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EUROSISTEMA

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Ordinary Meeting of Shareholders

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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

In 2011 the world economy slowed. Output grew by 3.9 per cent, down from 5.3 per cent in 2010. Differences between the growth rates in the main areas were amplified: in the advanced economies GDP growth fell by 50 per cent, to 1.6 per cent; in the emerging and developing countries it declined much less sharply, to 6.2 per cent, providing the main contribution to the expansion of the world economy. In the first quarter of 2012 cyclical conditions were still weak, especially in Europe, less so in the United States and the emerging economies.

The differences in GDP growth rates became more apparent, including among the advanced countries. In the United States, after a very modest performance in the first quarter, economic activity picked up in the second half of the year; in the United Kingdom it continued to be very limited, held back by the fall in domestic demand and the rise in unemployment; in Japan it turned negative, owing to the considerable damage to production facilities caused by the earthquake of March 2011.

In the emerging and developing countries, where the main contribution to growth continued to come from domestic demand, economic activity experienced a generalized slowdown in the second half of 2011. In countries such as China, India, and especially Brazil, where 2010 was characterized by a very rapid recovery and a return to almost full production capacity utilization, the deceleration was mainly due to the effects of the restrictive policies adopted in the first half of the year in response to inflationary pressures. To this was added, towards the end of 2011, the weakening of foreign demand, in particular that of the euro area. In Russia economic activity was boosted by the larger receipts from exports owing to high oil prices.

In a climate of uncertainty stemming from tensions in the sovereign debt markets of the euro-area countries, the central banks of the leading advanced economies accentuated the expansionary stance of their monetary policies. The unconventional measures were reinforced and extended; reference rates remained at exceptionally low levels in the United States, Japan and the United Kingdom, while towards the end of the year they started to fall again in the euro area. In the early months of 2012, the Federal Reserve and the Bank of Japan modified their conduct of monetary policy with a view to increasing transparency. Inflation, driven by increases in the prices of energy and food commodities, had risen in the first nine months of 2011 but turned down again from the autumn onwards.

In the United States there were strong disagreements between the Administration and Congress over fiscal policy. Although several measures to support growth were extended until end-2012, the budget deficit narrowed slightly. The current laws, which provide for the entry into force of several automatic public spending cuts and the end of a series of tax reductions, would bring a sharp fall in the deficit-to-GDP ratio in 2013. In the United Kingdom the budget deficit declined, albeit by less than the target set in the plan to restructure the public finances launched in 2010. In Japan the costs of rebuilding the areas destroyed by the earthquake led to a worsening of the budget deficit, forcing the government to defer the formulation of plans to reduce the country's substantial debt.

In the second half of 2011, following the deterioration in the global economic outlook and the easing of domestic inflationary tensions, the central banks of the main emerging economies gradually made monetary conditions more accommodating; by contrast the action to consolidate the public finances initiated in 2010 was continued by withdrawing the stimulus measures introduced during the global crisis.

The United States

The United States economy expanded by 1.7 per cent in 2011 (Table 1.1). The pace of growth, which was very modest in the first quarter, subsequently picked up due to the acceleration in private consumption and non-residential investment and, towards the end of the year, the rise in stocks. In the third quarter GDP exceeded the pre-crisis peak.

Consumption increased by 2.2 per cent, outpacing the growth in real disposable income (1.3 per cent). The saving rate for the year accordingly declined to 4.7 per cent, from 5.3 per cent in 2010. Households nonetheless continued to reduce their debt, bringing it to 105.4 per cent of disposable income, almost twenty percentage points below the end-2007 level, when financial deleveraging began.

Non-residential fixed investment grew by 8.8 per cent, but in proportion to GDP remained below the peak registered in 2008. Residential investment continued to shrink (by 1.3 per cent), albeit at a markedly slower pace than in recent years. Following two years of strong gains, there was only a small improvement in hourly productivity; the fast growth in hourly wages accordingly determined an increase of 2.0 per cent in unit labour costs.

Non-farm payroll employment rose by 1.8 million units in 2011. In the last two years a total of 2.9 million jobs were created, barely one third of those lost in the previous two years. The unemployment rate fell by almost one percentage point, to 8.5 per cent in December, partly owing to a drop in the labour force participation rate. The long-term unemployed – those out of work for at least 27 weeks – continued to make up over 40 per cent of the total; their re-employment remains difficult, not least in view of the deterioration in human capital generally associated with long periods of inactivity.

According to preliminary estimates, in the first quarter of 2012 GDP continued to grow (at an annual rate of 2.2 per cent, down from 3.0 per cent in the previous quarter). The deceleration was due to the drop in non-residential fixed investment and the lower contribution of stocks, offset in part by the acceleration in consumption and exports. In the first four months of 2012 the recovery in non-farm payroll employment continued (803,000 units) and the unemployment rate fell further, to 8.1 per cent in April.

Table 1.1

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

	2009	2010	2011	2011				2012
				Q1	Q2	Q3	Q4	Q1
United States								
GDP (1)	-3.5	3.0	1.7	0.4	1.3	1.8	3.0	2.2
Domestic demand (1)	-4.4	3.4	1.6	0.7	1.0	1.3	3.1	2.1
Inflation (2)	-0.4	1.6	3.2	2.1	3.4	3.8	3.3	2.8
Japan								
GDP (1)	-5.5	4.4	-0.7	-7.9	-1.2	7.6	0.1	4.1
Domestic demand (1)	-4.0	2.7	0.1	-7.1	2.9	4.4	3.1	3.5
Inflation (2)	-1.4	-0.7	-0.3	-0.5	-0.4	0.1	-0.3	0.3
European Union								
GDP (1)	-4.3	2.0	1.5	2.6	0.7	1.1	-1.0	-0.2
Domestic demand (1)	-4.3	1.5	0.5	1.0	..	..	-2.4	....
Inflation (2)	1.0	2.1	3.1	2.9	3.2	3.1	3.2	2.9
United Kingdom								
GDP (1)	-4.4	2.1	0.7	1.0	-0.2	2.3	-1.2	-0.8
Domestic demand (1)	-5.4	2.9	-0.8	-3.7	0.9	2.1	-2.0	....
Inflation (2)	2.2	3.3	4.5	4.1	4.4	4.7	4.7	3.5
Canada								
GDP (1)	-2.8	3.2	2.5	3.7	-0.6	4.2	1.8	....
Domestic demand (1) (3)	-2.1	4.5	3.0	2.1	2.6	1.7	2.1	....
Inflation (2)	0.3	1.8	2.9	2.6	3.4	3.0	2.7	2.3
Advanced economies								
GDP (4)	-3.6	3.2	1.6	....	....	....	....	....
Memorandum item:								
World output (4)	-0.6	5.3	3.9	....	....	....	....	....

Sources: ECB, IMF and national statistics.
(1) Volumes at chain-linked prices; quarterly changes on previous quarter at an annual rate. – (2) Consumer price index; for quarterly data, changes on the corresponding quarter of the previous year. – (3) For Canada, domestic final demand. – (4) Weighted average, weighted by GDP at purchasing power parity, of the growth rates of the economies included in the aggregate.

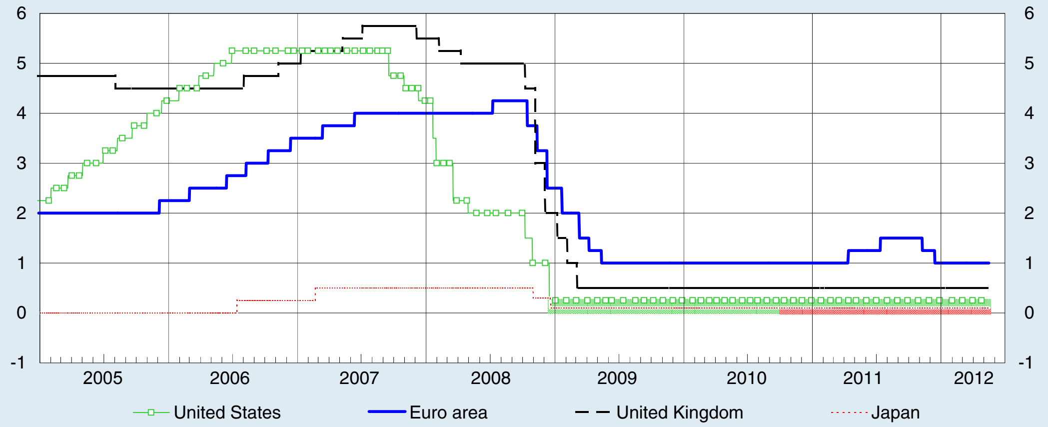
The situation in the property market remains delicate, owing to the contraction in the supply of mortgage loans from the banking system and the still high level of new mortgage foreclosures. The Case-Shiller home price index covering the ten largest metropolitan areas declined in 2011. In February 2012 the index was 5.9 per cent below the level of December 2010 and 35 per cent below the maximum recorded in June 2006. However, futures on the index point to expectations of prices stabilizing in the next few months.

Inflation, measured by the twelve-month change in the consumer price index, rose to a peak of 3.9 per cent in September, before gradually declining to 2.3 per cent in April this year. The consumption deflator showed a similar pattern, rising to 2.9 per cent in September and then dropping to 2.1 per cent in March.

Against a background of stable inflation expectations, although the Federal Reserve kept its reference rate in a range between 0.00 and 0.25 per cent (Figure 1.1), to counter the weakness of the labour market it adopted a more expansionary monetary policy stance, based on both a more explicit communication strategy and further unconventional measures. In April 2011 it indicated that it expected circumstances to justify maintaining the reference rate at exceptionally low levels until mid-2013; in January this year it extended that horizon until the last part of 2014. In the first half of 2011, the Federal Reserve completed its programme of long-term Treasury bond purchases launched in November 2010, for a total of $600 billion (equivalent to 4 per cent of GDP). Its balance sheet accordingly expanded to 19 per cent of GDP. In the same way as for the other central banks, the latest increase in its balance sheet also reflected factors unconnected with the responses to the crisis. In September the Federal Reserve announced *operation twist*, aimed at extending the average maturity of its holdings of securities through the purchase, by end-June 2012, of $400 billion of Treasury securities with remaining maturities of over six years and the sale of an equal amount of Treasury securities with remaining maturities of three years or less. To help ease conditions in the mortgage market, it also decided that income deriving from the redemption of government agency bonds and mortgage-backed securities (MBSs) would be reinvested in MBSs and no longer in government securities.

Figure 1.1

Official interest rates (1)
(daily data; per cent)

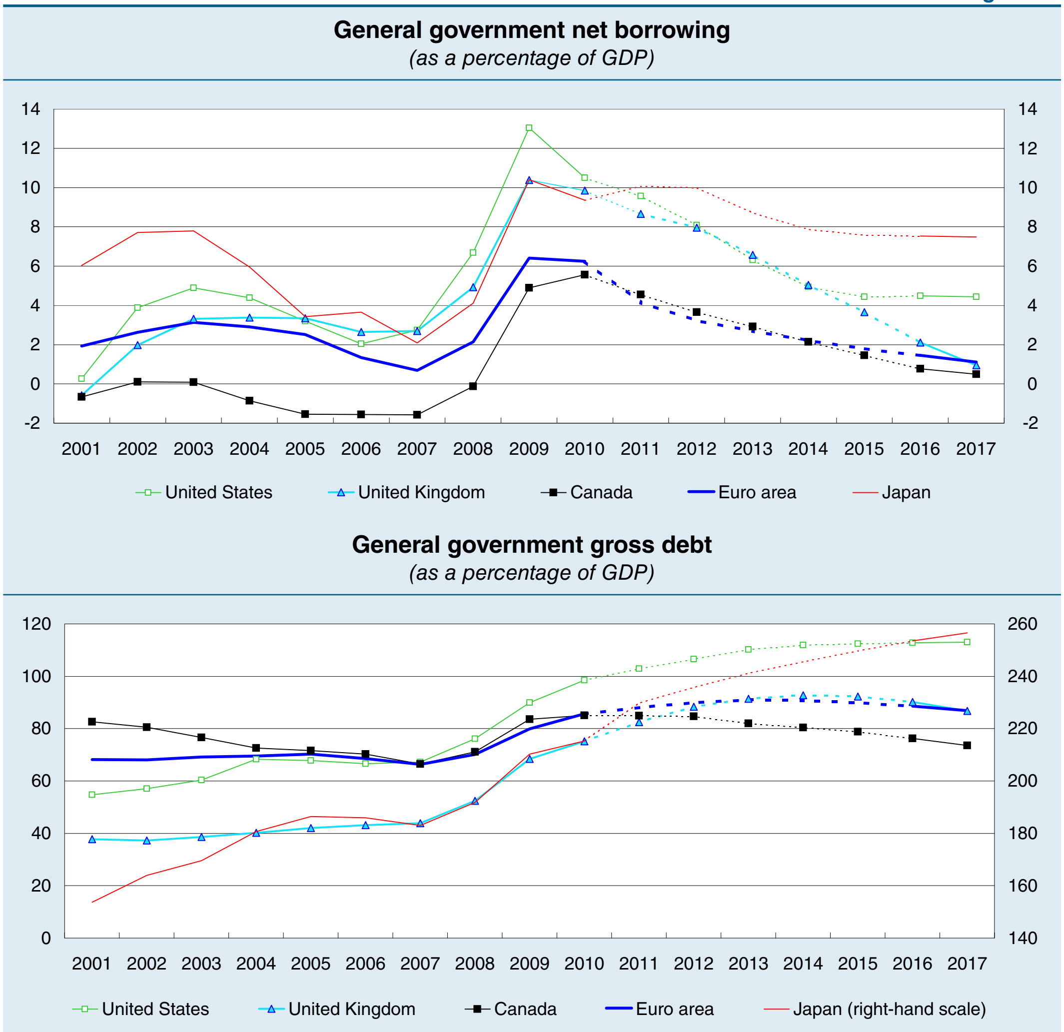


Sources: ECB and national statistics.
(1) For the United States, federal funds target rate; for Japan, uncollateralized overnight call rate target; for the euro area, interest rate on main refinancing operations; for the United Kingdom, interest rate on commercial banks' reserves with the Bank of England and, before 18 May 2006, repo rate.

