tax on interest income increased by 22.7 per cent (€2 billion), while that on managed assets fell by 15.9 per cent (€0.3 billion).

Among indirect taxes, VAT receipts increased by 4.4 per cent (€5.1 billion). They were increased by measures against evasion and avoidance but diminished by the increased deductions imposed by the European Court of Justice decision on the deductibility of company cars. Receipts from the excise tax on mineral oils, proportional to volume, decreased by 4.8 per cent or €1 billion in connection with the contraction in consumption.

Expenditure. – General government expenditure decreased from 49.3 to 49.1 per cent of GDP in 2007, amounting to €753.4 billion (Table 13.4). Not counting the main extraordinary expenditures (relating in 2006 to the cancellation of claims on TAV S.p.A., the high speed rail link corporation, and in 2007 to the abolition of the advance payment required of tax collection agents), they increased by 0.3 percentage points. Interest payments rose significantly, from 4.6 to 5 per cent of GDP. Capital expenditure (net of the extraordinary items mentioned) was unchanged at 4.1 per cent. Primary current expenditure decreased by 0.1 points for the second year running, to 39.6 per cent.

Table 13.4

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

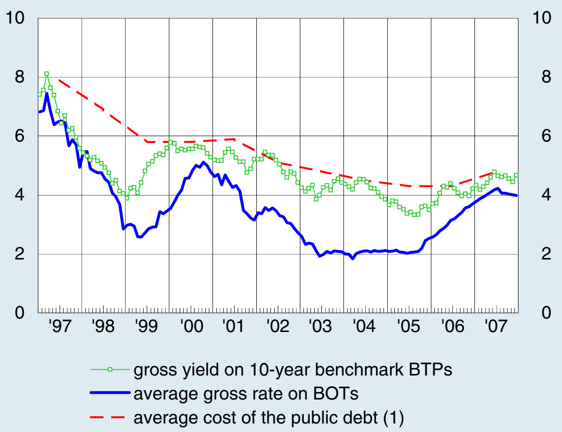
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Compensation of employees	10.6	10.6	10.4	10.5	10.6	10.8	10.8	11.0	11.0	10.7
Intermediate consumption	4.9	5.0	5.0	5.1	5.2	5.3	5.4	5.5	5.2	5.2
Market purchases of social benefits in kind	2.0	2.1	2.3	2.5	2.6	2.6	2.7	2.8	2.8	2.7
Social benefits in cash	16.7	16.9	16.4	16.2	16.5	16.8	16.9	17.0	17.0	17.3
Interest payments	7.9	6.6	6.3	6.3	5.5	5.1	4.7	4.5	4.6	5.0
Other current expenditure	3.2	3.1	3.1	3.2	3.3	3.6	3.6	3.6	3.6	3.7
Total current expenditure	**45.2**	**44.2**	**43.6**	**43.9**	**43.8**	**44.2**	**44.0**	**44.4**	**44.3**	**44.6**
of which: expenditure net of interest payments	*37.3*	*37.6*	*37.3*	*37.6*	*38.3*	*39.1*	*39.3*	*39.8*	*39.7*	*39.6*
Gross fixed investment (2)	2.3	2.4	2.3	2.4	1.7	2.5	2.4	2.4	2.4	2.4
Other capital expenditure (3)	1.4	1.5	1.4	1.8	1.9	1.9	1.5	1.7	2.6	2.1
Total capital expenditure (2)(3)	**3.8**	**3.9**	**3.7**	**4.2**	**3.6**	**4.3**	**4.0**	**4.1**	**5.0**	**4.5**
Total expenditure (2)(3)	**49.0**	**48.1**	**47.4**	**48.1**	**47.4**	**48.6**	**48.0**	**48.4**	**49.3**	**49.1**
of which: expenditure net of interest payments (2)(3)	*41.1*	*41.5*	*41.0*	*41.8*	*41.9*	*43.4*	*43.3*	*43.9*	*44.7*	*44.1*

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

The growth in interest payments (12.4 per cent, after a rise of 5.5 per cent in 2006) mainly reflects the increase of 0.4 percentage points in the average cost of debt to 4.8 per cent (Figure 13.3). In small part it also reflects the increase in the average stock of debt. The average cost of the debt was driven up by several factors: the rise in interest rates at issue since the end of 2005; the effects of swaps, which increased outlays by €0.6 billion (against the reduction by €0.5 billion in 2006 and €1.6 billion, on average, between 2002 and 2005); and a decrease of €0.7 billion in the cost of indirectly measured financial intermediation services, which the national accounts

Figure 13.3

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.

set off against interest payments and impute to intermediate consumption. Excluding the effects of these last two items, the average interest rate on the debt rose by 0.3 points.

Given the composition of the public debt at the end of 2007, it can be estimated that a 1-point rise in interest rates at issue entails an average increase in interest expense of 0.3 points in the first year, 0.4 in the second and 0.5 in the third; the increment rises to 0.6 points in the seventh year. The first-year rise is slightly greater than had been estimated for an interest-rate shock of the same magnitude in 2003, despite the reduction in the share of short-term and variable-rate paper between the end of 2003 and the end of 2007 (from 29.4 to 25.9 per cent of total outstanding government securities). A factor in the increase was large-scale resort, in funding the borrowing requirement, to the current accounts with the State Treasury on the part of entities external to general government. The balances on these accounts, which earn an interest rate equal to the average on Treasury bills, increased from €31 billion to €102 billion over the four years, essentially reflecting the increase in the balance of Cassa Depositi e Prestiti S.p.A. from €20 billion to €90 billion. More recently, trends in the sensitivity of interest expenditure to rate variations may have been significantly influenced by swaps, which were not taken into account in this estimation exercise.

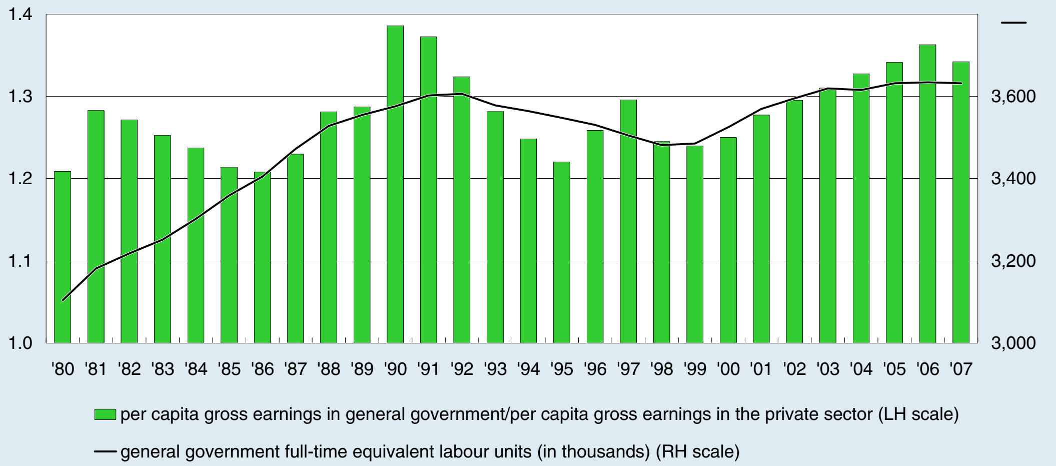
Social benefits in cash increased by 5.2 per cent compared with 4 per cent in 2006, and from 17 to 17.3 per cent of GDP. The pensions component rose by 4.2 per cent (3.4 per cent in 2006) and held stable at 15.3 per cent of GDP. Other benefits again recorded a high rate of growth (14.4 per cent, after 9.5 per cent in 2006).

Compensation of employees increased by 1.1 per cent (4.1 per cent in 2006), owing to the rise in per capita earnings; the ratio to GDP fell from 11 to 10.7 per cent.

According to the aggregate national accounts data, in 1980 gross per capita earnings in the general government sector were 21 per cent higher than in the private sector; the differential widened to 39 per cent in 1990 and then fell back to 22 per cent in 1995. It began to widen again at the turn of the century and in 2006 amounted to 36 per cent (Figure 13.4). The slight narrowing registered in 2007 will presumably be more than offset by the increase expected for 2008.

Figure 13.4

Earnings and employment in general government



Source: Based on Istat data; for 2007, estimates.

When data are analysed on an individual basis to take account of some differences in the composition of employment between the two sectors, the gap in favour of the public sector is generally less pronounced than in the national accounts but still substantial. In the sample of the Bank of Italy's Survey on Household Income and Wealth for 2006, which includes 5,800 employees, public-sector workers are on the average older than those of the private-sector (by 6 years), better educated (81 per cent with at least a high school diploma as against 54 per cent), more likely to be women (55 versus 38 per cent), more white-collar (87 per cent are clerical workers or managers, compared with 37 per cent in the private sector), and typically residing in the Centre or South (57 per cent, against 42 per cent). Average annual after-tax earnings were 21 per cent higher in the public sector (€18,200 as against €15,000); the difference in hourly earnings was greater (38 per cent).

Controlling for age, sex, marital status, education, occupational category and place of residence, the earnings differential in favour of the public sector can be estimated at 11 per cent in 2006. Among women it rises to 16 per cent, while it stands at about 5 per cent among men. It is wider in the South (15 per cent), among white-collar employees (12 per cent) and among better educated workers (16 per cent). These estimates do not take account of unobservable variables, such as occupational preferences, or of other monetary and non-monetary components of compensation, such as retirement benefits and job security.

Social benefits in kind, more than 90 per cent of which are dispensed by the healthcare system, increased by 0.9 per cent (2.7 per cent in 2006). A factor in the deceleration was a decline in spending on pharmaceuticals. Intermediate consumption increased by 2.7 per cent (3.8 per cent net of financial intermediation services indirectly measured). In 2006 budget constraints had reduced this item by 1.2 per cent.

Excluding the proceeds of real-estate disposals (€1.7 billion in 2006 and €1.4 billion in 2007), investment spending increased by 3 per cent after falling for two years (by a total of 3.6 per cent in 2005 and 2006). Its ratio to GDP slipped from 2.5 to 2.4 per cent.

In the five years from 2001 through 2005 about a quarter of general government investment (net of the proceeds of real-estate disposals) went for transport infrastructure (road and rail networks, ports and airports). The funding of the latter also involved transfers to public corporations (the State Railways in particular). By comparison with the rest of Europe, Italy is generally disadvantaged in transport infrastructure.

Local government

The overall local government deficit fell by more than 1 percentage point of GDP in 2007. The improvement reflects spending cuts (0.5 points), an increase in own revenue (0.2 points) and increased central government investment grants (0.3 points).

The reduction in expenditure resulted in part from decreases in compensation of employees (from 4.7 to 4.4 per cent of GDP) owing to the non-recurrence of back pay for contract renewals in 2006, and in production subsidies (from 0.6 to 0.5 per cent).

Healthcare expenditure declined from 6.8 to 6.7 per cent of GDP; net of employee compensation it was unchanged at 4.4 per cent, after a decade of steady increases. The slowdown was due to a decrease in expenditure on pharmaceuticals. The trend in this item was affected by several factors in 2007: price reductions adopted by the Italian Drug Agency (AIFA) in 2005 and 2006, which were retained in 2007; actions by regional authorities to curb outlays, as part of deficit reduction programmes; and greater resort by the regions to direct distribution of pharmaceuticals.

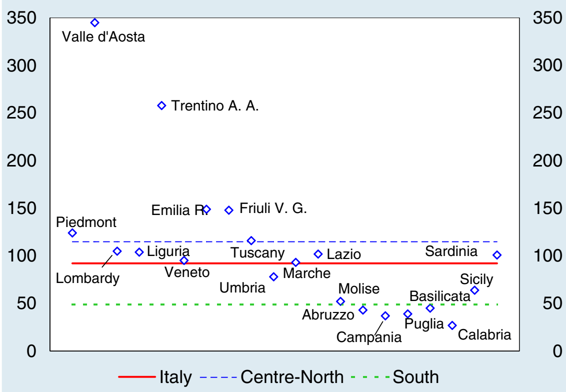
The control of healthcare spending has benefited in recent years from rules to discourage deficits in individual regions. The finance laws for 2005 and the years following introduced and strengthened a procedure that envisages – in case of a health system deficit – the issue of central government advisories, the appointment of special administrators, and automatic increases in regional income tax surcharge and IRAP rates.

Per capita spending by municipalities, whose transfer payments from central government are based essentially on historical expenditure, is highly variable. The differences in social service outlays are very substantial (Figure 13.5). Regional expenditure displays less dispersion, reflecting the dominant role of the healthcare system, which is required to guarantee essential service levels everywhere. (For further discussion on the public finances at regional level, see "Note regionali annuali" on the Bank's website at www.bancaditalia.it/pubblicazioni/econo/ecore/note).

Figure 13.5

Municipal expenditure on social services, by region, in 2004

(average per capita expenditure in euros)



Source: Istat, *La seconda indagine censuaria sugli interventi e i servizi sociali dei comuni*.

Own revenues, which are calculated net of resources from other public bodies and from abroad, increased by 7.1 per cent in absolute terms and from 8.4 to 8.6 per cent of GDP. In 2007 they amounted to 57 per cent of the local authorities' total expenditure. Own revenues were boosted by the regional and municipal income tax surcharges and by IRAP.

The power of regions and municipalities to raise the surcharge rate was restored in 2007 after having been suspended for four years, and many municipalities did so. The average municipal income tax surcharge rate increased in every region. The regional surcharge was raised in Emilia Romagna. The effect on tax receipts will be felt in 2008 (for municipalities, part of it emerged in the tax payments on account made in 2007).

The borrowing requirement and the debt

The borrowing requirement. – The overall borrowing requirement continued to fall in 2007, contracting from €54.4 billion to €30.5 billion and from 3.7 to 2 per cent of GDP (Table 13.5). Equity disposals, negligible in 2006, amounted to €3.5 billion last year (0.2 per cent of GDP) as a result of SACE S.p.A.'s reduction of shareholders' equity.

Table 13.5

General government balances and debt
(millions of euros)

	2003	2004	2005	2006	2007
Net borrowing	46,614	48,312	60,428	49,634	29,179
Total borrowing requirement	39,876	49,778	69,421	54,393	30,468
Borrowing requirement net of privatization receipts	56,742	58,093	74,039	54,432	33,968
Debt	1,393,495	1,444,603	1,511,534	1,575,630	1,596,705
Memorandum item:					
Privatization receipts (-) (1)	-16,866	-8,316	-4,618	-38	-3,500

Source: For net borrowing, Istat.
(1) The figures refer to central government.

The disparity between borrowing requirement and net borrowing. – The general government borrowing requirement net of equity disposals was greater than net borrowing by 0.3 points of GDP (1.2 points in 2006, net of the extraordinary expenditure in connection with the cancellation of claims on TAV S.p.A., and 0.7 points on average from 2002 through 2005; Table 13.6).

Essentially, the gap is due to the balance on financial items (net acquisitions of 0.4 per cent of GDP, 0.3 points less than the average for 2002-06). The difference between the cash- and accrual-basis accounts was practically eliminated (in 2006 it was 0.8 points of GDP, not counting the cancellation of the central government claims on TAV S.p.A.). In contrast with 2006, interest payments were lower on a cash than on an accrual basis, chiefly because of lower payments in connection with postal savings certificates and securities issued at a discount.

The debt. – After having risen for two years, in 2007 the ratio of public debt to GDP declined by 2.5 percentage points to 104 per cent. The decrease reflected the primary surplus and a reduction in the Treasury's assets with the Bank of Italy (see the box "General government debt", *Economic Bulletin* No. 48, April 2008).

The debt increased by €21.1 billion compared with €64.1 billion in 2006. The general government borrowing requirement was partly offset by the reduction in Treasury assets and by the appreciation of the euro, which lowered the value of foreign-currency liabilities by €0.3 billion (compared with €0.8 billion in 2006). Issue discounts (€4.1 billion, compared with €2.3 billion in 2006) contributed to the expansion of the debt.

As for the composition of the debt by instrument, in a reversal of the trend that marked the three years from 2004 through 2006, there was an increase both in the portion consisting of medium- and long-term securities (from 73.9 to 74.5 per cent) and in that of short-term paper (from 7.8 to 8 per cent). The share of currency and deposits declined by about 1 point to 9 per cent, mainly because of the elimination of private individuals' postal current accounts with the Treasury. The share of loans from monetary financial institutions was unchanged.

Table 13.6

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

		1998	1999	2000 (1)	2001	2002	2003	2004	2005	2006	2007 (2)
(a)	**Net borrowing (Istat)**	2.8	1.7	2.0	3.1	2.9	3.5	3.5	4.2	3.4	1.9
(b)	Balance of financial items	-0.1	0.6	2.2	0.5	0.3	0.3	1.0	1.2	0.5	0.4
(c)	Cash basis minus accrual basis	0.6	0.2	-1.1	0.6	-0.2	0.7	-0.3	-0.3	-0.1	0.0
	primary balance	*1.2*	*0.3*	*-0.6*	*0.9*	*0.2*	*0.9*	*-0.2*	*-0.4*	*-0.3 (0.5*)*	*0.2*
	interest payments	*-0.6*	*-0.1*	*-0.5*	*-0.2*	*-0.4*	*-0.2*	*-0.1*	*0.1*	*0.2*	*-0.2*
(d)=(a)+(b)+(c)	**Public sector borrowing requirement (MEF)**	**3.3**	**2.6**	**3.1**	**4.2**	**3.0**	**4.4**	**4.1**	**5.2**	**3.7**	**2.3**
(e)=(g)-(d)	Difference between the general government and public sector borrowing requirements	0.0	0.8	0.5	0.7	0.1	-0.2	0.1	0.0	-0.1	-0.1
(g)	**General government borrowing requirement net of privatization receipts (BI)**	**3.3**	**3.4**	**3.6**	**5.0**	**3.1**	**4.2**	**4.2**	**5.2**	**3.7**	**2.2**
(h)	Privatization receipts (-)	-0.7	-2.0	-1.3	-0.4	-0.2	-1.3	-0.6	-0.3	0.0	-0.2
(i)=(g)+(h)	**Total borrowing requirement (BI)**	**2.6**	**1.4**	**2.2**	**4.6**	**2.9**	**3.0**	**3.6**	**4.9**	**3.7**	**2.0**
(l)	Change in Treasury's deposits at the Bank of Italy	-0.7	0.6	-0.8	0.2	0.0	-0.6	0.2	-0.1	0.6	-0.9
(m)	Issue discounts	-0.5	-0.1	0.0	-0.2	-1.9	-0.3	0.0	-0.2	0.2	0.3
(n)	Change in the euro value of foreign exchange liabilities	0.0	0.6	0.1	0.0	-0.3	-0.2	-0.1	0.1	-0.1	0.0
(o)=(i)+(l)+(m)+(n)	**Change in the debt (BI)**	**1.5**	**2.5**	**1.5**	**4.6**	**0.8**	**1.9**	**3.7**	**4.7**	**4.3**	**1.4**
(p)=(a)-(o)	Difference between net borrowing and the change in debt	1.3	-0.7	0.5	-1.6	2.1	1.6	-0.2	-0.5	-1.0	0.5
(f)=(a)-(g)	*Difference between general government net borrowing and the general government borrowing requirement*	*-0.6*	*-1.6*	*-1.6*	*-1.9*	*-0.2*	*-0.8*	*-0.7*	*-1.0*	*-0.3*	*-0.3*
(q)=(g)-(o)	*Difference between the general government borrowing requirement and the change in debt*	*1.9*	*0.9*	*2.1*	*0.3*	*2.3*	*2.4*	*0.5*	*0.5*	*-0.7*	*0.8*

Sources: For net borrowing and interest payments on an accrual basis, Istat; for the public sector borrowing requirement (net of privatization receipts) 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 Finance, 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; for the balance on financial asset items, based on BI, *Conti finanziari.* The balance on financial asset items includes changes in holdings of the following instruments: cash and deposits, securities and loans; it does not include the change in the Treasury's deposits at the Bank of Italy, privatization receipts, or, for 2006, the change in loans due to the extraordinary cancellation of claims on TAV S.p.A. (€12,950 million). This cancellation reduced the component consisting in the difference between the primary balances on a cash and on an accrual basis, which is obtained as a residual.
(1) For purposes of comparability, net borrowing excludes the proceeds of the sale of UMTS licences entered on an accrual basis (€13,815 million); the borrowing requirement of the public sector and that of general government (both net of privatization receipts) exclude receipts from the sale of UMTS licences (€11,899 million, of which €10,709 million is included in privatization receipts). – (2) Provisional data. – (*) Excluding the effects of the cancellation of the claims on TAV S.p.A.

Halting the upward trend of recent years, local government debt remained practically stable in proportion to GDP at 7.1 per cent (Table 13.7). The bulk of this debt is owed by regions (41 per cent) and municipalities (42.6 per cent); provinces owe 8.1 per cent and other authorities 8.3 per cent. Assuming that the regional distribution of GDP was the same in 2007 as in 2006, debt ratio trends diverged. The ratio of local government debt to GDP declined in the Centre and the North-East (by 0.5 and 0.3

points respectively to 9.3 and 4.7 per cent), remained stable in the North-West (at 6 per cent) and increased in the South (by 0.6 points to 9 per cent).

Table 13.7

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

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
General government	**114.9**	**113.7**	**109.2**	**108.8**	**105.7**	**104.4**	**103.8**	**105.8**	**106.5**	**104.0**
Central government	*112.5*	*110.4*	*105.4*	*104.9*	*101.9*	*99.0*	*98.4*	*99.7*	*99.3*	*96.8*
Local government	*2.4*	*2.9*	*3.2*	*3.2*	*3.4*	*5.1*	*5.3*	*6.1*	*7.1*	*7.1*
Social security institutions	*0.0*	*0.4*	*0.5*	*0.6*	*0.4*	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*

Budgetary policy for 2008 and beyond

2008: targets and forecasts. – The Economic and Financial Planning Document released in June 2007 set the net borrowing target at 2.2 per cent of GDP in 2008 (Table 13.8). A reduction of 1.9 points in the public debt, to 103.2 per cent of GDP, was forecast. Net borrowing on a current legislation basis was estimated at 2.2 per cent. Counting obligations not specified in current legislation but reflecting Government commitments and established practice, it was estimated that the budget for 2008 would have to procure resources worth 0.7 per cent of GDP.

Table 13.8

Public finance objectives and estimates for the year 2008
(billions of euros)

	General government				*Memorandum items*	
	Net borrowing	Primary surplus	Interest payments	Debt	Real GDP growth rate (%)	Nominal GDP
Estimates on a current legislation basis						
Economic and Financial Planning Document (June 2007) (1)	35.9	42.5	78.4	….	1.9	1,606.1
as a percentage of GDP	*2.2*	*2.6*	*4.9*	*103.2*		
Forecasting and Planning Report (September 2007)	29.4	48.8	78.2	….	1.5	1,605.0
as a percentage of GDP	*1.8*	*3.0*	*4.9*	*103.1*		
Combined Report on the Economy and Public Finance (March 2008)	38.7	40.6	79.3	….	0.6	1,590.4
as a percentage of GDP	*2.4*	*2.6*	*5.0*	*103.0*		
Objectives						
Economic and Financial Planning Document (June 2007)	….	….	….	….	1.9	1,606.1
as a percentage of GDP	*2.2*	*2.7*	*4.9*	*103.2*		
Forecasting and Planning Report (September 2007) (2)	35.4	42.9	78.3	….	1.5	1,605.0
as a percentage of GDP	*2.2*	*2.7*	*4.9*	*103.5*		
Stability Programme (November 2007)	….	….	….	….	1.5	….
as a percentage of GDP	*2.2*	*2.6*	*4.9*	*103.5*		

(1) Includes the effects of Legislative Decree 81/2007. – (2) The primary surplus is taken from Section II of the Report.

In September the Forecasting and Planning Report trimmed the net borrowing forecast despite a downward revision of expected GDP growth in 2008 by 0.4 points to

1.5 per cent. The net borrowing target was nevertheless kept unchanged and a budget drawn up that would increase the deficit by about 0.4 points of GDP. The Stability Programme update in November confirmed the growth estimate and the public finance objectives. The planned improvement in structural net borrowing for 2008 was modest (0.2 points). The 2008 budget approved by Parliament increased net borrowing by €6.1 billion (see *Economic Bulletin* No. 48, April 2008).

The 2008 budget was the first to apply the reclassification of budget items according to missions and programmes. As designed by the State Accounting Office, the new classification consists of 34 missions and 168 programmes. The budget law also incorporated some proposals made by the Technical Committee on the Public Finances, created to carry out an extraordinary spending review, identify problems and suggest possible strategies for improvement. The Committee submitted two reports in 2007 ("Libro verde sulla spesa pubblica" and "Rapporto intermedio sulla revisione della spesa"), focusing on the expenditure flows of five ministries (Justice, Interior, Education, Infrastructures and Transport).

At the end of the year Parliament also approved a provision accompanying the budget, which included the implementing measures for the agreement on pensions, labour and competitiveness. The raising of the minimum age requirement for seniority pensions for workers with at least 35 years of contributions was made more gradual (under the previous law, on 1 January 2008 it would have risen directly from 57 to 60). Further, the first revision of the coefficients for converting accrued and revalued contributions into the annual pension award – introduced in 1995 for contributions-based pensions – was postponed to 2010. Future revisions were made more frequent and automatic.

The latest estimates. – The Government's Combined Report on the Economy and Public Finance in March 2008 updated the public finance estimates for the year. Net borrowing was revised from 2.2 to 2.4 per cent of GDP, even though the 2007 outturn was better than had been expected. Account was taken of the deferral to 2008 of the cost of some measures and of the worsening outlook for GDP growth (revised from 1.5 to 0.6 per cent). The Report estimated that the primary surplus would fall to 2.6 per cent of GDP from 3.1 per cent in 2007 because of a decline of 0.3 points in revenue and an increase of about the same amount in expenditure. Interest payments were expected to remain stable. Cyclically adjusted and net of temporary measures, net borrowing was projected to increase by 0.6 percentage points of GDP.

The European Commission, whose growth forecast is marginally lower than the Government's, puts Italy's net borrowing for 2008 at 2.3 per cent of GDP.

The Combined Report estimates the borrowing requirement net of equity disposals at 2.5 per cent of GDP (2.2 per cent in 2007). The disparity with respect to net borrowing would thus narrow further, from 0.3 percentage points to 0.1. The public debt is forecast to decline by one percentage point to 103 per cent of GDP.

In the first quarter of 2008 the general government borrowing requirement, net of equity disposals, amounted to €18 billion, €8.9 billion less than in the first quarter of 2007. The improvement mainly reflects increased receipts from tax collection agents, owing to the abrogation in December of the advance payment due from them, and receipts of accruing severance pay not assigned to alternative retirement schemes (in 2007 these payments began only in August). The growth in personal income tax receipts remained strong, while VAT receipts slowed. A more accurate evaluation of revenue trends will be possible in the summer when the data on self-assessed taxes are available.

Revenue will be sustained in 2008 by the growth in per capita earnings due to a cluster of major contract renewals. The prospective worsening of economic conditions should be only partly reflected in the public finances this year; the full effects will be felt in 2009, owing among other things to the lags built into the payment of corporate taxes.

In May the new Government abolished the municipal real-estate tax on most primary residences (at an estimated cost of €1.5 billion). It also reduced income tax on overtime pay and productivity bonuses (costing over €0.5 billion). This measure, which applies only to private-sector employees, will be introduced on an experimental basis in the second half of 2008. Additional expenditure of about €0.5 billion was also approved, mainly in connection with the waste collection and disposal emergency. To finance these measures, provision was made for spending cuts.

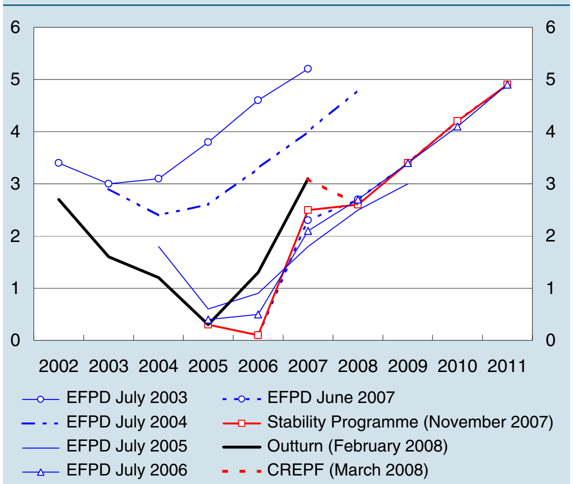
Medium-term plans and prospects

The Combined Report on the Economy and Public Finance estimates net borrowing on a current legislation basis at 2.1 per cent of GDP in 2009. This estimate assumes a scenario of gradual recovery in economic activity, with GDP growing by 1.2 per cent for the year. The European Commission, which projects slightly lower Italian GDP growth than the Combined Report in 2008 and 2009, puts net borrowing (on an unchanged-policies basis, hence taking account of the costs of established practices) at 2.4 per cent of GDP in 2009.

In the Combined Report's updated planning framework the public debt is projected to fall below 100 per cent of GDP in 2010, and a balanced budget is planned for 2011. Given the expected trend in interest payments, this will require that the primary surplus be increased to approximately 5 per cent of GDP, as the Stability Programme update in November indicated (Figure 13.6). For the three years 2009-2011, the plan is for a structural budget adjustment of 0.7 percentage points each year.

Figura 13.6

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



The reduction of the debt, the containment and qualitative improvement of expenditure and the reduction of tax distortions will enable Italy in the future to deal more effectively with the repercussions of demographic trends on the public finances.

Italian generational accounts

Generational accounting, developed in the early 1990s, produces indicators of the sustainability of budgetary policies and provides indications of their degree of inter-generational equity.

The generational balance of the average individual in a cohort is defined as the lifetime receipts of cash transfers and services from the public sector less total taxes and contributions paid. Budgetary policies are defined as sustainable if the sum of the balances of all living and future generations and existing public debt is zero or less.

A generational accounting exercise has been conducted at the Bank of Italy based on the latest available data, finding that the present-day value of the deficits that would be created by the retention of today's tax and spending policies (including the future rule changes already provided for by law) exceeds 100 per cent of GDP. The debt implicit in today's rules, that is to say, is of about the same magnitude as that already accumulated over the decades. Another gauge of the imbalance is the permanent increase in the primary surplus that would be necessary, by comparison with the 2007 outturn, to ensure sustainability. This increase comes to almost 3 percentage points of GDP.

To calculate the generational balance for each cohort, budget expenditure and revenue were divided among the various age-groups using sample surveys and administrative data. Taking 2006 as the base year, the exercise used the budget data for 2006 and 2007, the spending projections of the State Accounting Office, Istat's demographic forecasts and the Bank of Italy's Survey on Household Income and Wealth.

The European Commission has estimated that the sustainability of Italian public finances would require an increase in the primary surplus of 1.1 percentage points compared with 2007. However, that exercise assumes a constant ratio of revenue to GDP, whereas in the estimates presented here changes in revenue, like those in expenditure, depend on demographic trends.

Earlier generational accounting exercises, which portrayed the situation in 1990 and in 1998, showed that the very great imbalance of the Italian public finances of the early 1990s was considerably attenuated by the fiscal consolidation that enabled Italy to qualify for EMU. The latest exercise indicates that no further progress has been made in the decade since then.

As to inter-generational equity, if the entire cost of the adjustment necessary to achieve fiscal sustainability were charged to the future generations, their generational balance would be negative by about three times their average annual income. By contrast, individuals belonging to the youngest living generation, to whom the exercise applies today's rules, would have a slightly positive balance. The disparity is due largely to the significant ageing of the population, which will increase spending on healthcare and pensions while reducing the economically active population, those who will have to bear the cost of the benefits. Other factors are the already existing stock of public debt and the particularly generous pension rules for the older generations.

Considering only the part of generational accounts related to public pensions, the treatment of the various generations that are alive today can be compared. Under current rules, the present-day value of the expected pension benefits of a representative individual younger than 40 is only 75 per cent as great as that of a 60-year-old. This confirms that the reforms of the 1990s mainly reduced the rights of the younger generations and those still unborn. If lifetime contributions were also taken into account, the comparison would be still more favourable to the older cohorts.

Even allowing for the unavoidable uncertainty of very long-term estimates, these results show the need not to defer action to increase the primary surplus. Postponement would further widen the disparity of treatment to the disadvantage of future generations.

14. THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

In 2007 the non-financial private sector (households and firms) recorded a slightly negative financial balance for the first time since 1995 (Table 14.1). The low level of households' financial saving and the marked increase in firms' borrowing requirement contributed to this result.

Households' financial saving (the difference between the flows of financial assets and liabilities) fell to 3.4 per cent of GDP, well below the average for the last ten years (5.7 per cent). Financial investment in long-term deposits and medium and long-term securities increased during the year. There were further disposals of investment fund units and, for the first time since 1995, net disinvestment in the insurance sector. Households' medium and long-term financial debt grew more slowly than in 2006; the ratio of debt servicing costs to disposable income rose by almost one percentage point, to 7.9 per cent.

Firms' operating profitability remained stable at the low levels of 2006. The increase in net interest expense from 5.2 to 6.2 per cent of value added helped keep the proportion of investment covered by self-financing near a ten-year low (45 per cent). The external funding requirement rose to 3.5 per cent of GDP, from 2.4 per cent in 2006, and was covered mainly by recourse to bank credit. Firms' financial debt rose to 74 per cent of GDP, which is still low by international standards. Their leverage, calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices, started to grow again after remaining basically stable for three years and reached 41 per cent. The share of credit going to financially less solid companies diminished.

Households' financial saving and debt

With the growth in consumption, moderate though it was, outpacing disposable income, the financial saving of the household sector (comprising consumer households, producer households and non-profit institutions serving households) fell from €68 billion in 2006 to €52 billion and from 4.6 to 3.4 per cent of GDP (Table 14.1). Taking account of the loss of purchasing power due to inflation, the decline is sharper.

On the basis of preliminary data, Italian households' net wealth, consisting of the stock of financial and real assets net of liabilities, is estimated to have been equal to about eight times disposable income at the end of 2007, about the same as a year earlier.

Table 14.1

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

	2004	2005	2006	2007
Households (2)	83,646	71,179	68,004	51,874
of which: with abroad	*1,319*	*42,141*	*32,559*	*221*
Non-financial corporations	-12,752	-27,796	-36,065	-53,611
of which: with abroad	*13,683*	*53,960*	*38,631*	*76,390*
General government	-49,612	-60,940	-49,754	-30,683
of which: with abroad	*-19,269*	*-91,578*	*-36,967*	*7,264*
Monetary financial institutions	19,757	11,808	-17,108	25,667
of which: with abroad	*27,566*	*-47,978*	*-62,700*	*-67,073*
Other financial intermediaries (3)	-29,248	21,777	9,442	14,862
of which: with abroad	*-44,638*	*5,711*	*-26,257*	*-22,049*
Insurance companies (4)	-15,684	-26,988	11,942	-28,514
of which: with abroad	*17,445*	*26,785*	*41,195*	*-10,619*
Rest of the world account	3,894	10,959	13,539	20,404
Memorandum item:				
Non-financial private sector	70,894	43,383	31,939	-1,737
of which: with abroad	*15,002*	*96,101*	*71,190*	*76,611*
		As a percentage of GDP		
Households	6.0	5.0	4.6	3.4
Non-financial corporations	-0.9	-1.9	-2.4	-3.5
General government	-3.6	-4.3	-3.4	-2.0
Financial corporations (5)	-1.8	0.5	0.3	0.8
Rest of the world account	0.3	0.8	0.9	1.3
		As a percentage of GDP, adjusted for inflation (6)		
Households	3.6	2.5	3.3	1.2
Non-financial corporations	0.3	-0.7	-1.8	-2.3
General government	-1.6	-2.1	-2.2	-0.2

(1) Rounding may cause discrepancies in totals. The private sector comprises households and non-financial corporations – (2) Consumer households, producer households and non-profit institutions serving households. – (3) Includes financial auxiliaries. – (4) Includes pension funds. – (5) Monetary financial institutions, other financial intermediaries, insurance companies and financial auxiliaries. – (6) 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. – In 2007 Italian households made net disposals of Italian and foreign investment fund units worth €31 billion and €3.5 billion respectively (Table 14.2), against the background of rising yields on alternative assets and the worsening of financial market conditions in the second part of the year. For the first time since 1995 there was also a sizeable net outflow of savings from insurance-based financial products, which are included in life insurance reserves. Given an increase in the opportunity cost of holding liquid assets, sight deposits contracted. Higher yields increased net investment in medium and long-term securities and deposits with longer maturities. The shares of these instruments in the total stock of financial assets rose from 18 to 19 and from 9 to 10 per cent respectively.

In the second half of the year the turbulence that arose in the financial markets in the summer was associated with a reallocation of Italian households' financial portfolios towards less risky assets. Investment preference went mainly to bank deposits, post office savings accounts and certificates, and repos, while there was a substantial decline in net purchases of shares, which instead had expanded strongly in the first half of the year.

Table 14.2

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

	End-of period stocks			Flows	
	Dec. 2007	Percentage composition		2006	2007
		Dec. 2006	Dec. 2007		
ASSETS					
Cash and sight deposits	587,941	15.9	15.9	31,273	2,285
of which: deposits	*498,910*	*13.6*	*13.5*	*23,357*	*-2,733*
Other deposits	380,635	9.4	10.3	26,867	34,503
Short-term securities	26,044	0.4	0.7	14,353	13,572
Medium and long-term securities	584,115	14.5	15.8	21,052	61,345
of which: government	*177,564*	*4.3*	*4.8*	*-4,479*	*25,685*
corporate	*51,456*	*1.2*	*1.4*	*4,901*	*10,555*
bank	*355,095*	*9.0*	*9.6*	*20,631*	*25,106*
Investment fund units	185,941	6.1	5.0	-36,400	-31,430
Shares and other equity	880,089	25.3	23.8	5,130	24,159
External assets	326,758	8.8	8.8	32,559	221
of which: deposits	*17,578*	*0.4*	*0.5*	*11,404*	*3,116*
short-term securities	*1,674*	*0.0*	*0.0*	*463*	*563*
medium and long-term securities	*126,695*	*3.4*	*3.4*	*9,694*	*3,611*
shares and other equity	*100,062*	*2.7*	*2.7*	*1,227*	*-3,527*
investment fund units	*80,749*	*2.2*	*2.2*	*9,771*	*-3,542*
Insurance and pension fund reserves (2)	609,872	16.6	16.5	33,178	-948
of which: life insurance reserves	*364,272*	*10.2*	*9.9*	*20,832*	*-9,091*
Other financial assets (3)	115,899	3.0	3.1	-2,092	7,213
Total assets	**3,697,294**	**100.0**	**100.0**	**125,920**	**110,920**
LIABILITIES					
Short-term debt (4)	56,271	7.9	7.6	796	2,302
of which: bank	*53,601*	*7.6*	*7.3*	*506*	*1,791*
Medium and long-term debt (5)	469,468	62.5	63.7	48,767	46,466
of which: bank	*410,779*	*55.7*	*55.7*	*40,071*	*34,286*
Other financial liabilities (6)	211,479	29.6	28.7	8,353	10,277
Total liabilities	**737,218**	**100.0**	**100.0**	**57,916**	**59,045**
BALANCE	**2,960,076**			**68,004**	**51,875**

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

The evolution of financial investment according to microeconomic data. – The interest of Italian savers in managed assets has been declining since the start of the decade, in part for structural reasons. According to the Bank of Italy's Survey on Household Income and Wealth, between 2000 and 2006 the percentage of households owning Italian investment fund units fell from 12 to 8 per cent; individually managed portfolios followed a similar trend. The contraction of households' investment in investment fund units, both in terms of the incidence of ownership and as a share of the value of the portfolio of financial assets, was greater among households with below-median incomes. For higher-income households the pullback from investment funds was accompanied by a reduction in recourse to individually managed portfolios, of which these households are the main holders.

Between 2000 and 2006 the percentage of households with bank and post office deposits rose from 80 to 84 per cent and these instruments increased as a share of total financial assets. The reallocation towards deposits especially involved households with below-median incomes, revealing heightened risk aversion. The increase in purchases of bank and corporate bonds was concentrated mainly among households with above-median incomes.

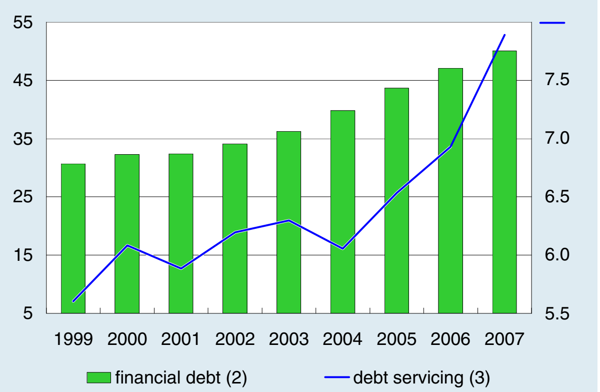
Six questions were included in the survey for 2006 with a view to eliciting respondents' ability to interpret the economic information used in making the most common financial choices quickly and accurately. The results show that about half of Italian households have not mastered the concepts that are essential to carrying out the most common types of financial transaction with competence. For example, half the sample respondents were not able to identify the balance in a current account statement, 60 per cent had trouble with the concept of compound interest, and fully 70 per cent were unable to interpret a graph illustrating the yields of two financial assets over a multi-year horizon. Other conditions being equal, the degree of financial competence is positively correlated with education, increases non-linearly with age (peaking at about age 45), and is higher among men and in the regions of the North. The data also show a strong correlation between correct responses and actual use of financial instruments, although the direction of causality could not be determined.

Financial debt. – Italian households' medium and long-term financial debt grew more slowly in 2007 (Table 14.2); the increase in loans for house purchases and in consumer credit remained large but was less than in the previous year. Financial debt rose from 47 per cent of disposable income at the end of 2006 to 50 per cent at the end of 2007 (Figure 14.1), still well below the average in the euro area (about 90 per cent) and in the other main industrial countries (above 100 per cent). It is low even though the aggregate figure for the household sector includes producer households, which are especially numerous in Italy; for consumer households alone, the ratio of financial debt to disposable income in Italy is 42 per cent.

Figure 14.1

Households' debt (1)

(as a 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 2007 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.