The stance of budgetary policy remained expansionary, despite a slight reduction in the substantial federal deficit (to 8.7 per cent of GDP). According to IMF estimates, the cyclically adjusted deficit narrowed to 7.2 per cent in 2011, from 7.8 per cent in 2010. Last August, after a deadlock lasting several weeks, the Administration and Congress reached an agreement on raising the maximum debt limit (Budget Control Act of 2011), failing which the United States would have been unable to honour its financial obligations. In December Congress approved the extension to end-2012 of two temporary stimulus measures that had been about to expire: the reduction of the employee's portion of the payroll tax for Social Security and the extension of unemployment benefits.

According to Congressional Budget Office (CBO) estimates, the federal budget deficit on the assumption of unchanged legislation will narrow to 7.6 per cent of GDP in the current financial year and to 3.8 per cent in the year ended September 2013, mainly owing to the automatic cuts agreed under last August's deficit-cutting deal and the ending of the temporary expansionary measures in place throughout 2012. In an alternative scenario, where these measures are hypothetically extended to the end of next year, the 2013 deficit would amount to 6.3 per cent of GDP. The IMF, which for next year considers the CBO's alternative scenario the more probable one, expects total debt to continue rising, to 110.2 per cent of GDP at the end of 2013 and 102.9 per cent at the end of 2011 (Figure 1.2).

Figure 1.2



Sources: IMF, *World Economic Outlook*, April 2012 and *Fiscal Monitor*, April 2012.

Japan

In 2011 Japanese GDP contracted by 0.7 per cent (Table 1.1). The catastrophic events of March 2011 seriously damaged the country's production system. Economic activity was affected above all by the difficulties in the supply of intermediate goods and electricity, which contributed to the fall in exports and stocks, as well as to the increase in imports. Private consumption and investment, which fell sharply after the earthquake, picked up again in the second half of the year as reconstruction work got under way. Conditions in the labour market improved slightly. The unemployment rate stood at 4.5 per cent in December, down by 0.4 percentage points on twelve months earlier.

In the first quarter of 2012 output, which accelerated to an annual growth rate of 4.1 per cent, benefited from the strong performance of household consumption and the build-up in stocks.

In 2011 the deflationary tendencies diminished in intensity with respect to the previous two years. Excluding energy and food products, the twelve-month decline in the consumer price index went from 1.2 per cent in December 2010 to 0.4 per cent in March 2012. On the basis of the overall index of consumer prices, in the early months of 2012 inflation was in slightly positive territory.

The Bank of Japan kept its reference rate for monetary policy in a range between 0.0 and 0.1 per cent and on several occasions between March 2011 and April 2012 bolstered disbursements of three- and six-month loans under its Asset Purchase Programme and related purchases of government securities and private sector financial instruments. The funds available under the programme currently amount to ¥70,000 billion (about 15 per cent of GDP), double that foreseen in October 2010. In April the programme was extended to June 2013 and its composition altered by increasing the share allocated to purchases of government securities. The size of the central bank's balance sheet, which records only the transactions concluded to date, accordingly expanded to about 30 per cent of GDP. In March the Bank of Japan increased its Growth-Supporting Funding Facility by ¥2,000 billion (to ¥5,500 billion); launched in June 2010, the Facility provides loans to private banks on favourable terms to finance investment in high-growth sectors. At the same time, the Bank of Japan made the conditions for accessing credit less stringent and extended the duration of the programme by two years, to March 2014. The ¥1,000 billion fund for the support of bank loans to firms located in the region hit by the earthquake, set up in April 2011, was extended to April 2013.

Japanese general government net borrowing rose to 10.1 per cent of GDP in 2011, owing in part to the substantial reconstruction costs incurred; according to IMF estimates, net borrowing will not decline until 2013. General government gross debt is expected to increase, exceeding 240 per cent of GDP at the end of 2013 (Figure 1.2).

The European Union

In 2011 the GDP of the 27 countries belonging to the European Union grew by 1.5 per cent, a similar result to that recorded in the euro area.

The United Kingdom. – GDP growth slowed sharply last year, from 2.1 to 0.7 per cent (Table 1.1). Household consumption declined by 1.2 per cent, as a consequence of the fall in real disposable income and restrictive supply conditions. Weak demand also affected investment (down by 1.2 per cent). By contrast, net exports contributed one percentage point to growth. Consumer price inflation rose to a twelve-month rate of 5.2 per cent in September, after which it fell sharply, to 3.5 per cent in March. The rate of inflation was affected by the increase in VAT and the rise in raw material prices.

The unemployment rate continued to rise; in December, it reached 8.4 per cent, the highest level of the last fifteen years. Private sector wages recorded a moderate increase of 2.5 per cent on average in 2011 (against 1.9 per cent in 2010), reflecting stable inflation expectations and the fragility of the labour market.

The Bank of England kept its reference rate for monetary policy at 0.5 per cent and increased its asset purchase programme (made up almost exclusively of government securities) by £75 billion in October and a further £50 billion in February, taking the total to £325 billion; its balance sheet expanded to 23 per cent of GDP. The central bank said it expected that the high margin of spare capacity and the decline in the prices of imported goods would moderate inflation, which would nonetheless remain above the 2 per cent target until mid-2013.

In the 2011-12 financial year (ended in March) the public sector borrowing requirement fell by one percentage point to 8.3 per cent of GDP. The improvement in the performance of the public finances was slightly below that forecast in the March 2011 budget. The start, in the 2015-16 financial year, of the reduction in the ratio to GDP of public sector net debt, and the elimination, by 2016-17, of the cyclically adjusted current budget deficit, have accordingly both been delayed. Based on IMF estimates, at the end of December gross public debt rose to 82.5 per cent of GDP, from 75.1 per cent the previous year; in 2014 it is expected to peak at 92.8 per cent (Figure 1.2).

The new European Union members. – In the seven new EU member countries not part of the euro area, GDP growth averaged 3.2 per cent last year, with significant differences among the countries (Table 1.2). Economic activity was particularly brisk in the economies supported by strong domestic demand (Latvia, Lithuania and Poland), while the weakness of consumption and investment in the others was not offset by adequate support from foreign demand.

Table 1.2

Main macroeconomic indicators for the new EU members not in the euro area (1)
(percentage changes unless otherwise indicated)

	GDP		Consumer prices (1)		Balance on current account (2)		External debt (2) (3)	Govt. budget balance (2)		Public debt (2)
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
Bulgaria	0.4	1.7	3.0	3.4	-1.0	0.9	87.2	-3.1	-2.1	16.3
Czech Republic	2.7	1.7	1.2	2.2	-3.9	-2.9	43.6	-4.8	-3.1	41.2
Hungary	1.3	1.7	4.7	3.9	1.2	1.4	146.9	-4.2	4.3	80.6
Latvia	-0.3	5.5	-1.2	4.2	3.0	-1.2	134.2	-8.2	-3.5	42.6
Lithuania	1.4	5.9	1.2	4.1	1.5	-1.6	75.0	-7.2	-5.5	38.5
Poland	3.9	4.3	2.7	3.9	-4.7	-4.3	62.6	-7.8	-5.1	56.3
Romania	-1.6	2.5	6.1	5.8	-4.4	-4.4	66.0	-6.8	-5.2	33.3
Total	**2.1**	**3.2**	**3.2**	**3.9**	**....**	**....**	**72.9**	**-6.4**	**-3.5**	**50.0**

Sources: Based on Eurostat and World Bank data.
(1) Harmonized Index of Consumer Prices. – (2) As a percentage of GDP. – (3) Gross.

In 2011 as a whole, consumer inflation was slightly above the levels of the previous year (3.9 per cent, up from 3.2 per cent in 2010). This reflected both the increases in energy and food prices and, in a number of countries, interventions on indirect taxes and administered prices.

In response to the intensification of inflationary pressures, in the first half of 2011 the central banks of Poland and Hungary raised their reference rates by 75 and 25 basis points, respectively. Towards the end of the year, to combat exchange rate tensions the Hungarian central bank further increased its reference rate in two steps by a total of 100 basis points. In Romania, instead, the improvement in inflation prospects allowed the central bank to ease monetary conditions.

During 2011 public sector deficits continued to decline, thanks both to the favourable cyclical conditions and to the adjustment measures enabling structural deficit reductions, except in Hungary, where the fiscal surplus almost exclusively reflected temporary revenues.

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

China. – In 2011 GDP expanded by 9.2 per cent, down from 10.4 per cent in 2010 (Table 1.3). While consumption continued to grow at a fast pace, investment and exports slowed in the second half of the year. The weakness of these two components of demand continued into the first quarter of this year, contributing to a further deceleration in output (to 8.1 per cent compared with the same period in 2011).

Table 1.3

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

	GDP		Consumer prices		Balance on current account (1)		Budget balance (1) (2)	
	2010	2011	2010	2011	2010	2011	2010	2011
China	10.4	9.2	3.3	5.4	5.1	2.8	-2.3	-1.2
India (3)	8.5	7.1	12.0	8.6	-3.3	-2.8	-9.2	-8.7
Brazil	7.5	2.7	5.0	6.6	-2.2	-2.1	-2.8	-2.6
Russia	4.3	4.3	6.9	8.4	4.7	5.5	-3.5	1.6

Sources: IMF and national statistics.
(1) As a percentage of GDP. – (2) Consolidated public sector. – (3) GDP at factor cost.

The growth in capital formation suffered as a result of the slowdown in government investment in infrastructure and more strained financial conditions. As in 2009 the contribution of net exports to the growth of output was slightly negative (by 0.5 percentage points), reflecting a greater slowdown of exports than imports. This led to a reduction in the surplus on current account.

While the last global crisis helped to reduce the dependence of economic growth on exports, an internal imbalance remains due to investment weighing excessively on demand. The growth of consumption was long inhibited by economic policies whose effect was to increase saving and the accumulation of capital, to the detriment of households' purchasing power and social spending.

Throughout the first half of 2011 inflationary pressures remained high, driven by the prices of food products, which were affected not only by the rise in international prices but also by bottlenecks in domestic supply. In July the twelve-month rate of increase in the consumer price index peaked at 6.5 per cent, before gradually declining to 4.1 per cent in December. On average in 2011 inflation was 5.4 per cent, well above the 4 per cent target set by the authorities. Increases in the cost of housing services pushed core inflation (excluding food and energy products) to 2.4 per cent, the highest value since 2006 when the index became available.

To counter inflation, in the first half of 2011 the People's Bank of China intensified the restrictive monetary policy stance it had adopted in 2010, raising the compulsory reserve ratio for bank deposits to 21.5 per cent for large banks and the reference rate for one-year bank loans by a total of 75 basis points. Moreover, to curb the acceleration in property prices, the authorities tightened lending conditions in the sector and introduced further restrictions on house purchases, in addition to those that took effect in 2010. From mid-2011 onwards, house prices began to slow significantly; in March 2012 they were declining in 42 of the 70 main cities.

The restrictive monetary measures led to a sharp contraction in credit and currency growth: at the end of 2011 the expansion of the total stock of loans granted by the banks slowed to a twelve-month rate of 15.8 per cent (from 19 per cent in 2010); that of the M2 money aggregate was well below the 16 per cent target set by the authorities. From the autumn onwards, following the abatement of inflationary pressures and signs of a worsening economic outlook, China's central bank began to ease monetary conditions, cutting the reserve requirement ratio for bank deposits by a total of 150 basis points. The authorities also began to ease credit conditions selectively, above all in favour of small and medium-sized firms.

In 2011 the public sector deficit fell to 1.2 per cent of GDP (from 2.3 per cent in 2010), benefiting from the sharp upturn in tax revenue and cutbacks in expenditure on infrastructure projects. The budget plan for 2012 predicts a slight rise in the budget deficit, to 1.5 per cent, reflecting an increase in social spending and in expenditure on public housing. According to the official estimates, the public debt will reach 25.8 per cent of GDP at the end of 2011; according to OECD estimates, which include off-balance-sheet liabilities of local governments and other governmental authorities, debt will instead amount to around 45 per cent of GDP.

The government has announced a programme of reforms that includes the redistribution of budgetary responsibilities between the central and local governments to make the financing of government spending easier and more transparent, especially in the less affluent provinces.

India. – GDP growth declined to 7.1 per cent, from 8.5 per cent in 2010. Last year's slowdown was sharpest in the manufacturing and construction sectors, the most vulnerable to the worsening financial conditions. The contribution of demand to the growth in fixed capital formation was nil, while the pace of growth in household consumption remained robust.

Inflation, as measured by the wholesale price index, remained high (9.5 per cent on average for the year), driven by the prices of raw materials, especially energy and food products, influenced by the considerable depreciation of the Indian rupee. Towards the end of the year the pressures eased, benefiting from the sharp slowdown in food prices. Wholesale price inflation nonetheless reached a twelve-month rate of 7.2 per cent in April, still above the price stability threshold of under 6 per cent set by India's central bank. Inflation measured by the new consumer price index, which includes rural areas and predominantly reflects trends in food prices, was 10.4 per cent in the same month, down from 12 per cent in 2010.