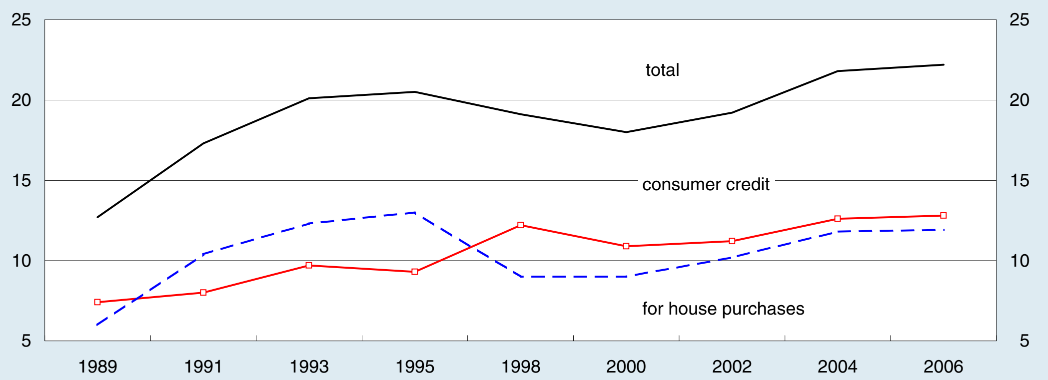
Medium-term trends in consumer households' debt. – Lending to Italian consumer households has expanded rapidly since the start of this decade, with average annual growth of 11.5 per cent in total loans and of more than 15 per cent in loans for house purchases. The increase in borrowing has been favoured by low interest rates and accompanied by an appreciable rise in house prices. The legislative changes introduced by the 1993 Consolidated Law on Banking, technological and financial innovation, and growing competition between intermediaries have also contributed by making it possible to tailor lending conditions more closely to households' preferences.

According to the Survey on Household Income and Wealth, the proportion of households with consumer loans rose from 9 per cent in 1995 to 13 per cent in 2006 (Figure 14.2). Deregulation and innovation were thus reflected in greater participation in the consumer credit market. This outcome was also facilitated by intermediaries' greater use of credit scoring techniques, which made the granting of credit more efficient.

Figure 14.2

Participation in the credit market (1)

(percentages)



Source: Banca d'Italia, Survey on Household Income and Wealth.
(1) Percentages of households with debt out of total households covered by the survey. Excludes debts contracted for professional reasons.

As regards loans for house purchases, which represent some 60 per cent of total lending to Italian households, their growth reflected a substantial increase in the average debt burden of the indebted households (up by about 50 per cent in real terms since the start of the decade) rather than broader participation in the credit market. The percentage of households with a mortgage loan followed the cycle of the real-estate market, declining in the second half of the 1990s and then rising in more recent years; by 2006 it had regained the level of the mid-1990s (Figure 14.2). The growth in participation recorded during the current decade has not extended to the lowest-income households. The increase in the average size of mortgage loans reflected the factors mentioned above and, in particular, the increase in the loan-to-value ratio, which in 2006 reached an average of about 70 per cent. In addition, it was possible to take out larger mortgages, thanks in part to the lengthening of their average maturity, which for contracts signed in 2006 exceeded 20 years.

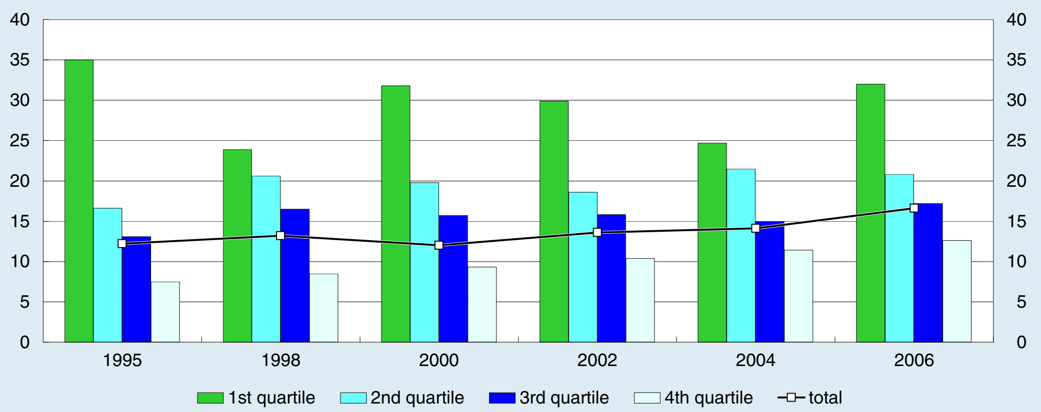
For indebted households, between 2000 and 2006 the median ratio of total debt to income rose from 27 to 37 per cent and the mean from 60 to 95 per cent. The increase involved all income brackets and was largest for households with a mortgage loan. During the same period there was a significant rise in the ratio of net wealth to disposable income, including for indebted households, due mainly to the increase in the value of property. Overall, household leverage (the ratio of debt to gross financial and real assets) rose during the second half of the 1990s and in the current decade, to stand at about 10 per cent at the end of 2006 for the median household, not unlike its level in the first half of the 1990s. A similar trend was recorded for the mean, which in 2006 exceeded 35 per cent; compared with the median, this indicator is influenced to a greater extent by the situation of the most heavily indebted households. The ratio of debt to total assets increases as income decreases: for households in the lowest income quartile, the median figure was greater than 20 per cent in 2006 (the mean was about 80 per cent).

Debt servicing. – Households' debt servicing costs (payments of interest and repayment of principal) rose in relation to disposable income by almost one percentage point in 2007, to 7.9 per cent (Figure 14.1). Almost half of the increase was due to the growth in the interest component resulting from the rise in mortgage lending rates. The debt servicing ratio has risen by almost two percentage points since the start of the decade.

However, the aggregate data refer to all households, both with and without debt. Debt servicing by indebted households alone can be analysed using the data of the Survey on Household Income and Wealth. The survey has collected data on the debt servicing of mortgage loans only on households' primary residence since 1995. For the median household, debt servicing costs on these loans amounted to 17 per cent of disposable income in 2006, compared with 12 per cent in 1995 and 2000 (Figure 14.3). Between 2004 and 2006 the largest increase was recorded for households in the lowest income quartile, whose mortgage loan instalments reached 32 per cent of disposable income; this high level had already been equalled and exceeded in previous periods (1995 and 2000). For households with above-median income, debt servicing was close to 15 per cent of disposable income in 2006, rising with respect to the past especially for households in the top income quartile.

Figure 14.3

Debt servicing on mortgage loans by income class (1)
(as a percentage of disposable income; medians)



Source: Banca d'Italia, Survey on Household Income and Wealth.
(1) Payment of interest and repayment of principal only on mortgage loans for the primary residence and only by households with this type of loan. Households are divided into income quartiles (ascending order). Excludes debt contracted for professional reasons.

The Survey on Household Income and Wealth only began to gather information concerning debt servicing on consumer credit in 2006. The portion of households whose total debt instalment that year amounted to 30 per cent or more of household income was 1.4 per cent (332,000 households scaled to the universe); 143,000 of these households (0.6 per cent of the total) belonged to the lowest income quartile and were among the most vulnerable to a rise in the cost of debt. Households whose debt instalment amounted to 50 per cent or more of income numbered 93,000 (0.4 per cent of the total), including 55,000 in the lowest income quartile (0.2 per cent of the total).

The financing of firms and their financial assets

Profitability and self-financing. – In 2007 the gross operating profit of non-financial enterprises was equal to 36 per cent of value added, about one percentage point less than during the recession of 2001-03. Primarily reflecting the increase in interest rates, net interest expense rose from 5.2 per cent of value added in 2006 to 6.2 per cent last year (Figure 14.4). After dropping sharply in 2006, the percentage of investment covered by internally generated funds remained basically stable at 45 per cent, one of the lowest levels in a decade (Figure 14.5). Firms' external funding requirement grew to €54 billion (Figure 14.5), partly as a result of the decrease in capital transfers from general government, which had been especially large in 2006 owing to the assumption by the State of the debts related to the financing of the high-speed rail link.

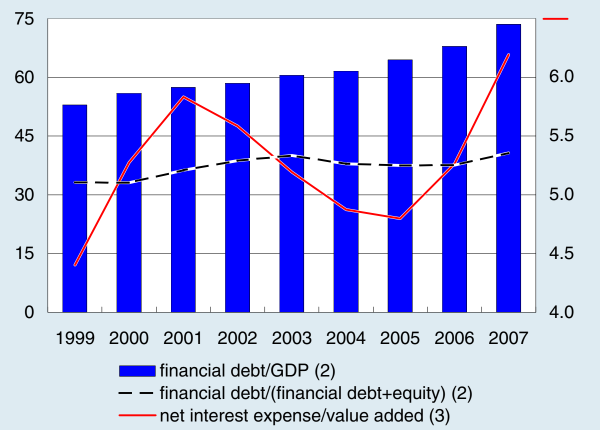
The ratio of the borrowing requirement to GDP was equal to 3.5 per cent in 2007. In the period 1995-2006 it had averaged 2.5 per cent, 1.2 percentage points more than in the euro area; this gap began to narrow in 2004 and closed completely in 2006.

Debt and the financial situation of firms. – The financial debt of firms increased substantially, by €128 billion, compared with €86 billion in 2006, and rose from 68 to 74 per cent of GDP. The latter figure was high compared with the levels for the last ten years but lower than in the euro area (83 per cent at the end of 2006). Leverage, calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices, which had remained basically stable for three years, began to increase again, to 41 per cent (Figure 14.4).

In 2007 the growth in loans was pronounced, particularly in the medium and long-term component. Firms' ability to raise funds on the bond market does not appear to have been affected by last summer's financial crisis: net

Figure 14.4

Corporate debt (1)
(percentages)

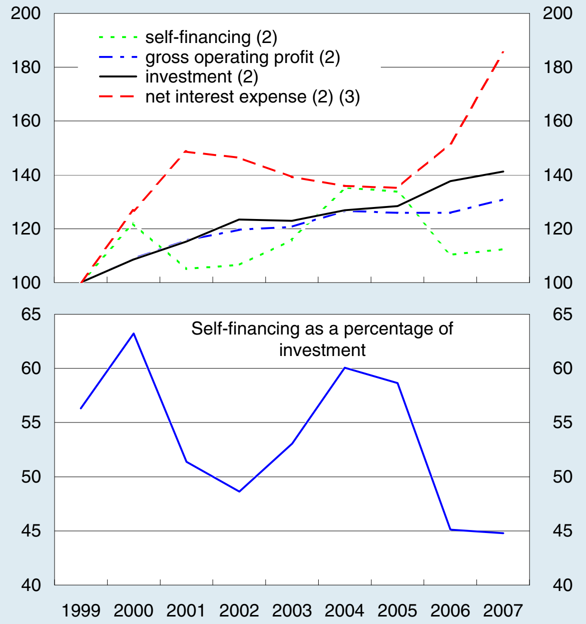


Sources: Bank of Italy, Istat.
(1) The data relate to "non-financial corporations". – (2) Left-hand scale. – (3) Right-hand scale. The figures for net interest expense are Bank of Italy estimates. Value added for 2007 is estimated from national accounts data.

issues of medium and long-term securities amounted to €4 billion in the second half and to nearly €10 billion for the whole year. In any case, Italian firms' recourse to the bond market remains low compared with that of firms in the main industrial countries.

Figure 14.5

The external funding requirement of firms (1)
(annual data)



Sources: Bank of Italy, Istat.
(1) Estimates based on national accounts data for the sector "non-financial corporations", 1999-2006. The data for 2007 are estimated on the basis of the national accounts for the year. Investment includes inventories. – (2) Indices, 1999=100. – (3) Bank of Italy estimates

Leverage also increased at large companies. According to the consolidated financial accounts of the main industrial groups, in 2007 leverage (calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at face value) rose by an average of more than 6 percentage points, primarily as a consequence of the loans raised by Enel to acquire the Spanish group Endesa.

According to the data on individual financial statements available at the Company Accounts Data Service up to 2006, the incidence of financial debt on value added was especially high for small firms and in the construction and services sectors, more moderate for manufacturing firms. The proportion of interest expense covered by internally generated funds was higher for large companies and for those in the energy sector; it was particularly low for construction firms.

Some indicators of firms' financial condition showed signs of worsening between 2005 and 2006. The percentage of interest expense covered by internally generated funds decreased and there was a decline in liquidity (measured as the ratio of current assets to current liabilities). While the average leverage ratio held basically steady at 50 per cent, leverage increased for small firms and for companies with low profits, which may have encountered greater difficulty in the face of higher external funding costs. By contrast, the indicator declined by one percentage point to 90 per cent among the most highly leveraged quartile of the sample. The share of sales revenues accounted for by the financially less solid companies remained below the average for the period 1990-2005. According to Central Credit Register data, the share of credit granted to these companies diminished.

Mergers and acquisitions and leveraged buyouts. – The year saw brisk activity in the market for corporate control. According to Thomson Financial, which monitors the main transactions, Italian firms announced 634 mergers and acquisitions worth €114 billion (€30 billion of it in connection with Enel's acquisition of Endesa). Considering only mergers and acquisitions of majority interests, there were 233 transactions worth €67 billion. In 2007 foreign acquirers announced 238 acquisitions of Italian non-financial companies, almost all of them small.

Since 2001 the largest annual volume of leveraged buyouts involving Italian non-financial companies was €16 billion in 2005; it fell to €2 billion in 2007. The share of all mergers and acquisitions consisting of leveraged buyouts rose from about 2 per cent in 2001 to 9 per cent in 2007.

Share issues, venture capital and private equity. – In 2007 the increase in the net worth of firms amounted to about €15 billion (Table 14.3), of which €2 billion came from issues of listed shares. The total value of share issues by listed companies was half that of the previous year.

A well-developed presence of private equity companies and venture capitalists can facilitate firms' access to the capital market. According to the Italian Private Equity and Venture Capital Association (AIFI), investment and fund-raising by private equity and venture capital companies in Italy increased to €4.2 billion and €3.0 billion last year. Large investments (greater than €150 million) accounted for more than half of the total, a higher share than in the three previous years. Almost 80 per cent of investments related to buyouts, aimed at restructuring the ownership of the company. Transactions directed to company expansion declined but still accounted for about 19 per cent of the total invested, while investments in young companies accounted for only about 1 per cent of the volume but nevertheless rose in number by comparison with the average for 2002-06. In those five years private equity investment averaged 0.2 per cent of GDP in Italy and 0.4 per cent in Europe, most of the difference being ascribable to transactions involving start-ups.

To gather information on how relationships between private equity investors and entrepreneurs develop in Italy, the Bank of Italy, in cooperation with the AIFI, conducted a series of interviews with firms in which venture capital or private equity funds had invested and with some of these intermediaries, surveying in particular a sample of 40 transactions. As in the United States, in the case of funding of start-ups it was found that staging mechanisms were common and that use was also made of clauses limiting the entrepreneur's permitted activities and assigning veto rights to the intermediary. On the other hand, hybrid capital instruments are less common than in the United States and the stake acquired by the intermediaries is smaller (around 30 per cent). As findings for the United States and Europe suggest, private equity investors often provide advice to the entrepreneur on various aspects of operations. The interviews reveal a relatively moderate degree of activism concerning the aspects related to product development, which are important in the early stages of a company's life. The contribution of advice is larger on financial matters and for the internationalization of companies through both acquisitions and cooperation agreements with foreign partners. Lastly, there are indications that private equity funds signal the quality of projects to outside financiers.

Project financing and public works. – In recent years government bodies have made increasing use of arrangements in which private capital participates in the financing of infrastructural projects (public-private partnership, the most common form of which is project financing). Under these contracts, all or part of the cost of building the facilities is borne by private companies, which use their own funds or resort to medium

Table 14.3

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

	End-of-period stocks			Flows	
	Dec. 2007	Percentage composition		2006	2007
		Dec. 2006	Dec. 2007		
ASSETS					
Domestic assets	**1,210,131**	**73.8**	**69.7**	**29,954**	**-7,743**
Cash and sight deposits	178,460	10.3	10.3	17,043	-14,060
Other deposits	11,771	0.6	0.7	-442	1,533
Short-term securities	365	0.0	0.0	307	-22
Medium and long-term securities	57,489	2.7	3.3	4,937	15,601
of which: government	*33,485*	*0.6*	*1.9*	*2,404*	*22,538*
corporate	*11,327*	*1.3*	*0.7*	*1,488*	*-6,533*
Shares and other equity	607,133	38.4	35.0	1,393	-12,420
Investment fund units	2,595	0.2	0.1	-425	-434
Trade credit receivable	293,544	18.0	16.9	2,037	-731
Other financial assets (2)	58,774	3.5	3.4	5,104	2,790
External assets	**524,981**	**26.2**	**30.3**	**60,099**	**94,909**
of which: deposits	*50,943*	*2.6*	*2.9*	*18,322*	*9,363*
trade credit receivable	*58,289*	*3.6*	*3.4*	*-577*	*-352*
short-term loans	*148,222*	*6.7*	*8.5*	*32,874*	*40,727*
securities	*27,361*	*1.3*	*1.6*	*1,345*	*6,218*
shares and other equity	*226,630*	*11.2*	*13.1*	*8,620*	*38,760*
Total assets	**1,735,112**	**100.0**	**100.0**	**90,052**	**87,166**
LIABILITIES					
Domestic liabilities	**2,944,584**	**89.8**	**89.9**	**104,650**	**122,258**
Short-term debt (3)	399,268	11.4	12.2	30,536	39,780
of which: bank	*348,470*	*10.0*	*10.6*	*30,462*	*34,004*
Medium and long-term debt (4)	560,850	15.6	17.1	43,467	70,046
of which: bank	*466,014*	*12.9*	*14.2*	*52,640*	*60,918*
Securities	53,979	1.7	1.6	4,612	4,750
of which: medium and long-term	*45,773*	*1.2*	*1.4*	*2,960*	*9,845*
Shares and other equity	1,465,285	47.2	44.7	15,384	8,849
Trade credit payable	299,535	9.5	9.1	2,078	-746
Other financial liabilities (5)	165,667	4.5	5.1	8,573	-422
External liabilities	**331,876**	**10.2**	**10.1**	**21,468**	**18,519**
of which: trade credit payable	*29,038*	*0.9*	*0.9*	*1,155*	*-874*
financial debt	*115,212*	*3.2*	*3.5*	*7,876*	*13,672*
of which: medium and long-term securities	*14,208*	*0.5*	*0.4*	*468*	*0*
shares and other equity	*183,145*	*5.9*	*5.6*	*14,162*	*6,289*
Total liabilities	**3,276,460**	**100.0**	**100.0**	**126,118**	**140,777**
BALANCE	**-1,541,348**			**-36,066**	**-53,611**

(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) Post office current accounts, staff pension provisions, domestic derivatives and other minor items.

and long-term debt. The repayment and remuneration of the capital invested depend on revenues from operating the facilities over a number of years. According to the National Project Financing Observatory, between 2002 and 2007 the tenders held in Italy rose in number from 186 to 362 and in total value from €1.3 billion to €5.2 billion. The average transaction size is rather low (about €18 million in 2007), since project financing is often used for small-scale projects that do not involve complex interactions between construction and operation (such as schools, cemeteries and car parks). The sector most extensively involved is transport, where the average transaction amount is highest.

Financial assets. – Italian firms made net disposals of domestic financial assets worth about €8 billion last year (Table 14.3). The decline in holdings was especially large for cash and domestic sight deposits (€14 billion), in connection with the widening of the yield spread between longer-term assets and current accounts. At the end of 2007 the share of liquid assets (cash and deposits) in firms' total financial assets stood at 14 per cent, about the same as a year earlier. External assets grew in 2007 by €95 billion, largely reflecting acquisitions of equity interests.

15. THE FINANCIAL MARKETS

The Italian financial markets enjoyed easy conditions until July 2007, but in the rest of the year reflected the global tensions triggered by the US subprime mortgage crisis. The situation continued to deteriorate in the first quarter of 2008, although some signs of improvement appeared between April and May.

Prices of Italian shares fell during the year, mainly owing to lower-than-expected growth in profits. As in the other euro-area countries, bank stocks reflected the turbulence on international markets.

The long-term yields on Italian government securities increased by half a percentage point. The yield spread between the 10-year BTP and the corresponding German Bund widened significantly following a generalized portfolio shift towards less risky assets.

The increased uncertainty, together with the diminished growth prospects of the Italian economy, led to a half-point rise in the yield differential between the bonds of Italian non-financial corporations and government securities, in line with what was happening to similar bonds in other euro-area countries. Net bond issues by Italian firms increased in all sectors, despite a brusque slowdown in the third quarter; again no issues were made by small and medium-sized enterprises, while those of low-rated and non-rated companies remained negligible.

Public sector securities

Supply and demand. – Net issues of Italian public securities declined considerably during 2007, from €38 billion to €26 billion, owing to the reduction in the general government borrowing requirement. The year-end stock decreased by more than 1 percentage point, to 85.9 per cent of GDP.

The average residual maturity of government securities rose slightly to 6 years and 8 months, while their average financial duration shortened by 1 month to 4 years and 7 months owing to the rise in interest rates on all maturities. There were net redemptions of CTZs and Republic of Italy securities (foreign-currency denominated government bonds), CCTs recorded zero net issues, while net issues of BOTs and BTPs were positive. Issues of the latter fell from €47 billion to €29 billion and for the first time since their introduction 10-year BTPs recorded net redemptions, amounting to €3 billion. By contrast, net issues of 30-year BTPs rose from €8 billion to €10 billion and those of BTP€i, indexed to euro-area consumer prices, from €12 billion to €16 billion.

Italian local authorities made almost no net issues, compared with €7 billion in 2006, having substantially reduced their borrowing requirement. The year-end stock was unchanged at €35 billion, or 2.7 per cent of total outstanding Italian public sector securities.

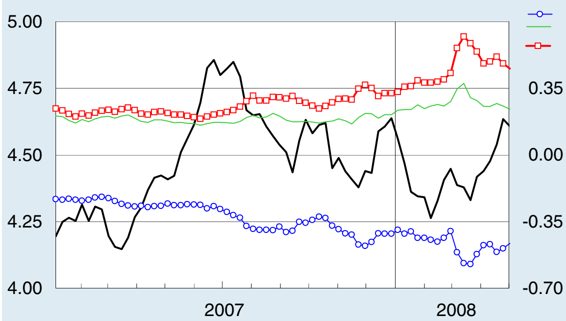
Households and firms made substantial net purchases of BTPs and BOTs and net sales of CTZs. Banks made net purchases of medium and long-term securities but sold short-term issues. Investment funds, which recorded massive net outflows, made large net sales of CCTs and BTPs and resumed purchases of BOTs and CTZs. The balance on trading in Italian government securities by foreign investors was slightly negative owing to large net sales of BTPs. At the end of the year the stock held abroad amounted to 50.9 per cent of the total, around 2 percentage points less than in 2006.

Interest rates. – Interest rates on medium and long-term government securities rose in the first half of 2007 in Italy, mirroring the trend under way in the euro area; they were driven upwards by the favourable economic conditions and expectations of a rise in official interest rates. However, the second half of the year saw a decline in response to the portfolio reallocation triggered by international financial tensions and the worsening of the macroeconomic outlook. At the end of the year the yield on the benchmark ten-year bond was 4.6 per cent, half a point higher than a year earlier. The real rate of interest, as deduced from the yield on ten-year bonds indexed to euro-area consumer prices, rose by 0.3 percentage points to 2.3 per cent. In the first four months of 2008 interest rates on government securities fell slightly.

From the summer of 2007 onwards, the yield spread between the benchmark 10-year BTP and the corresponding German Bund widened by 0.12 percentage points, reaching 0.35 points at the end of December (Figure 15.1). It then widened further in the early part of 2008, peaking at 0.65 points in March before narrowing to 0.42 points in mid-May. The premiums on CDSs on Italian government securities, which signal the probability markets assign to the issuer's insolvency, followed a similar pattern.

Figure 15.1

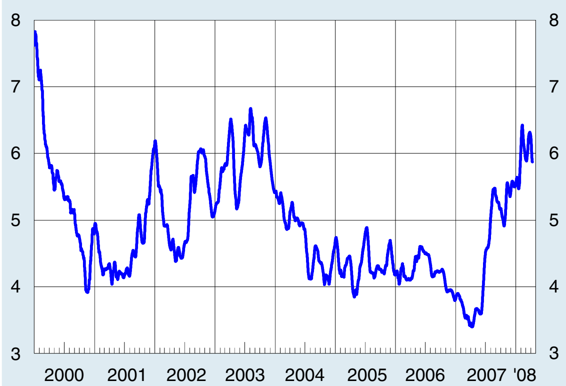
Gross yields on 10-year BTPs and main interest rate spreads (1)
(weekly averages; percentages and percentage points)



Source: Based on Bloomberg data.
(1) Yields on benchmark ten-year bonds. – (2) Right-hand scale. – (3) Spread between the yield on ten-year BTPs and the simple average of yields on corresponding government securities of three euro-area countries that recorded a budget surplus in 2006 (Finland, Netherlands and Spain); right-hand scale. – (4) Spread between ten-year Bunds and ten-year euro swaps; right-hand scale.

Figure 15.2

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.

The volatility of long-term rates implied in the prices of 10-year Bund futures options reflected the tensions on the financial markets. It rose rapidly from the summer of 2007 and in January 2008 was close to the peaks recorded in 2003 (Figure 15.2).

Corporate bonds and bank bonds

Issuance. – There was a substantial increase in issuance in 2007, despite a sharp downturn in the third quarter with the start of the international financial turmoil. Net Italian corporate bond issues rose to €90 billion in the year as a whole, compared with €77 billion in 2006 (Table 15.1). Net issues by banks and other financial corporations increased sharply in the fourth quarter and those by non-financial corporations also picked up, mainly thanks to Enel, involved in the acquisition of the Spanish electricity company, Endesa. Small and medium-sized enterprises made no net issues.

Table 15.1

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

VOCI	Net issues (2)			Stocks			As a % of GDP
	2005	2006	2007	2005	2006	2007	2007
Banks	41,502	60,371	63,904	484,370	544,742	617,849	40
Other financial corporations	27,951	13,156	15,985	154,531	167,666	174,238	11
Non-financial corporations	777	3,455	9,709	46,134	49,609	58,839	4
Total	70,230	76,982	89,598	685,035	762,017	850,926	55
Memorantum item:							
International market (3)	48,869	71,382	67,848	440,403	509,090	571,867	37

(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 values 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.

From August onwards, the international financial turbulence triggered a generalized upward repricing of risk, particularly that on asset-backed securities, causing issues of these to slow brusquely in the third quarter. Net Italian bond issues in connection with securitizations remained stationary at €37 billion and were concentrated in the first half of the year. The largest share related to sales of residential mortgage-backed securities by banks, while net bond issues by public sector entities and issues of CDOs remained extremely modest. There were no issues of covered bonds even though Italian banks have been allowed to issue these instruments since May 2007.

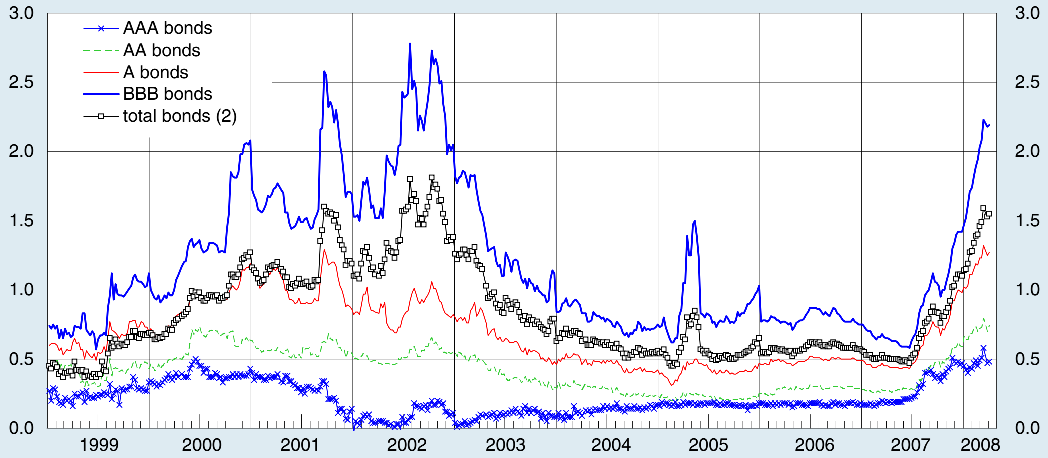
Despite the financial turmoil that began in the summer of 2007, issues of commercial paper doubled to €83 billion, mainly thanks to the UniCredit and Intesa Sanpaolo banking groups and Enel and ENI. Issuance by banks increased in the second half of the year, driven by the higher cost of longer-term funds and the persistent tensions on the interbank market.

Yields. – Corporate spreads on non-financial euro-denominated bonds rated at least BBB- or Baa3 (investment grade) rose by 1 percentage point in 2007, reaching 5.3 per cent. This was due not only to a generalized increase in risk-free yields, but also to the widening of the spread over government securities of comparable maturity from 0.6 to 1.1 percentage points in the second half of the year in response to the tensions in the credit market and the worsening of the macroeconomic outlook; the increase in the risk premium was particularly large for high-yield securities (Figure 15.3). In the first four months of 2008 the spreads on investment-grade securities widened further by half of a percentage point.

Figure 15.3

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, i.e. investment grade. The differentials are calculated with reference to French and German government securities of corresponding maturity. – (2) Includes all investment-grade bonds (i.e. rated at least BBB- or Baa3).

Spreads on the issues of Italian non-financial corporations remained in line with those on issues of other euro-area countries with comparable features: the premiums on CDSs issued by the leading Italian non-financial corporations followed a similar pattern. Throughout 2007 the spreads on bonds issued by the Fiat group remained narrower than those on other high-yield securities; in April 2008 a rating agency raised the company to the BBB- notch, the first of the investment-grade category. In the early months of 2008 there was a sharp rise in the premiums on CDSs and the spreads on securities issued by Telecom Italia; the latter were downgraded by a rating agency owing to uncertainty about the company's financial prospects and profits.

The premiums on CDSs on the leading Italian banks remained unchanged in the first half of 2007, before rising by around 0.3 percentage points later in the year, in line with the performance in the rest of the euro area. In 2008 they rose sharply until mid-March in response to the heightened international financial tensions culminating in the rescue of Bear Stearns, the US investment bank, before falling back two months later to a level slightly higher than at the beginning of the year but below the level registered for other euro-area banks.

The equity market

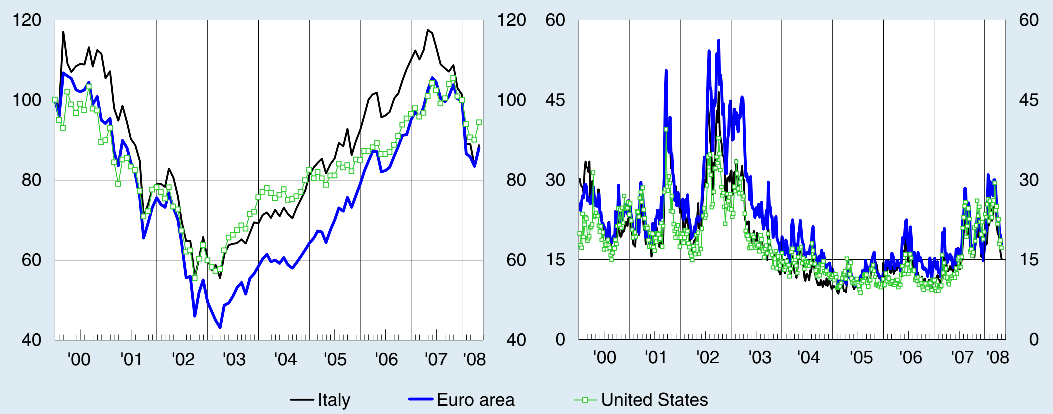
Share prices and trading. – At the end of 2007 the share prices of Italian companies were down 15 per cent from the peaks recorded in May, compared with a 6 per cent decrease for the leading euro-area companies (Figure 15.4). They declined further in the first quarter of 2008 in response to the growing financial turmoil and the deterioration in the international economic climate, but rose back slightly from the end of March as conditions on world financial markets eased somewhat. Nonetheless, the general index declined by 11 per cent between January and May of this year. Italian companies continued to pay generous dividends: on average in 2007 they were equal to 55 per cent of earnings, the same as in 2006 and more than 15 points higher than for the other euro-area companies.

Figure 15.4

Share markets

Indices (1)
(end-of-month data; 31 December 1999=100)

Expected volatility (2)
(end-of-week data; percentages)



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.

Substantial gains were posted on the Italian stock exchange by automobile and public utilities shares (15 and 5 per cent respectively), mainly owing to the performances of Fiat and Enel; oil companies' shares remained generally stationary. By contrast, share prices fell sharply for companies in the services (-24 per cent), basic materials (-19 per cent), telecommunications (-12 per cent) and banking sectors (-13 per cent). Prices of bank shares in Italy moved in line with those in the rest of the euro area, but the other sectors fared considerably worse. For the first time in four years the yield on shares listed in the STAR segment reserved for medium-cap firms that meet higher standards in terms of transparency for investors and corporate governance underperformed the general index (-15 per cent).

The prices of Italian equities were affected negatively by the performance of listed companies' current earnings, which did not come up to financial analysts' expectations. In the last quarter of 2007 they revised their profit growth expectations downwards for Italian companies in 2008 and 2009, while raising those for companies in the rest of Europe.

From the summer onwards, the volatility of Italian equities implicit in the prices of options on the stock exchange index showed a clear upward trend, similar to that in the euro area. By the end of the year it was higher than the average long-term value (Figure 15.4).

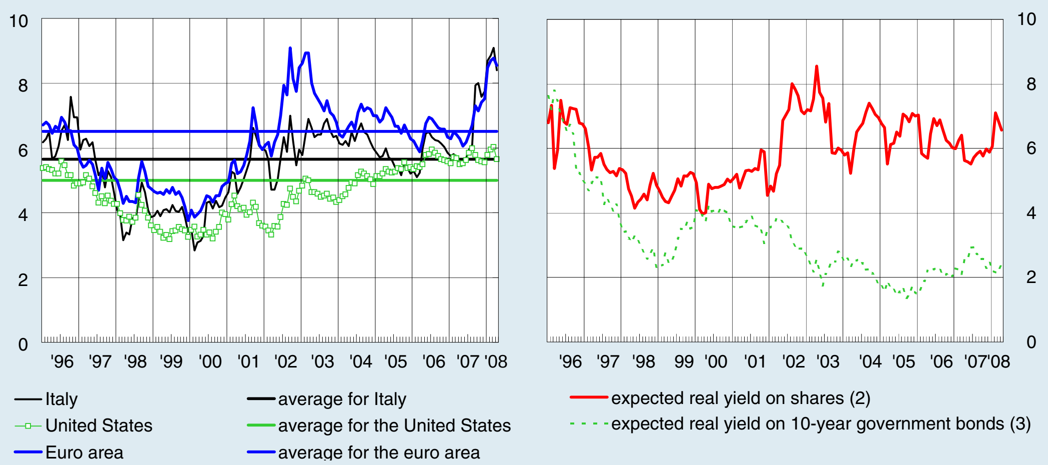
At the end of 2007 the price-earnings ratio of Italian shares was 7.8 per cent, against 5.9 per cent in 2006 (Figure 15.5). This was well above the average level recorded from the mid-1980s to date and indicated considerable caution on the part of investors in assessing the growth prospects of listed companies. During 2007 the expected real yield on shares, based on forecast earnings growth, was unchanged on average at 6.1 per cent, while that on 10-year government bonds rose from 2.2 to 2.5 per cent. The risk premium demanded by investors to hold shares, which was basically unchanged in 2007, rose brusquely in the first quarter of 2008 as the international financial tensions spread to all sectors of the stock market.

Supply and demand. – The financial turbulence did not cause a drop in IPOs, which continued at a rapid pace throughout 2007, although their average value diminished. Thirty-two new companies made IPOs, compared with 21 in 2006, including 10 in the STAR segment and 11 in the Expandi segment for small and medium-sized enterprises. Total fund-raising by the newly-listed companies amounted to €4.4 billion, against €4.8 billion in 2006, while companies already listed made additional share issues worth €3.9 billion, compared with €5.1 billion in 2006. New listings in the euro area increased considerably, from 202 to 212, and raised €31 billion, compared with €34 billion in 2006.

Figure 15.5

Current price-earnings ratios (1)
(end-of month data; percentages)

Expected real yields on Italian shares and Italian government bonds
(monthly data; percentages)



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

At the end of the year 300 companies were listed on the Italian stock exchange, up from 284 twelve months earlier (Table 15.2). Despite the new offerings, the fall in share prices led to a decrease in the total capitalization of Italian companies, from €779 billion to €734 billion and from 53 to 48 per cent of GDP. The ratio to GDP was 59 per cent in Germany, 103 per cent in the four Euronext countries (Belgium, France, the Netherlands and Portugal), 140 per cent in the United Kingdom and 144 per cent in the United States.

Directive 39/2004/EC, the Markets in Financial Instruments Directive (MiFID), was transposed into Italian law in November 2007.

Table 15.2

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

	2002	2003	2004	2005	2006	2007
Annual change in prices (1)	-23.7	14.9	17.5	13.9	19.0	-8.0
Listed Italian companies (number at end of year)	288	271	269	275	284	300
of which: in the STAR segment	*41*	*40*	*46*	*70*	*75*	*81*
Total market capitalization (2)	457,992	487,446	568,901	676,606	778,501	733,614
as a percentage of GDP	*36.3*	*37.5*	*43.1*	*49.3*	*52.8*	*48.0*
percentage breakdown: (3)						
industrials	*25*	*23*	*23*	*26*	*29*	*31*
insurance	*11*	*12*	*12*	*12*	*10*	*10*
banking	*22*	*26*	*25*	*32*	*33*	*30*
finance	*3*	*4*	*3*	*4*	*4*	*4*
services	*39*	*35*	*37*	*26*	*24*	*25*
Total	100	100	100	100	100	100
Gross share issues (4)	3,894	8,710	3,197	12,599	6,098	4,413
of which: in the STAR segment	*264*	*26*	*89*	*279*	*290*	*409*
Market value of newly-listed companies (5)	5,142	1,412	5,999	6,405	12,919	11,178
of which: foreign companies	*2.067*	*..*	*..*	*..*	*..*	*..*
of which: in the STAR segment	*..*	*..*	*..*	*797*	*3,620*	*3,881*
Dividends distributed (6)	18,650	17,030	21,849	22,907	28,317	30,625
Earnings/price ratio (7)	5.9	6.4	6.0	5.2	5.9	7.8
Dividend/yield (7)	3.8	3.4	3.4	3.0	3.2	3.7
Turnover						
spot market (8)	*572,940*	*580,703*	*641,376*	*893,853*	*1,078,390*	*1,489,868*
S&P/MIB index futures (9)	*673,836*	*527,024*	*467,122*	*585,445*	*761,580*	*954,524*
S&P/MIB index options (9)	*176,513*	*153,998*	*152,839*	*209,526*	*262,312*	*368,966*
Turnover ratio (10)	109	123	121	144	148	197

Sources: Borsa Italiana, Mediobanca and Thomson Financial Datastream.
(1) Percentage change in the MIB index over the year. – (2) End-of-period data. Italian companies. – (3) Does not include 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) Sources: To the end of 2003, Mediobanca; from 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.

The number of companies listed in Borsa Italiana's MTA International segment dedicated to the trading of shares of high-cap foreign companies already listed on other exchanges increased from 21 to 35 during 2007. In the first half of the year trading began on the *Mercato Alternativo del Capitale* (MAC) reserved to institutional investors and providing a platform for shares of Italian SMEs with simplified listing and prospectus requirements. At the end of the year three companies were listed on this segment. The ETF market continued to expand at a rapid pace.

The merger of Borsa Italiana and the London Stock Exchange Group was completed in October, creating Europe's leading exchange in terms of total capitalization and volume of trades. During the first stage the two exchanges will be managed separately; however, the group's organization envisages the progressive integration of various activities, including IT systems and settlement of trades, in order to improve efficiency and obtain economies of scale.

16. THE INSTITUTIONAL INVESTORS

In 2007 Italian institutional investors' consolidated net fund-raising was negative by €68 billion (Table 16.1). Their net assets declined by 6.8 per cent to €1,031 billion, or from 75 to 67 per cent of GDP. The contraction involved all the main forms of asset management: investment funds, individually managed portfolios and life insurance policies. The portion of total household financial assets managed by institutional investors declined from 30.1 to 27.9 per cent.

Table 16.1

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

	Net flows		End-of-period stocks			
	2006	2007 (1)	2006	2007 (1)	Percentage composition	
					2006	2007 (1)
Investment funds (2)	-39,068	-49,652	391,205	349,253	27.7	26.0
Insurance companies (3)	18,523	-7,492	436,480	428,988	30.9	32.0
Pension funds (4)	2,603	4,028	37,258	41,286	2.6	3.1
Individually managed portfolios	26,709	-26,409	547,631	520,684	38.8	38.9
Total	**8,767**	**-79,525**	**1,412,574**	**1,340,211**	**100.0**	**100.0**
Consolidated total (5)	**-8,681**	**-68,107**	**1,105,704**	**1,030,683**	**–**	**–**
as a percentage of GDP	*-0.6*	*-4.4*	*74.7*	*67.1*	–	–

Sources: Based on Bank of Italy, Isvap, ANIA and Covip data.
(1) Provisional. – (2) Italian investment funds and SICAVs. – (3) Technical reserves. – (4) Balance sheet assets. – (5) Net of investments in Italian collective investment undertakings by the other categories of intermediary, investments by insurance companies and pension funds in portfolios individually managed by asset management companies, and the technical reserves of insurance companies deriving from the management of open pension funds.

The net outflow of savings from Italian institutional investors in 2007 was due in part to the worsening of financial market conditions during the second half of the year. The increase in volatility and the fall in share prices spurred a reallocation of households' portfolios towards low-risk assets, which, as in similar phases in the past, was carried out mainly through direct investment in bonds and government securities and the holding of long-term deposits. In addition, the Italian asset management industry continued to suffer from the sharp contraction of the investment fund sector, under way for a number of years.

The outflow of resources from harmonized Italian investment funds remained substantial. In contrast with the previous years, net fund-raising was also negative for foreign funds controlled by Italian intermediaries. For hedge funds, closed-end securities funds and closed-end real-estate funds, subscriptions continued to exceed redemptions. Further growth was achieved by exchange-traded funds (ETFs), with their low costs and high liquidity.

Individually managed portfolios recorded a net outflow of funds in 2007. The premium income of life insurance companies fell for the second consecutive year, reflecting the decline in premiums on with-profits policies and capitalization contracts.

The growth of pension funds received a boost from the new rules on supplementary retirement provision that took effect in January 2007. According to Covip estimates, in 2007 the ratio of the number of private-sector workers in supplementary plans to the number of potential participants rose by 10 percentage points to 25 per cent. Enrolment rates nonetheless remain relatively low, especially among younger workers, women and the self-employed. Resources under management at the end of the year amounted to about 3 per cent of GDP, still well below the level in the other main industrial countries.

Investment funds

Fund-raising and net assets – Italian investment funds registered net redemptions of €49.7 billion last year, up from €39.1 billion in 2006 (Table 16.2). After years of strong growth, foreign funds controlled by Italian intermediaries recorded a net outflow (€3.2 billion).