To combat inflationary pressures the central bank maintained the restrictive monetary policy stance it had adopted in 2010, repeatedly raising the repo rate – now the main monetary policy rate – by a total of 450 basis points, to 8.5 per cent, and the reserve requirement ratio by 100 basis points, to 6 per cent. At the beginning of 2012, in response to the deteriorating economic outlook and tensions on the liquidity market, the central bank modified its monetary policy stance, lowering the reserve requirement ratio by 125 basis points and, in April, it cut interest rates by 50 basis points.

India's public finances continue to be more vulnerable than those of the other main emerging economies. In 2011 the consolidated public sector deficit stood at 8.7 per cent of GDP, a high level, reflecting the difficulty of curbing expenditure, especially that on subsidies to support the consumption of food and energy products (amounting to 2.4 per cent of GDP). According to IMF projections, in the next two years the budget deficit will stay at current levels and public debt at 67 per cent of GDP, well above the average of the emerging countries.

Brazil. – After the strong recovery of 7.5 per cent recorded in 2010, GDP slowed abruptly last year, growing by barely 2.7 per cent. There was a sharp deceleration in investment and exports, while household consumption continued to expand at a strong pace, thanks to low unemployment and the marked expansion in bank credit in the first half of the year.

On the supply side, industry recorded a particularly severe slowdown, with an average annualized contraction in value added of 2.5 per cent in the last three quarters of 2011.

In the first part of 2011 the central bank followed the restrictive monetary policy stance it had adopted in the spring of 2010, raising the Selic reference rate by a total of 225 basis points, to 12.5 per cent, and strengthening macro-prudential policies aimed at limiting the growth in credit to households. It also intensified the measures designed to curb the expansion in short-term foreign debt, one factor in the excessive expansion of liquidity. These measures helped to ease the inflationary pressure: from the peak of 7.3 per cent reached at the end of the third quarter, the year-on-year rate of change in consumer prices fell back to within the target range of 4.5 ± 2 per cent set by the central bank. As economic activity began to weaken, the central bank reversed its course of action, cutting the reference rate by 350 basis points, to 9 per cent, the lowest level of the last two years.

The easing of monetary conditions was accompanied by continuing fiscal consolidation: thanks to government-approved spending cuts the general government deficit fell to 2.6 per cent of GDP, from 2.8 per cent in 2010, and the primary surplus stood at 3.1 per cent. According to the IMF, the primary balance will remain unchanged in 2012 and 2013.

Russia. – The Russian economy grew by 4.3 per cent in 2011, buoyed by domestic demand, which benefited from the increased revenues produced by exports of energy products. Consumer price inflation rose to 9.4 per cent in mid-2011, before falling back to 3.6 per cent in April; excluding the most volatile components, however, it was higher at 5.3 per cent.

After the gradual adoption of restrictive measures in the first half of 2011, in December the central bank lowered its reference rate to 8 per cent. The consolidated budget balance recorded a surplus of 1.6 per cent of GDP, thanks to the high tax receipts from the energy sector. Russia's dependence on these revenues, however, represents an element of vulnerability for its public finances, exposing the balanced budget heavily to fluctuations in oil prices.

2. THE FINANCIAL AND FOREIGN EXCHANGE MARKETS

Deteriorating prospects for growth in the advanced economies and the uncertain outlook for the public finances of several euro-area countries sparked a phase of pronounced financial market instability in 2011. The strains were felt on the sovereign debt markets of a growing number of euro countries, including Italy and Spain, prompting a sudden increase in risk aversion. This fuelled demand for government securities of reputedly more reliable countries and caused a sharp drop in corporate share and bond prices. Banks' funding costs rose. Tensions were also heightened by investors' doubts regarding EU crisis management mechanisms. Thanks to the efforts of the European Central Bank, the measures taken by a number of governments and the agreement reached on financial assistance for Greece, the situation improved briefly at the beginning of this year. By April, however, spreading concerns about the economic difficulties of some euro-area countries and expectations of a deterioration in the world economy pushed premiums on sovereign risk higher, although not quite to the levels recorded last winter.

Conditions on the emerging countries' financial and foreign exchange markets reflected these reverses. Over the year as a whole, private capital continued to flow from the advanced to the emerging countries, attracted by higher yields and better medium-term growth prospects. However, portfolio investments, which constitute the most volatile component, contracted after spearheading the resumption of inflows in the previous two years.

Industrial countries

Conditions on the financial markets improved overall in the early months of 2011, notwithstanding the generalized increase in volatility caused by the situation in Libya and the earthquake in Japan on the one hand and new strains on Greek, Irish and Portuguese government securities on the other. These countries' difficulties did not have any significant backlash on the government securities of the leading industrial nations, conditions on the interbank markets remained easy, risk premiums on corporate bonds continued to fall, and share prices edged upwards.

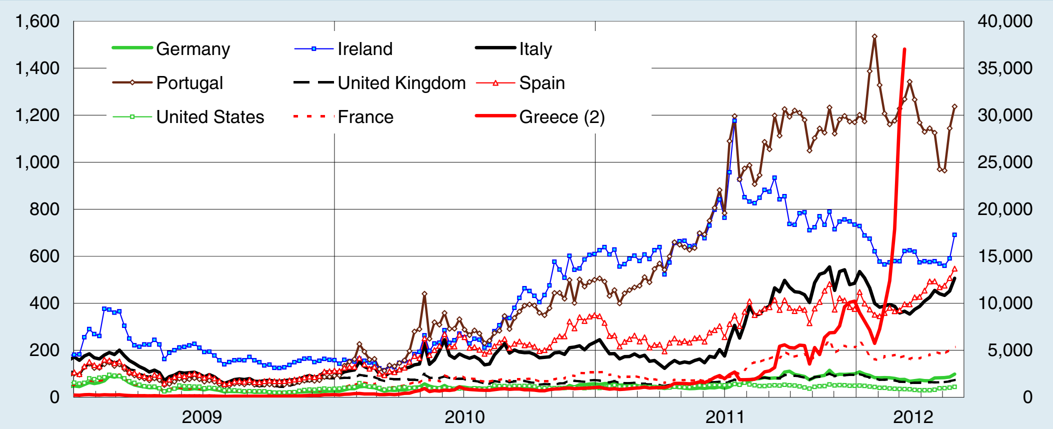
The situation began to deteriorate rapidly around the middle of the year. The financial market strains spread to other euro-area countries, notably those with a large public or private debt such as Italy, Spain and to a lesser extent Belgium. Contributing factors were the poorer outlook for growth in the industrial economies, indecision inside the European Union about what policies to adopt to counter the crisis, and uncertainty about involving the private sector in restructuring Greece's debt. Risk aversion escalated, causing investors to shift their portfolios into reputedly safer financial assets. This was deleterious for the banking industry, whose funding costs soared, particularly those of European banks with large portfolios of government securities that exposed them heavily to sovereign risk. In July, the European authorities drew up a new plan of financial aid for Greece and introduced greater flexibility in the use of the European Financial Stability Facility (see the box "The decisions of the EU Council of 21 July 2011", *Economic Bulletin*, December 2011), and in August the ECB resumed purchases under the Securities Market Programme. Tensions rose nonetheless, reaching systemic proportions by the end of the year, to which the rating agencies' repeated downgrading of the sovereign issues and banks of many European countries and worsening macroeconomic situation contributed. The decisions taken at the European summit meetings of 26 October and 9 December (see the box "The decisions of the euro-area heads of state or government of 26 October and 9 December 2011", *Economic Bulletin*, January 2012) did not manage to assuage doubts about the efficacy of crisis management tools.

Towards the end of the year, the premiums on five-year CDSs on Greek and Portuguese government securities rose to new heights of 10,000 and 1,200 basis points respectively, against 1,000 and 500 points at the beginning of the year (Figure 2.1). Smaller but still significant increases were also observed for Italian, Spanish, Belgian and French government securities, which in November peaked at 550, 480, 400 and 245 basis points respectively. The yields on ten-year government bonds of the reputedly safest countries began to decline in mid-March last year. Initially, this was due to greater uncertainty about the prospects for economic growth, later also to increased risk aversion and the consequent hunt for safe havens. In the United States, Germany and the United Kingdom, yields fell by about 1.5 percentage points, settling at an almost all-time low of 2 per cent at the end of the year. In Japan, where ten-year yields were already very low, they decreased slightly to 1 per cent.

Figure 2.1

Premium on 5-year CDSs on government securities of selected countries (1)

(end-of-week data; basis points)



Source: Thomson Reuters Datastream.
(1) Up to the week ending on 18 May 2012. – (2) Right-hand scale. The last quotation available is that for the week ending on 9 March, during which agreement was reached on private sector involvement in the debt restructuring.

On the interbank markets, liquidity began to dry up in the second half of 2011, especially for European borrowers. From July to December the interest rate spreads between unsecured three-month interbank deposits and three-month overnight index swaps – a measure of counterparty and liquidity risks – quadrupled to almost 100 basis points for the euro and doubled for the dollar and sterling to around 50 and 60 points respectively, values not seen since mid-2009; they remained virtually unchanged for the yen. European banks in particular experienced great difficulty raising funds in dollars, chiefly owing to a cutback in the supply from US money market funds. At the end of November, the leading central banks took steps to counter the risks associated with a sudden shortage of liquidity in dollars by making it less costly to use the dollar swap lines agreed in May 2010; they also extended the agreements to February 2013. The premiums on five-year CDSs of the leading international banks moved in step with the interest rate spreads on the interbank market, holding steady at 140 basis points (median value) in the first seven months of the year. They then rose until November, when they peaked at around 420 point for US banks, reflecting the latter's exposure to euro-area countries and financial intermediaries and the legal risks attached to domestic real-estate mortgages.

The tension let up considerably in the early months of this year thanks to several factors: the measures adopted by a number of euro-area governments, the ECB's provision of substantial medium-term liquidity to the banking system via two auctions in December and February (see the box "The effects of the three-year refinancing operations", *Economic Bulletin*, April 2012), and the adoption of a new agreement on Greek debt restructuring and financial assistance (see the box "Private sector involvement in resolving the Greek crisis", *Economic Bulletin*, April 2012). Spreads on the interbank markets narrowed and by the third week in May stood at roughly 50 basis points for sterling, 40 for the euro and 30 for the dollar, although these were historically high values. The premiums on five-year CDSs on the main international banks fell back to about 300 points for both US and European banks. As conditions eased on the financial markets, lending to firms showed signs of picking up.

Turmoil returned to the markets at the end of March. By the third week in May the premium on CDSs on Spanish government securities rose to a new peak of about 550 basis points, while the premiums on Italian, French, Belgian and Irish government securities stayed below the high points of the end of 2011. Long-term interest rates on government securities settled at 1.7 per cent in the United States, 1.8 per cent in the United Kingdom, 1.3 per cent in Germany and 0.8 per cent in Japan.

After declining for more than two years almost without interruption, risk premiums on private sector bonds changed tack in the summer and from July to December the yield spreads between the bonds of non-financial companies with a high credit rating (BBB) and ten-year government securities rose by some 40 basis points, to 220 for the dollar and 196 for the euro. Those for high-yield bonds increased by 70 and 200 basis points to 605 and 750 respectively. Risk premiums then fell back between the beginning of the year and the third week in May, but not below the values recorded at the beginning of the previous year. Firms reduced their recourse to the bond market in 2011. Net issues in the United States, the euro area and the United Kingdom totalled about $100 billion, down by almost a half on the previous year's figure but still higher than the $50 billion recorded in 2008.

The worsening of the economic situation and increase in risk aversion took their toll on the share markets. Over the summer, share prices fell by 15 per cent in Japan and the United States and 26 per cent in the euro area, with even greater losses in the financial sector. Autumn brought an improvement and by the third week in May this year prices were up by 14 per cent compared with mid-September in the United States, by 6 per cent in the euro area, 4 per cent in the United Kingdom and 1 per cent in Japan.

The sovereign debt tensions had only a limited effect on the foreign exchange markets. The euro rose significantly against the other main currencies in the first quarter of 2011 before weakening thereafter and losing, over the year, 3.2 per cent against the dollar, 8.2 per cent against the yen and 2.5 per cent against sterling. The yen continued to appreciate against the dollar despite coordinated action by the G7 central banks. The flight to quality brought new upward pressure to bear on the Swiss franc, which hit a low point of SF1.04 to the euro in August. The Swiss National Bank countered the slide at the beginning of September by setting a minimum threshold of SF1.20 to the euro, which was subsequently maintained with minor fluctuations. The euro appreciated briefly at the beginning of this year before falling back and settling in the third week of May close to its value at the end of 2011. In nominal effective terms, the dollar and yen had returned by April 2012 to much the same values, as at the beginning of last year, while sterling had appreciated slightly (2.6 per cent) and the euro depreciated (2.2 per cent).

Emerging economies and new EU members not in the euro area

In 2011, the share markets of the emerging economies weakened overall, after picking up strongly the year before. Their performance was halting in the first six months, partly a reflection of the monetary tightening introduced to counter the risk of overheating and related inflationary pressures. When the sovereign debt crisis flared up again in the euro area in the third quarter and economic activity slowed, share prices fell as there was a sharp outflow of portfolio investment. The largest losses occurred in the markets of Central and Eastern Europe, which are those most exposed to developments in the euro area.

Sovereign debt premiums, which were relatively low and stable in the first half of 2011, rose sharply during the summer. The yield spread between emerging economies' government debt securities denominated in dollars and those of the United States widened by over 100 basis points, exceeding 400 points on average. The increase was particularly large in some of the new EU member countries that have not yet adopted the euro, reflecting tensions specific to their economies.

In 2011, there were again large net inflows of private capital to the emerging and developing economies, amounting to 2 per cent of GDP, just slightly below the 2010 figure. Whereas flows were substantial in the first half of the year, in the summer the more volatile components slowed sharply in response to increased uncertainty on the international financial markets. Direct investment, which is generally stable, increased, eventually accounting for over half of total inflows to Latin America and Asia. By contrast portfolio investment, which had contributed to the rapid upturn in capital movements in the previous two years, contracted sharply. Shares were hit worse than bonds, but there were large disinvestments of both in the fourth quarter in all the main areas, as in the 2008-09 crisis.

Flows of bank capital (included in the balance of payments under *Other investment*) recovered only in part before 2010 owing to the long-term effects of balance-sheet consolidation by the leading international banks following the financial crisis. In the first half of 2011, however, they picked up strongly, particularly towards Asia. This trend broke off in the summer when the euro-area banks began to speed up their deleveraging.

According to data on the cross-border claims on emerging countries of BIS reporting banks, inflows of about $320 billion in the first half of the year gave way to outflows of around $94 billion in the second. In the Central and East European countries, whose financial systems are more vulnerable because of their dependence on financing from euro-area banks to make good the lack of residents' deposits, outflows peaked in the third quarter. The trend subsequently eased and total outflows amounted to just under $50 billion (1.2 per cent of annual GDP). Some of the Asian emerging economies registered a brusque outflow of capital, amounting to $67 billion or 0.5 per cent of their annual GDP. This was confined to the fourth quarter, however, and was due to sales of securities and non-renewals of short-term credits. Thanks to the sounder balance-sheet and liquidity situation of the local financial systems it should be possible to limit the restrictive effects on credit supply.

3. WORLD TRADE AND PAYMENTS BALANCES

The rapid recovery of world trade in goods and services in 2010 was followed last year by a significantly weaker expansion of 5.8 per cent as demand slackened in the advanced countries.

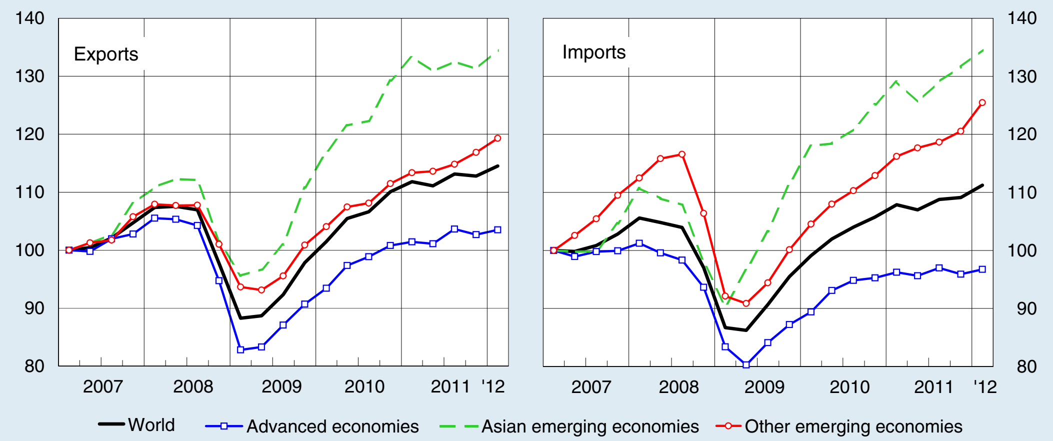
The prices of commodities peaked in the summer and then fell back, although they remained at historically high levels.

World trade

The abrupt slowdown in world trade in 2011 was mainly due to sluggish demand in the advanced economies, whose volume of imports increased by 4.3 per cent, compared with 11.5 per cent in 2010. In the final quarter of the year their imports of goods were still below the peak recorded in the first quarter of 2008 (Figure 3.1).

Figure 3.1

World trade in goods: main geographical areas (1)
(average quarterly data; volumes; index, Q1 2007=100)



Source: CPB Netherlands Bureau for Economic Policy Analysis.
(1) For the first quarter of 2012, average of the first two months of the year.

The weakness of demand in the advanced economies affected the exports of the emerging economies, especially the Asian countries specialized in producing intermediate and durable consumer goods. Given the tight links of the international production chain in that region, the Asian countries' exports were temporarily depressed by the interruptions in the supply of intermediate goods following the earthquake in Japan in March 2011 and the floods in Thailand in October. China's export growth slowed sharply to 9.5 per cent from 27.5 per cent in 2010 but still exceeded both the global and the emerging-country average.

Commodity-exporting countries benefited from a further improvement in their terms of trade in 2011; oil exporters recorded the largest gains (about 15 per cent). Partial evidence points to a moderate upturn in world trade in the first few months of 2012, assisted by the expansion of flows between emerging countries, accompanied by continuing sluggishness of imports by advanced countries.

The Eighth Ministerial Conference of the World Trade Organization, held last December in Geneva, approved the accession of Russia to the WTO (following that of China in 2001). The WTO summit also relaunched the plurilateral agreement on government procurement, whose signatories increased to 42 (the European Union member states and other advanced economies, including Israel, Singapore, South Korea, Taiwan and Hong Kong). By contrast, the deadlock of multilateral trade liberalization talks in the decade-long Doha Round was not overcome.

Commodity prices

The upward movement of commodity prices, under way since 2009, accelerated sharply between the autumn of 2010 and the beginning of last year. In the following months commodity prices fell back, responding to signs of slowing global demand, but despite this inversion of trend in 2011 the dollar prices of food commodities rose on average by 20 per cent and those of metals by 14 per cent. In the final part of 2011 the behaviour of crude oil prices differed markedly from that of other commodity prices, owing to resurgent geopolitical tensions, which provoked interruptions of oil production in some countries of Africa and the Middle East and an increase in risk premiums. The outcome was an average rise of 31.6 per cent in the dollar prices of crude oil for the year, larger than the price increase for other commodities and comparable to the one recorded in 2008.

The annual growth in world demand for crude oil eased from 3.3 per cent in 2010 to 0.9 per cent last year, reflecting a 1.3 per cent drop in the advanced countries and a slowdown in demand growth from 5.8 to 3.1 per cent in the emerging countries, due mainly to the slackening of oil consumption in China.

The growth in supply also slowed, helping to reduce world inventories for the second consecutive year. Despite an increase in North America, non-OPEC countries' oil production stagnated, reflecting the structural reduction in extraction capacity in Europe. The OPEC countries sought to make up for the decline in Libyan crude oil production after the outbreak of the civil war – the shortfall averaged 1.4 million barrels a day between March and October – mainly by drawing on spare capacity in Saudi Arabia. In response to differing regional market conditions, the price spread between Brent and Dubai crude (the benchmarks for Europe and Asia, respectively) and WTI (the benchmark for North America) increased in 2011, reaching a historic high of $13 a barrel.

The role of natural gas in international energy supply has expanded in recent years. In 2011 this trend accelerated as a result of the interruption of oil production in a number of countries and of nuclear power generation in Japan. In the last three years natural

Table 3.1

Current account of the balance of payments and foreign exchange reserve flows
(billions of dollars and percentages)

	Current account balance (1)						Reserves		
	2009		2010		2011		2009	2010	2011
	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	Amount	Amount
United States	**-376.6**	**-2.7**	**-470.9**	**-3.2**	**-473.4**	**-3.1**	**53.1**	**1.7**	**15.5**
Euro area	**-32.2**	**-0.3**	**-56.5**	**-0.5**	**-42.2**	**-0.3**	**64.1**	**17.4**	**16.5**
Japan	**146.6**	**2.9**	**204.0**	**3.7**	**119.3**	**2.0**	**12.9**	**39.3**	**196.7**
United Kingdom	**-31.4**	**-1.5**	**-75.1**	**-3.3**	**-46.4**	**-1.9**	**11.4**	**12.6**	**10.9**
Canada	**-40.1**	**-3.0**	**-49.3**	**-3.1**	**-49.0**	**-2.8**	**10.5**	**2.8**	**8.7**
Latin America	**-22.4**	**-0.6**	**-55.2**	**-1.1**	**-68.2**	**-1.2**	**50.5**	**104.6**	**119.4**
Asia	**468.9**	**5.2**	**368.9**	**3.4**	**325.9**	**2.6**	**696.5**	**636.5**	**438.6**
Newly-industrialized Asian economies	123.9	7.7	137.3	7.2	137.3	6.6	161.3	88.9	53.5
Hong Kong	*18.0*	*8.6*	*12.4*	*5.5*	*12.4*	*5.1*	*73.3*	*12.9*	*16.6*
Singapore	*30.3*	*16.3*	*55.6*	*24.5*	*57.2*	*22.0*	*13.6*	*37.9*	*12.2*
South Korea	*32.8*	*3.9*	*29.4*	*2.9*	*26.5*	*2.4*	*68.8*	*21.6*	*12.8*
Taiwan	*42.9*	*11.4*	*39.9*	*9.3*	*41.3*	*8.8*	*5.6*	*16.6*	*11.9*
ASEAN-4	73.8	6.3	45.5	3.1	46.1	2.7	50.7	87.4	52.3
Indonesia	*10.6*	*2.0*	*5.1*	*0.7*	*2.1*	*0.2*	*14.0*	*29.3*	*13.6*
Malaysia	*31.9*	*16.5*	*27.2*	*11.4*	*32.2*	*11.5*	*4.3*	*9.5*	*26.9*
Philippines	*9.4*	*5.6*	*8.9*	*4.5*	*7.1*	*3.3*	*5.6*	*16.6*	*11.9*
Thailand	*21.9*	*8.3*	*13.2*	*4.1*	*11.9*	*3.4*	*26.8*	*32.0*	*-0.1*
China	297.1	6.0	237.8	4.0	201.7	2.8	466.8	450.0	336.7
India	-26.0	-2.1	-51.6	-3.2	-59.2	-3.5	17.8	10.1	-4.0
Central and Eastern Europe	**-49.5**	**-3.1**	**-81.8**	**-4.7**	**-114.1**	**-6.0**	**39.1**	**22.0**	**7.3**
Oil-exporting countries	**175.2**	**4.0**	**341.7**	**9.0**	**590.1**	**13.0**	**19.9**	**61.3**	**167.6**
OPEC (2)	91.2	4.9	222.7	11.2	429.5	17.5	12.6	9.7	136.9
Algeria	*0.4*	*0.3*	*12.1*	*7.5*	*19.6*	*10.3*	*5.8*	*13.6*	*20.2*
Angola	*-6.7*	*-8.9*	*8.6*	*10.4*	*8.2*	*8.1*	*-4.2*	*6.1*	*8.6*
Ecuador	*-0.2*	*-0.3*	*-1.9*	*-3.3*	*-0.2*	*-0.3*	*-0.9*	*-1.4*	*0.2*
Iran	*9.5*	*2.6*	*25.3*	*6.0*	*51.4*	*10.7*	….	….	….
Iraq	*-8.9*	*-13.8*	*-1.4*	*-1.7*	*9.1*	*7.9*	*-3.8*	*6.3*	*10.4*
Kuwait	*25.9*	*24.4*	*36.9*	*29.6*	*73.9*	*41.8*	*3.2*	*1.0*	*4.6*
Libya	*9.4*	*14.9*	*16.8*	*20.9*	*1.6*	*4.4*	*6.4*	*0.9*	*0.4*
Nigeria	*13.3*	*7.9*	*2.5*	*1.3*	*14.8*	*6.2*	*-8.2*	*-9.8*	*0.3*
Qatar	*10.0*	*10.2*	*33.5*	*26.3*	*49.4*	*28.4*	*8.7*	*12.3*	*-14.4*
Saudi Arabia	*21.0*	*5.6*	*66.8*	*14.8*	*141.1*	*24.4*	*-32.6*	*35.0*	*96.0*
United Arab Emirates	*9.1*	*3.4*	*9.1*	*3.1*	*33.3*	*9.2*	*49.6*	*-45.5*	*13.9*
Venezuela	*8.6*	*2.6*	*14.4*	*4.9*	*27.2*	*8.6*	*-11.4*	*-8.6*	*-3.2*
Mexico	-5.1	-0.6	-3.1	-0.3	-8.8	-0.8	4.5	20.7	23.7
Norway	40.5	10.8	51.9	12.4	70.6	14.6	-2.1	3.9	-3.4
Russia	48.6	4.0	70.3	4.7	98.8	5.3	4.9	26.9	10.4

Sources: IMF and national statistics.
(1) Due to errors, omissions and differences in international statistics, the world current account balance has not been nil but positive since 2004 (according to IMF estimates by $373.5 billion in 2011). – (2) The flows of foreign exchange reserves do not include Iran. For the United Arab Emirates, the flow of foreign exchange reserves for 2011 refers to the end of September.

gas price trends have differed between regions. In the United States the combination of greatly expanded production and stagnant demand more than halved prices, which fell to historically low levels. In Europe, by contrast, the cost of gas, imported mainly from Russia and North Africa, moved in line with oil prices owing to the existence of long-term contracts indexing it to the prices of crude oil and petroleum derivatives.

In the opening months of 2012 the prices of non-energy commodities recovered partially and crude oil prices continued to rise. From the end of March onwards the prices of all raw materials turned downwards in connection with renewed fears about the resilience of the world economic recovery.

Balance-of-payments disequilibria

After worsening slightly in 2010, the US current account deficit remained broadly unchanged at about $470 billion, or 3.1 per cent of GDP, roughly half the size of its ratio to GDP in the five years preceding the last global recession (Table 3.1). The widening of the trade deficit, due basically to the higher cost of oil imports, was counterbalanced by larger surpluses on services and net investment income.

Thanks to the improvement in their terms of trade, in 2011 the oil-producing countries' current account surplus increased appreciably to reach the previous high of 2008 (over $580 billion), rising from 9.0 to 13.0 per cent of GDP. The abundant petrodollar revenues of the last two years supported the growth in these countries' imports.