Table 16.2

Italian investment funds: market structure (1)
(number of funds and millions of euros)

	Number of funds (2)		Net assets		Net fund-raising	
	2006	2007	2006	2007	2006	2007
Harmonized open-end funds	836	802	309,493	260,120	-49,891	-50,951
Equity	346	309	68,770	51,055	-12,133	-17,315
Balanced	63	59	29,023	22,745	-2,938	-6,346
Bond	302	281	121,255	92,611	-36,848	-29,361
Money-market	40	37	67,008	71,052	-7,079	2,133
Flexible	85	116	23,437	22,657	9,107	-62
Non-harmonized open-end funds	417	454	62,135	63,701	7,735	-1,314
Hedge funds	204	243	23,592	30,393	5,543	5,354
of which: funds of funds	*191*	*219*	*22,411*	*28,352*	*4,906*	*4,837*
Other	213	211	38,543	33,308	2,192	-6,668
of which: funds of funds	*137*	*132*	*22,986*	*17,585*	*768*	*-5,392*
Total open-end funds	**1,253**	**1,256**	**371,628**	**323,821**	**-42,156**	**-52,265**
Closed-end securities funds	74	98	3,182	3,883	273	319
of which: reserved to qualified investors	*60*	*85*	*2,484*	*3,335*	*377*	*570*
Closed-end real-estate funds	118	173	16,395	21,549	2,815	2,294
of which: reserved to qualified investors	*90*	*143*	*9,178*	*13,945*	*2,007*	*2,091*
Total closed-end funds	**192**	**271**	**19,577**	**25,432**	**3,088**	**2,613**
Total	**1,445**	**1,527**	**391,205**	**349,253**	**-39,068**	**-49,652**
Memorandum item:						
Foreign funds controlled by Italian intermediaries (3)	742	784	202,553	201,918	11,781	-3,153
of which: hedge funds	*20*	*28*	*5,780*	*7,143*	*898*	*685*

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 net assets of Italian investment funds fell by 10.7 per cent to €349 billion, mainly as a result of the volume of net redemptions, while those of foreign funds controlled by Italian groups remained virtually unchanged at €202 billion.

In contrast with the previous years, investment funds' fund-raising was also down sharply or turned negative in the other main European countries. Harmonized funds in Germany recorded net redemptions of €13.6 billion and in France of €28.8 billion, while those in Luxembourg and the United Kingdom saw the net inflow of resources decline by €52.9 billion and €27.2 billion respectively.

As in the previous year, almost all of the redemptions recorded by Italian investment funds were attributable to harmonized funds and involved all categories except money-market funds, which began to see renewed net inflows in the second half of 2007 in concomitance with wide fluctuations in securities prices. Among non-harmonized funds, there was a further net inflow of resources to hedge funds, closed-end securities funds and closed-end real-estate funds.

In the first few months of 2007 the net redemptions of investment fund units reflected households' increased preference for direct investment in government securities at a time of rising real interest rates on government paper. In the subsequent months they reflected the strong flow of households' savings towards less risky assets in response to the financial market turbulence triggered by the US subprime mortgage crisis; an additional factor was banks' decision to sell a larger portion of their own bonds to customers.

After expanding strongly in the second half of the 1990s, the total net fund-raising of investment funds managed by companies controlled by Italian intermediaries suffered a sharp slowdown, owing in part to the increase in the volatility of share prices in the first few years of the decade. Between 2001 and 2005 net redemptions of units of harmonized Italian funds amounted to €75 billion; almost all of this outflow was counterbalanced by net subscriptions of units of harmonized foreign funds controlled by Italian intermediaries. The significant change in the composition of total fund-raising is ascribable to the more favourable tax treatment of foreign funds and management companies compared with Italian ones. In 2006-07 the net outflow of resources from harmonized Italian funds amounted to €101 billion, against a net inflow of only €7 billion to foreign funds.

Financial intermediaries, most notably banks, play an important role both in the ownership structures of fund management companies and in the distribution of units of Italian investment funds. At the end of 2007, management companies controlled by one or more Italian banks accounted for 82 per cent of the total net assets of open-end Italian funds and those controlled by insurance companies for just 3.5 per cent; foreign intermediaries' share amounted to 8 per cent. In 2007 the share of banks' branch networks in gross fund-raising was virtually unchanged, standing at 77 per cent.

Supply. – The number of harmonized open-end funds continued to diminish in 2007 as a result of mergers between management companies, whereas that of hedge funds and closed-end securities and real-estate funds rose further (Table 16.2). In the last four years hedge funds' and closed-end funds' shares of the total net assets of Italian investment funds increased respectively from 1.4 to 8.7 and from 1.4 to 7.3 per cent.

Hedge funds have expanded significantly in Italy in the last four years, their number rising from 81 to 243 and their assets from €5.8 billion to €30.4 billion. Nearly all of these assets are in funds that invest in units of other funds (largely foreign hedge funds); the "fund of funds" structure makes it easier for subscribers to diversify risk and to monitor the individual funds in their portfolios. The same period also saw appreciable growth in closed-end funds, largely reserved to qualified investors: the number of closed-end real-estate funds rose from 19 to 173 and their net assets from €4.4 billion to €21.5 billion, while the number of closed-end securities (private equity) funds increased from 35 to 98 and their net assets from €1.4 billion to €3.9 billion.

Asset allocation. – Against the large volume of net redemptions, harmonized Italian funds made net disposals of securities worth €36 billion (€38.9 billion in 2006). The concentration of new subscriptions in money-market funds and the financial market turbulence were reflected in net purchases of BOTs and CTZs and substantial disposals of shares and long-term debt securities. The volume sold was especially large for Italian and foreign shares, whose portions of the total portfolio fell by 1.1 and 2.5 percentage points respectively to 5.6 and 21.9 per cent. The share of total foreign assets declined from 54.4 to 51.2 per cent; that of euro-denominated securities rose from 79.3 to 82.8 per cent.

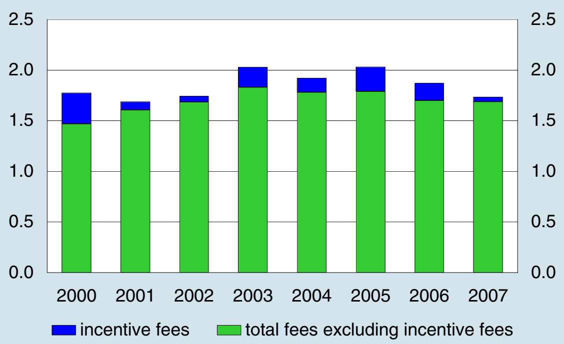
Yields and fees. – In 2007 the average yield on harmonized Italian investment funds net of taxes and fees was practically nil (0.3 per cent). The returns on equity funds were negative by 1.6 per cent and those on balanced funds by 0.6 per cent; money-market, bond and flexible funds turned in better results (2.7, 1.3 and 0.3 per cent respectively). Although Italian investment funds' direct exposure to structured securities and bonds issued in securitization transactions was limited as a whole, their performance in the second half of the year was affected by the broad decline in the main stock exchange indices after the eruption of the subprime mortgage crisis in the United States.

The total fees charged to harmonized investment funds (management fees, incentive fees, fees paid to depositary banks, securities brokerage commissions and other minor items) – which are ultimately borne by subscribers – amounted to €3.8 billion, of which €3.4 billion went to fund management companies. The ratio of total fees to average annual net assets was 1.7 per cent (Figure 16.1), with a decrease of 0.1 percentage points due entirely to incentive fees. The total annual fees borne by subscribers of ETFs are substantially lower; according to Borsa Italiana, at the end of April 2008 they averaged 0.44 per cent of net assets.

Of the total fees paid to management companies by open-end funds in 2007, 74 per cent

Figure 16.1

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. For continuity with the data for 2000-02, securities brokerage commissions are excluded. The data relate to harmonized investment funds and SICAVs. The data for the last two years are provisional.

went in retrocession to distribution networks (placement and maintenance fees); the percentage rises to 78 per cent for management companies controlled by Italian banks. The retrocession payments to distribution networks were equal on average to 1 per cent of net assets under management (0.8 per cent for the period 2000-07); for management companies controlled by Italian banks, the proportion was 1.1 per cent (0.9 per cent in 2000-07).

Individual portfolio management

In 2007 there was a net outflow of €26.4 billion of savings from individually managed portfolios, the first negative outcome on record since statistics began to be collected on this sector in the early 1990s. Total assets under management fell by 4.9 per cent to €521 billion.

As with investment funds, in the case of individually managed portfolios the outflow of funds, which was concentrated in the fourth quarter, reflected portfolio reallocation by households. An additional factor was the low average returns achieved by individual portfolio management services during a phase marked by the broad decline of prices on the main international stock exchanges.

The average financial result of individually managed portfolios (measured as the percentage increase in net assets less net fund-raising) was virtually nil, compared with 1.6 per cent in 2006. Portfolio managers made net disposals of securities worth €28 billion, most notably Italian and foreign investment fund units. The share of investment funds in individually managed portfolios fell from 40.8 to 36.9 per cent.

Insurance companies

In 2007 the premium income of insurance companies decreased by 7 per cent to €99.1 billion. This outcome was due entirely to the life sector, whose premium income declined by 11.4 per cent, from €69.4 billion to €61.4 billion; the sharp fall in premiums from with-profits policies and capitalization contracts (down by 17.3 and 50 per cent, respectively) was offset only in part by the 6.1 per cent growth in premiums from unit- and index-linked policies, whose share of total life premium income rose by 7.8 percentage points to 47.3 per cent. At the same time, there was an increase in applications for early surrender of policies, most markedly in the case of capital redemption contracts.

Insurance companies' technical reserves fell by 1.7 per cent to €429 billion. Reserves in the life sector declined by 3.7 per cent, while those in the non-life sector rose by 9.5 per cent.

In 2007 and the first four months of 2008 the share prices of Italian insurance companies fell by 14 per cent, in line with the decline recorded by insurance shares in the euro area as a whole. The performance of insurance shares reflected both investors' fears regarding possible asset write-downs as a consequence of the crisis in the financial markets and the negative results for premium income of the life sector.

Pension funds

In 2007 the assets managed by pension funds grew by 10.8 per cent to €41.3 billion (about 3 per cent of GDP), thanks above all to the €3.1 billion increase in the assets of the funds set up after the 1993 reform (Table 16.3).

Table 16.3

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

	2006				2007 (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	**4,012**	**3,072**	**940**	**3,600**	**4,531**	**3,134**	**1,397**	**3,005**
Securities portfolio	**28,315**	**16,334**	**11,980**	**11,635**	**31,603**	**16,900**	**14,703**	**13,342**
Bonds	17,418	9,759	7,659	8,405	20,050	10,269	9,782	9,973
Shares	4,917	1,968	2,949	1,495	5,206	1,798	3,408	1,483
Investment fund units	5,980	4,607	1,372	1,735	6,347	4,833	1,513	1,886
Mortgage loans and other financial assets	**2,282**	**2,332**	**-50**	**4,989**	**2,528**	**2,629**	**-101**	**4,635**
Real estate	**2,649**	**2,649**	**–**	**9,721**	**2,623**	**2,623**	**–**	**9,647**
Total assets	**37,258**	**24,388**	**12,870**	**29,945**	**41,286**	**25,287**	**15,999**	**30,629**

Sources: Based on data from the 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.

The new legislation on supplementary retirement provision (Legislative Decree 252/2005) entered into force ahead of schedule on 1 January. Starting in the second half of 2007, flows of accruing severance pay have been assigned to supplementary retirement schemes in the absence of a choice to the contrary by the worker. In addition, significant tax benefits were introduced and the regulatory framework was strengthened.

Private-sector payroll workers had six months starting from January 2007 (for newly-hired workers, six months from the date of hiring) to decide whether to keep their accruing severance pay with their employer or have it paid into a supplementary retirement scheme (occupational pension fund, open pension fund or individual retirement insurance policy). If workers opt to keep their accruing severance pay with the employer, the company can continue to set it aside if it has fewer than 50 employees; otherwise, it must pay it into a special fund set up at INPS (Fondo della Tesoreria). Where workers do not make an explicit choice, accruing severance pay is to be paid into the guaranteed subfund of the supplementary retirement scheme for their industry or, if one is lacking, into a new pension fund set up at INPS (FondInps), whose objective is to achieve returns at least equal to those that companies' severance pay provisions would have obtained.

According to Covip data, in 2007 the total number of workers subscribing to supplementary retirement schemes increased from 3.2 to 4.5 million (Table 16.4). The number of workers who did not make an explicit choice (for whom the reform provides for enrolment by default) was very low. Membership increased in all the types of supplementary scheme. At the end of the year 44 per cent of all those enrolled had signed up with occupational pension funds, 26 per cent with individual insurance-type retirement schemes, 16 per cent with open pension funds and 14 per cent with pension funds set up before 1993.

Table 16.4

Supplementary retirement schemes: market structure (1)
(amounts in millions of euros)

	Number of funds (2)		Number enrolled (3)		Total assets	
	2006	2007	2006	2007	2006	2007
Pension funds set up after the reform of 1993	126	123	1,659,858	2,734,583	12,784	15,898
Occupational funds	42	42	1,219,372	1,988,639	9,257	11,599
Open funds	84	81	440,486	745,944	3,527	4,299
Pension funds set up before the reform of 1993	448	433	649,519	650,000	24,388	25,287
Individual retirement insurance policies	–	72	876,000	1,133,147	4,546	5,805
Total	**–**	**628**	**3,185,377**	**4,517,730**	**41,718**	**46,990**

Source: Based on Covip data.
(1) Excludes FondInps and the Bank of Italy and UIC staff pension funds. – (2) The data for individual retirement policies and the total only include retirement policies compliant with the requirements of Legislative Decree 252/2005. – (3) For funds set up before the 1993 reform, estimates.

During the year the growth in enrolment was particularly significant among the categories of workers, such as younger workers, women and the self-employed, who in the future will have the greatest need to supplement the resources deriving from the public pension system. Nonetheless, the membership rates among these categories are still low.

Yields and fees. – According to Covip data, in 2007 the average yield of pension funds (net of taxes and management fees) was 2.1 per cent for occupational funds (3.8 per cent in 2006) and -0.4 per cent for open funds (2.4 per cent in 2006). These returns reflected the fall in prices on the main international stock exchanges, which had a stronger impact on the yield of open funds, characterized by a high proportion of equity subfunds. At the end of 2007 shares made up about one quarter of the portfolios of occupational funds and practically one half of those of open funds. The yield gap between the two categories of fund was also affected by the differences in management expenses. Open funds have higher fund-raising costs than occupational funds and, unlike the latter, do not benefit from possible employer contributions to expenses.

The market in pension fund asset management services is highly concentrated. According to data from Mefop S.p.A., a company created to foster the development of pension funds, at the end of September 2007 the resources of occupational pension funds were entrusted to 33 management companies; the top five accounted for nearly 50 per cent of total resources.

Despite the recent changes introduced in the governance of supplementary retirement schemes by Legislative Decree 252/2005, there are still problem areas concerning the roles and powers of the management and control bodies and the resolution of conflicts of interest. As regards occupational pension funds, potential conflicts of interest can arise from the fact that the position of person responsible for the fund, with powers of oversight in respect of the executive body, can be held by the fund director. On the other hand, for open pension funds based on collective enrolment, the supervisory body is normally composed of two members appointed by the bank, asset management company, securities firm or insurance company that instituted the fund, with no representation of fund members.

The market for annuities. – By purchasing an annuity, savers can convert the capital accumulated during their working career into a regular flow of payments after retirement, transferring their longevity risk to the insurance company. Savers can purchase an annuity directly from an insurance company or under agreements between insurance companies and pension funds. The current rules, with some exceptions, require pension fund members to convert at least 50 per cent of the capital accrued into an annuity.

The number of annuities connected with supplementary retirement schemes is small, since the new pension funds have still not fully entered the payout phase. The market in individual annuities is underdeveloped too: demand for these products is low, since the public pension system has delivered relatively generous benefits until now; another deterrent may be the difficulty of evaluating the advantageousness of the products purchased.

17. CREDIT INSTITUTIONS

The activity of Italian banks in 2007 was shaped by the increase in official rates until June and, in the second half of the year, by the crisis triggered by subprime mortgages in the United States. The overall direct and indirect exposure of Italian banks to financial assets linked to subprime mortgages was modest; the turmoil in the financial markets affected the cost and composition of their borrowed funds. The effects of the deterioration in the business cycle were milder.

The ratio of bank lending to GDP rose by 5 points to 109 per cent. Credit to firms and households continued to grow very rapidly; default rates remained at the low levels recorded in the last eight years. The slowdown in transactions in the real-estate market had limited consequences, visible mainly in slower growth in lending to construction firms and estate agents. The volume of new mortgage loans granted to households again increased slightly from the very high level of 2006.

Information from the Italian banking groups participating in the Eurosystem's Bank Lending Survey indicates that lending conditions for firms were tightened slightly in the second half of the year, with spreads increasing mainly for those with the highest risks. In the first few months of 2008 banks reported a further tightening of conditions for firms and more restrictive terms for mortgage loans to households as well.

The shift of the forward yield curve made it more rewarding for households to invest in longer-term savings instruments, thus squeezing the demand for deposits. From the summer onwards the sharp fall in demand in the international markets for private debt securities and the rise in risk premiums made it particularly difficult and costly for banks, including Italian institutions, to raise wholesale funds by issuing bonds. Domestic issues increased and bond coupons rose. Overall, the unit cost of funding rose by 0.8 percentage points.

In 2007 the return on capital (ROE) of banks operating in Italy, calculated on the basis of unconsolidated balance sheets, fell by 2.3 percentage points to 9.5 per cent, after having risen every year since 2002. The fall can be ascribed to slow growth in profits, due in part to the turmoil in the financial markets, and to an increase in capital resources.

Assets

Lending. – Lending to residents by Italian banks increased by 10.1 per cent in 2007 (Table 17.1), similar to the rate of growth recorded in the euro area. There was a slight slowdown in bank lending in Italy by comparison with the preceding year, reflecting partly the accounting effects of the assignment of loans and partly slower growth in lending to households. By contrast, loan demand from the business sector remained strong, especially for medium and long-term credit. The slowdown in lending spread to firms in the first quarter of 2008.

Table 17.1

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. 2006	Dec. 2007	Mar. 2008	2007				2008	December 2007
				Q1	Q2	Q3	Q4	Q1	
Assets									
Securities	5.3	7.3	18.8	3.0	8.7	-18.0	43.6	55.0	236,833
of which: government securities	3.8	-1.0	-1.6	5.9	3.1	-31.2	29.1	2.4	114,393
Loans	11.5	10.1	9.6	11.5	9.3	8.2	11.8	9.7	1,678,166
of which: (3)									
short-term (a)	*10.5*	*8.1*	*11.2*	*6.5*	*6.0*	*10.4*	*10.7*	*19.2*	*516,963*
medium and long-term (b)	*11.6*	*11.7*	*10.1*	*11.2*	*12.1*	*11.2*	*12.4*	*5.1*	*936,347*
(a)+(b)	*11.2*	*10.4*	*10.6*	*9.4*	*9.9*	*10.9*	*11.8*	*10.2*	*1,453,310*
bad debts (4)	*3.8*	*1.1*	*1.5*	*8.9*	*2.0*	*4.3*	*-10.0*	*11.0*	*47,434*
External assets	19.8	12.6	6.5	38.5	25.1	2.4	-9.5	11.2	375,498
Liabilities									
Total funding	13.2	11.1	10.4	15.6	17.3	2.1	10.6	11.8	2,169,762
Deposits from residents of Italy (5)	8.3	4.2	5.5	5.9	2.2	2.4	7.9	9.3	1,045,218
of which: (6)									
current accounts	*6.7*	*2.9*	*4.4*	*1.5*	*4.4*	*4.6*	*1.5*	*7.1*	*647,499*
with agreed maturity	*9.8*	*14.3*	*23.7*	*-8.6*	*6.6*	*18.8*	*47.3*	*25.3*	*51,031*
redeemable at notice	*-0.8*	*-0.5*	*2.4*	*-3.1*	*-4.9*	*-1.9*	*15.0*	*8.7*	*227,821*
repos	*29.4*	*12.1*	*4.6*	*55.6*	*-9.3*	*-12.0*	*27.9*	*15.7*	*105,342*
Bonds (7)	12.5	11.9	14.7	13.1	12.3	7.0	15.5	24.8	618,054
External liabilities	25.6	22.9	13.4	40.4	57.1	-3.6	7.2	1.8	506,490

(1) The figures for March 2008 are provisional. Unless otherwise indicated, from October 2007 onwards the data include those reported by Cassa Depositi e Prestiti S.p.A. 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) The stock figures are net of loans granted by Cassa Depositi e Prestiti S.p.A. 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) Deposits from customers resident in Italy other than MFIs. – (6) Excludes those of central government. – (7) Includes bonds held by non-residents.

Whereas lending by banks belonging to large groups slowed down, the volume of loans granted by local banks ("small" and "minor" banks in the Bank of Italy classification, excluding those belonging to groups and the branches of foreign banks) continued to expand very rapidly. Business by the branches of foreign banks was also particularly brisk; their market share increased from 6.1 to 7.1 per cent, especially in the arrangement of finance for large industrial groups.

Lending to firms. – With self-financing at a low ebb, lending to non-financial companies continued to increase rapidly in 2007, rising by 12.9 per cent. As in the preceding year, the growth in credit to firms with 20 or more employees remained strong (13.6 per cent). In the first half of the year the increase in lending to large firms, across all the main branches of activity, contributed to financing many mergers and acquisitions; in the second half it reflected mainly the financing of an acquisition in the energy sector. Lending to small firms continued to increase much more slowly, at a similar rate to that recorded in 2006 (6.4 per cent).

Lending to manufacturing industry rose by 6.6 per cent in 2007, the same rate as in the previous year. It increased somewhat faster for firms producing metal products, agricultural and industrial machinery and transport equipment, where the growth in production and investment held up rather better.

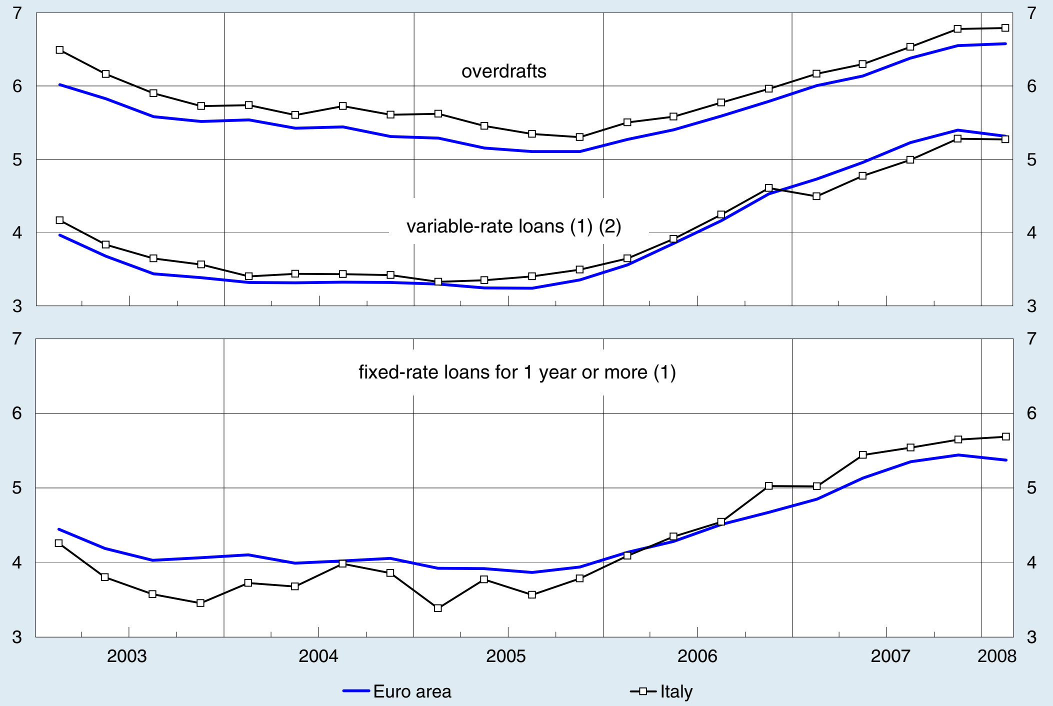
The downturn in the real estate market affected the growth in credit to certain categories of firm. Lending to construction firms continued to increase rapidly, but the pace slackened towards the end of the year. The slowdown in lending to firms providing real-estate services was more pronounced and explains much of the fall in the rate of growth of credit to the services sector.

In 2007 interest rates on loans to firms continued to rise, adjusting with the usual lag to increases in official rates (Figure 17.1). The increase in the cost of bank credit for Italian firms mirrored the rise in the euro-area average. Rates on new loans other than overdrafts rose to 5.5 per cent and those on overdrafts to 6.8 per cent.

Figure 17.1

Interest rates on bank loans to firms

(quarterly data)



Source: Based on ECB data.
(1) New loans. – (2) Variable rate or renegotiable within one year.

The quality of credit to Italian firms remained broadly the same as in 2006 and in line with the levels recorded since the end of the 1990s: the flow of new bad debts equalled 1 per cent of outstanding loans, compared with 1.1 per cent in 2006.

The current weakness of the business cycle and the high exposure to the risk of interest rate changes could in future translate into a rise in the rate of corporate default. At the end of 2007 84 per cent of the stock of medium and long-term loans was indexed to market rates. Around 90 per cent of all credit to firms, at short, medium and long term, is at indexed interest rates. The exposure to interest rate risk is even higher in the construction sector.

Lending to households. – In 2007 lending to consumer households grew more slowly than in the previous year, but the rate of increase was still substantial (8.7 per cent, compared with 10.7 per cent in 2006); if loans taken off banks' balance sheets as a result of assignment are taken into account, the slowdown was less marked, from 13.7 to 12.9 per cent. The effects of the cooling of the real-estate market have been modest so far.

Signs of a significant deterioration in lending conditions for house purchases did not emerge in the wake of the turmoil in the financial markets. The volume of new mortgages was similar in the two halves of 2007; for the year as a whole it amounted to €62.7 billion, the highest figure over the last decade and marginally higher than that recorded in 2006.

In the last two years the proportion of new variable-rate loans granted to families for house purchases has fallen by 37 percentage points, approaching the euro-area average of 43 per cent. However, the high percentage of variable-rate loans granted in the past means that the exposure of Italian households to the risks stemming from changes in market rates remains above the European average. At the end of 2007 variable-rate mortgages still accounted for 72 per cent of the total stock of mortgage loans.

The rise in interest rates prompted some borrowers who had taken out mortgages at indexed rates when money market rates had been particularly low to apply to their lender for revision of the terms under the new law on the early termination and portability of mortgages. According to a survey conducted by the Economic Research Units at the branches of the Bank of Italy among a sample of banks representative of lending conditions in the credit market, in 2007 more than 80 per cent of banks stated that they had renegotiated the contractual terms of mortgages taken out by households (the interest rate, the duration or the repayment arrangements, for example). The value of loans renegotiated, about one tenth of which involved borrowers in repayment difficulties, was equal to around 3 per cent of total mortgages outstanding. Moreover, 58 per cent of the banks interviewed indicated that they had offered mortgage loans to replace loans previously taken out with other lenders. The value of replacement mortgages can be estimated at close to 1 per cent of the outstanding stock.

In 2007 the rate of interest on new variable-rate mortgages rose by 0.8 percentage points to 5.5 per cent; in the euro area there was a similar increase to 5.3 per cent. The rise reflects the gradual adjustment of bank interest rates to the increase in official rates: since the end of 2005, when monetary policy began to be tightened, policy rates have risen by 2 percentage points and rates on variable-rate loans for house purchases by 1.9 points. Banks did not pass on to their customers the full amount of the increases in money market rates caused by the credit crisis; on an annual average basis, the differential between the one-month Euribor rate and the rate charged on variable-rate mortgages narrowed by 15 basis points. The cost of fixed-rate borrowing for terms of ten years or more increased by 0.6 percentage points to 5.9 per cent (compared with 5.2 per cent in the euro area), reflecting the increase in the cost of fund-raising and households' greater preference for loans of this kind.

In Italy the cost of both variable-rate and fixed-rate loans is higher than in the rest of the euro area. In the case of fixed-rate loans the differential widened in recent years to more than 1 percentage point in August 2006 before narrowing to 0.7 points at the end of 2007.

In 2007 consumer credit from banks and supervised financial companies grew more slowly than in 2006, but the rate of increase was still a considerable 13.8 per cent (Table 17.2).

Table 17.2

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

	Percentage changes on previous year			Outstanding 2007 (1)	Percentage of total
	2005	2006	2007 (1)		
			Loans for house purchases		
Total credit	18.0	12.3	8.9	243,155	100.0
up to 5 years	*-0.7*	*-19.8*	*-11.0*	*1,106*	*0.5*
over 5 years	*18.2*	*12.6*	*9.0*	*242,049*	*99.5*
			Consumer credit		
Total credit	19.4	17.9	13.8	97,044	100.0
of which: credit cards	*21.8*	*12.5*	*7.8*	*12,336*	*12.7*
for purchases of motor vehicles	*15.3*	*16.2*	*10.7*	*33,130*	*34.1*
Banks	17.2	12.7	5.4	49,790	51.3
of which: credit cards	*28.8*	*12.1*	*8.0*	*5,054*	*5.2*
for purchases of motor vehicles	*19.5*	*14.5*	*-0.8*	*13,652*	*14.1*
Financial companies	22.5	25.1	24.2	47,254	48.7
of which: credit cards	*17.4*	*12.7*	*7.6*	*7,282*	*7.5*
for purchases of motor vehicles	*11.9*	*17.7*	*18.5*	*19,478*	*20.1*
			Other lending		
Total credit	4.2	3.6	11.1	63,093	100.0

Source: Supervisory returns.
(1) Provisional.

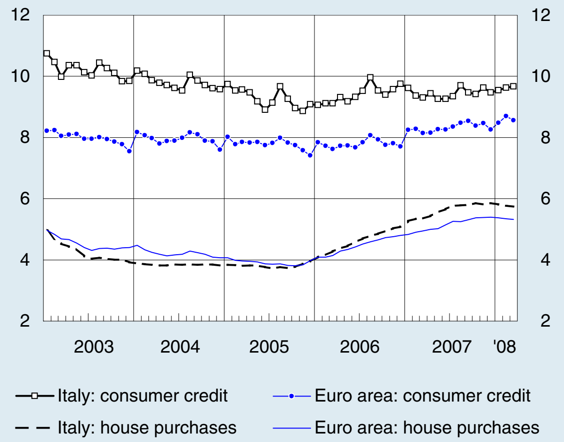
The annual percentage rate of charge (APRC) on new consumer credit granted by banks had been falling since August 2006, but in the summer of 2007 it began to rise again gradually, reaching 9.7 per cent in March of this year (Figure 17.2). The differential in relation to the average for the euro area, which had been more than two percentage points at the end of 2006, narrowed by 0.9 points.

The quality of credit to households remained high last year; the ratio of new bad debts to outstanding loans was 0.8 per cent, the same as in 2006. The expansion in the market in real-estate loans in recent years may have increased the financial vulnerability of households, especially in the lower income brackets, but without yet being reflected in an increase in bad debts.

The rise in property prices and in the loan-to-value ratio led to an increase in the average size of new mortgages; according to Central Credit Register data, for which the reporting threshold is €75,000, it rose from €125,000 in 2004 to €140,000 in 2007. The increase in interest rates from the end of 2005 onwards, at a time when the proportion of variable-rate borrowing was high, was reflected in a rapid increase in households' debt servicing costs. Analysis of Central Credit Register data on mortgage lending to households between 2004 and 2006 indicates that in the four years ending in 2007 3.5 per cent of borrowers were late with at least one repayment instalment and that 1.5 per cent were reported as a bad or impaired debt. With interest rates rising, the percentage of late payments was 3.8 per cent for variable-rate mortgages, compared with 1.8 per cent for fixed-rate loans.

Figure 17.2

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.

Securities. – At the end of 2007 the value of residents' and non-residents' debt instruments held by banks (excluding Cassa Depositi e Prestiti) amounted to €287 billion, €23 billion more than a year earlier but €4 billion less than at the end of the first half of the year. The contraction in the second half of 2007 occurred entirely in government securities, whose share of the total portfolio fell from 49.5 to 42.9 per cent. A contributory factor was strong household demand for such securities, which the banks encouraged. The ratio of liquid assets (cash and securities other than shares) to the sum of liquid assets and loans remained essentially unchanged, at 15.6 per cent, but the ratio that looks only at government securities fell by 0.5 points to 7.7 per cent.

Liabilities

In 2007 the Italian banking system's total funding – deposits from resident customers, bonds and fund-raising abroad – increased by 11.1 per cent, marking a slowdown from the previous year's rate of 13.2 per cent.

Deposits. – The rate of growth in deposits from customers resident in Italy, which account for almost half of overall funding, decreased from 8.3 per cent in 2006 to 4.2 per cent last year as a result of the fall in households' financial investment and portfolio adjustment in favour of securities, which offered a higher return. The slowdown affected primarily current accounts, which were penalized by an increase in the opportunity cost of holding liquid assets. The average interest rate paid by Italian banks on current account deposits rose by 0.5 points to 1.7 per cent; net of tax, the negative differential in relation to the issue yield on Treasury bills widened by 0.4 points on an annual average basis.

Bonds. – Bond issues by Italian banks, which increased by 11.9 per cent compared with 12.5 per cent in 2006, were affected by the financial crisis triggered by subprime mortgages, especially as regards the composition of subscribers.

The banks' ability to raise funds in international markets was greatly curtailed in the second half of the year; new bond issues on the Euromarket by euro-area banks totalled €157 billion, compared with €233 billion in the corresponding period of 2006. Italian banks were also affected, even though their overall exposure to American subprime loans was small. Between June and December their Euromarket bond issues came to €12 billion, well below the €30 billion recorded in the second half of 2006. The decrease involved the largest categories of bank ("major" and "large" in the Bank of Italy classification), for which the ratio of Euromarket issues to total gross issues fell to 40.9 per cent, compared with 61.1 per cent a year earlier; for the Italian banking system as a whole the ratio came down from 46.4 per cent in 2006 to 30.3 per cent in 2007.

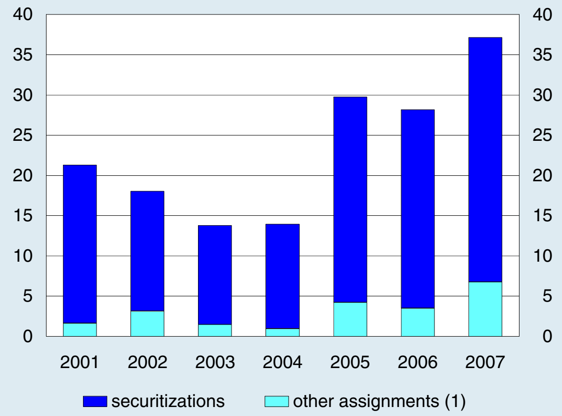
The slowdown in bond issues in the international markets was offset to a large extent by domestic issues, which also benefited from the reduction in households' subscriptions of investment fund units. The banks' issuance policies on the domestic bond market were reflected in an increase in coupons. The issue yield on variable-rate bonds rose by 114 basis points to 4.9 per cent and that on new fixed-rate issues by 69 basis points to 4.4 per cent. The differential between the remuneration on new variable-rate bond issues and that on Treasury credit certificates widened by more than 10 basis points. The differential between the yield on new fixed-rate issues and Treasury bonds, which is normally negative, narrowed from 40 to 10 basis points.

The interbank deposit market. – The change in investors' perception of risk following the US subprime mortgage crisis and uncertainty about the actual risk borne by the leading banking groups also affected cross-border interbank funding. Deposits from foreign banks and money market investment funds constitute more than one fifth of total fund-raising by the Italian banking system. In the second half of 2007 the rate of growth in this aggregate decreased but nevertheless remained high (25.8 per cent in 2007, compared with 41.7 per cent in the twelve months ending in June). The same period saw a contraction in interbank deposits intermediated on e-Mid, the screen-based market in money market deposits for terms of between one day and one year, together with a significant increase in interest rate volatility. Supervisory returns, which provide information on total interbank exposures outstanding at the end of each month, nevertheless show that total interbank liabilities between banks resident in Italy continue to expand, albeit more slowly since last summer. This change could reflect an increased propensity on the part of banks to provide each other with liquid funds by means of bilateral transactions, which remain confidential, rather than in organized markets. If both bilateral transactions and those settled on the screen-based market are considered, the structure of the domestic interbank market has changed little. The average number of counterparties for each debtor bank remains broadly unchanged at around 12 lending banks, as does the degree of concentration of the volume of deposits.

Figure 17.3

Loan assignments

(annual flows; billions of euros)



Source: Supervisory returns.
(1) Assignments of loans without recourse other than securitizations.

Loan assignments. – In recent years disposals of loans from banks' portfolios have helped finance the strong expansion in lending by Italian banks. In each year from 1999 to 2006 loan assignments averaged €19 billion, corresponding to about 7 per cent of medium and long-term loan disbursements. Despite the difficulties in the international markets, transactions in the secondary credit market involved a very high volume of loans in 2007, equal to €37 billion (€28 billion in 2006; Figure 17.3); the volume of loans assigned by banks in the fourth quarter was higher than in the same period of the preceding year.

The difficulties in placing on the market the securities issued by the vehicle companies that act as intermediaries in securitization operations had two consequences. First, the share of loans assigned directly by banks to non-bank intermediaries – a type of operation based on bilateral agreements between the assignor and the assignee that are not intended to lead to the issue of securities, in which the assigned loans act as the underlying – rose from 12 per cent in 2006 to 18 per cent. Secondly, a not inconsiderable share of the securities issued in connection with securitization operations was subscribed by banks belonging to the groups that were assigning the loans; in some cases the securities were used as collateral for refinancing operations with the Eurosystem.

Profit and loss accounts

This section presents an aggregate analysis of banks' unconsolidated profit and loss accounts. The findings make it possible to assess the profitability of the Italian banking system and differ from those on Italian banking groups analysed in Chapter 20: *Credit institutions and the impact of the turmoil in the financial markets*, since they exclude the income and costs of non-bank subsidiary companies and those of foreign subsidiaries; they do, however, include the results of banks not belonging to groups and the branches of foreign banks operating in Italy. Gross income approximates to the Italian banking industry's contribution to gross domestic product.

Net interest income grew by 7.3 per cent, compared with 10.5 per cent in 2006 (Table 17.3). The cost of hedging interest rate risk increased. Net of this component, the balance between interest income and interest expenses continued to rise at a sustained rate of 10.7 per cent owing to the expansion in the volume of business.

Table 17.3

Profit and loss accounts of Italian banks (1)

	2005	2006	2007	2006	2007
	As a percentage of total assets			**Percentage changes** (3)	
Net interest income (a)	1.41	1.43	1.36	10.5	7.3
Other net income (b) (2)	1.52	1.58	1.35	13.4	-3.3
				(10.7)	*(-4.4)*
of which: trading and fair-value valuation	*0.10*	*0.19*	*0.10*	*102.3*	*-40.7*
services	*0.82*	*0.79*	*0.70*	*4.6*	*0.1*
dividends and similar income (2)	*0.34*	*0.40*	*0.35*	*27.3*	*1.5*
				(16.7)	*(-2.6)*
Gross income (c=a+b) (2)	2.94	3.01	2.71	12.0	1.8
				(10.6)	*(1.4)*
Operating expenses (d)	1.74	1.72	1.57	7.6	3.5
of which: banking staff costs (3)	*0.93*	*0.92*	*0.87*	*8.0*	*7.0*
Operating profit (e=c-d) (2)	1.20	1.30	1.14	18.3	-0.6
				(15.2)	*(-1.8)*
Value adjustments, readjustments and allocations to provisions (f) (2)	0.31	0.27	0.30	-4.0	23.3
of which: in respect of loans	*0.18*	*0.17*	*0.17*	*1.9*	*16.6*
Extraordinary income (g)	0.03	0.06	0.18	139.0	217.5
Profit before tax (h=e-f+g) (2)	0.92	1.09	1.02	29.6	6.0
				(26.5)	*(5.4)*
Tax (i)	0.26	0.28	0.27	18.1	8.2
Net profit (h-i)	0.66	0.81	0.75	34.1	5.3
			Other indicators		
Net profit as a percentage of capital and reserves (ROE) (4)	9.9	11.8	9.5		
	Amounts			**Percentage changes**	
Total assets (millions of euros)	2,545,644	2,784,102	3,153,911	9.4	13.3
Average number of employees	337,441	338,724	341,949	0.4	1.0
of which: banking staff	*336,546*	*338,152*	*341,944*	*0.5*	*1.1*
Total assets per employee (thousands of euros)					
at current prices	7,544	8,219	9,223	8.9	12.2
at constant prices (5)	6,050	6,332	6,976	4.7	10.2
Staff costs per employee (thousands of euros)					
at current prices (6)	67.8	71.1	74.4	4.9	4.6
at constant prices (5) (6)	53.3	54.8	56.3	2.7	2.7
Memorandum items: (7)					
Total assets (millions of euros)	2,552,285	2,793,035	3,187,297	9.4	14.1
Total number of employees (8)	336,599	339,691	341,538	0.9	0.5
of which: banking staff (8)	*335,726*	*339,683*	*341,538*	*1.2*	*0.5*

(1) Rounding may cause discrepancies. The data for 2007 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.

Income from trading was strongly affected by the turmoil in the financial markets in the second half of 2007, falling by 40.7 per cent; income from this source had more than doubled in 2006.

Income from services remained broadly unchanged, whereas it had risen by 4.6 per cent the previous year. The fall in share prices and uncertainty in the financial markets depressed demand for professional asset management services, which was reflected in a decline in commission income. Income from collection and payment services declined owing to the increased use of payment instruments that are less costly for customers, such as electronic transfers, and to a fall in commission on transactions with banks other than the one holding the customer's current account. This effect is mainly attributable to the integration of the distribution networks of the large groups that have been formed recently.

Gross income, excluding dividends on bank shares, increased by 1.4 per cent, against 10.6 per cent in 2006.

Staff costs, excluding the cost of early retirement schemes and directors' fees, rose by 5.8 per cent (5.1 per cent in 2006). The number of banking staff increased by an annual average of 1.1 per cent. Staff costs per employee rose by 4.6 per cent to €74,400, reflecting allocations to provisions in respect of expected higher expenses under the new national labour contract for the sector.

Overall operating costs increased by 3.5 per cent, compared with 7.6 per cent in 2006. The rise was 4.8 per cent if the non-recurrent effects of the change in the criteria for calculating severance pay under the reform of supplementary pension provision are removed. Operating profit fell by 1.8 per cent.

Net value adjustments on assets and allocations to provisions increased by 23.3 per cent, absorbing around one quarter of operating profit. Factors in the increase were write-downs on securities in portfolios other than the trading portfolio, higher allocations to provisions for risks and charges and net value adjustments on loans. The latter rose by 16.6 per cent, reflecting the revision of criteria for assessing the quality of loans to customers by some banks, mainly those that were acquisition targets.

Extraordinary income more than tripled in 2006, to a large extent owing to the disposal of business units.

Profit after direct taxes rose by 5.3 per cent, compared with 34.1 per cent in 2006. ROE net of tax, which is obtained by adding in the net income of foreign branches, was 9.5 per cent (11.8 per cent in 2006), in line with the average over the last ten years.