The current account surpluses of the main Asian exporters of manufactured goods were dented by the slump in world demand and the worsening of the terms of trade. The deterioration was especially sharp for Japan, whose balance fell from $204 billion to $119.3 billion (2 per cent of GDP) and remained positive thanks entirely to the foreign assets accumulated in the past, which continued to generate a large flow of investment income. Japan ran a trade deficit (0.6 per cent of GDP) for the first time in more than 30 years. China's current account surplus shrank again, declining to 2.8 per cent of GDP, far below its pre-recession level (about 10 per cent of GDP in 2007). This performance mainly reflected the sharp contraction in the trade surplus, caused not only by the slump in demand in the advanced countries and the sharp rise in crude oil prices, but also by structural factors.

World foreign exchange reserves rose by $1 trillion in 2011, comparable to the increase in 2010. While the build-up of reserves proceeded more rapidly than in 2010 in the oil-exporting countries, its pace slowed significantly in the Asian countries, except for Japan. China, the leading holder of world reserves, increased its stock to nearly $3.2 trillion, or 40 per cent of GDP.

4. THE G20 AND INTERNATIONAL ECONOMIC COOPERATION

In 2011 and the first few months of 2012 the international community responded to the weakened economic outlook and increased risk of financial instability with a series of initiatives. At the G20 Leaders Summit, held in Cannes in November 2011, the Group of Twenty decided on economic policy commitments to counter the main risk factors and sustain growth (the Cannes Action Plan for Growth and Jobs). In the early months of 2012 the G20 decided to foster a further increase in the IMF's resources and, at the same time, sought to give momentum to the reform of the Fund's quotas and governance approved in 2010.

The G20 established some principles for capital flow management and measures to strengthen the international monetary system; it also continued to promote the improvement of the international financial regulatory and supervisory framework.

Lastly, the G20 approved a detailed action plan for development and poverty reduction including measures to give fresh impetus to investment in infrastructure, reduce the volatility of food prices, facilitate international transfers of emigrants' remittances and improve access to financial services on the part of the most disadvantaged (financial inclusion).

Growth support policies and containment of financial instability risks

Discussions about policies in support of balanced growth and to contain financial instability risks reflected the different priorities of the main protagonists: for the United States, exchange rate flexibility as a premise for containing external imbalances; for European countries, the strengthening of IMF resources, as a means of addressing the current debt crisis; for the main emerging economies, the reform of IMF quotas and governance to increase their own ability to influence IMF policies.

Framework for Strong, Sustainable and Balanced Growth: the Cannes Action Plan for Growth and Jobs. – In 2011 the G20's evaluation of national economic policies continued under the Mutual Assessment Process, which is the pillar of the coordinated action for strong, sustainable and balanced growth. At the Cannes summit, the G20 decided to publish reports on the countries with the highest external and internal imbalances (China, France, Germany, India, Japan, the United Kingdom and the United States). The reports analyse the causes of the imbalances and formulate economic policy recommendations to reduce them.

IMF resources and loans to member countries. – In 2011 the IMF approved five new financial assistance programmes, for a total of SDR 28.2 billion, compared with the eleven programmes for SDR 60.2 billion approved in 2010. In addition, SDR 70.3 billion was committed for three countries (Colombia, Mexico and Poland), beneficiaries of the Flexible Credit Line (FCL), which applied to renew this precautionary line of credit for a further two years. In the first four months of 2012 three new programmes were approved, including a four-year Extended Fund Facility (EFF) for Greece.

The stock of IMF credit to its member countries, equal to SDR 55.6 billion at the end of 2010, rose to 87.3 billion at the end of 2011 and 94.2 billion in April 2012; just over half of the latter figure was disbursed to euro-area countries. On the same dates, the stock of financial resources that had been committed but not yet disbursed by the IMF was, respectively, SDR 103.8 billion, SDR 116.0 billion and SDR 121.6 billion.

As regards the endowment of the IMF's resources, the reform of the New Arrangements to Borrow (NAB) formally came into force on 11 March 2011. The total amount of resources made available by countries participating in the NABs is about SDR 370 billion ($590 billion). At the end of April the IMF's forward commitment capacity, i.e. its effective capacity to disburse new loans (taking account of the NABs, disbursements and repayments already planned for the next twelve months and net of the prudential balance), was SDR 247.5 billion.

In consideration of the risks associated with the persistent tensions in the European sovereign debt markets, and in response to the call of the IMF, last April several G20 countries decided to build up the resources of the IMF through bilateral loans for a total of $430 billion. The most important contributions were made by the euro-area countries (about $200 billion), Japan ($60 billion), Saudi Arabia ($15 billion), South Korea ($15 billion) and the United Kingdom ($15 billion); Brazil, China, India and Russia have not yet quantified their direct contributions. The United States and Canada decided not to participate.

IMF quotas and governance. – The G20 is currently committed to ratifying the reforms it approved in 2010. These reforms, which relate to changes in the rules for electing members of the Executive Board and the doubling of the IMF's quotas (from SDR 238.4 billion to SDR 477.0 billion), have not yet entered into force because the necessary majority has not been obtained.

Reform of IMF surveillance and the international monetary system

IMF oversight of its member countries. – The traditional Triennial Surveillance Review was completed by the IMF in October 2011. The report identified five operational priorities to improve the quality and effectiveness of the IMF's surveillance of its member countries: (a) to adopt a systemic vision to take account of the repercussions that the economic policies of one country can have in third countries; in view of this, it is expected that the spillover reports, published for the first time in 2011 only for five countries and economic areas of systemic importance (the United States, Japan, the euro area, China and the United Kingdom), will be published periodically; (b) to deepen the evaluation of macroeconomic and financial risks – in particular of those that could have systemic consequences – and their related transmission channels; (c) to conduct more effective surveillance of national financial systems, extended to include macroprudential policies; d) to strengthen the analysis of countries' external stability, not concentrating attention exclusively on exchange rates; and (e) to strengthen the IMF's traction on individual countries' economic policy choices; this objective should be pursued by means of greater candour in surveillance, improving the effectiveness of communication strategies and encouraging closer dialogue with the economic policy authorities of the individual countries.

Reform of the international monetary system. – At the Cannes summit the G20 agreed some important principles for capital flow management measures, to be implemented at the national level on a voluntary basis. These principles, which are the result of a delicate compromise between advanced and emerging countries, aim to set limits on the recourse to such measures. These include capital controls, which are more specifically aimed at regulating the acquisition of financial assets by foreign investors. The principles recognize that in circumstances of high and volatile capital flows, capital flow management measures can play a useful stabilizing role; nevertheless they should complement rather than replace monetary, prudential, exchange rate and foreign reserve management policies to promote macroeconomic and financial stability. The measures should work in a counter-cyclical fashion, be targeted at specific risks that are identified, transparent and properly communicated; taken together these characteristics indicate the basically temporary nature of the measures.

Reform of the international financial sector. – In 2011 the G20 continued its commitment to reform the regulatory and supervisory framework for the international financial system. In particular, at the Cannes summit measures were adopted to address the risks associated with global systemically important financial institutions, establishing the need to subject them to enhanced supervision to reduce the likelihood and impact of their resolution.

Commitments for development and poverty reduction

The G20's development agenda. – In 2011 the G20 countries approved an action plan for development and poverty reduction, while recognizing that these objectives are dependent on strong, sustainable and balanced global economic growth. In recent years, poverty rates have been noticeably affected by the slowdown in world growth and the two periods of sharp increases in food prices in 2007-08 and 2010-11.

The plan has two main lines: the creation of a solid basis for growth for developing countries and the strengthening of their ability to face adverse economic shocks. As regards growth, the French presidency of the G20 gave particular support to investment in infrastructure. General criteria were agreed to identify and fund infrastructure projects of higher quality in terms of both their impact on growth and their economic and environmental sustainability. With regard to economic shocks, initiatives were launched to reduce increases in food prices and give the most vulnerable groups in the population effective protection against food price fluctuations.

Bilateral assistance. – In 2011 state development aid, measured at constant prices and exchange rates, declined by 2.7 per cent compared with 2010. Excluding flows connected with exceptional debt cancellations, it was the first reduction since 1997 and was due to the public finance adjustment efforts under way in the main donor countries.

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

5. MACROECONOMIC DEVELOPMENTS

In 2011 GDP growth slowed to 1.5 per cent, from 1.9 per cent in the previous year. Economic activity began to weaken in the summer and output is still about one percentage point lower than in 2008. There were large disparities in GDP growth rates, with rapid expansion in Germany, slow growth in Spain and Italy, and large contractions in the countries adopting fiscal consolidation programmes, such as Greece and Portugal.

In the euro area as a whole, exports, driven by trade with the emerging countries, provided the main support for economic activity, returning above pre-recession levels. Domestic demand instead lost momentum. Consumption expenditure was held back by concerns stemming from the poor outlook for the labour market and real disposable income. Investment picked up slightly after three years of contraction. The downturn in construction investment eased.

The macroeconomic situation was still favourable in the first two quarters of 2011 but began to deteriorate rapidly in the summer with the slump in the international business cycle. Afterwards, financial market tensions played an increasing role, affecting both borrowing conditions and domestic demand. GDP contracted in the last quarter of the year and then remained stationary in the first three months of 2012.

The current account deficits of Greece, Portugal and Spain diminished during 2011, partly owing to the weak performance of the economy. Imbalances within the area remain substantial nonetheless and are reflected in countries' net international investment positions, which in some cases are significantly negative; deficit financing was made more difficult by the financial strains, which broke off capital flows to some countries.

Consumer price inflation in the euro area rose to an average of 2.7 per cent in 2011, against 1.6 per cent in 2010. It was pushed up mainly by the large rises in world commodity prices and by the raising of indirect taxes in many countries as part of public finance adjustment measures. Core inflation, i.e. excluding food and energy products, stayed moderate at 1.4 per cent. Medium- and long-term expectations remained stable and consistent with the Eurosystem's definition of price stability.

The euro area

The GDP of the euro area, which Estonia joined on 1 January 2011, grew by 1.5 per cent last year, against 1.9 per cent in 2010 (Table 5.1), although with considerable disparities between countries. Growth was stronger in Germany (3.0 per cent), about average in France (1.7 per cent), and slack in Italy and Spain (0.4 and 0.7 per cent respectively). In Greece and Portugal, output contracted.

Table 5.1

GDP, imports and the main components of demand in the major euro-area countries (1)
(chain-linked volumes; percentage changes on previous period)

	2009	2010	2011	2011			
	Year	Year	Year	Q1	Q2	Q3	Q4
				GDP			
France	-3.1	1.7	1.7	0.9	..	0.3	0.1
Germany (2)	-5.1	3.7	3.0	1.3	0.3	0.6	-0.2
Italy (2)	-5.5	1.8	0.4	0.1	0.3	-0.2	-0.7
Spain (2) (3)	-3.7	-0.1	0.7	0.4	0.2	..	-0.3
Euro area (2)	-4.3	1.9	1.5	0.7	0.1	0.1	-0.3
				Imports			
France	-9.6	8.9	4.9	3.1	-0.6	0.4	-1.4
Germany	-9.2	11.7	7.4	1.0	2.9	2.7	-0.3
Italy	-13.4	12.7	0.4	-2.3	-1.4	-1.2	-2.5
Spain (3)	-17.2	8.9	-0.1	0.1	-1.8	2.3	-6.5
Euro area	-11.7	9.6	3.8	0.7	0.4	0.7	-1.4
				Exports			
France	-12.1	9.6	5.3	1.2	0.9	1.4	1.1
Germany	-13.6	13.7	8.2	1.6	2.7	2.6	-0.8
Italy	-17.5	11.6	5.6	0.2	0.7	2.0	..
Spain (3)	-10.4	13.5	9.0	2.0	0.7	4.1	-1.6
Euro area	-12.7	11.2	6.2	1.3	1.2	1.4	-0.4
				Household consumption (4)			
France	0.3	1.5	0.3	..	-0.9	0.4	0.1
Germany	-0.1	0.6	1.5	0.5	-0.7	1.2	-0.2
Italy	-1.6	1.2	0.3	..	-0.1	-0.3	-0.7
Spain (3)	-4.3	0.8	-0.1	-0.5	0.2	0.1	-1.0
Euro area	-1.2	0.9	0.2	..	-0.5	0.2	-0.5
				Government consumption			
France	2.5	1.8	0.2	-0.1	..	0.2	0.2
Germany	3.3	1.7	1.4	0.1	0.8	0.6	0.1
Italy	0.8	-0.6	-0.9	0.3	-0.4	-0.6	-0.7
Spain (3)	3.7	0.2	-2.2	1.3	-1.9	-2.0	-1.1
Euro area	2.5	0.5	..	..	..	-0.2	-0.3
				Gross fixed investment			
France	-10.6	1.2	3.5	1.3	0.7	0.2	1.3
Germany	-11.4	5.5	6.4	4.0	..	0.3	1.1
Italy	-11.7	2.1	-1.9	..	-0.1	-0.6	-2.4
Spain (3)	-16.6	-6.3	-5.1	-0.4	-1.1	-0.4	-4.3
Euro area	-12.1	-0.5	1.3	1.6	-0.2	-0.2	-0.5
				National demand (5)			
France	-2.5	1.6	1.6	1.4	-0.5	..	-0.6
Germany	-2.6	2.4	2.4	1.1	0.2	0.5	0.1
Italy	-4.4	2.1	-0.9	-0.5	-0.3	-1.1	-1.4
Spain (3)	-6.2	-1.0	-1.7	-0.1	-0.5	-0.5	-1.8
Euro area	-3.8	1.2	0.5	0.4	-0.2	-0.2	-0.7

Sources: Based on national statistics and Eurostat data.
(1) The quarterly data are adjusted for seasonal and calendar effects. – (2) The quarterly data include information made available after the publication of the full set of national accounts. – (3) The annual percentage change is based on quarterly data. – (4) Consumption of resident households and non-profit institutions serving households. – (5) Includes changes in stocks and valuables.

The main contribution to output growth throughout the area again came from exports, supported from the spring onwards by improved competitiveness as a result of the euro's depreciation. The area's exports increased by over 6 per cent; the expansion was particularly large in Germany (8.2 per cent) but in line with the area average in France and Italy. Taking import growth also into account, net foreign trade made a positive contribution of 1 percentage point to euro-area GDP growth.

Household spending stagnated in the area as a whole and in the main countries. The only exception was Germany, where very favourable labour market conditions fostered a sharp upturn in consumption after a long period in the doldrums. General government consumption remained stationary overall, in connection with the budget adjustment measures undertaken in most countries.

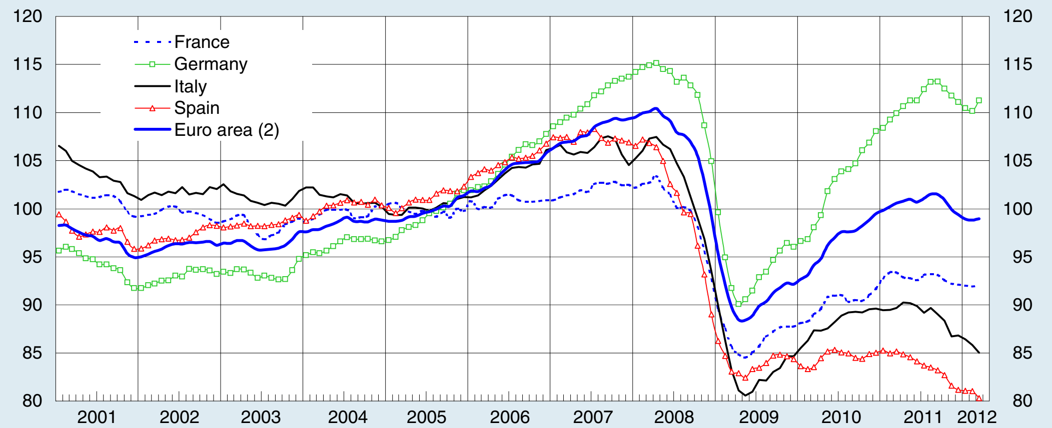
Real disposable income of euro-area households did not grow in 2011 as the rise in nominal income was entirely offset by the upturn in inflation. The propensity to save of consumer and producer households decreased slightly, to 13.6 per cent.

After contracting for three years, gross fixed investment increased by a modest 1.3 per cent, buoyed by investment in machinery and equipment, which rose by 4.0 per cent. Construction investment continued to contract (down by 0.9 per cent for the year and by 16.5 per cent since 2007), particularly in Spain as a result of the conditions of the real-estate market. Among the leading countries, only Germany bucked the trend, recording growth of 5.8 per cent last year as the recovery under way since 2010 following the long period of stagnation since the mid-1990s gained strength.

Figure 5.1

Industrial production in the major euro-area countries (1)

(moving averages for the 3 months ending in the reference month)

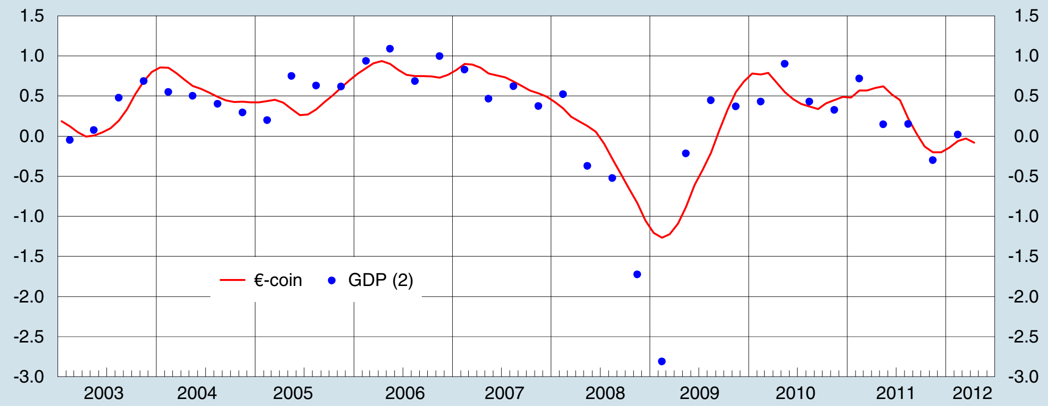


Sources: Based on Istat and Eurostat data.
(1) Indices, 2005=100; seasonally adjusted data. – (2) The aggregate for the euro area relates to 17 countries.

Macroeconomic conditions deteriorated from the summer onwards, reflecting renewed tension on the sovereign debt market and the downturn in the international business cycle. The increasingly pessimistic outlook of households and firms reflected on their consumption and investment decisions. Industrial production declined (Figure 5.1). In the last quarter, area-wide GDP contracted for the first time since spring 2009, by 0.3 per cent quarter on quarter. Output stagnated in the first three months of 2012. In the spring, the Bank of Italy's monthly €-coin coincident indicator, which measures euro-area output adjusted for short-term volatility, was slightly negative, suggesting that economic activity will remain weak (Figure 5.2).

Figure 5.2

Coincident cyclical indicator (€-coin) and euro-area GDP (1)
(3-month percentage changes)



Sources: Bank of Italy and Eurostat.
(1) For details on the €-coin indicator, see http://eurocoin.bancaditalia.it. – (2) The aggregate for the euro area relates to 17 countries.

Prices and costs

Consumer price inflation in the euro area rose by 1 percentage point to 2.7 per cent on average in 2011 (Table 5.2). The increase was almost entirely due to rises for energy (11.9 per cent) and food products (3.3 per cent) caused by strains affecting world commodity prices. Net of these two components, core inflation remained moderate (1.4 per cent). Indirect tax increases in some countries also helped to push up inflation.

Table 5.2

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

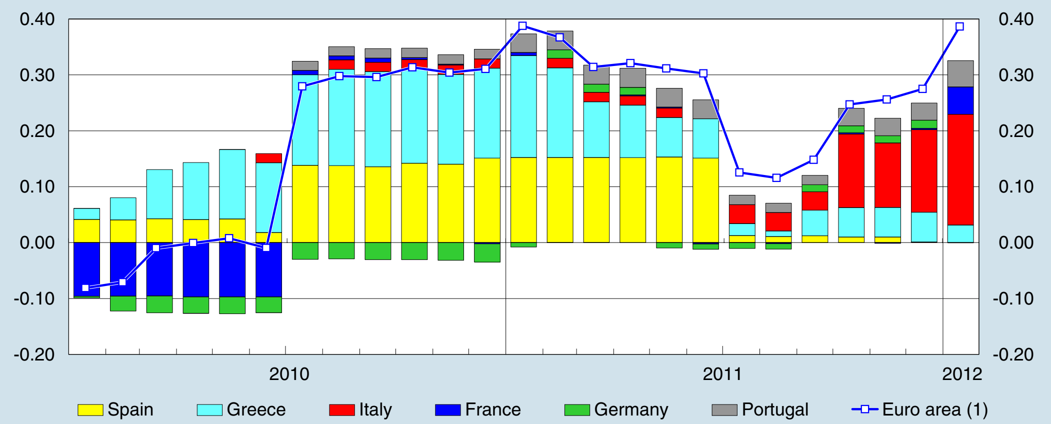
	France (1)			Germany			Italy			Spain (1)			Euro area		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
Consumer prices (2)															
Overall index	0.1	1.7	2.3	0.2	1.2	2.5	0.8	1.6	2.9	-0.2	2.1	3.1	0.3	1.6	2.7
Index excluding food and energy products	1.4	1.0	1.1	1.3	0.6	1.2	1.6	1.7	2.0	0.9	0.8	1.2	1.4	1.0	1.4
of which: goods	*0.5*	*0.2*	*0.5*	*1.2*	*0.5*	*1.0*	*1.3*	*1.2*	*1.4*	*-0.9*	*0.3*	*0.5*	*0.6*	*0.5*	*0.8*
services	*2.2*	*1.5*	*1.6*	*1.5*	*0.7*	*1.4*	*1.8*	*1.9*	*2.5*	*2.2*	*1.1*	*1.6*	*2.0*	*1.4*	*1.8*
Food products	0.5	1.3	2.3	-0.3	1.5	2.5	1.9	0.5	2.7	0.2	1.1	2.8	0.7	1.1	2.7
of which: processed	*0.8*	*0.7*	*2.9*	*-0.1*	*0.8*	*3.0*	*1.9*	*0.9*	*2.9*	*1.0*	*1.4*	*4.2*	*1.1*	*0.9*	*3.3*
unprocessed	*-0.1*	*2.1*	*1.4*	*-0.7*	*3.0*	*1.4*	*1.9*	*0.0*	*2.5*	*-0.7*	*0.7*	*1.3*	*0.2*	*1.3*	*1.8*
Energy products	-11.2	9.7	12.0	-5.4	3.9	10.0	-8.9	4.2	11.2	-9.0	12.5	15.7	-8.1	7.4	11.9
Producer prices (3)	**-6.4**	**3.4**	**6.0**	**-4.0**	**1.5**	**5.6**	**-5.4**	**3.1**	**5.0**	**-3.4**	**3.2**	**6.9**	**-5.1**	**2.9**	**5.9**
GDP deflator	**0.5**	**0.8**	**1.6**	**1.2**	**0.6**	**0.8**	**2.1**	**0.4**	**1.3**	**0.1**	**0.4**	**1.4**	**0.9**	**0.7**	**1.3**

Source: Based on Eurostat data.
(1) For 2011, the GDP deflator is calculated on the basis of the quarterly national accounts. – (2) Harmonized index of consumer prices. – (3) Producer price index for industrial products sold in the domestic market.

The contribution that changes in taxation make to inflation can be assessed by comparing the overall harmonized index of consumer prices with the index at constant tax rates. Eurostat calculates the latter by adjusting selling prices for the impact of changes in indirect taxes, assuming them to be passed on immediately and in full. The gap between the two measures of inflation widened from the middle of 2010 on (Figure 5.3) after Greece, Portugal and Spain enacted adjustment programmes. Once the effects of these had worn off, the gap began to grow again in the last quarter of 2011, mainly owing to the indirect tax increases introduced in Italy and, at the beginning of this year, also in France and Portugal.

Figure 5.3

Contributions of selected countries to the differential between overall euro-area HICP inflation and at constant tax rates
(percentage points)



Source: Based on Eurostat data.
(1) Differential between the12-month percentage changes in the overall HICP and at constant tax rates.

The rate of inflation in the area has come down slightly since the start of the year, falling to 2.6 per cent in the twelve months to April, after reaching 3.0 per cent towards the end of last year in connection with the slowdown in energy prices. Core inflation remained stable at 1.5 per cent.

Producer prices, costs and profit margins. – The producer prices of products sold in the domestic market rose by 5.9 per cent in 2011, compared with 2.9 per cent in 2010, with a sharp upturn in the first half of the year ascribable to the products directly affected by higher commodity prices. When the pressures on the cost of inputs eased, the rate of producer price inflation began to slow and continued to do so through the beginning of this year; in March, the twelve-month rise in producer prices was 3.3 per cent. With the nominal effective euro exchange rate basically stable, the increase in the producer prices of non-energy goods sold outside the euro area was roughly in line with that of domestic market prices (3.5 and 3.8 per cent respectively on average in 2011).

Unit labour costs began to increase again in 2011, rising by 0.8 per cent against a decrease of 1.0 per cent in 2010 (Table 5.3). The acceleration in hourly earnings growth from 1.1 to 2.1 per cent and the slowdown in hourly productivity growth from 2.1 to 1.3 per cent in connection with the cyclical downturn in the second half of the year contributed in equal measure. Unit labour costs followed different patterns in the service sector and in industry excluding construction, rising by 1.4 per cent in the former and declining by a further 0.5 per cent in the latter, where the growth in value added was more marked.

Table 5.3

Unit labour costs and their components in the major euro-area countries (1)
(percentage changes on previous year)

	Hourly labour costs		Hourly productivity						Unit labour costs	
					Value added (2)		Hours worked			
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
					Industry excluding construction (3)					
France	3.7	3.9	7.1	0.9	3.3	0.5	-3.6	-0.4	-3.2	2.9
Germany	-1.5	2.0	6.3	2.4	9.8	5.9	3.3	3.4	-7.3	-0.3
Italy	2.4	2.2	9.0	0.4	7.0	1.2	-1.9	0.9	-6.1	1.8
Spain	1.2	1.9	6.1	4.2	0.6	1.9	-5.1	-2.2	-4.6	-2.2
Euro area	1.2	2.5	7.7	3.0	6.9	3.6	-0.8	0.6	-6.1	-0.5
					Services (4)					
France	2.2	2.4	1.2	1.0	1.8	2.1	0.7	1.1	1.0	1.4
Germany	0.4	2.6	0.0	0.6	2.2	1.9	2.2	1.3	0.4	2.0
Italy	1.6	0.5	1.3	0.2	1.4	0.8	0.1	0.6	0.4	0.3
Spain	-0.4	-0.7	1.9	0.3	1.4	1.1	-0.5	0.7	-2.3	-1.0
Euro area	1.0	1.8	0.8	0.4	1.4	1.2	0.7	0.7	0.3	1.4
					Total economy					
France	2.5	2.7	1.7	1.1	1.5	1.8	-0.2	0.7	0.8	1.5
Germany	-0.1	2.5	1.8	1.2	4.1	2.9	2.3	1.7	-1.9	1.3
Italy	1.9	0.9	2.6	0.3	2.1	0.6	-0.5	0.3	-0.7	0.6
Spain	-0.3	-0.3	2.4	1.6	0.0	0.6	-2.3	-1.0	-2.6	-1.9
Euro area	1.1	2.1	2.1	1.3	2.0	1.5	0.0	0.2	-1.0	0.8

Sources: Based on Eurostat data; for Italy, based on Istat data.
(1) On the basis of the number of hours worked. For France, annual percentage change on the basis of raw quarterly data. – (2) Added value at base prices, chain-linked volumes, reference year 2005. – (3) Manufacturing, mining and quarrying, and electricity generation and distribution. – (4) Comprises "wholesale and retail trade, transport and telecommunications", "financial and real-estate services" and "other services".