PAYMENT SYSTEM AND FINANCIAL MARKET INFRASTRUCTURES AND SERVICES

18. THE PAYMENT SYSTEM

The turmoil in the money and financial markets since last summer has had no effect on the orderly, efficient working of the European payment system. An essential contribution to this result was liquidity injections by the central banks.

Last year and the first months of this saw fundamental progress towards the creation of a fully integrated euro area for payment execution and settlement. In the large-value segment, the new TARGET2 settlement system went operational as scheduled. In the retail segment, the Single Euro Payments Area (SEPA) project moved into the final phase with the possibility of executing cross-border payments using electronic instruments under the new pan-European standards.

Within the Eurosystem, the advance of integration was accompanied by the definition and initial application of new methodological and operational standards for the oversight function, based on joint analysis, assessment and intervention.

The Bank of Italy has made a wide-ranging contribution to the integration process: implementation and operation of pan-European payments platforms; adaptation of prevalently domestic systems; promotion of more efficient and secure payment services and instruments that serve the needs of firms, public administration and final users; and participation in the relevant fora for coordination to adapt European and national regulations to the new scenario.

The integration of European payment services and systems

TARGET2, the new trans-European payment and settlement system created and operated jointly by the Banque de France, the Bundesbank and the Bank of Italy on behalf of the Eurosystem, went operational on 19 November 2007. On that date the central banks and banking systems of Austria, Cyprus, Germany, Latvia, Lithuania, Luxembourg, Malta and Slovenia began using the new single shared platform (SSP) of TARGET2. On 18 February they were joined by Belgium, Finland, France, Ireland, the Netherlands, Portugal and Spain. The third and final contingent of countries, Italy among them, began using the system on 19 May.

With a view to the full phase-in, the Eurosystem evaluated TARGET2's fulfilment of oversight requirements, and a joint assessment by the ECB and national central banks found it to be in full compliance with the standards. A special information guide was prepared setting out the organizational criteria and purposes of cooperative oversight.

On 30 April 2008 the Governing Board of the Bank of Italy officially "designated" TARGET2 to replace the BI-REL real-time gross settlement system for the purposes of Legislative Decree 210 of 12 April 2001 on the finality of payment orders and settlement.

In January 2008 it became possible to make retail payments via credit transfers and payment cards meeting SEPA standards. The objective of the European Payments Council – the organization created by European banks to run the project – is to complete the migration from national to pan-European instruments and procedures by the end of 2010. However, the launch of the direct debit schemes has been deferred pending the member states' transposition – by 1 November 2009 – of the new Payment Services Directive 2007/64/EC of 13 November 2007.

The coexistence of national schemes with the new pan-European ones may prevent the full benefits of SEPA for the European economy from unfolding. A number of organizations (ECB, the European Commission, banking communities, business associations) have accordingly suggested setting a legal deadline for the definitive discarding of national products in favour of their SEPA counterparts.

The authorities and payment operators see considerable growth potential for innovative products. Prepaid instruments, for instance, could effectively replace cash for small transactions. Wider use of electronic payments can reduce banks' operating costs and lower charges to customers. If the use of these instruments is to be encouraged, fraud prevention remains fundamental, and banks must intensify their efforts in this sphere by adopting advanced technology.

European standards for oversight of retail payment services and instruments are being designed to increase their reliability and efficiency and so raise the level of customer confidence in these modern, secure means for payment execution. The principles and overall methodology for oversight of payment card schemes have been established.

Keeping step with developments in retail payments, the Bank of Italy has adapted its BI-COMP clearing system to SEPA requirements. To make more alternative channels available for the execution of SEPA-compliant credit transfers, on 28 January the Bank launched its BI-COMP "routing" service for foreign counterparties that belong to the European STEP2 system and signed interoperability agreements with other European retail clearing and settlement systems. Since 8 April BI-COMP has been interoperable with the Dutch Equens system, one of Europe's leading retail payment systems, allowing Italian banks, without joining, to reach its participants to send and receive SEPA credit transfers.

Integration has been sustained by significant European regulatory developments. The Payment Services Directive for the internal market establishes a uniform legal framework for retail payment services within the Union. It will stimulate competition in the market for payment services, which will gain new operators and new products. The Commission has also taken further steps to rationalize the legal framework: revision of Directive 2000/46/EC on electronic money, amendment of Regulation 2560 of 19 December 2001 on cross-border payments in euros, and the third anti-money-laundering directive to counter the exploitation of the payment system for money laundering and the financing of terrorism (Regulation 1781/EC of 15 November 2006).

Domestically, the volume of paper-based instruments (which are not covered either by the SEPA project or by Community rules) is still quite large, occasioning regulatory measures and new projects. The provisions governing cheques were substantially revised by Legislative Decree 231 of 21 November 2007 on the circulation of payment instruments.

Payment instruments

The number of payments made using cashless bank or postal instruments increased by 3.5 per cent in 2007, after rising 3 per cent the previous year. Cheques continue to give way to more automated instruments such as cards and standing payment and collection orders, their use diminishing by 6 per cent. The value of electronic payments increased by 6.6 per cent overall. Despite the progress of the last decade, Italy is still far below the European average in the use of cashless payment instruments, especially by households. In 2007 there were 64 cashless payments per inhabitant in Italy, against 166 in the Eurosystem countries in 2006. However, Italy is basically on a par with the other leading European countries in infrastructural access endowment (such as POS terminals) and in the relative composition of cashless instruments.

On-line transactions using credit cards and credit transfers again increased significantly in 2007. About 60 million credit transfers, 12 per cent of the total, were effected on-line, representing an increase of 28.3 per cent. Internet credit card transactions numbered about 28 million, up by more than 40 per cent. Among card-based transactions, again last year the fastest growth (46.3 per cent) involved general-purpose prepaid cards, serving above all for low-value payments in both physical and virtual channels.

The third survey of ICT use by Italian businesses found appreciable automation of on-line exchange of payment instructions and settlement by firms. About 90 per cent of the respondents reported having used on-line banking services (e.g. information, collection and payment), compared with 80 per cent in the 2005 survey. However, there is still considerable scope for growth in on-line transactions (such as e-commerce), especially among SMEs. The survey covered firms with sales of at least €2.5 million; 41 per cent of the respondents made orders, bookings and purchases of goods and services on line in 2007. The share making or receiving on-line electronic invoices was 12 per cent, sharply up from 4 per cent in 2005.

Postal payment instruments continued to gain customers. Automated credit transfers increased by 33.1 per cent, the use of debit cards by 13.2 per cent and that of prepaid cards by 43.1 per cent. As in previous years, the postal customer base expanded significantly. The number of postal current accounts increased by 7.2 per cent to 5.2 million; the number of payment cards held by households increased by 17.6 per cent to over 9 million at the end of the year.

Charges for credit transfers were reduced, in particular those ordered by telephone or via Internet (Table 18.1). As to personal and cashier's cheques, there were no significant changes in handling time to funds availability, according to data published on ABI's PattiChiari website. In 2007 the maximum number of days for availability was 6.5 (slightly down from 6.6 in 2006); value dates were practically unchanged.

Table 18.1

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
2007	1.94	3.10	4.80	0.89	1.13	1.32

Source: ABI – PattiChiari (March 2005 – April 2006 – March 2007 – April 2008).

As in previous years, the number of cases of irregular use of cheques increased. The number of persons reported to the interbank database of irregular cheques and payment cards rose by 27.6 per cent and that of cheques by 26.8 per cent. The total value of the cheques so registered came to €1.2 billion, an increase of 12.3 per cent.

The State treasury service

The State treasury service is completing the computerization of collection, payment and reporting services and the total dematerialization of expenditure documents. The adaptation of treasury payments to SEPA standards is under way, reflecting the leading role that the public administration is called on to play in that project. In 2007, in line with developments in the electronic treasury service, the procedure for single payment of tax receipts by public bodies was instituted. The new procedure, which will be fully phased in this year, involves electronic payments from the paying bodies (i.e. their treasurers) to the Revenue Agency and from the latter to the Bank of Italy, for subsequent, totally automated accounting entry.

The revision of the electronic payment order was completed, permitting use of the operational and communications procedures of the General Government Payments Information System. For orders to be credited to bank or postal current accounts, which use retail credit transfers, the new procedure, in place since January 2008, is SEPA-compliant.

There was a further increase in the number of entities participating in the Computerized Public Administration Payment System, which the Bank of Italy operates on account of the Ministry of the Economy and Finance. Designed for prompt and detailed collection of data on the public accounts, the System makes data available for budgetary management and monitoring. In cooperation with the Ministry, ABI and the National Centre for Computerization in Government, the Bank has promoted initiatives to sensitize participants and improve the quality of the data submitted.

With the suppression of the UIC (under Legislative Decree 231 of 21 November 2007), as of 1 January 2008 its external treasury activities – collections and payments involving non-euro-area countries in euros and foreign currency on account of State and other public entities – were taken over by the Bank of Italy.

Payment infrastructures

The progressive elimination of national barriers and the standardization of retail payments under SEPA have increased the contestability of the technological services market, prompting the leading European firms to seek the potential advantages of a larger scale of operation. This has triggered both mergers and alliances between infrastructure operators.

In Italy, the merger of the Interbank Automation Company (SIA) into the Interbank Service Company (SSB) was completed in May 2007. The new company SIA-SSB has continued to collaborate with the European STEP2 clearing system and further expanded its presence in Eastern Europe with the acquisition of Giro Bank Card cPlc in Hungary.

The Seceti company began cooperation with the central credit institution for mutual banks, ICCREA, to provide retail payment services with a shared ICT platform. At European level, Seceti reached an agreement with Equens to facilitate cross-border payments between their respective members and a cooperation agreement with Stet of France and VOCA of Britain to advance the use and integration of their respective national systems. A wholly-owned subsidiary of ICCREA, Seceti was merged into the latter on 9 May 2008.

The Eurosystem has set four standards for assessing the adaptation of infrastructures to the new European payment schemes. Following the indications of the central bank, the clearing and settlement infrastructure operators will conduct a self-assessment of their compliance with the standards, and the results will be made public. The adaptation of Italy's payment infrastructures to SEPA is being monitored by the Bank of Italy's oversight function, pursuant to the Bank's powers under national law.

Last year SWIFT, the international payment message service provider, was called on – within the context of cooperative oversight coordinated by the Belgian central bank, in which the Bank of Italy participates – to comply with a set of standards and methods ("High Level Expectations") issued by the oversight authorities to improve control of this systemically important activity. SWIFT, in order to increase the reliability of its network and at the same time satisfy confidentiality requirements, plans to set up a new operations centre in Europe.

During the course of the year global, European and Italian plans for business continuity were intensified, aimed at guaranteeing the continued operation of payment infrastructures in the event of crisis and controlling the risk of contagion of any malfunction. Steps were taken to define a set of principles applying to systemically important payment systems, securities settlement systems and central counterparties.

Private clearing and settlement systems

The activity of the Continuous Linked Settlement system (CLS), in business since 2002 for the settlement of foreign-exchange transactions, continued to expand last year. The system handles about 55 per cent of global forex transactions. Its payment-versus-payment mechanism reduces the systemic risk of the transactions, which are generally very large. In November CLS also began settling some kinds of OTC derivatives trades.

The system's turnover increased sharply, especially at the height of the financial market turmoil, with a series of peak volumes. In March 2008 the average daily amount settled came to $4.5 trillion.

The sixth European survey of correspondent banking, conducted last year, found a further contraction in the use of this settlement procedure in the euro area. The survey analyses the possible risks of settlement through bilateral interbank channels.

The number of large Italian banks using the European STEP2 system to settle not only cross-border but also domestic credit transfers rose from six to nine. They sent over 41.6 million transfers, or 153,000 a day, to STEP2, a third of all the credit transfers entered into the system. In January 2008 STEP2 also began to handle SEPA credit transfers.

Settlement in central bank money

Within the euro area, the initial operating results attest very strong appreciation of TARGET2 by the banking industry in the countries that have already migrated to it. Between the launch in November and the end of December, TARGET2 settled an average of 225,000 transactions a day for a value of almost €1.3 trillion. The system's operational availability was always 100 per cent.

The flows handled by the Italian clearing and settlement systems operated by the Bank of Italy exceeded €56.4 trillion, 13.1 per cent more than in 2006. These flows were equivalent to 36.7 times GDP (Table 18.2). The BI-REL real-time gross settlement system accounted for 88.5 per cent of the total value. The BI-COMP clearing system accounted for 6 per cent and the cash leg of the securities transactions settled through BI-REL for 5.5 per cent.

Table 18.2

Funds handled by Italian clearing and settlement systems
(billions of euros)

	Clearing systems (1)			Gross settlement (2) (c)	Total flows (3)	
	BI-COMP gross flows (a)	Multilateral clearing balances				
		BI-COMP	Securities settlement and Express II (b)		(d)=(a+b+c)	(d)/GDP
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	30.4
2006	3,402	420	2,818	43,635	49,855	33.7
2007	3,376	415	3,123	49,902	56,401	36.7

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 ancillary multilateral 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. – In 2007 the system handled 57,000 transactions a day for a value of over €222 billion, representing 12 and 17 per cent, respectively, of the TARGET system's overall activity. Cross-border business grew more than domestic (21.3 as against 7.2 per cent), and customer transactions grew more than interbank (20.3 as against 13.1 per cent). The volume of the latter was affected by the sharp fall of nearly 27 per cent in transactions between Italian counterparties in the e-MID interbank deposit market, which are settled automatically via BI-REL, owing to the liquidity strains in the money and financial markets.

BI-REL also settles the balances of national ancillary systems and those resulting from Italian banks' transactions in ancillary systems internationally. The domestic component increased significantly (nearly 10 per cent) compared with 2006, owing almost entirely to settlement of the net balances of Express II. The daily value of the international ancillary systems Euro1 and CLS payments settled in BI-REL came to about €2.5 billion.

The degree of concentration of BI-REL payments remains high, the top five banks accounting for nearly 50 per cent of total transactions by value and the top three (one Italian bank and two foreign bank branches) for over 40 per cent.

The turnover rate of reserves held with the central bank remained stable at about 5 times. The use of intraday credit amounted to over €4.5 billion, down 6.5 per cent from 2006, and also down in proportion to the value of payments settled (about 3 per cent). The amount of collateral posted daily was more or less unchanged at €16.2 billion, but the component consisting of securities was reduced from €11.7 billion to €9.1 billion, offset by the increasing use of bank loans, which became eligible on 1 January 2007. About half the securities collateral was foreign, posted mostly through correspondent accounts between ESCB central banks. There was a significant increase in the use of cross-border collateral in Europe, in connection with the liquidity strains in the euro-area market.

The evolution of BI-COMP within SEPA. – The value of transactions handled in the BI-COMP clearing system was about the same as in 2006 (Table 18.2). The total value of the clearing balances settled also held steady at €415 billion, as did its share of the flows (12.3 per cent).

Between 28 January 2008 when SEPA was launched and the end of March only a very small share of credit transfers used the SEPA standard. BI-COMP settled an average of 287 SEPA transfers a day (0.02 per cent of the total) for a value of €18 million (0.28 per cent). For cross-border credit transfers the shares were higher (4 and 12 per cent respectively), according to a survey conducted in the first quarter of 2008 on the state of advancement of the migration of payment instruments to SEPA. Through 31 March 2008 the Bank of Italy's "routing" service was used to settle SEPA credit transfers from STEP2 members to BI-COMP participants worth a daily average of €2 billion, while the flow of payments from Italy into STEP2 amounted to €34,000 a day.

In its first two weeks, interoperability between BI-COMP and the Dutch Equens system involved SEPA credit transfers worth about €200,000 a day.

TARGET2-Securities and CCBM2

The TARGET2-Securities project will implement a platform, owned and operated by the Eurosystem, for settling securities transactions in central bank money. The platform is to be developed by the Bank of Italy together with the central banks of France, Germany and Spain, exploiting synergies with TARGET2 to reduce design and implementation costs and take advantage of its advanced business continuity features. The purpose is to improve efficiency and heighten competition in post-trading services in Europe.

Centralizing and standardizing securities settlement would reduce the cost of post-trading services and facilitate legal and operational harmonization. Participation by the central securities depositories would be voluntary. They would retain their business relationships with customers and their custody services, but would have to terminate their internal settlement procedures. A first public consultation on the principles and general features of TARGET2-Securities was held between April and June 2007. Based on the comments, and with the contribution of national user groups, a first version of the "user requirements" was drafted; in December this was submitted to a formal consultation procedure that was concluded on 2 April. During the summer of 2008 the ECB Governing Council, on the basis of the results of a study of the economic impact and the degree of participation by central securities depositories, will decide on the implementation of TARGET2-Securities, whose completion is now scheduled for 2013.

At the same time, work on the Collateral Central Bank Management project (CCBM2) also proceeded, the aim being to replace the ICT procedures of the single national central banks with a European platform for managing collateral in Eurosystem credit operations. CCBM2 will give Eurosystem counterparties a harmonized system for collateral management on a domestic and cross-border basis, thus increasing efficiency and reducing banks' back-office costs.

19. SECURITIES TRADING AND SETTLEMENT SYSTEMS

The integration of international financial markets

There was a noticeable acceleration in the process of concentration between the leading stock exchanges in 2007. Following the merger between Euronext and the New York Stock Exchange, two other major operations changed the structure of the equity trading scene at international level. As regards trading platforms, large international banks continue to work towards agreements on cross-border cooperation. There is also an emerging tendency for sovereign funds to acquire shareholdings in stock exchange management companies in order to diversify their investments.

In June 2007 agreement was reached on the merger between the London Stock Exchange (LSE) and Borsa Italiana, giving rise to the largest European market in terms of the liquidity and capitalization of the listed companies. In September Nasdaq acquired OMX, the technology group responsible for the integrated management of equity markets in Northern Europe. The Dubai Stock Exchange was also involved in that transaction, acquiring 20 per cent of the new group and also purchasing a 20 per cent shareholding in the LSE from Nasdaq. In the same month the Qatar Investment Authority, a sovereign fund of that country, also acquired a 15 per cent shareholding in the LSE. In February seven leading international banks, some of which are also behind the Turquoise project to develop a trading venue to compete with the European stock exchanges, launched Project Rainbow to create a new venue for derivatives trading among themselves and large hedge funds.

The Italian market management companies MTS and e-MID continued to strengthen their competitive position by expanding their range of services and opening up more widely to markets abroad.

The MTS group continued with its strategy aimed at extending the internationalization of its platform. Within the LSE group there were ongoing contacts with China with a view to developing the market in fixed-income securities in that country. A memorandum of understanding was signed with the Brazilian authorities to launch a platform for trading in Brazilian government securities in 2008. In June 2007 MTS launched a market in interest rate swaps. The possibility of allowing hedge funds to participate in a special segment of EuroMTS, thus broadening the spectrum of market participants, is still under consideration. With the incorporation of Directive 2004/39/EC of 21 April 2004 (MiFID) into national law on 1 November 2007, e-MID S.p.A. was authorized by Consob, in agreement with the Bank of Italy, to operate as an investment firm. The purpose of transforming it into an investment firm is to bring its structure more into line with that of the leading brokers operating in the sector internationally and to encourage the provision of a broader range of services in Europe thanks to the harmonized legal framework governing investment firms. e-MID also implemented a project to allow transactions in euros concluded in its market to be settled automatically via TARGET2.

The wholesale market in government securities

BondVision, the MTS platform for wholesale trading in government securities with institutional investors, continued to develop at a rapid pace. Trading volume on the repo segment of MTS (MTS/PCT) also increased, albeit less than in the previous year. Turnover on the MTS spot segment (MTS cash) rose slightly, but activity continued to contract on EuroMTS, the segment for trading in benchmark government securities of the euro area. The deepening of the subprime mortgage crisis in March of this year had a particularly strong impact on turnover on MTS cash.

In 2007 average daily spot turnover on MTS cash was €6.5 billion, 1.5 per cent more than the previous year. In the first three months of 2008 the increase in financial market volatility led to wide fluctuations in trading on MTS; volumes increased substantially in January, but in March trading was less than half the level of two months previously, falling to its lowest ever daily average of €3.3 billion, more than 57 per cent less than the levels before the crisis in July. Average daily turnover on EuroMTS fell by about 19 per cent between 2006 and 2007 to little more than €1 billion; there was a similar decline in the first quarter of this year. The bid-ask spread widened by an average of almost one basis point in 2007 to more than 5 basis points. In the first quarter of this year the spread almost doubled to about 9 basis points, prompting the management company to relax quoting obligations in March.

Daily turnover on the repo segment of MTS averaged €63 billion, an increase of 6 per cent over 2006 that can be ascribed to continued growth in the General Collateral segment and in overnight contracts, especially the latter.

The BondVision market continued to grow rapidly. In 2007 daily turnover in all types of trade averaged €2.5 billion (of which €1.5 billion was in Italian government securities), an increase of 22 per cent over the year. The number of participants increased further, from 295 to 333. The market's auction trading arrangements proved to be particularly appropriate for the present period of turbulence, since they limit the risks arising from the dealer's obligation to display binding offers.

The interbank deposit market

Interbank deposits traded on the e-MID electronic platform declined by 7 per cent last year, displaying greater concentration in terms of maturities and number of participants. Average daily turnover amounted to €22.4 billion, 92 per cent of which consisted of overnight transactions (88 per cent in 2006). Activity contracted from August onwards, when the crisis of confidence swept over the money and financial markets. The trend continued in the first three months of this year; the volume of trading was 44 per cent lower than in the same period of 2007 and activity by foreign banks steadily declined.

Fears about the creditworthiness of counterparties seriously affected market conditions and liquidity indicators. The bid-ask spreads on overnight deposits widened considerably, particularly in the final quarter of the year, and there was a contraction in the volume of deposits offered. In the first quarter of 2008 central banks' supplementary three-month transactions helped improve liquidity, but they were not sufficient to dispel the crisis of confidence among banks, which continued to quote for only modest transactions.

Centralized management, settlement and guarantee systems

The European post-trading industry is responding to public and private urging to improve its efficiency and integration. The signing of the Code of Conduct for the provision of guarantee and settlement services for share transactions has stimulated requests for connections between markets, central counterparties and settlement systems in various countries in accordance with the principle enshrined in MiFID, which provides for markets and intermediaries to choose the provider of post-trading services regardless of location. Differences between the legal systems of European countries continue to hamper the full liberalization of services, however. At the Ecofin Council meeting in March of this year the Finance Ministers and central-bank Governors of the EU reaffirmed the need to intensify efforts to remove the remaining legal and fiscal obstacles to the full integration of the European clearing and settlement systems.

In October 2006 the European stock exchanges, central counterparties and central securities depositories had signed a Code of Conduct for the provision of guarantee and settlement services for share transactions at the urging of the European Commission. In June 2007 the operators of those systems adopted a Guideline for access and interoperability to govern the establishment of links. By February 2008 more than 80 requests for connection had been made in the EU; the procedures for making the links have yet to be completed.

The Code of Conduct had the effect of improving the pricing transparency of post-trading activities. New operators intend to enter the market to meet the growing demand for integrated services from large intermediaries, which trade securities throughout Europe.

The US Depository Trust and Clearing Corporation (DTCC) has established a central counterparty in the United Kingdom called EuroCCP to guarantee transactions on the European Turquoise market. On 31 March 2008 EuroCCP was authorized by the Financial Services Authority (FSA) to provide central counterparty services in the United Kingdom.

The adoption of the Code of Conduct and the progress with the TARGET2-Securities project are leading to an intensification of initiatives for collaboration between the operators of post-trading systems.

In April 2008 seven European central depositories, including the German Clearstream and the Spanish Iberclear, concluded an agreement known as the Link Up Markets Initiative to create a technology infrastructure to facilitate connections between the various systems, with the aim of enabling participants on any domestic platform to have access to the settlement services provided by the other signatories to the agreement.

In 2007 the Italian post-trading companies participated in the development of TARGET2; they also further refined their systems in order to improve reliability and their ability to cope with critical situations.

Centralized securities management services. – The centralized management services performed by Monte Titoli remained by and large at the same level as in the preceding year as regards both the value of centralized financial instruments and the number of participating intermediaries, whereas the number of issuers increased further. The company is committed to implementing a multi-year programme to rationalize and automate communications with intermediaries and issuers by automating processes to a high degree in order to make the service more secure and efficient.

At market prices, the financial instruments in custody at the end of 2007 amounted to €2,770 billion, an increase of 2.9 per cent; the number of issues handled by the depository rose by 4.5 per cent and that of securities transfer orders by 22.7 per cent. Monte Titoli remains the third largest depository in Europe in terms of the value of securities under management, after the international depositories Euroclear and Clearstream. At the end of 2007 it had 2,451 participants in its centralized management system, compared with 2,334 in 2006; the number of issuers rose from 1,987 to 2,097.

Settlement of securities transactions. – In 2007 the activity of the Express II settlement system increased further. The average number of transactions entered daily into the net component was about 108,000, an increase of more than 5 per cent. By contrast, the average daily value of transactions (about €163 billion) was more or less stable, declining by 1.2 per cent. Around 70 per cent of the transactions handled by the system were concluded on regulated Italian markets. The proportion of transactions guaranteed by central counterparties continued to increase, rising from 32.6 per cent in 2006 to 36 per cent last year.

The system benefited from participants' growing recourse to automatic intraday credit from the Bank of Italy.

Clearing and guarantee services. – The turnover of Cassa di Compensazione e Garanzia, the Italian central counterparty, increased significantly in the share and derivatives markets, whereas there was a slight reduction in volume in the bond market.

The counterparty guaranteed 73.6 million contracts on the spot share market, with an average daily value of €6.3 billion, compared with 58.4 million contracts with an average daily value of €4.5 billion in 2006. There was also a substantial increase in the equity derivatives market (Idem), where the number of contracts rose from 31.6

million to 37.1 million. Activity in the spot segment of MTS rose from €471 billion to €556 billion, while in the repo segment the value of contracts guaranteed fell from €3,921 billion to €3,290 billion.

The margins posted with Cassa di Compensazione e Garanzia increased considerably, reflecting both the growth of trading in the markets it guarantees and the higher volatility of securities prices by comparison with previous years. The central counterparty service offered in the MTS market in conjunction with LCH.Clearnet S.A. contributed about 7 per cent to the total of margins collected.

In 2007 the daily average of initial margins requested was €2.6 billion, compared with €2.2 billion in 2006. The highest levels were recorded in May, with peaks of €5.6 billion being reached on some days. The daily average amount of margins exchanged between Cassa di Compensazione e Garanzia and LCH.Clearnet S.A. deriving from the activities of their respective participants was €41 million, compared with €48 million in 2006.

SUPERVISION OF BANKS AND OTHER INTERMEDIARIES

20. CREDIT INSTITUTIONS AND THE IMPACT OF THE TURMOIL IN THE FINANCIAL MARKETS

The turmoil had a more modest effect on the Italian banking system than on those of other advanced countries caught up in the US subprime mortgage crisis. Italian banks were less exposed, either directly or indirectly, to the risks from that market segment. An operational model in which complex mechanisms for transferring credit risk were less prevalent and which had a more stable funding structure helped limit the impact. Prudent supervisory rules and practices, particularly as regards the regulation of securitizations and the consolidation of off-balance-sheet vehicles, were a further factor in containing the effects of the crisis.

Some banks were nevertheless affected; the value of structured finance products in their portfolios fell owing to the deterioration in the guarantees on US mortgages to subprime borrowers or those with incomplete documentation (Alt-A) and by the reduction in market depth. Liquidity risks also increased, in the dual guise of an unexpected deterioration in borrowing conditions (funding liquidity risk) and in difficulty in liquidating assets in their portfolio on other than materially disadvantageous terms (market liquidity risk). In this situation, the Bank of Italy supplemented the ordinary inspection of banks by carrying out a series of investigations to assess the risk exposure of supervised institutions and to determine the vulnerability of the banking and financial system to market changes.

The effects of financial turmoil and supervisory activity

Investigations of risk exposure. – An initial survey of the exposure of the Italian banking system to assets linked to US subprime and Alt-A mortgages was carried out in August 2007. In September the banks were asked to make a complete assessment of the risks stemming from asset-backed securities (ABSs), collateralized debt obligations (CDOs) and positions in relation to investment vehicles and hedge funds.

The surveys showed that no bank in the system had direct exposure to the US subprime and Alt-A markets (in other words, through the direct granting of mortgages). In September 2007 forty banks had an indirect exposure amounting to €4.9 billion in connection with ABSs, CDOs and units in hedge funds, around half of whose underlying was invested in subprime and Alt-A loans; around 63 per cent of these instruments had a triple-A rating.

A similar investigation, based on supervisory returns at 30 September 2007, was carried out with regard to Italian open-end investment funds. No exposures to ABSs based on subprime or Alt-A loans were brought to light. More generally, it was found that ABSs and structured securities accounted for an extremely small part of the total assets of open-end investment funds. A study based on information provided by banks at the request of the Bank of Italy also showed that the overall exposure of Italian hedge funds was small. At the end of September 2007 Italian funds of funds, which account for the lion's share of the market, held 1.2 per cent of their total net assets in units of funds with a significant exposure (more than 20 per cent of assets). The limited impact of the crisis appears to be attributable mainly to the adoption of investment strategies involving adequate portfolio diversification and limits on investment in relatively illiquid securities.

As part of the supervisory measures that were initiated when strains began to appear in the international financial markets, a study was carried out into the exposure of the major banks towards specialized insurers guaranteeing and hedging debt instruments and other forms of finance (so-called financial guarantors, or monoline insurance companies). The aim of the study was to assess exposure to the counterparty risk associated with a possible deterioration in the financial situation of the monolines. At the end of last year the nominal value of the gross exposure of the Italian banks surveyed was €3.9 billion, almost all of which took the form of guarantees received. Only 6 per cent of the guarantees related to residential mortgage-backed securities (RMBSs) or CDOs based on subprime mortgages.

In September 2007 the Bank of Italy impressed upon banks the need for their governing bodies to be fully aware of structured finance operations in order to be able to value risk correctly. This is particularly important with regard to the structure and modus operandi of investment vehicles – especially conduits and structured investment vehicles – and the assets they have acquired. In this connection, Italian banking groups have been required to consolidate the accounts of their vehicles where the vehicles' risks and benefits in fact remained with the parent bank; in some cases the banks have reduced their exposure towards the vehicles by gradually disposing of the latter's assets. The banks' attention was also drawn to the need for strict balance-sheet valuation of instruments based on US subprime mortgages and all the other structured finance instruments adversely affected by the crisis. Moreover, they were asked to provide the market with adequate information about the composition of their portfolios, especially as regards structured finance and the valuation methods used. Specific measures in these respects are being taken in relation to the major banks.

Investigations have been commenced, accompanied by on-site inspections at a number of large institutions, to ascertain banks' exposure to the residential mortgage sector and more generally to construction firms. The investigations trace the recent growth in the Italian market in residential mortgages, which has been boosted by more aggressive marketing policies, partly as an effect of increased competition from foreign banks.

Monitoring of liquidity risk. – The turmoil in the international financial markets made it difficult for banks to roll over maturing market liabilities and to place new wholesale issues of securities; operations in the interbank markets also diminished. The direct effects of the turmoil were mild, however, thanks partly to the structure of banks' funding, which has traditionally been geared towards the retail sector, through both deposit-taking and the issue of bonds. Banks dealt with the difficulty in obtaining funds on international markets by stepping up domestic issues and offering higher yields on them. Their task was facilitated partly by the outflow of Italian households' savings from other institutional investors, such as investment funds and insurance companies.

More generally, banks pursued more cautious liquidity management policies, partly in response to supervisory measures. Since September 2007 the Bank of Italy has supplemented the routine monitoring of the banks' liquidity by asking the main banking groups and those intermediaries with a particularly large exposure to submit weekly returns on their consolidated position, not least because of their greater dependence on the market as a source of funding. The returns, which some medium-sized banks are also required to submit, cover liquidity positions at three months or less, the availability of liquid assets, the volume and nature of assets that can be earmarked for refinancing operations, the structural situation and the longer-term funding requirement. Particular attention is paid to the banks' organizational safeguards against liquidity risk: dialogue with the banks is designed to promote the adoption of best practice, including the creation of effective links between departments responsible for liquidity management and those performing an integrated assessment of corporate risks.

In addition to these checks, the supervisory authorities are ensuring that banks are aware of the need to keep liquidity risk under strict surveillance and to reinforce the tools at their disposal for assessing the impact of adverse events by carrying out sufficiently rigorous stress testing and keeping their contingency funding plans up to date.

A survey of large and medium-sized banks was carried out in the first few months of 2008 in order to gain a more detailed insight into the way in which they manage liquidity. It found that the Italian banking system tends to employ traditional liquidity management techniques, not least because most banks are in the commercial banking mould. The banks in the sample examined generally use gap analysis techniques, although some, especially the larger ones, are developing more advanced methods to estimate the behaviour of specific assets and liabilities (sight deposits and early mortgage redemptions, for example). The study also showed that stress tests are still at the development stage and that there are differences in the use of such tests, both as an aid to decision-making and for the preparation of contingency funding plans.

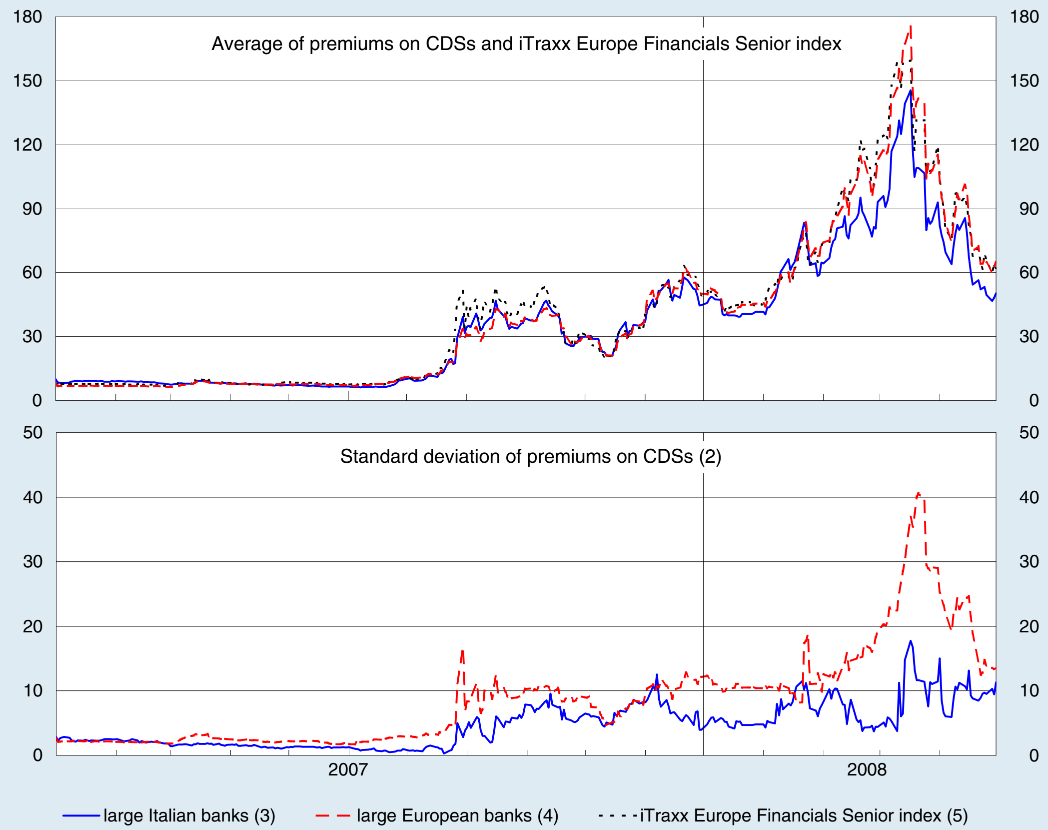
Market information on banks. – The uncertainty caused by the crisis and its repercussions on banks' balance sheets led to an increase in premiums on CDSs and a fall in the share prices of all the leading banks from the middle of last year onwards. Italian banks were affected to broadly the same extent as other leading European banks.

Spreads on CDSs rose to high levels in September and November of last year and began to increase again at the beginning of 2008; in mid-March they averaged close to 145 basis points for Italian banks and 175 for banks in Europe as a whole. They fell back from the second half of March onwards following intervention by the central banks and the publication of banks' balance sheets: by the end of April they stood at 50 and 65 basis points respectively. The premiums on Italian banks' CDS issues were slightly lower than the iTraxx Europe Financials index and the average for European banks. This presumably reflects the perception that Italian banks are better placed in terms of lower exposure to the subprime market and lower liquidity risk, partly in the light of the greater stability afforded by their fund-raising methods. Variations in the premiums on CDSs among European banks increased significantly in March. This could indicate differences in risk exposure and an improvement in the market's ability to differentiate among risk positions as information was published on losses in connection with subprime products. There was less variation among Italian banking groups (Figure 20.1).

Figure 20.1

Premiums on CDS contracts for large Italian and European banks (1)

(basis points, daily data)



Source: Based on Thomson Financial Datastream data.
(1) CDSs on 5-year senior debt issues. – (2) For each daily item, the cross-section standard deviation of the distribution of the premiums observed for large Italian banks and large European banks respectively. – (3) UniCredit, Intesa Sanpaolo and Monte dei Paschi di Siena. – (4) Banco Santander, BBVA, Barclays, BNP Paribas, Commerzbank, Crédit Agricole, Credit Suisse, Deutsche Bank, Dexia, Fortis, HBOS, HSBC Bank, ING Bank, Lloyds TSB, Royal Bank of Scotland, Société Générale and UBS. – (5) iTraxx Europe Financials Senior 6, 7, 8 and 9 on-the run series for 5-year maturities.

Uncertainty in the financial markets was also reflected in the share prices of the major Italian banks. Between the beginning of 2007 and the end of April of this year they fell by an average of around 30 per cent, in line with those of other leading European banks.

Implementation of the recommendations of the Financial Stability Forum. – The measures taken by the Bank of Italy were in line with those defined and developed at the international level, particularly the 67 recommendations of the Financial Stability Forum (FSF).

One of the Bank's primary concerns will be to participate in the work of international organizations, in particular that of the Basel Committee, which will have to adjust the prudential treatment of certain types of complex operation under Basel II and issue new guidelines.

Nine of the recommendations made to national regulatory and supervisory authorities can be considered to have already been implemented in Italy; these include the recommendation for the swift incorporation of the new Basel II prudential regulations into national legislation, the recommendation regarding remuneration policies for banks' managements, which are governed by the "Supervisory rules on the organization and corporate governance of banks" issued by the Bank of Italy in March 2008, and the recommendation to form colleges of supervisors for the largest cross-border banking groups.

The Bank of Italy plans to implement the recommendations that have yet to be enacted at national level by means of a series of measures appropriate to each of the areas of action indicated by the FSF.

As regards the strengthened prudential oversight of capital, liquidity and risk management, especially close attention will be paid to the banks' capital adequacy in the current market context as part of the prudential supervision laid down in Pillar 2 of Basel II. A working group will be formed for that purpose, bringing together the various supervisory departments in order to ensure consistency and uniformity in the criteria for determining additional capital, for example by defining stress testing procedures.

On the question of the recommendations to the banks regarding transparency of information and risk assessment criteria, the Bank of Italy has drawn the attention of the leading banking groups to the need for adequate disclosure about the risks associated with bouts of market turmoil; it plans similar action involving the financial system as a whole to raise awareness of the need to adopt the most advanced disclosure practices indicated in the FSF report.

As to the strengthening of the supervisory authorities' instruments for obtaining information and taking action, and in connection with the monitoring of liquidity risk and steps to raise awareness of this aspect, the banks will be asked to update their contingency funding plans at regular intervals.

One of the measures foreseen for strengthening the mechanisms for crisis management at cross-border financial institutions is the establishment of a working group, composed of representatives from the central banks as well as supervisors, whose functions would complement those of the supervisory colleges. The type of information to be shared in a crisis or in a crisis simulation exercise has already been defined for the supervisory colleges for the UniCredit and Intesa Sanpaolo groups, in which the Bank of Italy performs the function of home supervisor; it will thus be possible to implement the recommendation by the end of 2008.

Banking groups' profitability, capital and asset quality

Profitability. – In 2007 the net profits of Italian banking groups increased by 13 per cent, boosted by substantial capital gains and extraordinary income from restructuring operations carried out by some of the large groups. Ordinary profit, which excludes extraordinary items, fell by 2.7 per cent (Table 20.1). Groups account for around 85 per cent of the total assets of the banking system, consisting of both banking groups and independent banks. Return on equity (ROE) declined by about one percentage point to 12.9 per cent; net of capital gains and extraordinary income, it was down by almost three points, at 11.2 per cent (for a review of the unconsolidated profit and loss accounts of banks operating in Italy, see Chapter 17: *Credit institutions*).

Table 20.1

Consolidated income statement of Italian banking groups
(millions of euros; growth rates and percentage indicators)

	All groups			Main groups (1)		
	2006	2007 (2)	Change	2006	2007 (2)	Change
Net interest income (a)	44,877	48,648	8.4	31,949	33,597	5.2
Non-interest income (b)	41,646	37,358	-10.3	30,638	26,784	-12.6
of which: commissions	*28,689*	*28,934*	*0.9*	*21,089*	*21,016*	*-0.3*
Gross income (c=a+b)	86,523	86,007	-0.6	62,587	60,382	-3.5
Operating expenses (d)	51,413	51,469	0.1	36,521	35,523	-2.7
of which: staff costs	*29,953*	*29,662*	*-1.0*	*21,466*	*20,716*	*-3.5*
Operating profit (e=c-d)	35,110	34,538	-1.6	26,066	24,858	-4.6
Allocations to provisions and net value adjustments (f)	9,965	10,082	1.2	6,941	7,097	2.2
of which: in respect of loans	*7,040*	*7,405*	*5.2*	*4,741*	*5,019*	*5.9*
Ordinary profit (g=e-f)	25,145	24,457	-2.7	19,125	17,762	-7.1
Extraordinary profit (h)	2,593	1,749	-32.6	2,234	1,353	-39.4
Gross profit (i=g+h)	27,738	26,204	-5.5	21,359	19,114	-10.5
Taxes (l)	8,714	9,222	5.8	6,222	6,155	-1.1
Profit from asset classes in the process of being liquidated (after tax) (m)	310	4,668		187	4,671	
Profit of minority interests (n)	1,377	1,358	-1.4	1,036	988	-4.6
Profit of parent company (o=i-l+m-n)	17,958	20,292	13.0	14,288	16,642	16.5
Indicators						
Ratio of non-interest income to gross income	48.1	43.4		49.0	44.4	
Cost/income ratio (3)	59.4	59.8		58.4	58.8	
Value adjustments in respect of loans/Operating profit	20.1	21.4		18.2	20.2	
ROE	14.3	12.9		16.3	14.7	

Source: Consolidated supervisory returns of banking groups only.
(1) Five largest groups by total assets. – (2) Provisional data. – (3) Operating expense as a percentage of gross income (d/c).

The volume of business continued to grow strongly on an annual average basis, contributing to an increase of 8.4 per cent in net interest income, compared with 10 per cent in 2006. Non-interest income fell by 10.3 per cent, whereas it had risen by 7.5 per cent the previous year; the decrease was due to the continuing weakness of the asset management sector and, towards the end of the year, the impact of turmoil in the financial markets.

Gross income decreased by 0.6 per cent overall, in contrast to an increase of 8.8 per cent in 2006. The contribution of non-interest income to gross income, which is a measure of the diversification of sources of income, fell from 48.1 to 43.4 per cent.

The crisis affected banks' profitability mainly through its impact on income from trading in the banks' securities portfolio and on the fair-value valuation of securities, especially structured finance instruments. The large groups recorded write-downs of around €1.4 billion in 2007; further write-downs of some €1.2 billion have been announced for the first quarter of this year.

Operating expenses were unchanged; staff costs declined by 1 per cent. The cost/income ratio rose by around half a percentage point to 59.8 per cent.

Operating profit fell by 1.6 per cent. Total allocations to provisions and value adjustments rose by 1.2 per cent. In particular, allocations to provisions for bad debts increased by 5.2 per cent and rose by about one percentage point as a proportion of operating profit to 21.4 per cent.

The performance of the five largest groups did not differ greatly from that of groups as a whole. Their ROE fell from 16.3 to 14.7 per cent; excluding capital gains and extraordinary income, it decreased by three points. Despite a fall of 2.7 per cent in operating expenses, gross income contracted by 3.5 per cent, causing operating profit to decrease by 4.6 per cent. Their cost/income ratio rose slightly, to 58.8 per cent.

Capital adequacy. – In 2007 the banking system's supervisory capital and reserves, including that of banks not belonging to groups, rose by 5.1 per cent to €201.7 billion. The increase, which amounted to about €10 billion, was less than in the preceding year owing to a reduction in securities valuation reserves, which count as supplementary capital (Table 20.2).

Table 20.2

Capital adequacy of Italian banks and banking groups (1)
(end-of period data in millions of euros)

	Banking system		Main banking groups (2)	
	2006	2007	2006	2007
Allocations to supervisory capital	11,567	10,807	7,611	6,765
Supervisory capital	191,844	201,671	114,000	116,406
Capital ratio (%)	10.7	10.4	9.9	9.5
Tier 1 capital ratio (%)	7.8	7.6	6.8	6.5
Excess capital	49,767	46,544	22,758	19,111
Capital shortfalls	115	41	–	–
Number of banks with shortfalls	1	3	–	–

(1) Consolidated returns for banking groups and individual returns for banks not belonging to a group. Excludes the Italian branches of foreign banks. – (2) Five largest groups by total assets.

Tier 1 capital rose by 5.5 per cent to €149.6 billion owing to the effect of the new rules on capital deductions. The treatment of items to be deducted from capital is one of the main changes introduced by the new regulations on supervisory capital, which came into effect on 1 January 2007. Previously deductions were applied directly to the sum of tier 1 and supplementary capital, whereas now they are applied in equal parts to tier 1 core capital and supplementary capital.

Supplementary capital declined by 9.4 per cent to €57.6 billion, owing partly to the effect of the new regulations on deductions and partly to the reduction in securities valuation reserves as a result of the market turmoil in the second half of the year.

The overall capital ratio fell by 0.3 percentage points to 10.4 per cent; the increase in capital resources was not sufficient to offset the rise of 8.3 per cent in risk-weighted assets. Excess capital fell from €49.8 billion in 2006 to €46.5 billion in 2007. The tier 1 capital ratio, which comprises components with the highest capacity to absorb losses, decreased by 0.2 points to 7.6 per cent. The core tier 1 ratio – measuring tier 1 capital net of hybrid capital instruments – also declined by 0.2 points to 7.1 per cent.

The overall capital ratio for the largest banking groups fell from 9.9 to 9.5 per cent and their tier 1 ratio from 6.8 to 6.5 per cent. Their core tier 1 ratio came down from 6 to 5.7 per cent; at the end of 2007 around 88 per cent of the tier 1 capital of the largest groups consisted of components of the best quality, a relatively high proportion by comparison with large groups in other countries.

In 2007 the cost/income ratio and ROE of the largest Italian groups were broadly in line with the averages for large European banks, namely 61 per cent and 15.4 per cent respectively. Their capital ratios, by contrast, were lower than the averages of 7.8 per cent for tier 1 capital and 10.9 per cent for total capital.

Quality of bank assets. – At the end of last year the credit exposure in the consolidated balance sheets of banking groups, including foreign subsidiaries, stood at about €2,390 billion, 5.4 per cent more than a year earlier (Table 20.3). Exposures towards customers made up 82 per cent of the total. Off-balance-sheet exposures (lending commitments, guarantees, financial and credit derivatives and other commitments, including contingent credit lines) came to about €740 billion, an increase of 11.2 per cent in relation to 2006.

Table 20.3

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 balance-sheet exposures to residents		Cover ratio (2)
	2007 (3)		2006	2007 (3)	2007 (3)
			All groups (4)		
Balance-sheet exposures to customers	**1,959,765**	**72.6**	**100.0**	**100.0**	**2.9**
Performing	1,865,694	72.3	94.9	95.2	0.5
Non-performing	94,072	77.0	5.1	4.8	49.5
loans overdue and/or in breach of overdraft ceilings for more than 180 days	*7,405*	*95.2*	*0.4*	*0.4*	*7.9*
restructured loans	*4,538*	*39.6*	*0.3*	*0.2*	*30.4*
impaired loans	*21,821*	*83.6*	*1.1*	*1.1*	*26.4*
bad debts	*60,307*	*75.3*	*3.2*	*3.1*	*64.4*
Balance-sheet exposures to banks	**429,676**	**35.4**			**0.1**
Off-balance-sheet exposures	**742,281**	**42.8**			**0.3**
of which: to customers	*517,990*	*51.1*			*0.4*
to banks	*224,291*	*23.7*			..

Source: Banking groups' consolidated supervisory returns.
(1) Before value adjustments. – (2) Value adjustments as a percentage of total exposures. – (3) Provisional data. – (4) Includes Italian groups controlled by foreign banks.

Credit quality – as measured by the ratio of non-performing assets (bad debts, impaired loans, restructured loans and loans overdue and/or in breach of overdraft ceilings for more than 180 days) to balance-sheet exposures towards customers – improved slightly, from 5.1 to 4.8 per cent; the ratio relating solely to bad debts came down from 3.2 to 3.1 per cent. Balance-sheet write-downs cover 50 per cent of non-performing assets. The ratio of non-performing assets to total balance-sheet exposures was higher for resident customers (5.1 per cent) than for non-residents (4 per cent).

Risks

The credit risk of banks doing business in Italy with resident customers. – In 2007 the stock of adjusted bad debts declined from 3.7 to 3.4 per cent of total loans outstanding. This is slightly higher than the figure reported above, which includes exposure to borrowers abroad and refers only to unadjusted debts. The improvement was evident across all branches of activity and all areas of the country, although significant regional differences remain, with values of 6.5 per cent in the South and 2.8 per cent in the rest of the country.

The ratio of adjusted new bad debts recorded during 2007 to the stock of loans outstanding at the end of the previous year showed a modest overall improvement, falling from 0.84 to 0.82 per cent. Many sectors saw an improvement, but the ratio for consumer households increased from 0.77 to 0.8 per cent.

The trend in the quality of lending to firms can also be seen from a statistical analysis that estimates the probability of loan default within one year using corporate balance-sheet indicators and indicators of financial strain based on the Central Credit Register's data on credit relations. The sample relates to the loans of about 600,000 non-financial companies from banks and non-banks totalling almost €850 billion, equal to 95 per cent of total lending to non-financial firms.

The analysis does not reveal significant signs of deterioration in the quality of credit to households and firms. It should be pointed out, however, that there is normally a lag before any deterioration materializes and that the behaviour of aggregate default rates does not preclude difficulties in particular sectors or more exposed segments of the banks' customer base.

At the end of 2007 the average probability of default within one year, weighted by the amount of credit drawn, was 0.9 per cent, more or less the same as in the preceding year. Within the aggregate, there was an improvement for small and medium-sized firms (those with an annual turnover of €5 million or less). Firms in the South display more than twice the risk of firms elsewhere in the country. In the case of listed companies, the average risk, weighted by the amount of credit drawn and also taking account of the volatility and performance of share prices, was slightly higher than in 2006.

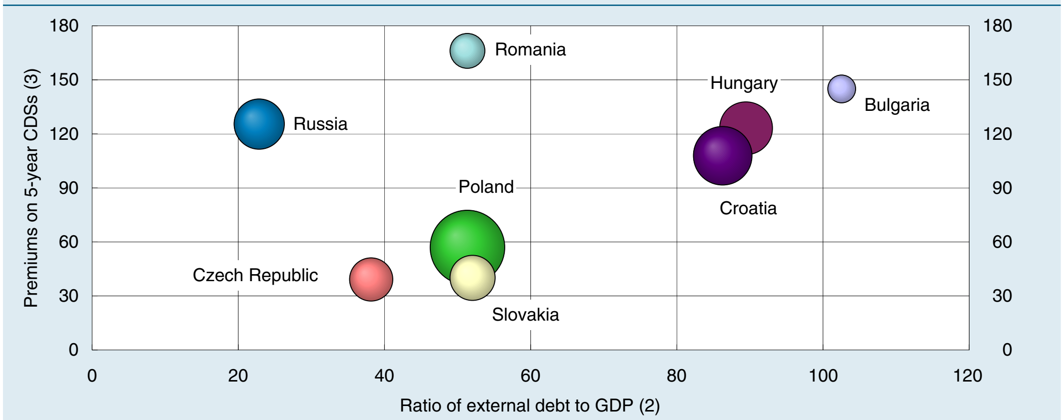
Large exposures – that is to say those towards a single customer or related group of customers which, on a risk-weighted basis, exceed 10 per cent of a bank's supervisory capital and reserves – decreased by 7.2 per cent in 2007 to €58.5 billion and fell from 32.8 to 29 per cent of total supervisory capital and reserves. The number of banking groups and banks with individual risk positions in excess of 25 per cent of capital decreased from 30 to 20; none of the largest groups fell into this category. The overshoots, which were small on average, remained more or less unchanged, at about €200 million.

Country risk and geographical concentration. – At the end of 2007 the exposure of the Italian banking system in respect of loan disbursements and credit commitments to borrowers in countries defined by the Bank for International Settlements (BIS) as developing countries amounted to €175 billion, equal to about 7 per cent of the system's total assets. The exposure has more than doubled over the past two years, owing largely to foreign positions reported by the UniCredit group following its take-over of the HVB group.

More than 80 per cent of the exposure was towards countries in central and eastern Europe, where several banking groups have made acquisitions in recent years, some of them fairly large. Figure 20.2 shows the exposure of Italian banks towards countries in the area and two risk indices, one relating to CDS spreads on sovereign bonds, and the other to the external vulnerability of the countries in question. Other countries in which Italian banks showed significant investment interest in 2007 were Egypt and Kazakhstan.

Figure 20.2

Exposure to country risk (1)



Sources: Based on Thomson Financial Datastream data and supervisory returns; IMF projections for 2008 in IMF, Regional Economic Outlook: Europe, April 2008.
(1) The size of the circles is proportional to the exposure of the Italian banking system towards the countries indicated. – (2) Percentages. – (3) Average premiums on CDSs on sovereign bonds for the first quarter of 2008; basis points.

Italy's exposure to developing countries as a proportion of the total for the BIS reporting countries increased to 5.2 per cent but remained lower than that of countries such as Germany (9.4 per cent), France (8.7 per cent), Spain (7.6 per cent) and the Netherlands (6.6 per cent). Italy's exposure to offshore centres fell to only €18 billion and its share to 1.1 per cent.

Survey of credit risk in the mortgage sector. – The Bank of Italy has examined the activities of banks in the market in loans for house purchases, based on a sample of banking groups and individual banks representing around 70 per cent of the sector. The survey supplements the banks' supervisory returns by providing information on non-performing positions for various categories of borrower; it is designed to show trends in default rates for various loan categories defined on the basis of borrower risk (assessed in advance from banks' credit scoring models), contractual interest rate, level of collateral and distribution channel (bank branch network or other financial or non-financial entity).

The preliminary results of the survey show that the average default rate rose between 2006 and 2007 but remained fairly low. The increase is confirmed by the rise in default rates recorded by the Central Credit Register for the wider aggregate of lending to households. Default rates were above average for loans granted by distribution channels not associated with bank networks. Risk is higher where variable interest rates apply or the loan-to-value ratio is high.

The survey confirms that the proportion of indexed-rate mortgages declined during 2007 to around 70 per cent for the banks in the sample, compared with 80 per cent at the end of 2006.

The predominant view among banks is that the growth in residential mortgages will be affected by the slowdown in the property market. Moreover, supervisory returns for the first few months of 2008 show a contraction in the overall stock of loans for house purchases. Market prospects are also being affected by the changes introduced by Decree Law 7/2007 of 31 January 2007 on loan cancellation and portability (the "Bersani Decree", ratified with amendments by means of Law 40/2007 of 2 April 2007). Banks are not expressing particular concern about funding constraints, such as difficulty in financing new lending by means of securitization operations.

Exposure towards the hedge fund sector. – Italian banks have only a small exposure towards hedge funds, consisting of loans to Italian hedge funds and fund units held in banks' portfolios. In December 2007 their gross exposure (excluding guarantees) was €4.8 billion, equal to 2.5 per cent of the banking system's supervisory capital and reserves. It was highly concentrated, however, with about 80 per cent of the total being held by ten banks, for which the exposure averaged 5.7 per cent of their supervisory capital and reserves. Investment in fund units (€3.2 billion) represented 66 per cent of the total exposure and about 1 per cent of the banks' securities portfolio.

The use of credit risk transfer instruments. – At the end of last year banks operating in Italy (hence excluding banks' foreign subsidiaries) had an exposure of €23.9 billion in connection with securitization operations; this was similar to the amount outstanding a year earlier and equal to 1.4 per cent of the total of lending and the securities portfolio.

Around three quarters of exposures related to securitizations by third parties; moreover, almost 90 per cent consisted of balance-sheet exposures, mainly in the form of securities, while the remaining 10 per cent consisted of guarantees or credit lines. A breakdown of exposures according to degree of subordination shows that 74 per cent related to senior tranches, 18 per cent to mezzanine tranches and 8 per cent to junior tranches.

In 2007 banks operating in Italy sold or securitized loans amounting to €37.1 billion, equal to 2.6 per cent of the stock of lending at the beginning of the year and significantly more than the figure of €28.2 billion recorded in 2006; part of the increase was due to self-securitization operations, which are designed to hold on the balance sheet securities that may be eligible as collateral in refinancing operations with the central bank. Around 16.8 per cent of loans sold or securitized last year was classified as bad debts, compared with 12.1 per cent in 2006.

At the end of last year the notional value of outstanding credit derivatives (mainly CDSs) held by Italian banks and their foreign subsidiaries, either as purchasers or sellers of protection, was almost €620 billion. Purchases and sales of protection were broadly in balance: the notional value of purchases was about €315 billion and that of sales about €305 billion. In almost all cases the counterparties to the contracts were non-residents, predominantly banks.

At the end of the year the intrinsic positive value of contracts, in other words the potential gain that the banks would have booked if the credit derivatives had been closed out at that date and which for the banks constitutes an exposure to a potential counterparty risk, was €6.4 billion, equal to 0.3 per cent of banking groups' total balance-sheet exposure to customers at that date.

Financial derivatives. – Between 2000 and 2007 the notional value of the financial derivatives of banking groups and banks operating in Italy rose from €2,000 billion to €11,600 billion; more than three quarters of this amount related to transactions with non-residents.

Operations with resident non-institutional customers (firms and public authorities) are carried out mainly to cover customers' interest rate risks on their borrowing; in many cases, however, they also entail a speculative element.

On the basis of data from the Central Credit Register, which records exposure to contracts with a positive intrinsic value for banks operating in Italy, the exposure stemming from Italian banks' derivative contracts with firms increased by 41.7 per cent in 2007 to €5 billion; the exposure to large companies (those with a turnover of over €5 million) more than doubled, while that to small firms diminished. Exposure to the public sector contracted by 29.5 per cent to €1.2 billion at the end of the year.

Stress testing the banking system

The turmoil in the international markets underlined the importance of investigations to identify the causes of systemic vulnerability of the banking and financial system. Stress testing provides an assessment of the strength of the system as a whole following extreme but plausible hypothetical shocks. Together with other analytical and supervisory tools, stress-testing exercises help improve the effectiveness of monitoring of the system and make it possible to hone supervisory measures and target them on the prevention and containment of risks.

In collaboration with the leading banks, the Bank of Italy has launched a programme of periodic stress tests. The exercises conducted in the first half of May related to the main types of risk: credit, interest rate, market and liquidity risks. They were devised using a variety of methods and postulating specific adverse scenarios for each type of risk. Although such exercises bring to light areas in which the system is potentially vulnerable to shocks, they must each be interpreted separately rather than in combination.

When designing the scenarios, which may be adapted to reflect changes in the macroeconomic situation and in the markets, consideration was given both to events that have not occurred in the past and to the observed distribution of risk factors and the correlation between them.

A top-down approach was adopted for credit and interest rate risk affecting banks' balance sheets. The simulation is be carried out by the supervisory authorities using the data on banks' portfolios reported by all banks in the system. The approach for market and liquidity risks, by contrast, was bottom-up; here the exercise is carried out by banks on the basis of the data and methods in their possession. In particular, a representative sample of banking groups was asked to estimate the impact of predefined shocks on their trading portfolios and on their net liquidity positions.

The top-down stress test for credit risk was based on expected losses calculated as the product of the credit exposures of around 600,000 non-financial firms (disregarding factors tending to mitigate the risk), their estimated probability of default within one year (PD) and the loss in the event of default ("loss given default", LGD). Rising levels of PD and LGD were postulated.

Multiplying the estimated PD values for this year by four on the basis of data for 2007 in order to reproduce the default rate of non-financial firms observed in 1993 during a particularly severe downturn and assuming an LGD of 45 per cent indicates an erosion of about 7 per cent of the consolidated supervisory capital and reserves of 2007.

The objective of the assessment of the exposure of Italian banking groups to interest rate risk is to measure the change in the value of assets and liabilities over a one-year period as a result of adverse interest rate movements. A variety of hypotheses of changes in the yield curve were taken into consideration for that purpose: a parallel upward shift, an increase in the slope of the curve, inversion of the curve.

A scenario similar to the one postulated by the Basel Committee for stress tests of this kind (based on a parallel increase of 200 basis points in the yield curve and sensitivity measures that reflect the current level of interest rates) shows that as at the end of 2007 the losses on the entire balance sheet would average 6.1 per cent of supervisory capital and reserves and those on the banking book alone 2.9 per cent. Losses vary considerably from one banking group to another; around one tenth of the banks would suffer losses on their banking book in excess of the threshold of 20 per cent of supervisory capital and reserves.

In order to assess exposure to market risks inherent in banks' portfolios of securities held for trading purposes, scenarios were defined that postulate changes of differing scale in interest rates, share prices and exchange rates, in their respective volatilities and in credit spreads. The exercises were carried out using the bottom-up approach by the selected banks for changes in the risk factors considered both individually (sensitivity analysis) and in combination (scenario analysis). Various scenarios with different degrees of criticality were postulated; the effects of the shocks were assessed over a timescale of ten days. The study showed that, in the context of the risk factors examined, the banking groups in question would be particularly vulnerable to a widening of credit spreads. However, the effect of the various scenarios on supervisory capital and reserves appears to be modest.

Finally, with regard to liquidity risk, the banking groups were asked to assess, on a consolidated basis, the impact of two stress scenarios on their net liquidity position and on the number of days of "survival" (that is to say the period over which the bank is able to cope with liquidity strains independently, using its own available liquid reserves). The two scenarios replicate a crisis affecting several markets simultaneously and one particularly serious crisis affecting the individual bank. They were based on the hypothesis of a reduction in the ability to roll over certain liabilities and an increase in the haircut on certain assets. The groups were asked to assess the effects of the scenarios over a timescale of one month. In addition, they were asked to carry out exercises to assess the responsiveness of specific positions, including interbank funding. Finally, they were asked to make a qualitative assessment of the adequacy of their liquidity position to withstand shocks of relatively long duration (three months). The results of the simulations showed that the banks had good resistance to the scenario involving shocks to several markets simultaneously. There was some vulnerability, although not among the largest banks, to the scenario of a shock affecting an individual bank.

To summarize, the four exercises demonstrated that the system offered a good level of resistance to the scenarios postulated. The exercises do not, however, take account of complex interactions between risks and interdependence between the real economy and the financial system.

Profitability, capital and risks of non-bank intermediaries

Asset management companies. – The profits of asset management companies on ordinary activities amounted to €1,284 billion in 2007, not dissimilar to the figure for the previous year (Table 20.4). Net profit rose slightly to €826 million and ROE based on net balance-sheet capital and reserves was 42 per cent, the same as in 2006. Gross operating profit was unchanged, as a decline in fee and commission income was balanced by a corresponding fall in fee and commission expenses.

Table 20.4

Asset management companies: income statement data
(millions of euros and percentages)

	2006		2007		Percentage change
	Amount	Percentage (1)	Amount	Percentage (1)	
Fee and commission income	6,979	316.1	6,594	299.3	-5,5
Fee and commission expenses	4,771	216.1	4,391	199.3	-8,0
Gross operating profit (2)	**2,208**	**100.0**	**2,203**	**100.0**	**-0,2**
Administrative expenses (-)	1,168	52.9	1,285	58.3	10,0
of which: staff costs(-)	*482*	*21.8*	*633*	*28.7*	*31,3*
Other operating expenses (-)	39	1.8	37	1.7	-5,1
Total operating expenses (3)	**1,240**	**56.2**	**1,374**	**62.4**	**10,8**
Other operating income	104	4.7	147	6.7	41,3
Net operating profit	**1,072**	**48.6**	**977**	**44.3**	**-8,9**
Net profit on financial operations	192	8.7	307	13.9	59,9
Profit on ordinary activities	**1,264**	**57.2**	**1,284**	**58.3**	**1,6**
Taxes (-)	473	21.4	458	20.8	-3,2
Net profit (loss) for the year	**785**	**35.6**	**826**	**37.5**	**5,2**

Source: Supervisory returns.
(1) Amount as a percentage of gross operating profit. – (2) Management of individual and collective portfolios. – (3) Includes value adjustments to tangible and intangible fixed assets.

The increase of 10.8 per cent in operating expenses was due mainly to the cost of additional staff incurred by intermediaries operating in innovative market segments. The ratio of total operating costs to gross operating profit rose from 56.1 to 62.3 per cent. A total of 50 intermediaries posted a loss for the year; 34 of these had been registered for less than three years and operated mainly in innovative sectors. The other loss-making companies were mainly businesses with non-banking roots which experienced problems of strategic positioning and/or operational deficiencies.

At the end of 2007 the supervisory capital and reserves of asset management companies, consisting almost entirely of prime assets, amounted to €1,607 million, 4.12 times the minimum capital requirement of €390 million, compared with a ratio of 4.26 in 2006. For 151 intermediaries the capital requirement coincides with the minimum share capital required to take up activity (€1 million), since the "other risks" requirement (25 per cent of operating costs) and the requirement measured in relation to assets under management were lower. For 55 businesses the capital requirement was represented by the "other risks" coefficient.

Investment firms. – The operating profit of the 97 reporting investment firms increased by 5.2 per cent in 2007 as a result of an increase in income from trading for own account and from the provision of advice and ancillary services, while operating costs remained more or less unchanged. Total net profit came to €180 million; ROE calculated on the basis of net balance-sheet worth was 20.5 per cent, compared with 24.3 per cent in 2006. Operating efficiency improved slightly, with the ratio of operating costs to profit on ordinary activities declining from 63.5 to 61.9 per cent. The sector is highly concentrated, so that overall performance is strongly influenced by the results of the major operators.

At the end of 2007 the firms' supervisory capital and reserves, which consisted almost entirely of prime assets, was about 15 per cent higher than a year earlier, at €775 million. The capital aggregate was 4.97 times the capital requirement of €156 million, compared with a multiple of 4.85 at the end of 2006.

Financial companies under Article 107 of the Consolidated Law on Banking. – The 168 financial companies not classified as financial vehicles engaging in securitization operations recorded improved results last year, their net profit rising by 10.7 per cent to €1.5 billion. Gross income benefited from an increase of 10 per cent in net interest income and one of 20.6 per cent in income from services; these gains outweighed the increase in operating costs and value adjustments for credit risks. ROE worked out at 17.6 per cent.

At the end of 2007 the supervisory capital and reserves of financial companies totalled €14.7 billion, 10.5 per cent more than a year earlier, owing primarily to the allocation of profits for 2007 to reserves and to a lesser extent to capital increases.

The supervisory capital and reserves of leasing, factoring and consumer credit companies (including forms of support provided in securitization operations) were equivalent to 7.3 per cent of their risk-weighted assets at the end of 2007. The decrease of 0.6 percentage points by comparison with 2006 was due to the growth in business.

The new prudential regulations, which became applicable to financial companies on 1 January 2008 (so-called "equivalent supervision"), lay down differing levels of capital to be set aside against credit risk according to whether the company accepts deposits from the public and whether it belongs to a banking group. For institutions availing themselves of the option to accept deposits, the requirement is set at the same level as for banks (8 per cent of assets at risk), while for all other intermediaries it is 6 per cent. The requirement is reduced by one quarter for financial companies belonging to banking groups.

Credit quality deteriorated slightly owing to an increase in the proportion of loans overdue for more than 120 days from 6.6 to 7.1 per cent of lending and, to a smaller extent, to a rise in new positions classified as bad debts from 1.4 to 1.5 per cent of lending (Table 20.5).

Table 20.5

Financial companies: credit quality
(millions of euros and percentages)

	Bad debts		Overdue claims (1)		Lending		New bad debts (3)	New overdue claims (3)	New bad debts/ performing loans (4)	New overdue claims/ lending (5)
	Gross	Net (2)	Gross	Net (2)	Gross	Net (2)				
2005	3,997	1,456	7,176	6,736	121,669	121,128	1,618	6,236	1.5	6.2
2006	3,813	1,216	8,114	7,630	137,752	134,350	1,568	7,306	1.4	6.6
2007	4,459	1,624	9,938	9,403	163,704	158,282	2,063	8,994	1.5	7.1

(1) Claims overdue by more than 120 days from the scheduled repayment date. – (2) Net of write-downs. – (3) Annual flows before write-downs. – (4) Annual flow of new bad debts as a percentage of performing loans at the end of the previous year; performing loans are lending net of bad debts. – (5) Annual flow of new overdue claims as a percentage of lending at the end of the previous year; lending is net of bad debts and overdue claims.

The loan portfolio became less concentrated, thanks to a decline in the total number and amount of large exposures and a reduction in positions exceeding the large exposures ceiling, even in relation to the more stringent individual limit on loans, which in 2007 was lowered from 60 to 40 per cent of supervisory capital and reserves.

21. THE STRUCTURE OF THE FINANCIAL SYSTEM

The Italian banking and financial system is integrated in the European market and includes intermediaries of international stature as a result of the process of consolidation in recent years. For the five largest Italian banking groups, foreign units account on average for more than one third of total assets. Branches and subsidiaries of foreign banks have a significant share of banking business in Italy, including retail business.

Table 21.1

The structure of the Italian financial system

	31 December 2006			31 December 2007		
	Number of intermediaries			Number of intermediaries		
	Group members	Non-group	Total	Group members	Non-group	Total
Banking groups			87			82
Banks	227	566	793	224	582	806
limited company banks	*198*	*47*	*245*	*199*	*50*	*249*
cooperative banks (banche popolari)	*18*	*20*	*38*	*15*	*23*	*38*
mutual banks (banche di credito cooperativo)	*11*	*425*	*436*	*10*	*430*	*440*
branches of foreign banks	–	*74*	*74*	–	*79*	*79*
Investment firms	18	88	106	21	86	107
Asset management companies and SICAVs	67	132	199	63	151	214
Financial companies entered in the register referred to in Article 107 of the Consolidated Law on Banking	99	345	444	100	380	480
Electronic money institutions	–	3	3	–	3	3
Other supervised intermediaries (1)	–	2	2	–	2	2

(1) Bancoposta and Cassa depositi e prestiti.

In the asset management market in Italy resources are being reallocated from Italian investment funds towards alternative investment products. The acquisition of leading asset management companies by foreign banking groups is changing the configuration of the market. The amount of funds flowing to the insurance sector is growing significantly.

Last year saw a continuation of the growth of intermediaries managing closed-end securities and real-estate funds and hedge funds; the innovative sectors are prevalently the domain of non-bank intermediaries.

Banks and banking groups

Mergers and acquisitions. – In the ten years 1998-2007 the process of consolidation, consisting of more than 300 mergers and acquisitions, resulted in the transfer of more than 50 per cent of the total assets of the banks operating in Italy. During the same period acquisitions of foreign banks by Italian groups had an impact equal to 26.2 per cent of the system's assets, helping to increase its international integration.

The merger of Capitalia into UniCredit was authorized in the second half of 2007. The transaction expanded UniCredit's territorial coverage and improved its positioning in some specialized lines of business. At the end of 2007 the group, with about 9,700 branches (of which more than 5,000 in Italy) was the second-largest in the euro area by market capitalization and the sixth-largest by total assets. The Antitrust Authority made its approval of the merger subject to UniCredit selling about 180 branches, disposing of its equity interest in Assicurazioni Generali and reducing its interest in Mediobanca.

Following the merger of Intesa and San Paolo that became legally effective on 1 January 2007, the group began corporate operations to achieve the objectives of integration and simplify the group's structure with rationalization measures bearing on subsidiaries operating in the same market, sector or country. In the opening months of 2008 Intesa Sanpaolo completed its acquisition of control of Banca CR Firenze, holding a 60 per cent interest, and made a residual tender offer for the rest of the share capital.

The group's geographical structure, following the disposals made pursuant to the order of the Antitrust Authority, consists of some 7,300 branches (including more than 1,200 located abroad). In the domestic market Intesa Sanpaolo is the largest group, with 18.4 per cent of total system assets (19.5 per cent counting Banca CR Firenze).

In November 2007 Banca Monte dei Paschi di Siena (MPS) signed an agreement with Banco Santander to acquire the Banca Antonveneta group. The transaction, which recently received authorization, will expand the MPS group's branch network significantly and boost its market share to 8.3 per cent of system assets, reinforcing its position as the third banking pole in Italy.

The cooperative banking sector also witnessed reorganization measures in connection with mergers and acquisitions during the year. The UBI Banca group began carrying out the activities envisaged in the integration plan in the fields of asset management, consumer credit, leasing, and sales of financial products. During the year it sold one business segment (61 branches) to Banca Popolare di Vicenza, as required by the Antitrust Authority. Banco Popolare undertook important projects to rationalize its equity interests in the asset management sector and is reorganizing the branch network among the main territorial banks of the group.

The degree of concentration of the Italian banking system. – The top five banking groups' share of system assets in the domestic market rose from 48.6 per cent in 2000 to 51.5 per cent in 2007 and the Herfindahl-Hirschman index, calculated on the total assets of the units operating in Italy, increased by 28 per cent to 768 (on a scale of

10,000). The two indicators rise to 54.6 per cent and 828, respectively, taking into account the acquisition of Antonveneta by MPS and that of Banca CR Firenze by Intesa Sanpaolo.

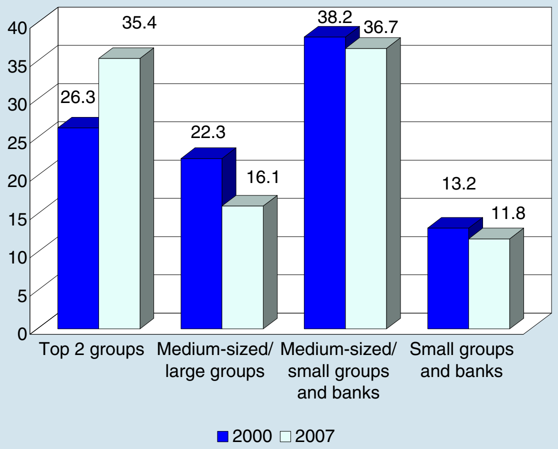
In the five leading European countries by total assets, the average degree of concentration – gauged by the market share of the five largest groups – is 46 per cent; the figure for Italy (51.5 per cent) is second to that of France. Higher levels of concentration are found in the countries with smaller banking systems.

The structure of the system is characterized by four classes of intermediary. The top tier is composed of two groups (UniCredit and Intesa Sanpaolo), large even by European standards and with significant international operations, accounting for 35.4 per cent of system assets (Figure 21.1). Next come three medium-sized/large groups with prevalently domestic operations, two of them led by cooperative banks, with a market share of 16.1 per cent. The intermediate class consists of 56 groups and stand-alone banks with average total assets of €16.4 billion. It includes intermediaries with prevalently traditional business, specialized banks, subsidiaries of foreign banking groups, and some banks active in the asset management and bancassurance sector. The most numerous class comprises 603 small intermediaries specialized in financing the local economy. This class includes mutual banks and the branches of small foreign banks and has a market share of 11.8 per cent.

Figure 21.1

Degree of concentration of the Italian banking system (1)

(percentages)



Source: Supervisory reports.
(1) Market shares of total assets, calculated using consolidated data for banking groups (with reference to Italian units only) and individual data for banks not belonging to a group.

The internationalization of the system. – For the top five banking groups, foreign units accounted for 35.3 per cent of total assets at the end of 2007 (38.3 per cent at the end of 2006). For all banking groups, the share was 25.7 per cent (26.4 per cent at the end of 2006).

At the end of 2007, 22 subsidiaries of foreign groups accounted for 11.2 per cent of system assets, against 10 per cent a year earlier. If the acquisition of Banca Antonveneta by MPS had already been completed, the share would have fallen to 9.2 per cent. The branches of foreign banks (excluding Bayerische HVB, which is included in the UniCredit group) accounted for 8.2 per cent of system assets (7.6 per cent in 2006).

After consolidating their presence in eastern Europe, where Italian groups have an average market share of about 18 per cent (Table 21.2), Italian intermediaries have turned to new geographical areas, launching acquisitions of important banks in the countries of the former Soviet Union and in North Africa. The main acquisition abroad in 2007 was UniCredit's takeover of ATF, Kazakhstan's third-largest bank. In early 2008 UniCredit finalized its acquisition of Ukrsotsbank, the fourth-largest Ukrainian bank.

Table 21.2

Foreign presence in the banking systems of selected European countries (1)
(at 31 December 2007)

	Number of banks			Assets		
	Total	*of which:* foreign-controlled branches and subsidaries	*of which:* Italian-controlled branches and subsidaries	Total (billions of euros) (2)	*of which:* % held by foreign-owned banks	*of which:* % held by Italian-owned banks
Austria	827	55	16	897.2	26.7	18.1
Belgium	110	85	1	1,402.9	23.4	0.1
Bulgaria	29	21	1	30.2	82.3	14.5
Croatia	38	20	7	48.5	90.6	43.6
Czech Republic	37	29	4	140.4	97.6	9.1
France	401	161	11	6,375.0	12.2	1.7
Germany	2,015	139	16	7,625.7	11.4	4.1
Hungary	231	34	5	105.6	86.0	20.3
Luxembourg	156	144	13	915.4	91.7	3.9
Netherlands	91	32	1	2,229.5	15.6	..
Poland	64	40	4	235,2	71.2	18.2
Romania	42	36	18	69.4	87.8	8.8
Russia	1,092	86	3	560.1	17.2	1.6
Slovakia	26	21	2	49.6	73.0	25.5
Slovenia	35	11	2	42.3	28.8	10.4
Spain	282	98	3	2,946.7	11.6	0.1

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. – (2) Total assets shown in company accounts.

Non-bank intermediaries

Asset management companies. – The year was marked by the continued growth of companies specialized in managing closed-end real-estate funds, closed-end securities (private equity) funds and hedge funds. Such companies (140) now considerably outnumber those that mainly run traditional open-end funds. Of the 27 companies established in 2007, eleven are dedicated to private equity activity, four manage open-end hedge funds, four are specialized in other open-end funds and eight in real-estate funds.

The dynamics of the asset management industry. – The structure of the asset management market, consisting of the aggregate of the portfolios managed individually or collectively by asset management companies, banks and investment firms, has been influenced in the most recent years above all by the reallocation of resources from Italian investment funds towards alternative products (bank bonds and insurance policies) and by the growing penetration of funds run by foreign intermediaries. The structure has also been affected by the acquisition of some leading asset management companies by foreign banking groups. Meanwhile, insurance groups' asset management companies, which in the past years have increasingly assumed the role of single financial asset manager within their groups, have benefited from the increase in the inflow of resources to the insurance sector.

Compared with the situation in the other main European countries, the supply of investment funds is relatively undiversified in Italy and product innovation is less intense. With some exceptions, the outsourcing of production – through the supply of funds set up by Italian groups' subsidiaries established in Luxembourg and Ireland – has been dictated not by strategies of international expansion but by tax treatment of products and asset management companies.

The volume of assets under management by the three largest groups (Generali, UniCredit and Intesa Sanpaolo) has become very substantial. To a differing extent these groups have developed a presence in the main European markets, in part through mergers and acquisitions, but they are not big enough to play a role similar to the one they have in the European banking and insurance markets. The top Italian group ranks fifteenth by assets under management. The Watson Wyatt ranking shows only three Italian intermediaries among the top 30 European asset management groups, compared with eight British, five French and five German groups. In terms of assets under management, the British, French, Swiss and German have shares of approximately 20 per cent, compared with 5 per cent for the leading Italian groups.

The rest of the asset management industry consists of an intermediate class of medium/small companies, for the most part belonging to banking groups or held by more than one bank, that offer a "generalist" line of products, and a small number of independents that have grown rapidly in recent years but pursue niche strategies and have a limited volume of assets under management.

Investment firms. – During the year eight new investment firms were established (two of them foreign-owned). The majority of the new firms specialize in individual portfolio management. About one third of all registered investment companies are bank-controlled. Those directly or indirectly controlled by foreign groups also account for about one third of the total.

Financial companies. – At the end of 2007 about two thirds of the financial companies in the special register referred to in Article 107 of the Consolidated Law on Banking were securitization vehicles. Among the other types of company, those belonging to banking groups increased.

The specialized nature of leasing and factoring business explains the large market share held by non-bank financial intermediaries. In particular, financial companies held a 72.1 per cent share of the leasing market (of which 53.3 per cent attributable to intermediaries belonging to Italian banking groups) and banks the remaining 27.9 per cent. In factoring, financial companies held 86.9 per cent of the market (of which 63.2 per cent attributable to intermediaries belonging to Italian banking groups) and banks the remaining 13.1 per cent.

Financial companies' share of the consumer credit market grew further in 2007, from 45 to 49.1 per cent. The increase was equally divided between independent operators and intermediaries belonging to banking groups, whose market shares amount to 29.1 and 20 per cent, respectively.

The presence of foreign intermediaries that control registered financial companies remains significant. In 2007 it was greatest in the consumer credit, leasing and factoring sectors, where their market shares were 18.7, 17.8 and 11.6 per cent respectively.

22. SUPERVISION

International cooperation

The activity of the principal international committees on financial stability and supervisory cooperation focused on analysing the causes and effects of the market turmoil and the best ways to improve the soundness of financial systems. The tensions on the markets heighten the need for measures to improve the regulatory framework and supervisory arrangements and for closer coordination and cooperation between the authorities of different countries.

The Basel Committee. – The Committee on Banking Supervision has launched several projects designed to improve aspects of the new Basel II Capital Accord following the recommendations of the Financial Stability Forum. Under the first pillar, the prudential treatment of some structured products and of liquidity lines granted to off-balance-sheet vehicles will be tightened to remove the scope for arbitrage and false incentives to acquire risk. Treatment of the specific risk in the trading book will be reviewed to take account of potential losses not only in case of default but also due to unexpected events, such as ratings migration, bad corporate news or a sudden drying up of market liquidity. With respect to the second pillar, studies will be conducted with a view to drawing up guidelines for the fine-tuning of intermediaries' risk management practices, particularly stress testing procedures, internal risk measurement methods for securitizations and exposures to off-balance-sheet vehicles. As to the third pillar, the Committee is now examining how best to ensure that markets receive clearer information on complex instruments and banks' involvement in the activity of unconsolidated vehicles.

The tensions that developed on international markets from August of last year have highlighted the importance of sound liquidity risk management by banks. In February of this year the Basel Committee published a report on supervisory practices around the world as a basis for a review and updating of its 2000 guidelines. A new report will be issued for consultation in July, containing recommendations to banks on rectifying shortcomings in their liquidity risk management, particularly as regards stress testing methods, contingency funding plans and the management of off-balance-sheet assets and commitments. The Committee has also begun to weigh the appropriateness of tightening liquidity risk regulation and supervision standards and stepping up convergence of liquidity rules for cross-border banking groups. The Bank of Italy has contributed to these efforts in order to highlight the best practices adopted by intermediaries and promote prudential approaches that will guarantee equal treatment between banks and countries.

The Ecofin Council. – Within the European Union, initiatives to address financial market turbulence are progressing in a coordinated manner, consistent with those of the Financial Stability Forum and the bodies responsible for the development of international supervisory standards. In October 2007 the Ecofin Council adopted a road map, updated in May of this year, outlining specific measures to strengthen the financial system with the following objectives: to increase transparency for investors, markets and supervisors; to improve standards for the valuation of financial products; to tighten prudential rules and banks' risk management by adopting measures that will be incorporated in the Commission's review of the capital adequacy directive; and to foster greater efficiency in the financial markets, among other things by encouraging rating agencies to improve their creditworthiness assessment techniques.

At the meetings of October 2007 and May 2008 the Council decided to take further action to strengthen the mechanisms for guaranteeing financial stability in Europe and encourage more efficient cooperation among national authorities in the management of cross-border crises of systemic importance.

In May this year the Finance Ministers, central bank governors and representatives of supervisory authorities agreed on a new Memorandum of Understanding on cooperation in the field of cross-border financial stability; it updates the 2005 Memorandum, extending it to the authorities responsible for supervision in the securities, insurance and pension fund sectors. The main innovations of the new Memorandum are the adoption of common principles for the management of cross-border crises, the creation of a shared analytical framework for assessing the systemic impact of crisis, and the formulation of common operational guidelines for the cooperation procedures to be followed by all authorities in the event of crises. For countries sharing financial stability concerns due to the presence of cross-border groups, the new Memorandum provides a master agreement form for the crisis management of a single group, detailing procedures for the exchange of information and setting out general principles for the allocation of any costs. In 2009 the Economic and Financial Committee will test the effectiveness of the new Memorandum of Understanding and of the mechanisms for guaranteeing financial stability by conducting a financial crisis simulation at European level.