Inflation expectations. – The expectations of the professional forecasters surveyed by Consensus Economics for average inflation in 2011, equal to 1.8 per cent in January, rose in line with actual inflation. Their forecasts for 2012, which remained stable just below 2 per cent until January this year, were revised slightly upwards to 2.4 per cent in May (Table 5.4). Longer-term expectations and those that can be inferred from the financial markets have been systematically consistent with the Eurosystem's price-stability objective.

Table 5.4

Inflation expectations in the main euro-area countries surveyed by Consensus Economics (1)

	2012	2013
France	2.1	1.7
Germany	2.1	1.9
Italy	3.0	2.5
Spain	2.0	1.6
Euro area	2.4	1.8

Source: Consensus Economics.
(1) May 2012.

Employment

According to national accounts data, employment in the euro area was basically stable in 2011 at the previous year's levels. The increase recorded in the first six months was almost entirely offset by the decline that followed as the economic cycle weakened. The unemployment rate began to rise in the summer, to stand at 10.9 per cent in March this year, 1 percentage point higher than a year earlier. For the active population under 25 years of age the unemployment rate is about double that.

In Germany, where GDP growth has recouped its losses from the 2008-09 recession, the number of persons in work rose by 1.3 per cent in 2011 (more than half a million). The jobless rate fell to 5.6 per cent in March of this year, the lowest level since the early 1990s.

In Spain, employment declined further, by 2.0 per cent over the year as a whole. The fall was particularly sharp in the construction industry (15.0 per cent) where over a million jobs have been lost since the peak of the cycle in 2007. The jobless rate hit 24.1 per cent in March of this year.

In Italy and France the number of persons in work increased by 0.3 and 0.7 per cent respectively. However, the unemployment rate rose in both countries in the second half of the year as the economic situation deteriorated and in March of this year reached 9.8 per cent in Italy and 10.0 per cent in France.

The balance of payments

In 2011 the euro area's current account was more or less in balance (negative by €3.2 billion, 0.03 per cent of GDP) after the small deficit of the previous year (Table 5.5). The improvement was due to a larger surplus on trade in services, partly offset by the reduction in that on goods trade. Net outflows on the financial account rose to €24.6 billion.

Table 5.5

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

	2007	2008	2009	2010	2011
Current account	**7.4**	**-143.5**	**-21.9**	**-6.8**	**-3.2**
Goods	42.2	-21.8	31.3	15.1	4.6
Services	47.9	42.1	36.4	49.6	61.1
Income	5.3	-66.8	3.5	31.8	31.7
Transfers	-88.1	-97.0	-93.1	-103.3	-100.6
Capital account	**4.8**	**10.0**	**6.7**	**6.4**	**10.8**
Financial account	**3.0**	**121.3**	**9.4**	**-2.5**	**-24.6**
Direct investment	-90.4	-231.1	-105.1	-113.9	-151.1
Portfolio investment	126.8	261.4	265.7	165.1	308.3
Financial derivatives	-66.9	-84.5	20.0	18.5	-20.8
Other investment	38.6	178.9	-175.7	-61.7	-150.7
of which: monetary financial institutions (2)	*85.9*	*-132.1*	*67.7*	*-19.5*	*-339.2*
Change in official reserves (3)	-5.1	-3.4	4.6	-10.5	-10.2
Errors and omissions	**-15.1**	**12.2**	**5.8**	**3.0**	**17.0**

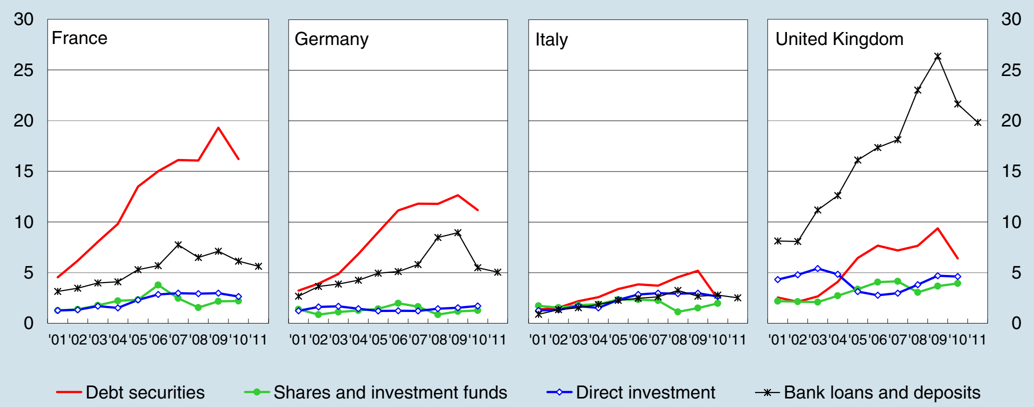
Source: ECB.
(1) The aggregate for the euro area relates to 17 countries. – (2) Excluding the Eurosystem. – (3) A minus sign indicates an increase in reserves.

The current account. – Goods exports grew by 13.2 per cent at current prices and exchange rates, rising above the 2008 levels. The sharp upturn in the first quarter gave way to slower growth that reflected the slackening of world trade despite the improvement in price competitiveness. Imports of goods rose by 14.0 per cent, partly owing to the rising prices of oil and other commodities, especially in the first half of the year. The surplus on trade in services widened to €61.1 billion. The balance on the income account was again positive, with a surplus of €31.7 billion.

The small deficit on the euro-area's current account continues to conceal large disparities between member states. Some countries still display very considerable imbalances, which narrowed, however, in 2011 in Portugal and to a lesser extent in Greece and Spain, while Ireland had already returned to balance in 2010. The financing of these four countries' deficits in the last ten years (until 2009 in the case of Ireland) has given rise to large net external debtor positions. The main categories of assets (direct investment, portfolio investment in shares, investment funds and debt securities, bank loans and deposits) can be broken down by "counterparty country" using BIS, Eurostat and IMF data. It emerges that the largest European countries (France, Germany, Italy and the United Kingdom) increased their gross claims on the four countries considerably in the last decade. This trend came to a halt in 2010 (Figure 5.4); in particular, debt securities and bank loans and deposits, which include interbank exposures, declined sharply (data cover the period to the third quarter of 2011). France's total exposure to Greece, Ireland, Portugal and Spain amounts to around 27 per cent of GDP, that of Germany to 19 per cent. For both countries the largest share is in the form of debt securities, followed by bank loans. Italy's exposure is smaller, amounting to around 10 per cent of GDP, while the UK is very heavily exposed (35 per cent), especially towards Ireland and for bank loans and deposits.

Figure 5.4

Claims on Greece, Ireland, Portugal and Spain by investor country and type of instrument (1)
(as a percentage of GDP)



Sources: Based on BIS, Eurostat and IMF data.
(1) Bank loans and deposits are as recorded on 30 September 2011.

Direct and portfolio investment. – The euro area's financial account registered net direct and portfolio investment inflows of €157.1 billion in 2011, mostly due to the €143.2 billion increase in net purchases of portfolio securities, which was only partially offset by the increase in net outward direct investment.

Direct investment returned to growth after a substantial reduction in both inward and outward investment in 2010. The 26.3 per cent increase in outflows to non-euro-area countries was entirely ascribable to investment by non-bank corporations, mainly in equity capital.

Portfolio investment varied considerably during the year. Net inflows were exceptionally high in the first half, above all owing to large purchases by non-residents of securities issued by banks and non-financial enterprises. Non-residents' demand focused on highly liquid securities with a high credit rating, in a climate of pronounced volatility and increased tensions on the financial markets. A further sharpening of these tensions in the second half of 2011 triggered a repatriation of capital; non-residents withdrew their funds while euro-area residents, particularly in the banking sector, made net disposals of foreign investments to offset the reduction in fund-raising abroad.

Deposits and loans. – Overall, in 2011 there was virtually no change in external liabilities in the form of loans or deposits from non-residents. In the fourth quarter, however, the inflow of funds to financial institutions in the euro area declined sharply in response to concerns of non-resident investors about the stability of some banking systems. The decline was offset by other sectors, aided by coordinated action of the Eurosystem and other central banks in the form of liquidity swaps in their respective currencies. On the asset side, residents' deposits and loans abroad increased by €158.9 billion in the year as a whole. However, a resurgence of financial market tensions towards the end of the year led to a disinvestment of funds, particularly by the resident banking sector.

The international investment position. – At the end of 2011 the euro area's international investment position showed net liabilities of €1,136.4 billion, or 12.1 per cent of GDP, compared with 13.4 per cent a year earlier. The improvement reflected the favourable movements in the prices of financial assets and liabilities and the depreciation of the euro in the second half of the year, as well as the decrease in net liabilities on the financial account.

6. BUDGETARY POLICIES

In general, the budget deficits of the euro-area countries showed a marked improvement in 2011, despite the unfavourable economic situation, although efforts to achieve adjustment were by no means uniform. The European Commission estimates, however, that the public finances will continue to improve in 2012 and 2013 thanks to the measures adopted so far and to the gradual recovery in economic activity that is expected to get under way, albeit very slowly, as early as the second half of this year.

Tensions on the sovereign debt markets of several countries made it necessary to speed up the reform of European governance. As a result, national governments and European institutions drafted a set of measures to tighten budgetary discipline, coordinate economic policies, manage macroeconomic imbalances and financial crises, and foster structural reform.

Budgetary policies and performance in 2011. – After a small reduction in 2010, area-wide general government net borrowing decreased by 2.1 percentage points last year, to 4.1 per cent of GDP (Table 6.1). The European Commission estimates that the area's structural deficit, i.e. adjusted for the effects of the business cycle and temporary measures, decreased by 1.0 points, to 3.4 per cent.

The results were generally better than the targets set in the stability programme updates submitted last year, which had projected a decrease of 1.5 points in area-wide net borrowing over GDP. The improvement with respect of 2010 was greater than expected, particularly in Germany (by 2.5 percentage points of GDP), Portugal (2.4 points), Estonia (1.3 points) and Austria (1.2 points).

On 17 May, Spain's Instituto Nacional de Estadística notified Eurostat that it had revised net borrowing in 2011 upwards by 0.4 percentage points of GDP over the April 2012 estimate, to 8.9 per cent. The increase was put down to the failure to include some of the autonomous regions' expenditures in the earlier figure.

The 2.4 point decline in the area-wide primary deficit, to 1.1 per cent, was due to a 1.8 point contraction in primary expenditure, to 46.3 per cent, following the introduction of measures to strengthen the public finances. Just over half of the reduction related to capital spending, which decreased from 4.4 to 3.4 per cent. Interest expense rose by 0.2 points to 3.1 per cent of GDP, reflecting the increase in debt and its average cost in almost all the euro-area countries.

Current spending was lowered by stringent measures regarding public sector employment, particularly in countries where public sector wages are much higher than in the private sector. In 2011 employee compensation in general government decreased for the second year running, by 0.2 percentage points to 10.6 per cent of GDP.

Table 6.1

General government net borrowing and debt
(as a percentage of GDP)

	Net borrowing				Debt			
	2010	2011	2012 (1)	2013 (1)	2010	2011	2012 (1) (2)	2013 (1) (2)
Austria	4.5	2.6	3.0	1.9	71.9	72.2	74.2	74.3
Belgium	3.8	3.7	3.0	3.3	96.0	98.0	100.5	100.8
Cyprus	5.3	6.3	3.4	2.5	61.5	71.6	76.5	78.1
Estonia	-0.2	-1.0	2.4	1.3	6.7	6.0	10.4	11.7
Finland	2.5	0.5	0.7	0.4	48.4	48.6	50.5	51.7
France	7.1	5.2	4.5	4.2	82.3	85.8	90.5	92.5
Germany	4.3	1.0	0.9	0.7	83.0	81.2	82.2	80.7
Greece	10.3	9.1	7.3	8.4	145.0	165.3	160.6	168.0
Ireland	31.2	13.1	8.3	7.5	92.5	108.2	116.1	120.2
Italy	4.6	3.9	2.0	1.1	118.6	120.1	123.5	121.8
Luxembourg	0.9	0.6	1.8	2.2	19.1	18.2	20.3	21.6
Malta	3.7	2.7	2.6	2.9	69.4	72.0	74.8	75.2
Netherlands	5.1	4.7	4.4	4.6	62.9	65.2	70.1	73.0
Portugal	9.8	4.2	4.7	3.1	93.3	107.8	113.9	117.1
Slovakia	7.7	4.8	4.7	4.9	41.1	43.3	49.7	53.5
Slovenia	6.0	6.4	4.3	3.8	38.8	47.6	54.7	58.1
Spain	9.3	8.5	6.4	6.3	61.2	68.5	80.9	87.0
Euro area	6.2	4.1	3.2	2.9	85.6	88.0	91.8	92.6

Source: European Commission, *Spring Forecast*, May 2012.
(1) Forecasts. – (2) In accordance with Eurostat's decision of 27 January 2012, the projected debt of each country includes its share of loans granted by the EFSF, bilateral loans to other EU countries and their share in the capital of the ESM.