The Council has also invited the Commission to examine the possibility of extending the scope of Directive 2001/24/EC on the reorganization and winding up of credit institutions to embrace foreign subsidiaries; conduct a feasibility study of the project to reduce the obstacles to cross-border transfers of assets, introducing adequate safeguards in banking, bankruptcy and company legislation; and consider potential measures to increase the interoperability of deposit insurance schemes, speed up refund times and improve information for depositors.

In December 2007 and again in May the European Council, assisted by the main European institutions and organizations, approved a set of recommendations to improve the operation of the Lamfalussy procedure at all three levels. The aim is to achieve faster progress towards convergence and more effective supervision within Europe, especially of cross-border groups.

As regards Levels 1 and 2 of the procedure, which relate to the adoption of legislation and regulations, the European institutions are requested to limit the inclusion of options and national discretionary scope in directives and implementing measures and to accompany measures with assessments of their economic impact and of their impact on the mechanisms for supervisory convergence. The Council has invited all member states to include in their mandate to the national supervisory authorities an undertaking to enhance supervisory cooperation and convergence and to take account, in performing their tasks, of the repercussions on the financial stability of other member countries. It also calls for the introduction of measures to strengthen the Level 3 committees.

The Bank of Italy has approved the proposals to provide the Committee of European Banking Supervisors with improved decision-making mechanisms and greater resources, enabling it to play a more incisive role in reinforcing supervisory cooperation and the convergence of supervisory practices.

European Union regulations. – The Commission has begun a review of the directives on capital adequacy of credit institutions and investment firms (Directive 2006/48/EC and Directive 2006/49/EC), particularly in the areas of cross-border cooperation between home and host authorities in normal and crisis situations, on the regulation of large exposures, and on the treatment of hybrid instruments in the calculation of supervisory capital. In April this year the recommendations were submitted to public consultation, which will be accompanied by an impact study. The official presentation should take place in September.

The supervision committees. – The Bank of Italy contributed to the work of the CEBS to foster uniform application of the new capital adequacy rules and enhance the convergence of supervisory practices. In September 2007 the Committee approved a voluntary and non-binding mediation system for disputes between national authorities. In October it approved the peer-review mechanism, setting up a special review panel to evaluate the convergence of supervisory practices in specific areas. In December, efforts coordinated by the Bank of Italy under the umbrella of the CEBS led to the publication of a model for multilateral agreements between authorities charged with the supervision of European banking groups and a paper on the functioning of the colleges of supervisors; together they will form a basis for cooperation and for the organization of supervision on large cross-border groups in normal and crisis situations. In particular, the multilateral agreement model will provide the authorities sitting on the boards with a guide to the stipulation of written collaboration agreements.

In December 2007 the CEBS also published a proposal for an amendment to the guidelines on consolidated prudential returns in order to harmonize the frequency and timing of their transmission to the national authorities. The proposal, which was put out to public consultation, includes the introduction, in 2011, of a quarterly reporting requirement and 35-working-day transmission deadline.

Italian legislation

The legislative framework in the financial sector has changed with the transposition of the Community directives on takeover bids and markets in financial instruments. Their purpose is to enhance the protection of investors and savers, promote integration and competition in the financial markets, maintain the contestability of corporate control, and increase market transparency. As regards the prevention of money-laundering, Directive 2005/60/EC, the third anti-money-laundering directive, was transposed by Legislative Decree 231/2007.

Transposition of the Takeovers Directive. – The method adopted to transpose the directive was designed to reconcile the different concerns – contestability of control and protection of minority shareholders – and confirms the principles underpinning the previous law: 30 per cent threshold for mandatory tender offers, passivity rule, and right to recede from shareholders' agreements during a tender offer. The breakthrough rule renders some restrictions on the transfer of securities and certain voting rights unenforceable in respect of the offeror. Under the principle of reciprocity, the passivity rule and the breakthrough rule do not apply if the offeror is subject to other legislation and is not bound by the same rules or equivalent provisions.

Transposition of the MiFID. – The amendments to the Consolidated Law on Finance following the transposition of the MiFID (Legislative Decree 164/2007) have profoundly altered the legislative framework for investment services and activities. The range of activities reserved to authorized intermediaries has been extended, with the provision of advice and the management of multilateral trading facilities now included among investment services; greater flexibility has been introduced in the rules by correlating the level of safeguards to the type of service offered and the characteristics of clients; coordination among supervisory authorities has been reinforced.

The transposition of the directive was concluded on 29 October 2007 when the supervisory authorities issued a set of provisions. The Bank of Italy and Consob introduced a joint regulation setting out the organizational requirements and procedures for intermediaries offering investment services (principally investment firms and banks). As the objective of the new provisions is to create a common organizational framework for all operators, they also apply to intermediaries authorized to engage in collective asset management (asset management companies and SICAVs). Coordination between the supervisory authorities for investment services and for collective asset management was reinforced under a memorandum of understanding signed by the Bank of Italy and Consob on 31 October 2007 and annexed to the joint regulation.

The Bank of Italy has also issued separate provisions establishing the minimum start-up capital for investment firms and regulating the conduct of business abroad and the deposit and sub-deposit of clients' assets, scaling requirements differently for retail and professional investors. Consob has laid down rules of conduct for the provision of investment and collective asset management services and regulated the markets.

Anit-money-laundering. – Legislative Decree 231/2007 introduced substantial innovations in the prevention of money-laundering, such as the extension of provisions in this matter to include the financing of terrorism and the introduction of customer risk profiles. It also makes provision for the incorporation of the Italian Foreign Exchange Office (UIC) into the Bank of Italy and the creation of the Financial Intelligence Unit (FIU), which brings together tasks related to the reporting of suspicious operations, especially the examination and financial analysis of reports, the analysis of statistical flows, contacts with national authorities and foreign FIUs and the investigation of omitted reports.

As supervisory authority the Bank of Italy has been granted broad powers of regulation, control and sanction. The Decree entrusts the sectoral supervisory bodies, acting in concert, with tasks relating to the issue of provisions on the correct evaluation of clients, organization, internal procedures and controls, and recording of operations. The Bank of Italy is also responsible for ensuring, where appropriate via on-site inspections, that supervised entities comply with the requirements of the law.

Prudential regulation. – In 2007 the adaptation of prudential regulation to the new European legislation (Basel II) was completed with the issue of supervisory provisions relating to investment firms and the extension of the new supervisory framework to financial intermediaries listed in the special register under Article 107 of the Consolidated Law on Banking. In observance of the principle of proportionality, investment firms with low risk exposure owing to the nature of their business will be eligible for simplified prudential rules.

The transposition of the Basel II Accord gave rise to a broader review of the legislation. In this framework, the year 2007 saw the completion of the implementation of the new rules on guaranteed bank bonds and the organic reform of loan guarantee consortia, which was completed in 2008 with the issue of supervisory provisions by the Bank of Italy. These consortia are subject to supervisory and prudential systems similar to those applying to financial intermediaries and cooperative banks.

Regulations on governance. – Banking supervision focuses closely on organizational aspects. In an increasingly complex context, efficient governance becomes crucial to the achievement of corporate objectives in conditions of sound and prudent management.

The “Supervisory regulations on the organization and corporate governance of banks”, issued by the Bank of Italy in March 2008, tackle the most important aspects: duties and powers of corporate bodies, their composition, compensation and incentives, exchange of information. The regulations were issued in response to the changes introduced by the reform of company law and their reflection on the Consolidated Law on Banking, particularly as regards the possibility for banks to move away from the traditional system of management and control. The regulations follow international best practices.

The rules give substance to the principles set out in the Decree of 5 August 2004 issued by the Minister of the Economy and Finance. In general, they grant banks full autonomy to select the most appropriate governance models for their characteristics and strategies and are applied according to the criterion of proportionality. Decisions must be carefully evaluated and documented and described in a specific corporate governance proposal.

The provisions set out the functions – of strategic supervision, management and control – that are relevant to supervision. The functions must be divided among or within the organs of management so that their respective duties are clearly identified and constructive dialogue and correct control procedures can be established. This system emphasizes the position of the chairman of the strategic oversight body and the role of the independent and non-executive directors.

Bank-customer relations. – The Bank of Italy is developing several projects relating to financial education to increase the public's awareness of the risks and opportunities offered by the market and contribute to the implementation of Article 128-*bis* of the Banking Law enacted by the Law on the Protection of Savings, which makes it compulsory for intermediaries to belong to mechanisms for the out-of-court settlement of disputes with customers. In this connection, the Bank has prepared a draft regulation for consultation and held meetings with representatives of banks and consumer associations prior to submitting a proposal to the Interministerial Committee on Credit and Savings.

In recent years the subject of bank-client relations has also been tackled in legislative provisions, which have had a direct effect on specific aspects of the regulation on transparency and on selected products and services offered to customers. The principle of safeguarding the weaker party also underpins some of the provisions of Law 244/2007 (2008 Finance Law). This law introduces and regulates the matter of class actions. The aim is to improve the safeguards for consumers and savers by reducing the cost of court action and thus removing some of the obstacles to the judicial protection of rights where damage, whether contractual or resulting from an unlawful act, has been modest but affected a large number of claimants.

In order to improve the safeguards for bank customers regarding the early cancellation and portability of mortgages, the Bank of Italy recently reminded banks to apply the regulations correctly and provide clear and complete information on conditions and on the exercise of their rights. The Antitrust Authority also recently announced that it would take measures to ensure that these regulations were fully implemented. Finally, in May 2008 the Government announced that it had reached an agreement with the Italian Bankers' Association allowing borrowers to renegotiate existing mortgages so as to keep repayment instalments constant while lengthening the duration.

Asset management. – The objective of the proposed regulations in this sector is to foster competitiveness, enhance the intermediaries' autonomy regarding organization and risk management, and reduce and simplify administrative formalities.

Given the need for legislative and regulatory solutions to re-launch the asset management industry in Italy, in February of this year the Bank of Italy formed a working group in which representatives of other supervisory authorities, business associations and management companies also take part. The overall situation of the industry was analysed, with closer investigation of issues such as the differences in the regulatory treatment of various forms of investment, the taxation of investment funds, the role of distribution networks and group links, and the development of Community legislation. Potential lines of action should be mapped out by the end of this summer.

Control processes

The supervisory review process. – The Bank of Italy is engaged promoting a model of bank supervision that conforms with the principles of the new prudential regulations (Basel II) and reflects the changes taking place in the structure, operating models and risk exposure of the system it supervises.

The task of defining the methods and criteria for the supervisory review and evaluation process provided for under the second pillar of Basel II is nearing completion. As part of this process, the function responsible for continuous controls of supervised banks will prepare an annual evaluation of the present and prospective situation of each bank and undertake the required supervisory measures. Many of the activities covered by this process are already being performed by the Bank of Italy. These include the periodical off-site analysis of the supervised banks and intervention where weaknesses or problems require.

The main innovations introduced include adapting the methodology currently used to evaluate banks' risk exposure and the methods of performing supervisory controls and intervention, which aim towards a more transparent dialogue with banks.

Supervision is ordinarily performed through exchanges between banks and the supervisory functions responsible for on-site and off-site inspections, acting in close coordination. Full knowledge of the strategies, scope of business and risk exposure of supervised banks, which is essential for risk-based supervision, requires close and frequent dialogue with banks, proportionate to their complexity and problematic aspects. Contacts will consist in off-site analysis of the information requested, including targeted investigations, and meetings with senior management.

Inspections will play a crucial role in this process. They will serve to verify the reliability of information and the soundness of internal safeguards; they will focus increasingly on specific problems and evaluate implementation of the corrective measures required by the supervisory authority; they will include a broader assessment of conduct regarding the observance of requirements in sectors with greater reputational and operational risk exposure (money-laundering, usury and transparency).

This broader framework of dialogue also embraces exchanges of information with the banks recently involved in mergers concerning the improvement in their structures, information systems and corporate cultures; the aim is to speed up the expected results of the mergers in terms of economic objectives and creation of value at a time when the financial markets of the leading countries face new and more difficult conditions.

Contacts are also being developed with banks concerning the steps taken for the Internal Capital Adequacy Assessment Process (ICAAP) required by the second pillar of Basel II. The first documents must be submitted by the end of September 2008 for individual and October for consolidated assessments.

In the case of cross-border groups, it is important that the supervisory authority base its review of the ICAAP, methods of analysis and methodology and outcome of assessments on the same approach as the other authorities responsible for the supervision of the various members of the group. As home supervisor for the UniCredit and Intesa Sanpaolo groups, the Bank of Italy is directing the activity of the relevant supervisory colleges – which focused initially on validating internal capital adequacy assessment systems – towards the requirements of the second pillar.

The Bank also participates as host authority in the supervisory colleges organized by the home authorities in charge of consolidated supervision of foreign groups with major subsidiaries in Italy. At the present stage these boards are engaged principally in the validation of advanced credit and operational risk management models.

Concerning the intermediaries listed in the special register set up under Article 107 of the Consolidated Law on Banking, the Bank of Italy is now assisting them in the correct application of the new prudential system. The system is “equivalent” to the one applying to banks and is considerably more structured that the previous version; an important innovation is the introduction of minimum capital requirements in respect of the different types of risk exposure.

Compliance with the requirements of the first pillar. – Supervisory activity is being intensified to verify that banks comply with the new capital adequacy rules for credit, operational, market and counterparty risk.

The large banking groups, which are engaged in developing advanced methods of calculating their capital adequacy requirements, are undergoing a complex process of validation of their internal risk assessment system by the supervisory authority prior to submitting an official application for approval.

The UniCredit group was the first to receive authorization, in March of this year, to use its internal capital adequacy assessment process for credit and operational risk. Proceedings are under way for the formal approval of the systems of two more banking groups.

For banks using simplified methods for the calculation of capital requirements, dialogue with the supervisory authority centres on the organizational and procedural effects of the new methods of calculation, particularly in view of their more segmented credit portfolios and the new provisions regarding credit risk mitigation techniques.

Derivatives business with retail customers.– Following a global trend, Italian banks have expanded their derivatives business considerably in recent years, raising the proportion of contracts with private individuals and firms and constantly increasing their complexity; as a result great skill is needed for proper product pricing and greater care to ensure that non-professional clients truly understand the content. An important factor for the banks is adequate management of the risks – counterparty, legal and reputational – associated with the use of derivatives, which can jeopardize stability and customer confidence.

Supervisory activity on banks’ derivatives business is guided by the results of a recent self-assessment exercise requested by the Bank of Italy to evaluate the suitability of the organizational structures, operating processes and risk measurement and control system for these products, in particular very complex and high-risk instruments traded with customers. A need for action was identified in certain areas, which will be the subject of further exchanges with the supervisory authority.

Control of organizational structures. – Central to banking supervision is the examination of corporate governance and internal control systems. The purpose of dialogue with the banks is to produce a joint assessment of the initial experiences with the new dualistic administration and control model. Close attention has been paid to specific aspects of the governance of cooperative banks, in particular the social dialectic and the representation of corporate bodies. The supervisory authority assigns increasing importance in its assessments to ensuring that the mechanisms governing the remuneration and bonuses of directors and senior management of supervised banks are consistent with prudent risk management policy and long-term strategies.

THE GOVERNOR'S CONCLUDING REMARKS

The new European gross interbank settlement system (TARGET2), in the development of which the Bank of Italy was a leading participant, is now operational. The Bank also collaborated in the establishment of the Single Euro Payments Area (SEPA). These initiatives will give further impetus to the integration of interbank services, bringing additional benefits to the citizens of Europe.

The Bank has completed the reorganization of its economic research and international relations function.

The Einaudi Institute for Economics and Finance was established in 2007, taking over the legacy of the former Ente Einaudi. It has already gained international recognition as an active promoter of theoretical and empirical research; it aims to provide a permanent base for highly qualified researchers.

Banking supervision must be adapted continuously to changes in the markets. The reform of this sector, which will come into effect on 1 August, will strengthen the safeguards of the Italian banking and financial system against the emergence of new risks, increase the protection of savings, and reduce the costs for intermediaries.

Today the General Council decided to merge the two functional areas of Central Banking and Markets and Payment System and Treasury Services. Financial management will be separated from institutional functions; risk monitoring will be independent of investment activity.

Like many other central banks, the Bank of Italy has an equities portfolio that it manages in compliance with strict rules of conduct: it does not invest in the shares of banks or other bodies it regulates; it adopts a long-term investment strategy; it exercises its shareholder rights according to principles based on international best practice and designed to reinforce the role of minority shareholders. As announced last year, we have intensified the restructuring of our portfolio, reducing the proportion of Italian shares and eliminating every discretionary element in new investments, which are now limited to benchmarked collective funds.

The reorganization of our branch network will begin in September.

It is no longer necessary for the Bank to have its own offices in the financial centres of the euro area; they will be closed by the end of this year. In agreement with the Ministry of Foreign Affairs, the Bank will second economic experts to Italian embassies in the main emerging countries of Asia and Latin America.

On 1 January 2008 the Bank of Italy acquired the powers, functions and personnel of the Italian Exchange Office, which has been closed. A Financial Intelligence Unit has been established, with broad powers to identify operations associated with money laundering and the financing of terrorism. The Unit is an independent body that performs its functions autonomously; the Bank regulates its organization and will increase its resources and capabilities, which are already stronger than in the past. Staff from the Unit act as advisors to the public prosecutors, in particular those most active in this area. Banking supervision plays an integral part in activities to combat money laundering.

The implementation of this broad programme of renewal and reorganization is confirmation that complex structures can be reformed without compromising the performance of delicate institutional functions.

The General Council and the Governing Board express their sincere gratitude to all the staff for their extraordinary commitment throughout this period of transition.

International finance

The turbulence that swept through the financial markets last summer came at the climax of an exceptional expansion in credit and finance, which for many years had contributed to the rapid growth of the world economy.

The long period of favourable macroeconomic conditions, the abundance of liquidity and low real interest rates had increased the amount of risk and the degree of debt that borrowers, investors and intermediaries were willing to take on. The rapidity of financial innovation heightened the system's potential to multiply credit in relation to invested capital. Operators did not keep pace in their ability to evaluate and manage the associated risks.

From 2003 onwards the narrowing of risk premiums and the reduction in expected volatility encouraged the rapid spread of loan securitization techniques using ever more complex and innovative securities that appeared to meet the requirements for the highest ratings. The rapid growth of the market in credit derivatives, which allowed investors to redistribute and hedge risks, helped to create an impression of virtually limitless opportunities for apparently safe investments. Credit instruments had never before appeared to be so liquid. As in a spiral, easy credit helped to reduce insolvency rates among borrowers, further reducing risk premiums and thus feeding new flows of lending.

Financial institutions, including some of the leading international banks, gave further impetus to this process, creating a sort of shadow banking system of vehicles specializing in investment and fund-raising on the credit derivatives market. Since these vehicles were not consolidated in the banks' balance sheets and were subject to much less stringent accounting and prudential requirements in the main financial centres, they operated with negligible capital, large liquidity imbalances, and an extreme maturity mismatch between assets and liabilities, due in part to gaps in the prudential rules prior to Basel II. Rating agencies, investors and banks underestimated the risk associated with structured products and, above all, the sudden concentration that would occur in the event of a generalized deterioration in the market. The banks, in particular, did not realize that if their vehicles' securities could not be refinanced in the market they would be forced to intervene to support them.

At the same time, redistributing the risk weakened the incentive for rigorous credit selection, above all in the United States; credit standards deteriorated and the foundations became fragile.

The trigger for the crisis came from the American real estate market. With interest rates rising, the fall in house prices led to an increase in defaults on subprime mortgages, revealing their high risk. Structured securities linked to this sector began to depreciate and their ratings were downgraded rapidly and drastically. Highly leveraged investors had to meet margin calls. The change in the perception of risk was sudden and swiftly spread to similar instruments in other market segments. Structured products offered by bank-related vehicles became impossible to refinance in the money market. To prevent their collapse, the sponsoring banks greatly increased their own liquidity requirements. The supply of funds on the interbank market dried up.

The spiral that had driven the expansion of credit and finance went into reverse. A shortage of liquidity, the changed perception of risk and the reduction in leverage reinforced one another. The sharp depreciation of structured products was reflected in the valuation of bank assets themselves; uncertainty about the level of exposure, the extent of losses and the soundness of the banks' capital base increased the counterparty risk perceived in the interbank market, making the latter even less liquid. Forced to take back onto their balance sheets assets they had previously transferred and to record write-downs on them, the banks saw the size and rigidity of their balance sheets grow and their capital position weaken.

The central banks intervened when it appeared that the turmoil could have systemic implications. The scale, flexibility and promptness of their intervention and the degree of international cooperation were unprecedented. They averted a systemic crisis that could have had devastating effects on the real economy. They prevented it from also seriously harming those who bore no responsibility for it.

Although tensions in some markets are easing, normal conditions have not yet been restored. In some market segments, spreads and risk premiums, which had even been too low in previous years, are still close to the peaks reached at the height of the crisis. Other segments, such as securitization business, are finding it difficult to return to normal activity. The value of many financial and real assets has been written down sharply.

When, where and how the crisis would have broken was impossible to know; the event that triggered it occurred in a fairly marginal segment of financial activity. Despite this, some of us had been persuaded of the extreme fragility of the situation for some time. The build-up of tensions was apparent well before last summer. In my first public speech in my present capacity at the beginning of 2006, I drew attention to the imbalances that had developed and the new risks accompanying the undoubted benefits of financial innovation. In this forum a year ago, I pointed out that investors' perception of risk could suddenly change, with destabilizing effects, and that while growing market complexity and interdependence made the system stronger and more efficient in normal times, it could increase its vulnerability to extreme events.

Helping the market to recover does not mean taking over its role. Nor would undoing financial innovation help. That would make the system poorer, not more secure. The history of financial crises, even recent ones, reminds us that traditional instruments and intermediaries are not necessarily any more stable and reliable. At the end of the eighties, well before today's structured financial products became widespread, the crisis among American Savings and Loans Associations cost US taxpayers more than 2 per cent of the United States' annual GDP. The Japanese banking crisis, which followed only a few years later, entailed even greater cost.

A retrospective examination of the events of recent months is essential in order to design the measures to be taken for the future of the international financial system. In the leading international financial centres, incomplete regulation and perverse incentives led to excessive borrowing, especially since its true scale was not perceived, and to an undervaluation of risk.

The financial system that will emerge from the crisis must have different rules, less debt, and more capital. This is the unifying principle of the recommendations made by the Financial Stability Forum in its recent report, which considers the essential elements to be the rapid adoption of the new Basel II prudential criteria and an increase in capital requirements, particularly in respect of structured products. The report proposes instruments to improve liquidity and risk management, enhance the transparency of financial institutions' accounts, overhaul rating mechanisms and set guidelines for emergency measures.

The report was approved by the Group of Seven. Most of the proposals it contains do not require legislation, but can be adopted directly by the regulatory authorities that contributed to their design; they constitute a coordinated response to the crisis that does not disrupt the integration of the global financial market. They can and must be put into practice without delay. It is important that the shared determination to implement them should not falter at the first signs of an easing of tensions.

The repercussions that the financial turmoil is having on the real economy in the industrialized countries, and especially the United States, have become clear since the end of 2007. Its effects on emerging and developing economies have been less pronounced. These economies are now making a decisive contribution to supporting global production and trade.

The greatest threat to the world economy now comes from the build-up of inflationary pressures and the possible worsening of the American slowdown. The principal source of concern remains the continued rise in the prices of energy and other raw materials. While on the one hand this rise reflects in part the still robust growth prospects of the emerging economies, on the other it is having a further recessionary impact on the advanced economies and feeding inflation, thus constraining the monetary policy stance.

The single monetary policy and the Italian economy

Since last autumn consumer price inflation in the euro area, fuelled by increases in energy and raw materials prices, has accelerated by about 1.5 points, reaching an average of 3.3 per cent in the first quarter of this year. This is the highest level since the first half of the nineties. The latest figures point to a further acceleration.

Nevertheless, the rise in domestic costs has remained modest, and no wage-price spiral has developed to date. The firm anchoring of inflation expectations has allowed the European Central Bank to keep interest rates unchanged for quite some time, thus helping to support the economy. This is an important difference from previous oil crises, when in some European countries the instability of inflation expectations led to equally unstable monetary conditions, characterized by repeated cycles of expansion and forceful restriction, with dramatic repercussions on the economic cycle. Today the European Central Bank is keeping monetary policy firmly focused on the objective of price stability over the medium term while ensuring, in cooperation with the other major central banks, the necessary liquidity to maintain the orderly functioning of the global financial system at a time of severe strain.

In 2007 Italy's economy, along with the rest of the euro area, was affected by the global downturn and the acceleration in commodity prices; however, it slowed more markedly than those of the other euro-area countries. The phase of cyclical weakness will continue for at least the current year. Exports, which in the last two years grew at an annual rate of almost 6 per cent, have been the mainstay of GDP growth. The expansion in domestic demand was very modest, the capacity utilization rate declined, investment slowed sharply and business confidence indicators worsened.

Household expenditure is being curbed by the feeble growth in disposable income and by rising prices, which in recent months have hit the consumption of lower-income households hardest. Consumption continues to be affected by precarious employment relationships, which are especially prevalent among young people and in the weaker segments of the labour market. Uncertainty over current income and prospects for future increases are acting as a brake on spending decisions, not least owing to the shortcomings in the social safety net. Despite the improvements made in recent years, for example by increasing ordinary unemployment benefits, there has not yet been a comprehensive and rigorous overhaul of the protections offered, which is essential to combine flexibility and fairness in the labour market.

With international prices rising, the strong euro is protecting the purchasing power of citizens and their savings. But it calls for a disciplined approach by all those who contribute to the production of national income: devaluation of the currency, a short-lived boost for firms, is no longer an option. Competitiveness and the country's ability to grow depend on productivity: it is on this front that intelligence and action must be concentrated.

The productivity problem

The problem of productivity has remained unresolved for over ten years. Notwithstanding the interpretative difficulties caused by a changing statistical picture, the last two years have confirmed the existence of a productivity gap in relation to our main competitors.

Businesses exposed to international competition have not remained inactive. As I indicated on this occasion last year, parts of the economy have started to restructure; this development is not unrelated to the adoption of the euro and the disciplining effect it has had.

Our surveys indicate that this structural change is occurring in all branches of industry. In both the traditional and the more advanced sectors, for every business that has closed down or is experiencing serious difficulties, there is another that has made a qualitative leap in its competitive capacity. Corporate mortality levels have risen, but the profitability and internationalization of enterprises that survive are growing. The average size of businesses is increasing; ownership and control structures are being modernized, in part thanks to advances made in company law and the law on markets.

These developments are encouraging; they reveal a more varied panorama than that painted by the aggregate statistics on productivity.

But in the economy as whole, most of which is sheltered from international competition, average productivity is still making no headway.

It is vital that Italian enterprises continue on the path of structural renewal. In the long term, wealth is not generated by defending monopolies or protection but by investing, innovating and taking risks.

Value added is barely keeping up with employment. In the last ten years the number of persons employed in industry and private services has risen by 17 per cent, or by 2.5 million, of whom two-fifths are immigrants. The unemployment rate has declined to just over 6 per cent, compared with over 7 per cent in Germany and France. In the North, unemployment has been at 4 per cent for seven years. These are the positive effects of new legislative and contractual measures introduced from the mid-nineties onwards, and of moderate wage growth. We cannot be satisfied with these results until the employment rate, especially for women, has caught up with European levels, until appropriate forms of flexibility have been introduced in the entire labour market rather than being concentrated in individual segments, and until there has been a generalized increase in productivity, which can be translated into higher earnings for payroll workers.

The public sector must help the economic restructuring process by acting in its own spheres of competence. The causes of the stagnation of productivity are well known. For some time, there have been calls from various quarters to increase productivity in public services by opening them to the market, to reduce rent-seeking by strengthening competition at national and local level, to ensure that schools and universities meet the standards of an advanced country, to bring infrastructure up to a satisfactory level, to ease the tax burden, to provide de facto legal certainty and effectiveness by simplifying legislation and making the justice system work, and to guarantee law enforcement and security everywhere.

A number of measures have been taken by successive governments in recent years. The gravity of the problems that have dogged the Italian economy for too long demands that the entire spectrum of public action – from the legal and regulatory framework to the size and quality of the budget – be directed towards achieving the priority objective of productivity and growth.

Economic efficiency and the budget

Budgetary policy must remain anchored to the macroeconomic necessity of reducing the ratio of debt to GDP. But if it is not oriented towards efficiency and growth at the microeconomic level, the economy will be held back and the restoration of sound public finances itself made more difficult.

Italy's public finances have improved in the last two years. In 2007 net borrowing fell to 1.9 per cent of GDP. The public debt declined to 104 per cent of GDP, the level at which it stood in 2004.

The outlook for the current year is less favourable. Based on the Combined Report on the Economy and Public Finances, net borrowing will rise to 2.4 per cent of GDP. The deficit adjusted for cyclical effects and temporary measures is set to worsen by 0.6 percentage points. The reduction of the debt ratio will be modest.

Even in a difficult economic climate, the ratio of public debt to GDP must continue on a downward path. The Government's intention to move soon to define the measures to be adopted in the next three years could make budgetary action more systematic and facilitate the achievement of a balanced budget in 2011.

Deficit reduction in the last two years was due above all to the sharp increase in the ratio of tax and social security contributions to GDP by 2.8 percentage points between 2005 and 2007. The ratio of fiscal revenue to GDP stands at 43.3 per cent, just below the peak recorded in 1997 at the height of the efforts to meet the Maastricht criteria; it is almost 3 percentage points above the average in the other European Union countries. The gap with respect to the United States and Japan is even wider.

The scale of irregular economic activity makes the burden on honest taxpayers heavier than in the rest of Europe. For every 100 euros of labour costs incurred by the employer, the taxes and social security contributions for a typical worker with no dependents amount to 46 euros in Italy. In the other euro-area countries the proportion averages 43 per cent of labour costs; in the United Kingdom it is 34 per cent and in the United States 30 per cent. The regional tax on productive activities further widens the gap between our country and the others. Despite the reduction that took effect in 2008, the overall rate of taxation on business profits is 8 percentage points above the average of the other EU countries.

High tax rates undercut firms' international competitiveness, reduce their propensity to invest and may cause distortions in their choice of size. They depress the earnings from regular work and discourage the regularization of unreported employment. As early as 1946, in the Constituent Assembly, Luigi Einaudi warned that "only by lowering current tax rates and reducing the incentive to engage in fraud will it be possible to obtain more revenue for the State".

Laying down a multi-year path for the reduction of some important tax rates would improve the expectations of both households and firms. Tax relief needs to be concentrated where it can give the most support to growth by reducing the distortions affecting economic activity. The effect on the economy will be all the greater if the formalities for taxpayers are simplified and legislation is made more stable.

Reducing the taxation of the components of earnings most closely related to productivity can have a positive effect on productivity itself, permit better plant utilization and encourage wage negotiations to reward increases in efficiency. Further ahead the tax burden will need to be alleviated for increasingly broad categories of workers, with preference given to measures that are simple and neutral.

Despite a slight slowdown recently, in the last ten years primary current expenditure has grown at an average annual rate of 2.1 per cent in real terms, which was much faster than GDP. This tendency will have to be corrected if the public debt is to be reduced and the tax burden eased. According to the macroeconomic scenario contained in the Combined Report on the Economy and Public Finances, achieving a balanced budget in 2011 and reducing the fiscal burden to 40 per cent of GDP over five years will require primary current expenditure to contract in real terms by about 1 per cent of GDP per year.

Every measure to curb public expenditure involves political and technical difficulties and runs up against deeply entrenched practices and special interests. The recent experience of other countries, such as Germany, nonetheless shows that substantial expenditure savings can be made without jeopardizing the fundamental goals of public action. The analyses conducted by the Technical Committee for the Public Finances indicate that there is scope for savings in many branches of expenditure. Contributions can come from measures to rationalize the presence of central government offices across the country, make managers accountable and introduce methods of assessment that reward the most deserving employees.

Some 30 per cent of the spending on old-age and seniority pensions currently goes to persons aged less than 65. In the medium and long term an increase in the average retirement age, accompanied by determined steps to boost supplementary pension provision, can make a major contribution to reducing public expenditure and help to contain the widening gap between the purchasing power of older pensioners and that of persons in employment.

Some features of the Italian pension system keep too large a proportion of the population from working. In Italy only 19 per cent of people aged between 60 and 64 are in work, as against 33 per cent in Spain and Germany, 45 per cent in the United Kingdom and 60 per cent in Sweden. It is time to remove the constraints and disincentives that stop people on the earnings-based pension system from continuing to work, widen the choice of retirement age for people on the contributions-based system, clear the remaining obstacles to combining earnings and pensions, and encourage flexible forms of employment, with hours that can be adapted to individual needs. This would allow people who have accumulated experience and expertise to continue, if they wish, to put them to use for their own benefit and for the benefit of their families and society.

The development of the Mezzogiorno and fiscal federalism

The quality of public expenditure and of the services it finances is fundamental for the development of the South of Italy, because the ratio of such expenditure to GDP is higher in the southern regions and because the inefficient use of public resources – all too often diverted towards special interests or plundered by organized crime – helps keep the South in its condition of backwardness and economic dependence.

The scope for growth is much greater in the South than in the North. Measures to exploit it can make a decisive contribution to the revival of the entire Italian economy.

In 2007 the ratio of the per capita GDP of the South to that of the Centre and North was less than 60 per cent; it is still lower than thirty years ago. In Germany the per capita GDP of the eastern Länder grew much faster than that of the rest of the country in the last ten years. However, there are large differences within the Mezzogiorno: Abruzzo, Molise and Sardinia are no longer economically backward according to European Community standards.

Average labour productivity in the South is 18 per cent less than that in the Centre and North; the employment rate is 19 points lower. The proportion of irregular employment is still close to 20 per cent, twice the level in the central and northern regions. While necessary, the increased flexibility that has begun to be introduced in recent years in the use and remuneration of labour is not sufficient to overcome the persistent imbalances of the labour market in the South.

The backwardness of the South is influenced by the weakness of the public administration, insufficient trust and cooperation and a widespread habit of ignoring the rules. For southern society to advance, economic intervention must go hand in hand with the strengthening of social capital.

Over the last ten years regional policy in favour of the Mezzogiorno has been able to count on a volume of financial resources comparable to that available for the extraordinary intervention that was discontinued in 1992. The results have fallen short of expectations.

Public expenditure tends to be proportional to the population while revenue reflects per capita incomes and tax bases, which are much lower in the South. The net flow of resources to the South intermediated by the State, excluding interest payments on the public debt, is estimated to be of the order of 13 per cent of the GDP of the South and 3 per cent of that of Italy as a whole. This is a very large amount; for the Mezzogiorno it is also evidence of uninterrupted economic dependence. The ratio to regional GDP is not uniform throughout the South, ranging from 5 per cent in Abruzzo to 20 per cent in Calabria.

Despite this major financial effort, the disparity between the South and the Centre and North in the quality of the public services provided for given levels of expenditure is considerable. Differences are to be found in every sector: from health care to education, from the administration of justice to that of the territory, and from the protection of personal safety to social policies and the creation of infrastructure.

The focus must be shifted from the quantity of resources to the quality of the results. The design and operating procedures of national policies must take account of the disparities between the effectiveness of the same measures in different parts of the country. Whether it is decided to adopt, on a case-by-case basis, systems founded on centralized or decentralized decision-making and administration, if the quality of public action in the South is to be raised, one point holds constant: public action degenerates without a system of independent and transparent assessment providing citizens with clear and comparable information on the quality of services. The level of students' scholastic achievement, the migration of patients to public hospitals in other regions, the length of hospital stays and recovery rates, and the duration of civil cases are examples in fields in which there appears to be the greatest need for objective, systematic and frequent observations with which to measure the progress of individual entities, establish a proper system of incentives and guide the allocation of public resources.

Fiscal federalism will gain more general public acceptance the more it improves the effectiveness of public action. The local authorities, which the Constitution and the law entrust with a growing role, have a special responsibility. It is important that local taxation and expenditure arrangements reward efficiency and direct resources towards the most productive uses and the highest priorities. The extent of regional redistribution of income that is achieved through equalizing flows between central government and local authorities is a political choice; but it is necessary that the rules for determining these flows be simple and transparent and that those who receive funds give a full account of their use. The system of transfers to the local authorities must abandon the historical expenditure criterion, which rewards inefficiency. The key to a sound system of fiscal autonomy is a close relationship between outlays and taxation; ideally, every additional expenditure should be financed by the citizens to whom the authority is accountable. Conditions for this are the existence of broad and stable tax bases, severe restrictions on borrowing and predefined rules for transfers from the centre.

Italian banks

The turmoil in international financial markets has affected Italian banks much less than those of other countries. Write-downs have been limited and profitability has fallen no more than moderately.

The modest importance in their balance sheets of the financial assets hit hardest by the crisis, the limited exposure to financial instruments linked to US subprime mortgages and more generally to American markets, and the dominant role of retail funding have spared Italian banks the problems of asset quality and liquidity management that have beset financial institutions in other countries. The creation of a more stable financial system has also benefited from a wise legislator and supervision in which support for innovation has been coupled with prudence.

Careful rules on prudential regulation of securitization operations, which have reached a significant volume in Italy as well, were adopted as early as 2000. Capital requirements may be reduced only where transactions actually transfer risk. Non-bank intermediaries, which can originate securitization operations, are subjected by the Bank of Italy to prudential rules and organizational requirements. Italian securitization vehicles are obliged to report the securitized claims to the Central Credit Register. Banks must comply with disclosure requirements in their financial statements.

Since the end of 2006 regulations have been in force under which only intermediaries that have an appropriate organization and effective control systems may engage in activity in structured financial products.

Strict rules do not work against the market but to its benefit, as is seen in times of difficulty. Nevertheless, no supervision, however robust, can eliminate every factor of vulnerability. Organization and capital call for constant attention on the part of banks.

The ability to make an integrated evaluation of all their credit, market and liquidity risks has been the decisive factor behind the success of the banks that in recent months have best weathered the difficulties due to the turmoil in the markets. For every bank it is essential to have an integrated system of management and control, and to identify in advance the interdependencies that suddenly appear in difficult times. The task is all the more urgent for banks that are large, complex and active in sophisticated markets and products. The consolidation of our banking system, which continued in 2007, must be accompanied by a significant acceleration in the integration of networks, organizational structures, IT systems and differing corporate cultures, not least to enable banks to manage the new and complex risks.

At the initiative of the Financial Stability Forum, international discussions are under way to strengthen capital requirements and at the same time mitigate their procyclical effects. The Bank of Italy will ask the banks, in line with the Basel II standards, to increase their capital so as to make it sufficient to face all their risks, particularly those that are hard to quantify; it supports the introduction of instruments that encourage the banks to accumulate excess capital when market conditions are favourable so that they are not forced to shrink their assets in times of crisis.

Dividend policies and all expansion plans must be consistent with a strengthening of banks' capital base.

Supervision

Well before the turbulence hit the market, the Bank of Italy began a thorough review of its methods of intervention, the principles of regulation and its own organization for the performance of its supervisory function.

We have increased targeted inspections, especially for new types of risk. A programme of on-site controls on the leading banks' operations in derivatives was launched in 2006 and intensified last year. On several occasions I have drawn attention to the need for banks, when proposing innovative and complex products to customers, to guarantee the formal and substantial fairness of the transactions, the transparency of conditions and scrupulous compliance with the rules; they must ensure that such products fully correspond to the needs and risk profiles of the customer. Otherwise they expose themselves to legal and reputational risks, and, if market conditions turn sour, to serious counterparty risks as well. Inspections by the Bank of Italy have put an end to irregularities, and in one case we adopted particularly severe measures. We have asked the internal control bodies of all banks to conduct a careful evaluation of the banks' organizational arrangements, operating processes and control systems connected with activity in derivatives. We have devoted special attention to the use of derivative contracts with Italian banks by regional governments and local authorities: these instruments can be misused, with adverse effects on the transparency of balance sheets and often without the risks being properly understood. The Bank of Italy is working with the Ministry for the Economy to draft new rules on the transparency of derivatives contracts signed by local authorities.

The normal quarterly reports on banks' liquidity have become inadequate. Accordingly, we have asked the main banking groups to make a weekly report, which permits continuous monitoring; the liquidity positions of these intermediaries have improved substantially since the turn of the year.

Alongside adequate capital and organization, the third factor of the stability of the banking system is the quality of corporate governance. The new regulations require banks to establish a clear demarcation of tasks and responsibilities between their governing bodies, lay down rules for their composition, enhance the role of the control body, giving it more powers than those envisaged by the general legal framework, require the adoption of reporting flows that ensure that decision-makers are fully informed, and promote correct systems of incentives and remuneration. The regulations, which we issued after an extensive and fruitful consultation, establish general principles and essential implementing guidelines; they do not provide identical solutions for all banks, but demand that the solutions be calibrated to the individual banks' specific situations, in accordance with the principle of proportionality.

In the reorganization of supervisory activities, the decision to create a special unit to monitor relations between intermediaries and customers marks a significant refocusing of the Bank's attention. Even if recent events have reminded us again that savers' primary defence is the stability of the banking system, fairness and transparency in relations with customers constitute an additional, essential safeguard; they are the condition for the full working of competition.

The law entrusts a variety of bodies with tasks for protecting savers and users of financial services in general. The Bank of Italy is responsible for monitoring the transparency of the contractual conditions of deposits, loans and payment instruments. Within the scope of our powers under the law, we act on the basis of a clear principle: fairness towards customers is not only a legal obligation, but also protects stability. In these turbulent months the solid base of retail funding has been an extraordinary strength of the Italian banking system.

Banks themselves have become far more aware that it is necessary to be seen as a fair player, a loyal partner. Public opinion, customers and consumer associations expect ever higher standards of conduct. In recent years, legislatures, governments and regulatory authorities have intervened when the system has been unable to find adequate solutions on its own.

Many issues are still unresolved. The rules on the early repayment and transfer of mortgages have been slow to be put into practice, owing in part to difficulties of application. In April the Bank of Italy urged the banks to come into full compliance, by shortening the time and reducing the formalities required, and introduced specific requirements to inform customers of their rights; the Competition Authority began inquiries into possible commercial malpractice.

The Government has recently adopted a measure, to be finalized in agreement with the banking system, to facilitate the renegotiation of variable-rate mortgages in order to stabilize the size of repayment instalments. Debt restructuring could provide relief to households and possibly benefit the banks as well, by reducing the number of defaults. The effects of the measure on the market in existing securitizations will need to be carefully scrutinized. In any event, the broadest possible scope must be left for competition to offer customers the best possible terms.

In the past we have already called attention to the commission on the maximum current account overdraft, which is hardly defensible in terms of transparency. Where the nature of the credit relation requires, this charge should be replaced by a commitment fee commensurate with the amount of credit granted, as in other countries. This innovation will require a complex adaptation of banking practices, but it should be undertaken with resolution, proposing the modification to new clients, not least to avert the risk of a mandatory solution imposed by law.

Developing a good system for the out-of-court settlement of disputes could help significantly to improve relations between intermediaries and customers. The consultation with the relevant stakeholders has now been concluded, and the Bank of Italy will submit a proposal to the Interministerial Committee for Credit and Savings to regulate a new ombudsman system in implementation of legislation.

Our survey of the costs of current accounts shows that banks offer especially competitive terms mainly to new customers; vis-à-vis existing customers, inertia reigns. The banks need to simplify the structure and terms of contracts. Any moves that the banking system makes in this direction are to be encouraged. The survey will be repeated in 2008.

Asset management

The decline of Italian investment funds has not halted. Open-end funds recorded net redemptions of 52 billion euros in 2007 and over 30 billion euros in the first quarter of 2008 alone. It is evident that the system for marketing financial products is inadequate to customers' requirements. The prime need is for advice, for help with making the choices that have to be made by those savers who, more than in the past, are now asked to provide for their future by means of financial investment, steering a path among a multitude of products that are often difficult to evaluate. The cost of better services to customers could be covered out of the ample earnings of the distribution networks.

There is a widespread perception among intermediaries themselves that the present structure of the industry needs to be changed. Some banking groups have decided to relinquish control of their investment fund management companies. Having a multiplicity of placement channels will yield benefits. However, it is also necessary to revise the rules of conduct of distributors in order to ensure that customers' rights are observed and to weaken the incentive to maintain closed distribution structures, thereby reducing position rents.

The working group organized by the Bank of Italy and involving the participation of authorities and firms active in the industry has found broad consensus on the main problems: drawing a clear line between product placement and advice, ensuring the independence of boards of directors from the parent company, adopting uniform standards of information transparency for all types of financial product, and eliminating the tax disadvantage of Italian investment funds. The group will set out proposals for urgent measures, some of which are within the competence of the technical authorities themselves, while others will need to be submitted to the Government and Parliament.

* * *

The financial turmoil that swept over the major advanced economies brought to an end a long period of growth, low inflation and plentiful credit. It is too early to say that it has passed: the write-down in asset values by the major banks involved has been much more rapid than in previous banking crises, but these past episodes teach us that initial estimates of their cost may be far exceeded by reality. And it is too early to assess fully the impact on the real economy: much will depend on the scale and speed of the recapitalization that is under way at the leading international financial institutions.

One thing is certain, however: the European monetary union, whose central bank celebrates its tenth anniversary tomorrow, has shielded its members from the worldwide turmoil. We still have vivid memories of the periodic currency crises that afflicted the lira whenever the markets sneezed.

Our banks have withstood well the onslaught of the crisis in recent months: the effect on their assets has been only marginal, their balance sheets are soundly based on fund-raising from customers. The banks bear a special responsibility. With a single monetary policy, it is predominantly the terms, quality and volume of credit, and hence the banks, that determine the specific financial conditions for the majority of enterprises in the various member countries. Since the introduction of the euro, they have become even more important than in the past as a determinant of the competitiveness of the country. A careful assessment of creditworthiness, transparency in customer relations and a dynamic approach towards customer assistance must be the main elements in their strategy.

Italy has the will, the ambition and the resources to return to the path of growth; it knows that, over the long term, growth is an essential precondition for financial stability. Its history demonstrates that there is nothing inevitable in the crisis of growth that has paralyzed it for years. The actors in the recovery must be those who hold the future in their hands: the young, who today are let down by the inadequacy of the education system, by a labour market that discriminates in favour of older people, and by an economic system that too often does not reward merit or value ability. There is broad agreement on the action to be taken, but it clashes with the vested interests that have written the script of our impoverishment in recent years. Political stability and strong institutions are the foundation on which to build the corrective measures. Their implementation will require the commitment of all the energies the country possesses. The reward is the resumption of lasting growth.

THE BANK OF ITALY'S ANNUAL ACCOUNTS

23. MANAGEMENT REPORT AND ANNUAL ACCOUNTS[1]

The Bank of Italy's annual accounts consist of the balance sheet, the income statement and the notes to the accounts. Amounts are presented in euros in the accounts and in thousands of euros in the tables of the notes to the accounts.

In February the Bank sends the balance sheet to the European Central Bank for consolidation with the accounts of the other Eurosystem central banks.

The draft annual accounts are transmitted to the Minister for the Economy and Finance.

The management report provides information on events in 2007 that influenced the Bank's operations and had an impact on the accounts. In addition to the Annual Report, the instruments used by the Bank to report on its activity are: the *Relazione al Parlamento e al Governo*, the *Bollettino di Vigilanza*, and periodic and occasional testimony before Parliament by the Bank's highest officers.

[1] This abridged English version of the Bank's annual accounts does not contain all the information required by law in the Italian version. In addition, it does not include the external auditor's report issued by PriceWaterhouseCoopers. The full Italian version can be found on the Bank of Italy's website (www.bancaditalia.it).

MANAGEMENT REPORT

The accounting period ended 31 December 2007 closed with a net profit of €95 million (€134 million in 2006). In particular, the result benefited from:

– the improvement in net interest income, which confirmed the rising trend of the Bank's profitability on ordinary operations (+€652 million), to which reference has already been made in earlier annual reports;
– the decrease in operating costs and other expenses (-€81 million);

By contrast, two factors had a negative impact:

– the large exchange losses on the foreign currency reserves (up from €287 million to €1,910 million) owing to the depreciation of all the main currencies against the euro;
– the reduction of €1,385 million in deferred tax assets, caused primarily by the introduction of new tax rates by Law 244/2007 (the Finance Law for 2008).

Deferred tax assets recognized in the accounts stem mainly from the carrying forward of the tax losses incurred in the financial years 2002-04. The amount of the taxes is determined on the basis of the tax rates that are expected to be in force when the temporary differences that produced them are reversed. Accordingly, the lowering of the corporate income tax rate from 33 to 27.5 per cent led to a reduction of €1,255 million in the deferred taxes recognized in the previous financial years.

Withdrawals from the provision for general risks amounted to €1,284 million. In the two previous years about €1.1 billion was allocated to the fund as part of the action to replenish the Bank's provisions following the withdrawal of about €4 billion in the three years 2002-04 to cover valuation losses.

The provision for general risks and the other provisions and equity reserves are part of the system of defences against the various risks to which the Bank is exposed in the performance of its institutional functions.

The Bank's institutional structure

The governance of the Bank of Italy is entrusted, as specified in the Statute, to the following central bodies: the shareholders' meeting, the General Council, the Governing Board, the Board of Auditors, the Governor, the Director General and the three Deputy Directors General.

Measures of an institutional nature having external significance are adopted by the Governing Board – made up of the Governor, the Director General and the three Deputy Directors General – on a collegial basis. The Bank of Italy has adopted a Code of Conduct for the members of the Governing Board that is in line with the codes in force in the rest of the Eurosystem.

The General Council, made up of the Governor and thirteen directors elected by general meetings of shareholders at the main branches, is charged with the general administration, management oversight and internal control of the Bank. Acting on a proposal from the Governing Board, the Council examines and approves the draft annual accounts; it also approves their submission to the Board of Auditors and the shareholders' meeting for final approval.

The Board of Auditors is responsible for overseeing the Bank's administration as regards observance of the law and the Bank's Statute and general regulations; it is also entrusted with accounting control. The annual accounts are audited by independent external auditors to attest compliance with the accounting standards for the purposes of Article 27 of the Statute of the European System of Central Banks.

Information on the Bank's functions and more details on its system of governance can be found on its website (www.bancaditalia.it), where information on the Bank's organization, organization chart and branch structure are also available.

Strategic and operational planning

The plan for the reorganization of the Head Office, the branch network and the representative offices abroad has entered the phase of gradual implementation.

The model for the branch network started out from the existing provincial system and moved towards a regionally based arrangement. It includes: branches located in regional capitals that will perform the whole range of tasks assigned to the network (economic analysis and collection of statistics, banking and financial supervision, payment services for the government, and other user services); branches performing the entire range of services except for economic analysis and collection of statistics; units specialized in supervision; branches specialized in the handling of cash; and branches specialized in user services. The plan will be implemented gradually starting in September 2008 and should be completed by the end of 2010. It is expected that 33 branches will be closed; in addition, in 6 provincial capitals instead of a branch there will be a unit for the performance of supervision under the management of the regional branch.

As regards the Head Office, the plans for the reorganization of the economic research and property management functions have been carried out. In addition, the General Council has approved plans for the reorganization of the banking and financial supervision functions, the implementation of which will begin on 1 August 2008.

The restructuring of the banking and supervision departments has been made necessary by the far-reaching changes that have taken place in markets, the institutional and regulatory framework, and the operational methods used in the performance of supervision. The aim of the reform is to: increase the ability to oversee the evolution of markets and the emergence of new risks; examine the impact of regulation more closely; ensure more effective forms of protection for savings, not least in relation to the growing complexity of financial products; and increase the effectiveness of controls while simultaneously reducing the burden on market participants. The plans also concern a new division of tasks and responsibilities between the Head Office and the branches. Accordingly, the staff training programme for 2008 in the field of supervision has been enhanced with a view to merging the supervisory cultures and practices of the centre and the branches.

An agreement has been concluded with the Ministry for Foreign Affairs for Bank employees to be located at embassies and consulates. This step is part of the broader programme for the reorganization of the Bank's presence abroad, which also provides for the closure in 2008 of the representative offices in Brussels, Frankfurt and Paris.

In December the Bank promoted the creation of the Einaudi Institute for Economics and Finance by contributing the initial capital. The purpose of the Institute is to foster research and high-level education in economics and finance.

The preparation of the Bank's Multi-Year Plan for the years 2008 and 2009 has been suspended in view of the overlap with the implementation of the reorganization of the Bank. The sectoral planning procedures (for personnel, IT and logistics) are being carried out regularly and adapted to the innovations deriving from the reorganization.

Among the procedures for expenditure budgeting and control, which help to ensure observance of the principles of economic efficiency, functionality and transparency of resource management, the Bank's cost accounting system is designed in conformity with the harmonized rules of the Eurosystem (Common Eurosystem-wide Cost Methodology), agreed among the central banks with the aim of making their costs comparable and fostering assessments of efficiency and contributing to the definition of charges for the services they supply.

A substantial portion of expenditure on goods and services again derived from the use of 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 annual budget approved by the General Council for 2008 shows a small decrease in expenditure commitments compared with the previous year. In addition, it shows: a continuation of the downward trend in the total number of employees (excluding the effect of the incorporation of the UIC); the renewal of IT procedures and the strengthening of the processing systems and platforms; the renovation of the buildings of the Head Office and the branches to support the organizational restructuring; and the substantial stability of the banknote production levels, established on the basis of the shares assigned by the ECB.

Human, IT and logistical resources

At 31 December 2007 the Bank had 7,400 employees: 3,891 assigned to the Head Office, 3,509 in the branch network, and 160 seconded to other national and international authorities, entities and institutions. Managers and officers made up, respectively, 8.1 and 17.7 per cent of total personnel. The staffs' average age was 48 years. About one third of all employees were women.

The number of staff declined by 148 in 2007; there were 339 terminations, for the most part among non-executive employees, and 191 entries, serving to meet needs for specialized skills and to provide generational turnover. Over the last ten years the number of staff declined by 1,549.

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 staff's professional development, training programmes were run again in 2007 to improve technical and specialized, computer, language and managerial skills. The programmes, which make increasing use of distance training methods, involved 4,680 employees, with an average of about 33 hours of training per participant.

Table 23.1

Composition of the Bank's staff										
	At 31 December 2006					At 31 December 2007				
	Men	Women	**Total**	At branches	At Head Office (1)	Men	Women	**Total**	At branches	At Head Office (1)
Managers	489	112	**601**	202	399	485	117	**602**	197	405
Officers	909	400	**1,309**	435	874	900	413	**1,313**	429	884
Coadjutors	755	453	**1,208**	625	583	747	449	**1,196**	590	606
Other	3,055	1,375	**4,430**	2,405	2,025	2,918	1,371	**4,289**	2,293	1,996
Total	**5,208**	**2,340**	**7,548**	**3,667**	**3,881**	**5,050**	**2,350**	**7,400**	**3,509**	**3,891**

(1) Includes personnel assigned to representative offices abroad and seconded to other organizations.

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.

As regards Europe, in addition to the renewal of ESCB infrastructure and applications, work continued on the creation of the new TARGET2 platform (euro payment system for the real-time settlement of high-value transactions in central-bank money), which was launched successfully in November 2007 after being developed in cooperation with the German and French central banks. On 19 May 2008 the new platform went live in Italy.

The initiative is of a strategic nature and contains innovative organizational and technological solutions. The TARGET2 platform, which meets the demand for advanced and harmonized payment services, allows banks present in a number of European countries to operate with a single account in central-bank money, thus reducing treasury management costs.

Among the applications developed for the Bank's institutional activity, there is the new system to support the management of the foreign reserves. As regards the internal management of the Bank, further progress was made in revising the expenditure procedure, which should be completed in the coming years. Turning to the services for internal users, the acquisition of strong authentication systems that allow members of the staff to access the Bank's information systems from outside, including by means of standard equipment, has been completed.

In 2008 the IT function will be engaged not only in the management of the TARGET2 platform but also in supporting the initiatives of the competent Bank functions serving to broaden the supply of services. Important in this respect is the Bank's contribution to the design of the new TARGET2-Securities platform for the centralized settlement of securities transactions. During the year a new infrastructure for communications with the branches will go live. It is necessary for the distribution at the workplace of new distance training services, access to the Internet and video communications; the manner of accessing the Internet will be made easier and more functional at the same time as access is extended to all computer users and workplaces are made more secure. IT solutions will be developed that will facilitate cooperation and monitoring of the supervisory activity performed by the Head Office and the branches.

At the end of the year the Bank's real estate had a book value of €3,516 million, of which €3,033 million referred to buildings used for institutional purposes and €483 million to property in which staff severance pay and pension provisions have been invested. The estimated value of the Bank's real estate at the end of the year amounted to €5,462 million, of which €3.925 million referred to buildings used for the Bank's operations and €1,537 million to property in which staff severance pay and pensions provisions have been invested.

The principal measures in 2007 concerned the continuation of the logistical reorganization of the units operating in the Rome area, the upgrading of plant and buildings to regulatory standards, the enhancing of plant and equipment at the banknote printing works and some branches, and the restoration and consolidation of some buildings used for the Bank's activities and some buildings rented to third parties.

The main property management measures scheduled for 2008 are related to the implementation of the reorganization plans for both the branch network and the Head Office.

Among the steps aimed at strengthening the technical and organizational measures for handling emergencies, a business continuity plan has been drawn up with the aim of ensuring the continuity of those of the Bank's processes that have been classified as critical in risk scenarios that cause buildings, information systems, staff or electricity not to be available.

Note issue

The Bank continued to participate in the activity of the Eurosystem aimed at studying and testing new banknote security features and in the drafting of common guidelines for the quality of the banknotes in circulation and measures against counterfeiting.

In 2007 the Bank of Italy produced 1 billion banknotes in €20, €50 and €100 denominations. It put 2.2 billion banknotes into circulation, for a total value of €84 billion. The return flow to the Bank amounted to 2 billion banknotes worth €75.3 billion; most of these notes were selected automatically at the Bank's branches. Growing demand for euro banknotes (from outside as well as inside the Community) and the increased need to replace worn notes have caused an upturn in required production that, after appearing in the quantities specified for 2007 and 2008, could become permanent in the medium term. These factors, together with the larger volumes foreseeable in view of the introduction of the second series of euro notes, call for measures to increase the production capacity of the Bank's printing works.

The value of the banknotes in circulation at the end of 2007 amounted to €128.5 billion (19 per cent of the Eurosystem total) and was up by 7.3 per cent from €119.7 billion at the end of 2006; the amount recorded in the accounts (€112.2 billion) represented the 16.6 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. The Bank also manages a part of the reserves transferred to the ECB; in this activity it refers to guidelines laid down by the Governing Council.

With effect from 3 December 2007 the Bank took over the management of the share of foreign currency reserves previously entrusted to the UIC in its capacity as an instrumentality of the Bank (see the post-balance sheet-events section).

To ensure that these 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 2007 the gold and foreign currency reserves were worth €68.4 billion, compared with €62.7 billion a year earlier. The increase mainly reflected the 18 per cent rise in the price of gold and was only offset in part by the depreciation against the euro of all the leading currencies (the US dollar, the yen, the pound sterling and the Swiss franc). As in the preceding years, the foreign currency reserves were mostly invested in government securities, securities of government agencies and the BIS, commercial paper, certificates of deposit and deposits at leading international banks. Use was also made of international futures markets for the management of the reserves. Between the end of 2006 and the end of 2007 the composition of the reserves other than gold and SDRs saw the share denominated in dollars basically unchanged at about 61 per cent, reductions in those denominated in pounds sterling and Swiss francs from respectively 26.5 to 22.1 per cent and 3.4 to 1 per cent, and an increase in that denominated in yen from 8.7 to 15.5 per cent. The composition of the reserves must be approved by the Governing Board.

Table 23.2

Composition of the reserves (1)
(millions of euros)

	31.12.2007	31.12.2006
US dollars	14,205	14,759
Pounds sterling	5,126	6,363
Japanese yen	3,592	2,087
Swiss francs	239	822
Other currencies	1	1
Gold	44,793	38,050
Net assets vis-à-vis the IMF (includes SDRs)	410	640
Total	**68,366**	**62,722**

(1) The reserves are valued at market exchange rates and prices. They do not include financial assets (units of collective investment untertakings and ETF shares) denominated in foreign currency representing the investment of reserves and provisions, as they constitute a separate foreign currency item.

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 Governing Board.

The Bank actively manages the interest rate risk on the foreign currency reserves so that, in order to achieve an additional yield with respect to the strategic benchmarks, the investment portfolios may diverge from the latter within predefined limits. Credit risk is controlled by means of a preliminary examination of the soundness of the counterparties admitted; in addition, upper limits are imposed for issuers, counterparties and financial instruments. During the year the Bank carried out the usual revision of the authorized counterparties and individual limits for investment transactions and monitored its exposure to counterparties and their financial condition and operating results on a daily basis. The upper limits for the main financial sectors were also revised in order to increase the liquidity of the reserves. The market and credit risks attaching to the foreign currency reserves and their liquidity are monitored in real time by means of the daily calculation of the investment results and the value at risk.

The Bank also holds a financial portfolio containing assets other than those linked to monetary policy and the management of the foreign currency reserves, whose strategic asset allocation reflects risk-return combinations defined over a long time horizon and on the basis of prudential criteria.

The management of the Bank's investments is subject to the ban on the monetary financing of the member states and public institutions of the euro area; accordingly securities of such issuers are not acquired at issue. In addition, operating methods are used that do not interfere with the formation of the prices of the financial instruments.

At the end of 2007 the book value of the portfolio was €89.3 billion, compared with €86.7 billion at the end of 2006; the increase was concentrated in the government securities component. The portfolio was invested mainly in bonds (especially Italian and other euro-area country government securities) and equities (primarily listed in the euro area); investments in bank shares are excluded.

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.

Table 23.3

Composition of the financial portfolio
(millions of euros)

	31.12.2007	31.12.2006
Government securities	80,528	78,391
Shares and participating interests	7,726	7,783
Convertible bonds and warrants	25	47
Other bonds	385	337
Units of collective investment undertakings and ETF shares	603	100
Total	**89,267**	**86,658**

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 2007 the fund's net assets in the Bank's balance sheet amounted to €99 million. Returns on assets and exposure to risk are measured daily.

The General Council decides whether securities are to be booked as fixed assets or held for trading. The bulk of the portfolio (91 per cent) consists of securities held as fixed assets and therefore, in accordance with the Eurosystem's accounting standards, is valued at cost. If all listed financial instruments were valued at market prices, the value of the portfolio would be €89.9 billion.

Transactions in 2007 were marked by the search for greater diversification of the portfolio by geographical area and issuer. During the year investments were made in new asset classes such as highly-rated euro-area covered bonds, shares of exchange-traded funds (ETFs) denominated in dollars and units of collective investment undertakings denominated in yen, with the exchange rate risk hedged. In the European share component a start was made on a gradual rebalancing of the portfolio away from Italian shares and towards foreign shares.

The management of financial risks is conducted with reference to the portfolio as a whole, that is both the fixed assets and the trading components.

Exposure to market risk, the main risk factor to which the financial portfolio is exposed, is monitored with various indicators, including both long and short-term value-at-risk and, for the bond component, duration according to yearly slots. In 2007 the riskiness of the equity portfolio was attenuated by the greater international diversification achieved by the addition of investments in units of collective investment undertakings and ETF shares, financial instruments that, by tracking large baskets of shares, are much less risky than those of individual issuers. In addition, the portfolio of fixed-rate securities was marked by a shorter duration than in the previous year.

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 the income statement.

Balance sheet highlights

The main factors that influenced the results for 2007 are described below, with reference to the reclassified accounts shown in Table 23.4, where the financial portfolio item includes not only the aggregates specified in Table 23.3 but also the Bank's interest in the capital of the ECB and the UIC endowment fund.

In 2007 profit before tax and the change in the provision for general risks came to €422 million (€1,199 million in 2006). The result does not include the return on investments of the ordinary and extraordinary reserves (€528 million), which, although it is included in the Bank's tax base, is allocated directly to the reserves pursuant to the Bank's Statute, and therefore does not contribute to the formation of profit.

Table 23.4

Summary of the annual accounts - Reclassified (1)

(millions of euros)

	Balance sheet aggregates	Income statement			
		Interest and dividends	*Results and writedowns*	*Other components of income*	*Contribution to net profit*
2007 FINANCIAL YEAR					
Gold	44,793				
Position in foreign currency	23,572	*1,123*	*-1,945*		*-822*
Financial portfolio	90,247	*3,676*	*43*		*3,719*
Lending to euro-area banks	28,070	*772*			*772*
Net intra-Eurosystem claims	26,777	*693*			*693*
Banknotes in circulation	-112,213				
Deposits for minimum reserve system	-35,071	*-844*			*-844*
General government deposits	-9,716	*-1,027*			*-1,027*
Revaluation accounts	-29,976				
Capital, reserves and provisions	-30,187				
Other income, net		*-8*		*118*	*110*
Operating expense and other costs				*-1,687*	*-1,687*
Prior-year income and expense				*36*	*36*
Appropriation of investment income to reserves under Article 40 of the Statute		*-492*	*-36*		*-528*
GROSS PROFIT		***3,893***	***-1,938***	***-1,533***	***422***
Allocation to the provision for general risks				*1,284*	*1,284*
Taxes on income for the year and productive activities				*-1,610,5*	*-1,610,5*
NET PROFIT		***3,893***	***-1,938***	***-1,860***	***95***
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*
Revaluation 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***

(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 and other equity, and other financial assets denominated in euros and foreign currency allocated to Items 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 (Items 9.2 and 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 other equity, the column Interest and dividends includes income from ETF shares and units of collective investment undertakings; net income from fees and commissions, the pooling of monetary income and other withdrawals from provisions are included under Other income, net.

The profit on ordinary operations, consisting of interest and dividends, increased by €652 million (from €3,241 to €3,893 million), primarily as a result of the improvement in net interest income (€631 million) produced by the rise in interest rates and the increase in the average stock of earning assets.

The contribution from trading and the valuation of financial positions in euros and foreign currency was a loss of €1,938 million, compared with a loss of €355 million in 2006. A key factor in this result was the depreciation of all the main currencies against the euro, which, as for other central banks, led to the charging to the income statement of a foreign currency revaluation loss of €1,910 million (€287 million in 2006).

Among the other items, operating expense and other costs declined by €81 million to €1,687 million. The decrease was due in large part to the reduction of €76 million in staff pensions and severance pay as a result of the smaller number of retirements in 2007; administrative expenses also decreased, falling by €2 million compared with 2006.

Taxes for the year amounted to €1,610 million (€669 million in 2006). Of the total, current taxes accounted for €225 million and deferred taxes for €1,385 million, the latter as a result of the decrease in deferred tax assets, caused mainly by the reduction in the corporate tax rate from 33 to 27.5 per cent provided for by Law 244/2007.

After taxes and the withdrawal of €1,284 million from the provision for general risks, as approved by the General Council, net profit for the year amounted to €95 million in 2007 (€134 million in 2006).

The year-end balance sheet total rose by €25,819 million to €244,376 million. On the assets side there were increases in the refinancing of credit institutions and intra-Eurosystem claims; on the liabilities side the increases in deposits for the minimum reserve system and banknotes in circulation were partially offset by the reduction in liabilities to general government.

At the end of 2007 the revaluation accounts, in which unrealized capital gains on gold, securities and foreign currency are recorded, amounted to €29,976 million, of which €25,373 million referred to gold, €4,373 million to price revaluations on euro-denominated securities and €230 million to price revaluations on securities denominated in foreign currency. The increase of €6,530 million in this item was due to the rise in the price of gold. The exchange rate revaluations with reference to the net assets denominated in foreign currency at the end of 2006 (€447 million) were almost entirely cancelled out by the aforementioned depreciation of all the main currencies against the euro.

Post-balance-sheet events

Legislative Decree 231/2007 provided for the transfer to the Bank of Italy on 1 January 2008 of the duties and powers of the UIC, together with the related instrumental human and financial resources; it also provided for the UIC to be suppressed with effect from the same date. In addition, the decree provided for the creation at the Bank of Italy of the country's Financial Intelligence Unit, designed to prevent and combat money-laundering and the financing of terrorism. The Unit is an independent body and carries out its functions in full autonomy.

As regards the implementation of the decree's provisions, the transfer of the UIC's tasks to the Bank of Italy was planned and carried out in conformity with the priority objective of fostering the complete integration of the two entities' functions, units, rules, procedures and resources. The solutions adopted were based on the criterion of analogy with the tasks performed by the Bank's units and the search for synergies, in accordance with the general objective of rationalization. The UIC's 450 employees were inserted into the Banks' staff in accordance with the rules governing the latter's employment.

At the beginning of 2008 the UIC was merged into the Bank of Italy. Its institutional activities, with special reference to preventing and countering money-laundering, the handling of euro and foreign currency collections and payments for general government and the preparation of balance-of-payments statistics were continued without interruption within the Bank of Italy.

The UIC's financial statements for the year ended 31 December 2007, its last set of accounts, were approved by the governing bodies of the Bank of Italy. The accounting effects of the UIC's merger into the Bank will be reflected in the Bank's financial statements for the year ending 31 December 2008, the opening balances of which will include the UIC's balance sheet at the end of 2007. In addition, to comply with its financial reporting obligations as a member of the Eurosystem, on 3 January 2008 the Bank sent the ECB the usual daily report on its accounts, updated to take account of the UIC's merger into the Bank. In fact the steps needed to integrate the accounting systems of the two institutions had already been taken in 2007.

As of 1 January 2008 the method of calculating monetary income has been revised by amending the agreement on the calculation of the return on assets (see the comment on the income statement item "Net result of the pooling of monetary income" in the notes to the accounts). Since that date, following the adoption of the euro by Malta and Cyprus, and considering only the Eurosystem national central banks, the Bank of Italy's percentage share of the ECB's capital has declined from 18.0260 to 17.9776 per cent (considering only the Eurosystem national central banks). 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.

In March 2008 the Bank completed the eighth updating of the "Security planning document for the handling of sensitive and legal data" referred to in Legislative Decree 196/2003 (the Personal Data Protection Code).

On 30 April 2008 the exchange rates of the US dollar and the pound sterling against the euro stood at $1.5540 and £0.7901 respectively, a depreciation compared with the values obtaining at the end of 2007 ($1.4721 and £0.7334). By contrast the yen appreciated, rising from ¥164.93 to ¥162.62.

BALANCE SHEET AND INCOME STATEMENT
for the year ended 31 December 2007

BALANCE SHEET

ASSETS	Amounts in euros 31.12.2007	31.12.2006
1 GOLD AND GOLD RECEIVABLES	**44,793,359,278**	**38,049,713,505**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**19,276,461,391**	**19,482,921,483**
2.1 Receivables from the IMF	1,163,950,124	1,442,125,295
2.2 Securities (other than shares)	14,661,776,735	14,066,133,147
2.3 Current accounts and deposits	3,352,466,453	3,844,246,298
2.4 Reverse operations	95,177,954	127,073,842
2.5 Other claims	3,090,125	3,342,901
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**5,052,179,843**	**6,856,912,396**
3.1 Financial counterparties	5,052,179,843	6,856,912,396
3.1.1 Securities (other than shares)	*425,939,892*	*2,279,590,337*
3.1.2 Reverse operations	*93,846,118*	–
3.1.3 Other claims	*4,532,393,833*	*4,577,322,059*
3.2 General government	–	–
3.3 Other counterparties	–	–
4 CLAIMS ON NON-EURO-AREA RESIDENTS	**1,000,000**	–
4.1 Claims on non-euro-area EU central banks	1,000,000	–
4.2 Securities (other than shares)	–	–
4.3 Other claims	–	–
5 LENDING TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS	**28,070,383,588**	**20,956,791,709**
5.1 Main refinancing operations	22,222,181,834	20,568,371,845
5.2 Longer-term refinancing operations	5,848,201,754	388,360,223
5.3 Fine-tuning reverse operations	–	–
5.4 Structural reverse operations	–	–
5.5 Marginal lending facility	–	–
5.6 Credits related to margin calls	–	59,641
6 OTHER CLAIMS ON EURO-AREA BANKS	**10,244,660**	**10,256,392**
7 SECURITIES ISSUED BY EURO-AREA RESIDENTS (other than shares)	–	**1,977,265,298**
8 GENERAL GOVERNMENT DEBT	**18,098,403,732**	**18,251,848,454**
9 INTRA-EUROSYSTEM CLAIMS	**43,743,527,387**	**30,845,236,993**
9.1 Participating interest in the ECB	721,792,464	726,278,371
9.2 Claims deriving from the transfer of foreign reserves to the ECB	7,217,924,641	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)	35,803,810,282	22,856,174,907
10 ITEMS TO BE SETTLED	**788,583**	**7,715,584**
11 OTHER ASSETS	**85,330,077,149**	**82,117,970,342**
11.1 Euro-area coins	28,161,819	29,749,139
11.2 UIC endowment fund	258,228,450	258,228,450
11.3 Financial assets related to investments of reserves and provisions	32,334,146,779	32,763,192,064
11.4 Other financial assets	38,868,175,415	33,699,788,659
11.5 Intangible fixed assets	27,613,610	30,969,284
11.6 Tangible fixed assets	3,677,274,966	3,856,918,157
11.7 Accrued income and prepaid expenses	1,374,387,959	1,199,375,024
11.8 Deferred tax assets	6,310,856,695	7,696,395,078
11.9 Sundry	2,451,231,456	2,583,354,487
TOTAL	**244,376,425,611**	**218,556,632,156**
MEMORANDUM ACCOUNTS	**324,200,245,943**	**277,230,077,095**

THE ACCOUNTANT GENERAL: Anna Maria Tarantola **THE GOVERNOR:** Mario Draghi

Audited and found correct - 31 March 2008
THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Angelo Provasoli, Dario Velo

BALANCE SHEET

LIABILITIES	Amounts in euros 31.12.2007	31.12.2006
1 BANKNOTES IN CIRCULATION	**112,213,480,080**	**105,519,190,400**
2 LIABILITIES TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS	**42,622,806,292**	**17,158,916,950**
2.1 Current accounts (covering the minimum reserve system)	35,071,182,091	17,156,764,192
2.2 Deposit facility	1,624,201	2,152,758
2.3 Fixed-term deposits	7,550,000,000	–
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	**9,881,376,565**	**22,963,778,039**
4.1 General government	9,715,516,047	22,944,941,571
4.1.1 Treasury payments account	*9,672,252,995*	*22,294,785,953*
4.1.2 Sinking fund for the redemption of government securities	*19,042,752*	*552,944,403*
4.1.3 Other liabilities	*24,220,300*	*97,211,215*
4.2 Other counterparties	165,860,518	18,836,468
5 LIABILITIES TO NON-EURO-AREA RESIDENTS	**88,074,509**	**88,448,209**
5.1 Current accounts (covering the minimum reserve system)	63,555,345	56,943,430
5.2 Deposit facility	24,519,164	31,504,779
6 LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**6,911**	–
6.1 Financial sector counterparts	6,911	–
6.2 General government	–	–
6.3 Other liabilities	–	–
7 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**1,827,308**	**866,140,753**
7.1 Deposits and balances	1,827,308	10,207,047
7.2 Other liabilities	–	855,933,706
8 COUNTERPART OF SDRs ALLOCATED BY THE IMF	**754,377,600**	**801,859,840**
9 INTRA-EUROSYSTEM LIABILITIES	**16,244,516,710**	**14,208,918,325**
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	16,244,516,710	14,208,918,325
9.3 Other liabilities within the Eurosystem (net)	–	–
10 ITEMS TO BE SETTLED	**25,944,024**	**28,549,723**
11 OTHER LIABILITIES	**2,285,730,067**	**2,246,189,431**
11.1 Bank of Italy drafts	756,236,790	712,604,755
11.2 Accrued expenses and deferred income	85,280,730	70,650,030
11.3 Sundry	1,444,212,547	1,462,934,646
12 PROVISIONS	**6,239,998,691**	**6,392,202,181**
12.1 Provisions for specific risks	543,255,280	722,303,819
12.2 Sundry staff-related provisions	5,696,743,411	5,669,898,362
13 REVALUATION ACCOUNTS	**29,975,834,755**	**23,446,340,100**
14 PROVISION FOR GENERAL RISKS	**6,647,281,997**	**7,931,281,997**
15 CAPITAL AND RESERVES	**17,300,013,298**	**16,771,058,495**
15.1 Capital	156,000	156,000
15.2 Ordinary and extraordinary reserves	11,757,789,279	11,229,489,963
15.3 Other reserves	5,542,068,019	5,541,412,532
16 NET PROFITS FOR DISTRIBUTION	**95,156,804**	**133,757,713**
TOTAL	**244,376,425,611**	**218,556,632,156**
MEMORANDUM ACCOUNTS	**324,200,245,943**	**277,230,077,095**

THE ACCOUNTANT GENERAL: Anna Maria Tarantola **THE GOVERNOR:** Mario Draghi

Audited and found correct - 31 March 2008
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INCOME STATEMENT

		Amounts in euros 2007	2006
1.1	Interest income	5,555,123,458	4,532,871,215
1.2	Interest expense	-2,482,653,362	-1,964,597,977
1	**Net interest income**	**3,072,470,096**	**2,568,273,238**
2.1	Profits and losses on financial operations	-33,769,902	-22,829,793
2.2	Writedowns of financial assets and positions	-1,910,093,729	-338,088,738
2.3	Transfers to/from the provision for general risks for exchange rate and price risks	1,284,000,000	-396,000,000
2	**Net result of financial operations, writedowns and transfers to/from risk provisions**	**-659,863,631**	**-756,918,531**
3.1	Fee and commission income	23,922,732	26,000,806
3.2	Fee and commisison expense	-20,092,696	-21,746,321
3	**Net income from fees and commissions**	**3,830,036**	**4,254,485**
4	**Income from participating interests**	**12,724,565**	**1,159,158**
5	**Net result of the pooling of monetary income**	**48,482,765**	**15,429,612**
6.1	Interest income	991,121,023	807,169,960
6.2	Dividends from equity shares and participating interests	305,435,758	297,743,456
6.3	Profits, losses and writedowns	42,394,186	137,763,645
6.4	Other components	2,270,850	2,063
6	**Net income from financial assets representing investments of reserves and provisions**	**1,341,221,817**	**1,242,679,124**
7	**Other withdrawals from provisions**	**3,945,005**	**6,289,483**
8	**Other income**	**61,744,483**	**52,436,053**
	TOTAL NET INCOME	**3,884,555,136**	**3,133,602,622**
9	**Appropriation of investment income to reserves provided for in the Statute** (1)	**-528,262,230**	**-565,539,832**
10.1	Staff wages and salaries and related costs (2)	-629,873,328	-633,760,260
10.2	Other staff costs	-40,495,991	-44,798,525
10.3	Transfers to provisions for accrued expense and staff severance pay and pensions	-97,496,268	-101,855,098
10.4	Pensions and severance payments	-292,440,524	-367,992,108
10.5	Emoluments paid to head and branch office collegial bodies	-2,889,078	-1,826,233
10.6	Administrative costs	-400,569,206	-402,894,351
10.7	Depreciation of tangible and intangible fixed assets	-195,756,041	-194,270,409
10.8	Banknote production services	–	–
10.9	Other costs	-27,423,359	-20,198,814
10	**Sundry expenses and charges**	**-1,686,943,795**	**-1,767,595,798**
11	**Other allocations to provisions**	–	–
12.1	Prior-year income	42,951,690	6,043,939
12.2	Prior-year expense	-6,654,154	-3,837,577
12	**Prior-year income and expense**	**36,297,536**	**2,206,362**
	PROFIT BEFORE TAX	**1,705,646,647**	**802,673,354**
13	**Taxes on income for the year and productive activities**	**-1,610,489,843**	**-668,915,641**
	NET PROFIT FOR THE YEAR	**95,156,804**	**133,757,713**

(1) Made in accordance with Article 40 of the Statute. – (2) The average number of employees in 2007 was 7,488, compared with 7,868 in 2006.

THE ACCOUNTANT GENERAL: Anna Maria Tarantola **THE GOVERNOR:** Mario Draghi

Audited and found correct - 31 March 2008
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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. 16 of 10 November 2006 (in *Official Journal of the European Union*, L 348, 11 December 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 2007 are described below. Where provided for by law, they were agreed with the Board of Auditors. As of 1 January 2007, in line with the latest rules laid down by the ECB (Guideline no. 16 of 10 November 2006 in *Official Journal of the European Union*, L 348, 11 December 2006), the economic approach accounting principle has been adopted. Among the options allowed, the Bank has adopted the "alternative method" under which:

– foreign exchange spot transactions with a trade date in the year and a settlement date in the next year are included in the net foreign exchange position at the trade date instead of the settlement date for the purpose of determining the average daily net cost and the net income for the year;
– interest accrued on foreign exchange assets and liabilities is recorded on a daily basis and included in the net foreign exchange position; these accruals include 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 temporis basis using a method based on compound capitalization – in relation to the residual life of the security).

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, which at the end of the year require account also to be taken of purchases of foreign currency with a trade date in the year and a settlement date in the next year;*

- *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, both held as fixed assets and not, account is taken of the amount of the amortization of the premium/discount, which, for those denominated in foreign currency, is recorded daily;*
- *the year-end valuation is effected:*

1) for securities not held as fixed assets:

a) equity shares, ETFs and marketable bonds (Guideline no. 16 of 10 November 2006), 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 the relevant security and any amount in excess thereof is included in the income statement. Foreign currency ETFs and units of collective investment undertakings stated in the balance sheet item "Financial assets related to investments in reserves and provisions" are not included in the net foreign exchange position but shown as a separate item;

b) non-marketable bonds (Guideline no. 16 of 10 November 2006), at cost with account taken of any diminution in value corresponding to special situations related to the position of the issuer;

c) non-marketable shares (Guideline no. 16 of 10 November 2006) 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 related 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 related advances are 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.

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 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. Interest accrued on foreign exchange assets and liabilities is recorded on a daily basis and included in the net foreign exchange position.

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 Official Journal of the European Communities, L337 of 20 December 2001, pp. 52-54, as amended).

The total value of euro banknotes in circulation is allocated within the Eurosystem 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 of each Member State that has adopted the euro 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 as compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the reference period established by law 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, after which income on banknotes is 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 Official Journal of the European Communities, 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 Official Journal of the European Union, 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 2007, as for 2006, 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 General Council.

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 items*).*

OTHER ASSETS AND LIABILITIES ITEMS

Receivables are stated at their nominal value, which, in view of the Bank's typical counterparties, coincides with their estimated realizable 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.

OFF-BALANCE-SHEET TRANSACTIONS AND MEMORANDUM ACCOUNTS

Forward purchases and sales of foreign currency

– *forward purchases and sales are recorded in the memorandum accounts at the trade date at the spot exchange rate of the transaction.*

  The difference between the values at the spot and forward exchange rates is recorded, on a pro rata temporis basis, under interest in the income statement.

Foreign currency swaps

– *forward and spot purchases and sales are recorded in the memorandum accounts at the trade date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a pro rata temporis basis, under interest in the income statement. The forward position is valued in conjunction with the corresponding spot position.*

At the time of the settlement of forward purchases and sales of foreign currency and foreign currency swaps, the entries in the memorandum accounts are transferred to the appropriate items of the balance sheet.

Interest rate futures denominated in foreign currency

– *are recorded in the memorandum accounts at the trade date at their notional value and translated at the end of the year at the exchange rate communicated by the ECB. 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.*

Other cases with the amount entered in the memorandum accounts

– *securities denominated in euros 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;*
– *commitments in respect of foreign currency transactions are shown at the contractually agreed exchange rate. The entries are deleted at the time the commitments are settled;*
– *other foreign currency amounts are converted at the year-end exchange rates communicated by the ECB.*

Comments on the items of the balance sheet

Gold and assets and liabilities denominated in foreign currency (Items 1, 2 and 3 on the assets side and Items 6, 7 and 8 on the liabilities side)

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 2006 (79 million ounces or 2,452 tons) – was entirely due to the rise in the metal's price. The movements in exchange rates had a negative effect on foreign currency assets.

Table 23.5

Gold and assets and liabilities denominated in foreign currency
(thousands of euros)

	31.12.2007	31.12.2006	Changes
Gold (Item 1)	**44,793,359**	**38,049,714**	**6,743,645**
Net assets denominated in foreign currency	**23,572,429**	**24,671,833**	**-1,099,404**
Assets denominated in foreign currency	**24,328,641**	**26,339,834**	**-2,011,193**
claims on non-euro-area residents (including the IMF) (Item 2)	*19,276,461*	*19,482,922*	*-206,461*
claims on euro-area residents (Item 3)	*5,052,180*	*6,856,912*	*-1,804,732*
Liabilities denominated in foreign currency	**756,212**	**1,668,001**	**-911,789**
liabilities to euro-area residents (Item 6)	*7*	*–*	*7*
liabilities to non-euro-area residents (Item 7)	*1,827*	*866,141*	*-864,314*
counterparts of SDRs allocated by the IMF (Item 8)	*754,378*	*801,860*	*-47,482*

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 31 December 2007 using that day's exchange rate of the euro against the dollar. Compared with end-2006, gold appreciated by 18 per cent (from 482,688 to 568,236 euros per ounce). The exchange rates of the main currencies against the euro showed depreciations of the US dollar (from 1,3170 to 1,4721), the yen (from 156,93 to 164,93), the Swiss franc (from 1.6069 to 1.6547) and the pound sterling (from 0.6715 to 0.7334). There was also a depreciation of the SDR (from 1.1416 to 1.0740 euros per SDR).

On the basis of these exchange rates there were unrealized losses at the end of the year that, after withdrawals from the corresponding revaluation accounts (€321 million for US dollars and €126 million for pounds sterling), were charged to the income statement for a total of €1,910 million (€1,295 million in respect of US dollars, €363 million in respect of pounds sterling, €135 million in respect of yen, €110 million in respect of SDRs and €7 million in respect of Swiss francs.)

After the above-mentioned movements, the revaluation accounts for gold and foreign currency amounted at the end of 2007 to €25,372 million, of which almost all was in respect of gold (see Revaluation accounts*). The exchange rates of the main currencies at 30 April 2008 are reported in the* Post-balance-sheet events *section of the* Management report.

The foreign currency assets and liabilities include accounts with the International Monetary Fund, foreign currency securities and other net assets denominated in foreign currency, consisting mainly of current accounts, deposits and reverse operations.

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.

Table 23.6

Accounts with the International Monetary Fund
(thousands of euros)

	31.12.2007	31.12.2006	Changes
Assets			
Receivables from the IMF (Sub-item 2.1)	**1,163,950**	**1,442,125**	**-278,175**
a) Italy's net position vis-à-vis the IMF	493,880	739,920	-246,040
quota in the IMF	*7,601,357*	*8,060,994*	*-459,637*
IMF holdings	*-7,107,477*	*-7,321,074*	*213,597*
b) Participation in the PRGF	445,156	496,007	-50,851
c) Special Drawing Rights	224,914	206,198	18,716
Liabilities			
Counterpart of SDRs allocated by the IMF (Item 8)	**754,378**	**801,860**	**-47,482**

Table 23.7

Securities denominated in foreign currency - stocks and movements
(thousands of euros)

	issued by		Total
	non-euro-area residents	euro-area residents	
Opening stocks	**14,066,133**	**2,279,590**	**16,345,723**
Increases	**42,702,337**	**6,140,620**	**48,842,957**
Purchases (1)	42,184,503	6,087,391	48,271,894
Net profits	21,463	-	21,463
Net price revaluations (2)	206,121	151	206,272
Premiums and discounts	290,250	53,078	343,328
Decreases	**-42,106,693**	**-7,994,270**	**-50,100,963**
Sales and redemptions	-40,697,310	-7,909,317	-48,606,627
Net exchange rate revaluations (2)	-251,606	-47,809	-299,415
Price writedowns (3)	-367	-148	-515
Exchange rate writedowns (3)	-1,157,410	-36,996	-1,194,406
Closing stocks	**14,661,777**	**425,940**	**15,087,717**

(1) Includes the adjustments to the average cost of the currency. – (2) Increase/decrease in revaluation accounts. – (3) Entered in the income statement.

The portfolio of securities denominated in foreign currency consisted primarily of bonds issued by government bodies and international organizations. Of the total portfolio 68 per cent consisted of securities denominated in US dollars, 17 per cent of securities denominated in pounds sterling and 15 per cent of securities denominated in yen.

The other foreign currency assets consisted mainly of time deposits (€6,708 million) denominated primarily in US dollars, current accounts (€1,177 million), denominated primarily in pounds sterling and Swiss francs, reverse operations (€189 million) and foreign banknotes (€3 million).

*Sub-item 3.1.2 (*Claims on euro-area residents denominated in foreign currency: reverse operations*) includes claims in respect of reverse operations with Eurosystem counterparties (€94 million) in connection with the Term Auction Facility. On the basis of this programme the Federal Reserve supplied the ECB with $20 billion within the context of a foreign currency swap line aimed at providing short-term funding in dollars to Eurosystem counterparties. At the same time the ECB activated back-to-back swaps with the NCBs that have adopted the euro, which used the dollar funds to provide liquidity to euro-area counterparties. The transactions involving back-to-back swaps were settled on non-interest-earning intra-Eurosystem accounts (see* Intra-Eurosystem claims and liabilities*).*

*Sub-item 11.3 (*Financial assets related to investments of reserves and provisions*) includes foreign currency investments that constitute a separate position with respect to the foreign assets and liabilities previously described (see* Securities portfolio*).*

Monetary policy operations (Item 5 on the assets side and Item 2 on the liabilities side)

Operations carried out by the Bank of Italy in connection with the single monetary policy of the Eurosystem.

Table 23.8

Monetary policy operations (thousands of euros)				
		31.12.2007	31.12.2006	Changes
Lending to euro-area banks (Item 5)				
5.1	Main refinancing operations	22,222,182	20,568,372	1,653,810
5.2	Longer-term refinancing operations	5,848,202	388,360	5,459,842
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		**28,070,384**	**20,956,792**	**7,113,592**
Liabilities to euro-area banks (Item 2)				
2.1	Current accounts (covering the minimum reserve system)	35,071,182	17,156,764	17,914,418
2.2	Deposit facility	1,624	2,153	-529
2.3	Fixed-term deposits	7,550,000	–	7,550,000
2.4	Fine-tuning reverse operations	–	–	–
2.5	Deposits related to margin calls	–	–	–
Total		**42,622,806**	**17,158,917**	**25,463,889**

On the assets side the stock of *main refinancing operations* rose at year-end while the average stock was close to that recorded in 2006, declining from €17,638 million to €17,466 million. The stock of *longer-term refinancing operations* rose very substantially at year-end and the average stock to a lesser extent, from €1,102 million to €1,697 million. The stocks of fine-tuning reverse operations and the marginal lending facility were equal to zero at year-end, while the average stocks respectively rose from €6 million to €78 million and fell from €4 million to €2 million. No recourse was made to structural reverse operations in 2007.

On the liabilities side the deposits held by banks to fulfil their minimum reserve obligations increased in terms of both year-end and average stocks (the latter from €17,544 million to €21,185 million). Fixed-term deposits showed a similar pattern, with the average stock rising from €24 million to €865 million. No recourse was made to fine-tuning reverse operations in 2007.

Securities portfolio (Items 7 and 8 on the assets side and Sub-items 11.3 and 11.4)

The bulk of the Bank's securities portfolio consists of bonds denominated in euros and shares, participating interests and bonds denominated in euros and foreign currency related to investments of reserves and provisions. Securities making up part of the foreign exchange reserves are commented under *Gold and assets and liabilities denominated in foreign currency*.

The Bank's portfolio comprises:

Table 23.9

Securities portfolio - stocks (thousands of euros)	31.12.2007	31.12.2006	Changes
A. Securities related to investments of reserves and provisions (Sub-item 11.3)			
1. Securities not held as fixed assets	**8,229,477**	**7,940,046**	**289,431**
a) Government securities	24,572	158,875	-134,303
b) Other bonds	44,881	67,064	-22,183
c) Shares and participating interests	7,557,094	7,613,984	-56,890
– of subsidiary companies and entities	*24,385*	*26,001*	*-1,616*
– of other companies and entities	*7,532,709*	*7,587,983*	*-55,274*
d) ETFs and units of collective investment undertakings	602,930	100,123	502,807
– of which denominated in foreign currency	*222,457*	–	*222,457*
2. Securities held as fixed assets	**24,104,670**	**24,823,146**	**-718,476**
a) Government securities	23,619,916	24,336,665	-716,749
b) Other bonds	315,948	317,675	-1,727
c) Shares and participating interests	168,806	168,806	–
– of subsidiary companies and entities	*107,949*	*107,949*	–
– of other companies and entities	*6,309*	*6,309*	–
– of other companies and entities denominated in foreign currency	*54,548*	*54,548*	–
Total A	**32,334,147**	**32,763,192**	**-429,045**
B. Other securities denominated in euros			
1. Securities not held as fixed assets (Item 7)	**–**	**1,977,265**	**-1,977,265**
a) Government securities	–	1,977,265	-1,977,265
2. Securities held as fixed assets	**56,932,887**	**51,917,945**	**5,014,942**
a) Government securities deriving from the bond conversion and the management of stockpiling	18,064,712	18,218,156	-153,444
b) Government securities (Sub-item 11.4)	38,819,289	33,699,789	5,119,500
c) Other bonds (Sub-item 11.4)	48,886	–	48,886
Total B	**56,932,887**	**53,895,210**	**3,037,677**
Total (A+B)	**89,267,034**	**86,658,402**	**2,608,632**

In more detail, the Bank's portfolio comprises:

A) securities related to investments of reserves and provisions (Sub-item 11.3 – *Financial assets related to investments of reserves and provisions*) both held and not held as fixed assets, denominated in euros and to a very small extent in foreign currency. At year-end 74 per cent of the portfolio consisted of bonds and the remainder of shares, participating interests, ETFs and units of collective investment undertakings. Most of the investments in shares consisted of listed securities.

Since 2007 the Bank has invested in ETFs and units of collective investment undertakings denominated in foreign currency. The resulting position is hedged against exchange rate risk by forward purchases of the corresponding currencies.

The controlling interests refer to Società italiana di iniziative edilizie e fondiarie S.p.A. (SIDIEF) and Bonifiche Ferraresi 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 and held as fixed assets, since those not held as fixed assets and entered in Item 7 were sold during the year.

In particular:

– Sub-item 11.4 (*Other financial assets*) consisted of bonds, of which 60 per cent were issued by the Italian Government and most of the remainder by other euro-area countries; the net purchases during the year were mainly of the latter category;

– Item 8 (*General government debt*) contained bonds 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 former 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 amount redeemed.

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 include securities whose book value (€50,179 million) was higher than the year-end valuation at market prices (€49,475 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 (Item 9 on the assets side and Item 9 on the liabilities sides)

Table 23.10

Positions with the ECB and the other euro-area NCBs
(thousands of euros)

	31.12.2007	31.12.2006	Changes
9.1 Participating interest in the ECB	721,792	726,278	-4,486
9.2 Claims deriving from the transfer of foreign reserves to the ECB	7,217,925	7,262,784	-44,859
9.4 Other claims within the Eurosystem (net)	35,803,810	22,856,175	12,947,635
Total	**43,743,527**	**30,845,237**	**12,898,290**
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	16,244,517	14,208,918	2,035,599
Total	**16,244,517**	**14,208,918**	**2,035,599**

On the assets side:

– the *participating interest in the ECB* decreased from €726 million to €722 million as a result of the recalculation of the Bank's share of the capital following the accession of Romania and Bulgaria to the European Union; for the same reason there was also a decrease in the *claims deriving from the transfer of foreign reserves to the ECB*, which are calculated in relation to the participation subscribed;

Pursuant to Article 28 of the Statute of the ESCB, the ESCB national central banks are the sole subscribers and holders of 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. On 1 January 2007 there was a further adjustment following the accession of Romania and Bulgaria to the European Union; at the end of 2007 the Bank of Italy's share of the ECB's paid-up capital was equal to 12.5297 per cent. Considering only the Eurosystem central banks, its share was last adjusted, to 18.0260 per cent, on 1 January 2007 following Slovenia's becoming part of the euro area; this figure was adjusted again, to 17.9776 per cent, on 1 January 2008 following the entry into the Eurosystem of the central banks of Malta and Cyprus.

At the start of the third stage of EMU, the Bank of Italy, together with the other 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 items of 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 rose by €12,915 million (from €22,841 million to €35,756 million); by contrast the average position over the year declined from €26,893 million to €23,800 million. At the end of 2007 the sub-item also included a claim of €48 million in relation to the net result of the pooling of monetary income for 2007, compared with €15 million in 2006 (see the comment on the items of the income statement: *Net result of the pooling of monetary income*).

As in 2006, the liabilities referred exclusively to the allocation of euro banknotes within the Eurosystem (see *Legal basis, methods of preparation and layout of the annual accounts*).

Other assets (Item 11 on the assets side)

This item consists mainly (83 per cent) of securities (see *Securities portfolio*) included in Sub-items 11.3 and 11.4. It also contains: *tangible* and *intangible fixed assets* (4 per cent); *deferred tax assets* (7 per cent), primarily in connection with prior-year tax losses. The item also includes the *UIC endowment fund*, contributed entirely by the Bank.

Table 23.11

Other assets (Item 11)
(*thousands of euros*)

	31.12.2007	31.12.2006	Changes
11.1 Euro and lira coins	28,162	29,749	-1,587
11.2 UIC endowment fund	258,228	258,228	–
11.3 Financial assets related to investments of reserves and provisions	32,334,147	32,763,192	-429,045
11.4 Other financial assets	38,868,175	33,699,789	5,168,386
11.5 Intangible fixed assets	27,614	30,969	-3,355
11.6 Tangible fixed assets	3,677,275	3,856,918	-179,643
11.7 Accrued income and prepaid expenses	1,374,388	1,199,375	175,013
11.8 Deferred tax assets	6,310,857	7,696,395	-1,385,538
11.9 Sundry	2,451,231	2,583,355	-132,124
other investments of severance pay and pension provisions	*81,191*	*81,498*	*-307*
assets of the supplementary pension fund	*98,693*	*85,326*	*13,367*
other	*2,271,347*	*2,416,531*	*-145,184*
Total	**85,330,077**	**82,117,970**	**3,212,107**

On 1 January 2008, pursuant to Article 62 of Legislative Decree 231/2007, the UIC was merged into the Bank of Italy, which succeeded to the UIC's rights and legal relationships. At 31 December 2007 the UIC's shareholders' equity, excluding the profit for the year, amounted to €2,454 million.

The value of the buildings owned by the Bank at the end of the year was estimated to be €3,925 million for those used for its operations and €1,537 million for those related to investments of severance pay and pension provisions.

Deferred tax assets (Sub-item 11.8) decreased by €1,385 million as a consequence of:

– the offsetting of €144 million of the deferred tax assets deriving from the carryforward of the tax losses for 2002-04;

– the recalculation on the basis of the corporate tax rate of 27.5 per cent (previously 33 per cent), which led to a net decrease in corporate taxes of €1,255 million (of which €1,253 million with reference to the tax losses for 2002-04);

– the increase of €14 million in the deferred tax assets deriving from other sources.

The amount of deferred taxes is calculated using the tax rates that are expected to be in force at the time the temporary differences that have generated them will be reversed. In particular, the reduction in the corporate income tax rate from 33 to 27.5 per cent and that in the ordinary Irap rate from 4.25 to 3.9 per cent, introduced by Law 244/2007, required the revision of the deferred taxes entered in the accounts in previous years.

The bulk of the deferred tax assets included in the balance sheet derive from the carryforward 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 carryforward 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 and the applicable tax law – 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 primarily 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 income tax and Irap made in 2007.

Banknotes in circulation (Item 1 on the liabilities side)

Banknotes in circulation (Item 1 on the liabilities side), which represent the Bank of Italy's share (16.6 per cent) of the total Eurosystem note issue (see *Legal basis, methods of preparation and layout of the annual accounts*), increased by €6,694 million (from €105,519 million to €112,213 million).

The banknotes actually in circulation, without taking account of the adjustments for their distribution within the Eurosystem, increased by €8,730 million (from

€119,728 million to €128,458 million). The average stock of banknotes rose from €105,604 million to €118,530 million, an increase of 12 per cent, compared with 9 per cent for the euro area.

Liabilities to general government and other counterparties in euros (Item 4 on the liabilities side)

The item referred 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 was particularly significant. Compared with 2006, both the year-end and the average balance on the Treasury accounts with the Bank of Italy decreased significantly, with the latter falling from €30,722 million to €21,483 million. The year-end balance of the sinking fund for the redemption of government securities decreased, while the average balance rose from €256 million to €326 million. The balance of the UIC's current account rose from €18 million to €165 million.

Liabilities to non-euro-area residents denominated in euros (Item 5 on the liabilities side)

These comprised:

– *liabilities to non-euro-area EU central banks*, which rose from €57 million to €64 million and referred almost entirely to the correspondent accounts of the Polish and Estonian central banks for their participation in the TARGET system (see *Intra-Eurosystem claims and liabilities);*

– *other liabilities*, which decreased from €32 million to €25 million and mainly referred to the accounts held by customers that use the Eurosystem Reserve Management Services (ERMS).

Other liabilities (Item 11 on the liabilities side)

These comprised the sub-items detailed below:

Table 23.12

Other liabilities (Item 11)
(thousands of euros)

	31.12.2007	31.12.2006	Changes
11.1 Bank of Italy drafts	756,237	712,605	43,632
11.2 Accrued expenses and deferred income	85,281	70,650	14,631
11.3 Sundry	1,444,212	1,462,934	-18,722
lira banknotes not yet presented for conversion net of the payments on account to the Treasury	*753,426*	*808,133*	*-54,707*
liabilities of the supplementary pension fund	*98,693*	*85,326*	*13,367*
other	*592,093*	*569,475*	*22,618*
Total	**2,285,730**	**2,246,189**	**39,541**

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 (Items 12 and 14 on the liabilities side)

Table 23.13

Provisions (Item 12) - balances and movements
(thousands of euros)

	Insurance cover	Tax provision	Sundry staff-related provisions				Total
			for staff severance pay and pensions	for staff costs	for severance pay of contract staff	for grants to BI pensioners and their surviving dependents	
A. Opening balances	**309,874**	**412,430**	**5,571,380**	**94,546**	**1,980**	**1,992**	**6,392,202**
B. Increases	**–**	**226,819**	**23,636**	**73,704**	**63**	**93**	**324,315**
Allocations	–	226,819	23,636	73,704	63	93	324,315
Other increases	–	–	–	–	–	–	–
C. Decreases	**–**	**-405,868**	**-66**	**-70,329**	**-216**	**-39**	**-476,518**
Withdrawals	–	-405,868	-66 (1)	-70,329	-216	-39	-476,518
Other decreases	–	–	–	–	–	–	–
D. Closing balances	**309,874**	**233,381**	**5,594,950**	**97,921**	**1,827**	**2,046**	**6,239,999**

(1) Transfer to the supplementary pension fund for newly hired staff who signed up to participate in the fund.

The reduction in *Provisions for specific risks* (Sub-item 12.1) was due to the net change in the tax provision, which was used to pay the taxes for 2006 and to which an allocation was made for the taxes for 2007. The increase in *Sundry staff-related provisions* (Sub-item 12.2) was the result of:

a) the allocation of €24 million to the severance pay and pension provisions, which rose from €5,571 million at the end of 2006 to €5,595 million at the end of 2007. Of this amount €4,614 million was for supplementary pensions and €981 million for severance pay;

b) the increase of €3 million in the provision for staff costs.

The *Provision for general risks* (Item 14) decreased from €7,931 million to €6,647 million following the withdrawal of €1,284 million approved by the General Council. In the two previous years about €1.1 billion had been allocated as part of a replenishment plan after approximately €4 billion had been withdrawn from risk provisions in 2002-04 to cover unrealized losses.

Revaluation accounts (Item 13 on the liabilities side)

These include the valuation at market prices of gold, foreign currency and securities (see *Gold, assets and liabilities denominated in foreign currency and the securities portfolio*).

Table 23.14

Revaluation accounts (Item 13) (thousands of euros)	Balance at 31.12.2006	Withdrawals	Net revaluations	Balance at 31.12.2007
Exchange rate revaluations	**19,076,133**		**6,296,362**	**25,372,495**
of which: gold	*18,628,821*		*6,743,646*	*25,372,467*
net foreign currency assets	*447,312*		*-447,298*	*14*
financial assets related to investments of reserves and provisions	*–*		*14*	*14*
Price revaluations	**4,366,242**		**237,078**	**4,603,320**
of which: foreign currency securities	*23,884*		*206,272*	*230,156*
securities denominated in euros from Item 7	*2,282*		*-2,282*	*–*
financial assets related to investments of reserves and provisions	*4,340,076*		*33,088*	*4,373,164*
Revaluations at 1 January 1999	**3,965**	**-3,945**	**–**	**20**
Total	**23,446,340**	**-3,945**	**6,533,440**	**29,975,835**

Capital and reserves (Item 15 on the liabilities side)

As detailed below:

Table 23.15

Capital and reserves (Item 15) (thousands of euros)		31.12.2007	31.12.2006	Changes
15.1	**Capital**	**156**	**156**	**–**
15.2	**Reserves under Article 39 of the Statute**	**11,757,789**	**11,229,490**	**528,299**
	Ordinary	5,827,829	5,573,990	253,839
	Extraordinary	5,929,960	5,655,500	274,460
15.3	**Other reserves**	**5,542,068**	**5,541,413**	**655**
	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	1,519,575	1,518,920	655
	Fund for the renewal of tangible fixed assets	1,805,044	1,805,044	–
Total		**17,300,013**	**16,771,059**	**528,954**

The movements of the ordinary and extraordinary reserves are detailed below:

Table 23.16

Movements in ordinary and extraordinary reserves (Sub-item 15.2) (thousands of euros)	Balance at 31.12.2006	Allocation of 2006 profit under Art. 39 of the Statute	Distribution to shareholders under Art. 40 of the Statute (1)	2007 income earned under Art. 40 of the Statute	Balance at 31.12.2007
Ordinary	5,573,990	26,752	-26,620	253,707	5,827,829
Extraordinary	5,655,500	26,752	-26,847	274,555	5,929,960
Total	**11,229,490**	**53,504**	**-53,467**	**528,262**	**11,757,789**

(1) From the income earned in 2006.

In 2007 the memorandum accounts totalled €342,200 million. They included the commitment to sell dollars forward made to the ECB in connection with the temporary dollar funding programme known as the Term Auction Facility (see *Gold and assets and liabilities denominated in foreign currency*) and €218 million of forward sales of foreign currency to hedge the exchange rate risk of foreign currency investments related to investments of reserves and provisions (see *Securities Portfolio)*.

Comments on the items of the income statement

The net profit for the year was €95 million, compared with €134 million in 2006.

Net interest income (Item 1)

Net Interest income rose by €504 million (from €2,568 million to €3,072 million).

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.

Table 23.17

Interest income (Sub-item 1.1)
(thousands of euros)

	2007	2006	Changes
On assets denominated in euros	4,372,940	3,411,752	961,188
securities	*2,363,880*	*1,893,105*	*470,775*
lending operations	*771,526*	*535,934*	*235,592*
intra-ESCB balances	*1,206,070*	*950,916*	*255,154*
other	*31,464*	*31,797*	*-333*
On assets denominated in foreign currency	1,182,183	1,121,119	61,064
securities	*770,196*	*691,960*	*78,236*
other assets denominated in foreign currency	*369,519*	*377,807*	*-8,288*
receivables from the IMF	*42,468*	*51,352*	*-8,884*
Total	**5,555,123**	**4,532,871**	**1,022,252**

In particular, interest income on positions in euros showed increases in:

– interest earned on securities, as detailed below:

a) €825 million, as in 2006, from the government securities received in the conversion under Law 289/2002;

b) €1,539 million (€1,068 million in 2006) from other bonds, partly held and partly not held as fixed assets; the increase was due above all to the expansion in the average size of the investment portfolio (from €28,881 million to €38,950 million);

– interest income from main refinancing operations (from €504 million to €694 million), owing to the rise in the applicable interest rates since the reference aggregate remained basically unchanged (€17,466 million, as against €17,638 million). There was also an increase in interest from longer-term refinancing operations (from €31 million to €74 million) owing both to the rise in the applicable interest rates and to the growth in the reference aggregate (on average from €1,102 million to €1,697 million);

– interest income from intra-Eurosystem claims in relation to the Bank's TARGET balances (from €775 million to €961 million) and that earned on the claims deriving from the transfer of foreign reserves to the ECB (from €176 million to €245 million). The increase reflects the rise in the applicable interest rates, which more than offset the fall in the average TARGET balances (from €26,893 million to €23,800 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 relating to the TARGET positions of the Polish and Estonian central banks (see the comment on the items of the balance sheet Intra-Eurosystem claims and liabilities*) 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.*

Among the items of interest income on foreign currency assets, there was an increase in that earned on securities, above all owing to the higher rates of return recorded.

The net interest income from financial assets representing investments of reserves and provisions is shown in a separate item (see Net income from financial assets representing investments of reserves and provisions*).*

Table 23.18

Interest expense (Sub-item 1.2)
(thousands of euros)

	2007	2006	Changes
On liabilities denominated in euros	2,423,089	1,884,193	538,896
Treasury payments account	*1,015,107*	*1,165,408*	*-150,301*
sinking fund for the redemption of government securities	*11,423*	*6,498*	*4,925*
current accounts (covering the minimum reserve system)	*844,036*	*503,822*	*340,214*
intra-ESCB balances	*512,573*	*205,409*	*307,164*
sundry	*39,950*	*3,056*	*36,894*
On liabilities denominated in foreign currency	59,564	80,405	-20,841
counterpart of SDRs allocated by the IMF	*31,855*	*30,090*	*1,765*
sundry	*27,709*	*50,315*	*-22,606*
Total	**2,482,653**	**1,964,598**	**518,055**

Among the components of interest expense for liabilities denominated in euros:

– the interest paid on the Treasury payment account decreased owing to the fall in the annual average balance (from €30,722 million to €21,483 million), which was only offset in part by the rise in the average rate of return;

– the interest paid on current accounts (covering the minimum reserve system) increased, owing both to the rise in the average rate of return and to the increase in the annual average amount of the above accounts (from €17,544 million to €21,185 million);

– there was an increase in the interest paid on intra-Eurosystem balances, which consisted almost entirely of the balances related to the allocation of euro banknotes within the Eurosystem. The increase was due both to the higher interest rates applied and to the larger average value of the reference aggregate (see the comment on the items of the balance sheet: *Intra-Eurosystem claims and liabilities*);

– there was an increase in sundry interest, above all in relation to that on fixed-term deposits, which rose from €0.7 million to €34 million.

Among the interest paid on liabilities denominated in foreign currency there was a decrease in sundry interest expense, which was mainly for reverse operations involving securities denominated in dollars, owing to the fall in the average stock of the reference aggregate.

Net result of financial operations, writedowns and transfers to/from risk provisions (Item 2)

The result for 2007 comprised:

– losses on foreign exchange trading (€58 million) due to sales of pounds sterling and Swiss francs, made as part of the plan to rebalance the foreign exchange reserves in favour of the yen; by contrast securities trading produced a profit of €22 million;

– writedowns of financial assets and positions, largely as a result of the valuation at year-end exchange rates of assets denominated in dollars (€1,295 million), pounds sterling (€363 million), yen (€135 million), SDRs (€110 million) and Swiss francs (€7 million);

– the transfer of €1,284 million from the provision for general risks.

Table 23.19

Net result of financial operations writedowns and transfers to/from risk provisions (Item 2)
(thousands of euros)

	2007	2006	Changes (1)
Profits (+) and losses (-) on financial operations	-33,770	-22,830	-10,940
profits/losses on securities trading	*22,260*	*-34,090*	*56,350*
profits/losses on foreign exchange trading	*-57,716*	*18,107*	*-75,823*
profits/losses on derivative contracts denominated in foreign currency	*-1,347*	*-7,517*	*6,170*
profits/losses on other transactions denominated in foreign currency	*3,033*	*670*	*2,363*
Writedowns (-) of financial assets and positions	-1,910,094	-338,089	-1,572,005
exchange rate losses	*-1,909,579*	*-287,236*	*-1,622,343*
price losses			
securities denominated in foreign currency	*-515*	*-44,242*	*43,727*
securities denominated in euros	*–*	*-6,611*	*6,611*
Transfers to (-) and withdrawals from (+) the provision for general risks for exchange rate and price changes	1,284,000	-396,000	1,680,000
Total	**-659,864**	**-756,919**	**97,055**

(1) Negative changes indicate smaller profits or larger losses/writedowns; positive changes larger profits or smaller losses/writedowns.

Net income from fees and commissions (Item 3)

The result for the year was in line with that recorded in 2007 (€4 million) since there was an equal reduction in *Fee and commission income* (from €26 million to €24 million) and *Fee and commission expense* (from €22 million to €20 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 (€7 million); the charges for Correspondent Central Banking Model services (€3 million); and those for the use of Central Credit Register information (€3 million) and substitute protest declarations (€5 million). *Fee and commission expense* included €14 million payable to the UIC for the management of the foreign exchange reserves up to 30 November 2007.

Income from participating interests (Item 4)

Income from participating interests referred to amounts allocated to the Bank in respect of its interest in the UIC's endowment fund and the capital of the ECB. The net income of the UIC included in the income statement was basically in line with that recorded in the previous year (€1 million). Instead, as in 2006, the ECB did not pay a dividend. The increase in this item from €1 million to €13 million was due exclusively to the payment to the Bank of Italy of a part of the ECB's shareholders' equity following the reduction in its share of the latter's capital as a result of new central banks joining the ESCB *(see the comment on the items of the balance sheet* Intra-Eurosystem claims and liabilities).

As in the previous year, the Governing Council decided to transfer the full amount of the ECB's gross income for the year (€286 million) to a provision for foreign exchange rate, interest rate and gold price risks. The gross result for the year included the ECB's seigniorage income (€2,004 million, of which the Bank of Italy's share was €361 million) which was not distributed to the Eurosystem NCBs. Following the above allocation, the ECB broke even in 2007 and accordingly no dividend will be paid to the Eurosystem NCBs (see Legal basis, methods of preparation and layout of the annual accounts*).*

Net result of the pooling of monetary income (Item 5)

This item rose from €15 million to €48 million.

The result in 2007 was the difference between the monetary income pooled, €4,126.3 million, and that redistributed, €4,174.8 million. The monetary income pooled of each NCB is determined by measuring the actual annual income that derives from the earmarkable assets held against its liability base. The liability base of each NCB consists of: banknotes in circulation; liabilities to credit institutions related to monetary policy operations denominated in euros; net intra-Eurosystem liabilities resulting from TARGET transactions; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is deducted from the monetary income to be pooled. The earmarkable assets of each NCB consist of: lending to euro-area credit institutions related to monetary policy operations; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; and a limited amount of each NCB's gold holdings in proportion to each NCB's capital key 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; from 2008 onwards the rate used will be the last marginal rate applied to Eurosystem main refinancing operations. The monetary income pooled by the Eurosystem is allocated to each NCB according to its subscribed capital key.

Net income from financial assets representing investments of reserves and provisions (Item 6)

The increase in this item was primarily due to the growth in interest received on securities as a consequence of both higher rates of return and the larger average stock of investments; by contrast, there was a decrease in the profits earned on the disposal of equity securities not held as fixed assets and an increase in writedowns, especially of equities.

Table 23.20

Net income from financial assets related to investments of reserves and provisions (Item 6)
(thousands of euros)

	2007	2006	Changes
Interest income	991,121	807,170	183,951
reserves pursuant to the Statute	*320,385*	*263,121*	*57,264*
other reserves and provisions	*670,736*	*544,049*	*126,687*
Dividends	305,436	297,743	7,693
reserves pursuant to the Statute	*169,032*	*170,525*	*-1,493*
other reserves and provisions	*136,404*	*127,218*	*9,186*
Profits/losses from trading and disposals	85,709	139,613	-53,904
reserves pursuant to the Statute	*63,069*	*133,226*	*-70,157*
other reserves and provisions	*22,640*	*6,387*	*16,253*
Writedowns	-43,315	-1,849	-41,466
reserves pursuant to the Statute	*-26,495*	*-1,334*	*-25,161*
other reserves and provisions	*-16,820*	*-515*	*-16,305*
Other components - reserves pursuant to the Statute	2,271	2	2,269
Total	**1,341,222**	**1,242,679**	**98,543**

Other transfers from provisions and other income (Items 7 and 8)

In 2007 a total of €4 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.

Table 23.21

Other income (Item 8)
(thousands of euros)

	2007	2006	Changes
Rental income from buildings	22,149	21,440	709
Procedures, studies and designs completed during the year	10,434	10,036	398
Other	29,161	20,960	8,201
Total	**61,744**	**52,436**	**9,308**

The increase in the sub-item *Other* was mostly due to the larger profits deriving from the sale of buildings (up from €2 million to €7 million).

Appropriation of investment income to reserves provided for in the Statute (Item 9)

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 in 2007 fell from €566 million to €528 million, owing to the smaller profits on trading and the volume of writedowns, primarily in connection with equities, which were only offset in part by the increase in the interest component (for more details, see *Net income from financial assets representing investments of reserves and provisions*).

Sundry expenses and charges (Item 10)

This item comprises:

Table 23.22

Sundry expenses and charges (Item 10)
(thousands of euros)

	2007	2006	Changes
Staff wages and salaries and related costs	629,873	633,760	-3,887
Other staff costs	40,496	44,799	-4,303
Transfers to provisions for accrued expenses and staff severance pay and pensions	*97,496*	*101,855*	*-4,359*
staff severance pay and pensions	23,636	30,349	-6,713
accrued expenses not yet paid	*73,704*	*71,005*	*2,699*
other	*156*	*501*	*345*
Pensions and severance payments	292,441	367,992	-75,551
Emoluments paid to head and branch office collegial bodies	2,889	1,826	1,063
Administrative costs	400,569	402,894	-2,325
Depreciation of tangible and intangible fixed assets	195,756	194,271	1,485
Other expenses	27,424	20,199	7,225
Total	**1,686,944**	**1,767,596**	**-80,652**

The decrease in *pensions and severance payments* was primarily due to that in severance payments (from €166 million to €86 million) as a consequence of the smaller number of retirements in 2007.

Table 23.23

The Bank's staff

	Average number of persons in service		Percentage composition	
	2007	2006	2007	2006
Managerial	1,902	1,970	25.5	25.1
Non-executive	4,465	4,704	59.9	60.0
General services and security	603	662	8.1	8.5
Blue-collar	486	498	6.5	6.4
Total	**7,456**	**7,834**	**100.0**	**100.0**
Contract workers	32	34		

Administrative costs declined by €2 million. Within this item security services and banknote escort increased by €3 million (from €88 million to €91 million), equipment rentals by €2 million (from €23 million to €25 million), external software leasing and maintenance by €7 million (from €25 million to €32 million) and systems assistance by €2 million (from €22 million to €24 million). By contrast, building maintenance decreased by €10 million (from €64 million to €54 million) and subsidiary materials for banknote production by €6 million (from €7 million to €1 million), while raw materials needed for the production of banknotes remained basically unchanged (rising from €25 million to €26 million).

Prior-year income and expense (Item 12)

Prior-year income rose by €37 million (from €6 million to €43 million), primarily in relation to the definitive acquisition by the Bank of Italy of €40 million from the banks that received advances under Ministerial Decree 1974, as activated by Law 588/1996. *Prior-year expense* rose by €3 million (from €4 million to €7 million).

Taxes on income for the year and productive activities (Item 13)

Taxes for the year amounted to €1,610 million and comprised both the current taxes due to the tax authorities and the change in deferred tax assets and liabilities (see the *deferred tax assets* sub-item in the comment on the item of the balance sheet *Other assets*).

More specifically, corporate income tax for the year included €143.7 million of taxes for the current year and recorded in the tax provision, €143.7 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, and €1,255 million in relation to the reduction in deferred tax assets caused by the lowering of the tax rate from 33 to 27.5 per cent; the net change in the remaining deferred tax components reduced the taxes for the year by €12 million. Overall, corporate income tax for the year amounted to €1,530 million, compared with €543 in 2006.

The regional tax on productive activities (Irap) fell from €126 million to €80 million, the result of €82 million of tax for the year, recorded in the tax provision, and a positive net change of €2 million in the deferred component. For the analysis of the changes in deferred tax assets and liabilities, see the comment on the items of the balance sheet *Other assets*.

PROPOSALS OF THE GENERAL COUNCIL

Pursuant to Articles 38 and 39 of the Statute and after hearing the favourable opinion of the Board of Auditors, the General Council proposes the following allocation of the net profit for 2007 of €95,156,804:

	euros
- 20 per cent to the ordinary reserve	19,031,361
- an amount equal to 6 per cent of the share capital to shareholders	9,360
- 20 per cent to the extraordinary reserve	19,031,361
- an additional amount equal to 4 per cent of the share capital to shareholders	6,240
- the remaining amount to the State	57,078,482
Total	95,156,804

Pursuant to Article 40 of the Statute, the General Council has also proposed the distribution to shareholders — drawing on the income earned on the ordinary and extraordinary reserves — of an additional €56,148,000, equal to 0.50 per cent (as in 2006) of the total reserves at 31 December 2006.

If these proposals are approved, the total dividend will be equal to €56,163,600 corresponding to €187,212 per share.

THE GOVERNOR

Mario Draghi

24. DOCUMENTATION ATTACHED TO THE ANNUAL ACCOUNTS

REPORT OF THE BOARD OF AUDITORS

ON THE 114th FINANCIAL YEAR OF THE BANK OF ITALY
AND THE ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2007

To the shareholders,

We have examined the annual accounts of the Bank of Italy for the year ended 31 December 2007, drawn up in accordance with the accounting standards and valuation methods decided by the General Council and agreed by us, described in detail in the notes to the accounts.

In our opinion the annual accounts of the Bank of Italy for the year ended 31 December 2007 have been prepared in accordance with the accounting standards and valuation methods indicated in the notes to the accounts. They comply with the law in force and 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 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 audited by external auditors, were compared by us with the accounting records and found to conform with them.

The inclusion in the balance sheet of deferred tax assets, arising primarily 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, deferred tax assets decreased by €1,385 million (from €7,696 million to €6,311 million), above all as a result of the reduction in the corporate income tax rate from 33 to 27.5 per cent by Law 244/2007.

The General Council approved the withdrawal of €1,284 million from the provision for general risks.

In our opinion the total amount of the Bank's general and specific risk provisions is prudent. In particular, the provision for severance pay and pensions comprises both the actuarial reserves corresponding to the situation of staff having entitlement and that of pensioners and the severance pay accrued by all the members of the staff in service at the end of the year having entitlement.

The accounts submitted for your approval show the following results:

Assets	€	244,376,425,611
Liabilities	€	226,981,255,509
Capital and reserves	€	17,300,013,298
Net profit for the year (as shown in the income statement)	€	95,156,804

The memorandum accounts, equal to €324,200,245,943, refer to deposits of securities and sundry valuables and commitments and contingent liabilities (for spot and forward purchases and sales of securities and sundry valuables), in foreign currencies and euros.

Pursuant to Article 39 of the Statute, the General Council proposes the following allocation of the net profit:

- 20 per cent to the ordinary reserve	€	19,031,361
- an amount equal to 6 per cent of the share capital to shareholders	€	9,360
- 20 per cent to the extraordinary reserve	€	19,031,361
- an additional amount equal to 4 per cent of the share capital to shareholders	€	6,240
- the remaining amount to the State	€	57,078,482
Total	€	95,156,804

Pursuant to Article 40 of the Statute, the General Council also proposes the distribution to shareholders — drawing on the income earned on the ordinary and extraordinary reserves — of an additional €56,148,000, equal to 0.50 per cent of such reserves at 31 December 2006 and within the limits laid down in the above-mentioned article.

During the year ended 31 December 2007 we attended all the meetings of the General Council and made the tests and controls within the scope of our authority, including checks on the quantities of cash and valuables belonging to the Bank and third parties, verifying at all times compliance with the law and the Bank's Statute and General Regulations. We monitored the activity of the Bank's peripheral units, in accordance with Articles 19 and 20 of the Bank's Statute, with the assistance of the examiners at the main and local branches, whom we thank warmly.

To the shareholders,

We recommend that you approve the annual accounts for 2007 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 the additional allocation to capital pursuant to Article 40 of the Statute.

THE BOARD OF AUDITORS

ANGELO PROVASOLI (CHAIRMAN)
GIOVANNI FIORI
ELISABETTA GUALANDRI
GIAN DOMENICO MOSCO
DARIO VELO

LIST OF ABBREVIATIONS

ABI	–	*Associazione bancaria italiana* Italian Banking Association
BI–COMP	–	*Banca d'Italia Compensazione* Bank of Italy Clearing System
BI–REL	–	*Banca d'Italia Regolamento Lordo* Bank of Italy real-time gross settlement system
BOTs	–	*Buoni ordinari del Tesoro* Treasury bills
BTPs	–	*Buoni del Tesoro poliennali* Treasury bonds
CCTs	–	*Certificati di credito del Tesoro* Treasury credit certificates
CIPA	–	*Convenzione interbancaria per i problemi dell'automazione* Interbank Convention on Automation
Confindustria	–	*Confederazione generale dell'industria italiana* Confederation of Italian Industry
Consob	–	*Commissione nazionale per le società e la borsa* Companies and Stock Exchange Commission
Covip	–	*Commissione di vigilanza sui fondi pensione* Pension fund supervisory authority
CTOs	–	*Certificati del Tesoro con opzione* Treasury option certificates
CTZs	–	*Certificati del Tesoro zero-coupon* Zero-coupon Treasury certificates
EFPD	–	Economic and Financial Planning Document
FPR	–	Forecasting and Planning Report
HICP	–	Harmonized index of consumer prices
ICI	–	*Imposta comunale sugli immobili* Municipal real estate tax
Iciap	–	*Imposta comunale per l'esercizio di imprese e di arti e professioni* Municipal tax on businesses and the self-employed
Ilor	–	*Imposta locale sui redditi* Local income tax
INAIL	–	*Istituto nazionale per l'assicurazione contro gli infortuni sul lavoro* National Industrial Accidents Insurance Institute
INPS	–	*Istituto nazionale per la previdenza sociale* National Social Security Institute

Irap	–	*Imposta regionale sulle attività produttive* Regional tax on productive activities
Irpef	–	*Imposta sul reddito delle persone fisiche* Personal income tax
Ires	–	*Imposta sul reddito delle società* Corporate income tax
ISAE	–	*Istituto di studi e analisi economica* Institute for Economic Research and Analysis
Istat	–	*Istituto nazionale di statistica* National Institute of Statistics
Isvap	–	*Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo* Supervisory authority for the insurance industry
MTS	–	*Mercato telematico dei titoli di Stato* Screen-based secondary market in government securities
QRBR	–	Quarterly Report on the Borrowing Requirement
SACE	–	*Istituto per i servizi assicurativi per il commercio estero* Foreign Trade Insurance Services Agency
SIM	–	*Società di intermediazione mobiliare* Italian investment firm
TARGET	–	Trans-European Automated Real-Time Gross Settlement Express Transfer System
UIC	–	*Ufficio italiano dei cambi* Italian Foreign Exchange Office

ADMINISTRATION OF THE BANK OF ITALY

AT 31 DECEMBER 2007

GOVERNING BOARD - DIRECTORATE

Mario DRAGHI	Governor - Member of the Governing Board
Fabrizio SACCOMANNI	Director general - Member of the Governing Board
Antonio FINOCCHIARO	Deputy director general - Member of the Governing Board
Ignazio VISCO	Deputy director general - Member of the Governing Board
Giovanni CAROSIO	Deputy director general - Member of the Governing Board

GENERAL COUNCIL

Paolo BLASI
Paolo DE FEO
Giampaolo de FERRA
Lodovico PASSERIN D'ENTREVES
Paolo LATERZA
Rinaldo MARSANO
Cesare MIRABELLI
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Ignazio MUSU
Gavino PIRRI
Stefano POSSATI
Nicolò SCAVONE
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Giovanni FIORI
Elisabetta GUALANDRI
Gian Domenico MOSCO
Dario VELO

ALTERNATE AUDITORS

Lorenzo DE ANGELIS
Sandro SANDRI

MANAGING DIRECTORS

Giancarlo MORCALDO	advisor to the governor on economic matters
Mario MELONI	organization and logistics
Francesco Maria FRASCA	advisor to the governor on economic institutions
Paolo PICCIALLI	secretary general
Anna Maria TARANTOLA	responsible for banking and financial supervision (ad interim) accounting and control
Franco PASSACANTANDO	responsible for central banking and markets (ad interim) payment system and treasury services
Matilde Carla PANZERI	responsible for currency circulation
Alberto Mario CONTESSA	advisor to the directorate on information technology
Salvatore ROSSI	responsible for economics, research and international relations