According to data taken from the EU-SILC survey for ten euro-area countries in the four years 2004-07, the gap between the gross hourly earnings of male employees (for whom comparison is more equal) in the public sector and in private enterprises with more than 50 workers is extremely wide, averaging around 25 per cent, in Ireland, Portugal and Spain. It is about 20 per cent in Italy and Slovenia and between 12 and 13 per cent in Austria and Greece but is negligible in Belgium, France and Germany. Controlling for employees' characteristics (in particular, educational qualifications and work experience, which tend to be greater in the public sector) the wage gap narrows to about 16 per cent in Spain and between 6 and 10 per cent in Ireland, Italy and Portugal, virtually disappears in Austria and Greece and turns negative in the remaining countries (between 4 and 11 per cent). In the case of Italy, a study using data on net earnings in 1998-2008 as reported in the Bank of Italy survey of household income and wealth, which classifies large corporations separately, finds that the gap, adjusted for employee characteristics, disappears in firms with more than 100 employees. This finding reflects the relatively higher salaries and productivity in large enterprises. In all the countries concerned, and particularly in Greece and Portugal, the gap widens when small firms are included, but it narrows if the comparison with private firms is limited to financial and manufacturing companies. This indicates that the gap depends in part on the sector and size of the private enterprise. Moreover, it is always widest for low-paid employees, pointing to the higher educational qualifications and greater work experience of employees in the public sector, where these characteristics are also better rewarded. For relatively high-paid employees, educational qualifications are less well rewarded in the public sector than in the private sector in most countries.

The public finances improved last year in all the euro-area countries except Cyprus and Slovenia, whose net borrowing increased by 1.0 and 0.4 percentage points of GDP respectively. However, there were wide disparities in the extent of the improvement, with Ireland, Portugal, Germany, Slovakia, Finland, France and Austria recording the greatest gains.

The average debt-to-GDP ratio in the euro area increased by 2.4 percentage points, to 88.0 per cent. It was over 60 per cent in twelve countries and topped 100 per cent in four. Greece and Italy, which were already above that mark in 2010, had ratios of 165.3 and 120.1 per cent respectively in 2011; they were joined by Ireland and Portugal with ratios of 108.2 and 107.8 per cent.

Financial support for countries in difficulty. – In 2011 Greece continued to receive financial assistance in the form of bilateral loans from euro-area countries, which in May 2010 had engaged to provide €80 billion. Of this amount, €21 billion was disbursed in 2010 and €31.9 billion in 2011 (Table 6.2). At the same time the IMF undertook to provide €30 billion, €10.5 billion of which was lent in 2010 and €9.6 billion in 2011.

Table 6.2

Financial support to countries in difficulty: detail
(billions of euros)

	2010	2011	2012 (Jan. - May) (1)	Total to May 2012	Total for support
IRELAND					
Bilateral loans	0.0	0.5	1.1	1.6	4.8
EFSF	0.0	7.6	4.6	12.2	17.7
EFSM	0.0	13.9	4.5	18.4	22.5
IMF	0.0	12.5	3.6	16.1	22.5
Total	**0.0**	**34.5**	**13.8**	**48.3**	**67.5** (2)
PORTUGAL					
EFSF	–	6.9	2.7	9.6	26.0
EFSM	–	14.1	6.0	20.1	26.0
IMF	–	13.0	5.6	18.6	26.0
Total	**–**	**34.0**	**14.3**	**48.3**	**78.0**
GREECE					
First support programme					
Bilateral loans	21.0	31.9	–	52.9	52.9
IMF	10.5	9.6	–	20.1	20.1
Total	**31.5**	**41.5**	**–**	**73.0**	**73.0** (3)
Second support programme					
EFSF	–	–	72.9	72.9	144.6 (4)
IMF	–	–	1.7	1.7	28.0
Total	**–**	**–**	**74.6**	**74.6**	**172.6**

Sources: For loans granted by the EFSF, the EFSM and the IMF, European Commission and the EFSF; for IMF loans under the second support programme for Greece, IMF; for bilateral loans to Ireland, agreement of 21 March 2012 between Denmark and Ireland and statements by the Financial Secretary to the UK Treasury of 31 January 2012 and 17 April 2012 for the loan between the UK and Ireland. Data on IMF loans reflect the exchange rate at which amounts in SDRs are converted into euros.
(1) Data on EFSF and EFSM loans refer to operations carried out before 16 May; data on IMF loans refer to operations carried out by 30 April. – (2) Does not include the €17.5 billion contribution of Ireland using the funds of the Irish Treasury and the National Pensions Reserve Fund. – (3) The first financial support programme for Greece totalled €110 billion, €30 billion of which was pledged by the IMF. The figure reported in the table is the amount actually disbursed by the end of 2011. The remaining sum was incorporated in the second support programme. – (4) Does not include €35 billion of securities issued by the EFSF to activate the buyback scheme underpinning the quality of securities issued or fully guaranteed by Greece.

The euro-area countries in difficulty also received financial support through two common instruments, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). During the year, the EFSM began to issue bonds backed by EU budgetary resources in order to finance the packages agreed in November 2010 in favour of Ireland and in May last year in favour of Portugal. Bond issues amounted to €28 billion in 2011, €13.9 billion of which went to Ireland and €14.1 billion to Portugal. The two countries also received €12.5 billion and €13 billion respectively from the IMF. The EFSF issued around €18 billion of securities in 2011 and granted loans of €7.6 billion to Ireland and €6.9 billion to Portugal.

A set of measures designed to increase the EFSF's capacity were approved during the course of 2011: (a) the guarantees provided by the euro-area countries were raised from €440 billion to €780 billion; (b) the Facility was authorized to make purchases of member countries' government bonds in the primary and secondary markets; (c) it was authorized to take action under precautionary programmes and to finance the recapitalization of financial institutions; and (d) it will be allowed to use the leverage options offered by granting partial risk protection on new government bond issues by euro-area countries and/or by setting up one or more vehicles to raise funds from investors and financial institutions (see the box "The decisions of the euro-area heads of state or government of 26 October and 9 December 2011", *Economic Bulletin*, January 2012).

On 2 February 2012 a number of revisions were made to the Treaty instituting the European Stability Mechanism. Its entry into force was brought forward by one year, to July 2012, and the voting rules were amended to allow decisions to be taken by a qualified majority of 85 per cent. This majority rule can be invoked in place of the requirement for unanimous decisions if the European Commission and the ECB determine that financial assistance measures need to be taken urgently, in the interests of the area's financial and economic stability. Furthermore, as in the case of the EFSF, the ESM has been endowed with additional instruments of intervention to support countries in difficulty: it can purchase member countries' government bonds also on the secondary market and is allowed greater flexibility in primary market purchases; it can take action under precautionary programmes; and it can finance the recapitalization of financial institutions.

In order to strengthen investors' confidence in the new arrangements, on 30 March this year the Eurogroup announced that the ESM's endowment capital would be paid up by 2014 instead of 2017 as originally planned. Payment will be made in five instalments, two in 2012, two in 2013 and the last in the first half of 2014. It was also agreed that as of July this year the ESM will become the main instrument for financing new support packages. The EFSF will continue to operate until existing financing arrangements terminate and it will be allowed to finance new projects until halfway through next year. From the middle of 2014 the ESM will have a total lending capacity of €500 billion.

In February and March this year Greece reached an agreement with the European Commission, the ECB and the IMF for a second support package consisting of €138 billion of loans from the EFSF and the IMF over the period 2012-16. This is in addition to the loans arranged in May 2010 but not yet disbursed by other euro-area countries (€24.4 billion excluding the quotas not paid by Ireland, Portugal and Slovakia) and the IMF.

By mid-May this year Greece had received €72.9 billion from the EFSF under the second financial support package. Around €30 billion was destined to contribute towards debt restructuring; €4.8 billion for payment of interest on government bonds; €25 billion for bank recapitalizations; and over €13 billion for the rest of the programme. Greece also received a further €1.7 billion from the IMF.

In the early months of 2012 the €13.8 billion loan package for Ireland comprised €4.6 billion from the EFSF, €4.5 billion from the EFSM and around €3.6 billion from the IMF. The United Kingdom and Denmark provided just over €1 billion under bilateral agreements. During the same period, Portugal received €14.3 billion, of which €6 billion from the EFSM, about €5.6 billion from the IMF and €2.7 billion from the EFSF.

The EFSF financed the 2012 support packages for Greece, Ireland and Portugal by issuing, up to 16 May, around €43 billion of long-term and around €20 billion of short-term fixed-rate bonds. In April a further €25 billion of variable-rate securities were transferred to the Hellenic Financial Stability Facility for the recapitalization of Greek banks.

In brief, the value of loans granted in 2011 totalled €110 billion, of which €74.9 billion came from European countries and financial institutions and €35.1 billion from the IMF. Of that total, €34.5 billion was used to provide financial support to Ireland, €34 billion to Portugal and €41.5 billion to Greece. A further €102.7 billion of loans were lent in the first half of 2012, €91.8 billion of which by European countries and financial institutions and €10.9 billion by the IMF. Ireland received €13.8 billion, Portugal €14.3 billion and Greece €74.6 billion. The loans disbursed to date amount to just over €244 billion, while the support packages envisage around €391 billion of loans through 2016, not including €35 billion of EFSF bonds issued for the buyback scheme designed to underpin the quality of securities issued or fully guaranteed by Greece and the €17.5 billion of Irish funds used to finance the country's support package.

The outlook. – According to the European Commission's forecasts of 11 May, area-wide net borrowing will decrease by a further 0.9 percentage points in 2012, to 3.2 per cent of GDP.

Assuming unchanged budgetary policies, the Commission estimates that the deficit will be reduced further, to 2.9 per cent of GDP, in 2013. The primary balance is projected to improve by 1.4 points in 2012-13, moving from a deficit of 1.1 per cent of GDP to a surplus of 0.3 per cent. The ratio of revenue over GDP will increase by 0.8 points while primary current expenditure and capital expenditure ratios to GDP will decrease by 0.2 and 0.4 points respectively. The debt-to-GDP ratio is expected to continue rising from 88.0 per cent in 2011 to 92.6 per cent in 2013.

The reform of European governance

The economic and financial crisis has highlighted several problems of the economic governance of the EU. Europe's budgetary rules have not ensured the adoption of prudent budget policies, capable of properly exploiting the favourable phases of the economic cycle to strengthen the public finances. The system of multilateral surveillance did not possess forceful tools to prevent and correct macroeconomic imbalances.

Moreover, there was no mechanism for intervention in the case of grave financial crisis in a member state. These problems led to a broad process of reform that began in March 2010 and gained impetus between the end of 2011 and the early months of this year, particularly in view of the tensions in the sovereign debt market of several countries.

The European semester. – The European semester was applied for the first time in 2011. The mechanism consists in a new cycle of annual budget planning common to all the EU countries and is designed to improve the coordination between national policies and Community guidelines.

The measures proposed in November 2011. – On 23 November 2011 the European Commission proposed two new regulations designed to strengthen economic surveillance of the euro-area countries, particularly those with an excessive deficit, financial difficulties, or requesting preventive financial assistance. The proposals were examined by the EU Council of 24 January 2012 and are still under discussion.

The measures entered into force in December 2011. – On 13 December last year the set of reforms of European governance proposed by the European Commission in September 2010 entered into force. Known as the "Six-Pack", they consist of five regulations and one directive, which tighten European fiscal discipline, introduce new procedures for the prevention, detection and adjustment of macroeconomic imbalances, and establish minimum standards for institutions and national budgetary plans.

Last December's reform reinforces the part of the Stability and Growth Pact relating to the prevention of budget imbalances by placing a cap on the growth of public expenditure according to a country's progress towards or maintenance of its medium-term budgetary objective (MTO).

For member states that have reached their MTO, the annual rate of growth of expenditure must not exceed the potential medium-term GDP growth rate, unless the overshoot is offset by discretionary increases in revenue. Countries that have not yet reached their MTO should ensure, until they do, that expenditure grows at a slower pace, consistent with an annual reduction of at least 0.5 percentage points of GDP in their structural budget balance.

Countries that deviate significantly and persistently from the path of convergence towards their MTO will be subjected to a financial sanction in the form of an interest-bearing deposit of 0.2 per cent of GDP.

Introduced as part of the corrective procedures in the event of budget imbalances, the Six-Pack makes operational the debt criterion of the Treaty of Maastricht requiring countries to keep their debt-to-GDP ratio below 60 per cent and, if they exceed this benchmark, to make corrections at a satisfactory pace. To be in compliance, countries whose debt exceeds 60 per cent of GDP must have reduced the differential over that threshold at an average rate of one-twentieth annually for the last three years. Alternatively, the Commission's projections may indicate that this will occur over the three-year period encompassing the two years following the last year for which the data are available. A smaller reduction does not automatically launch the excessive deficit procedure, as account will be taken of the impact of the economic cycle and other relevant factors. The latter comprise (a) the term structure and currency of the debt;

(b) the guarantees provided by the government, particularly to the financial sector; (c) the explicit and implicit liabilities stemming from population ageing; (d) the level of private sector debt and the risk that it may generate liabilities for general government; (e) the composition of public assets; and (f) the size and components of the difference between net borrowing and change in the debt.

Euro-area countries that are put in excessive deficit procedure will be subjected to a sanction in the form of a non-interest-bearing deposit. The sanctions will be imposed on a more automatic basis in both the preventive and the corrective phase of the Stability and Growth Pact. They will be adopted at the proposal of the Commission unless the Council reverse such decision by a qualified majority (*reverse voting*).

Regarding macroeconomic imbalances, the Six-Pack introduces a surveillance procedure that includes an early warning system based on a scoreboard with minimum and maximum thresholds. The indicators are analysed in the Commissions' annual *Alert Mechanism Report*.

In the event of particularly severe imbalances that put the good functioning of EMU at risk, the Macroeconomic Imbalance Procedure can be opened. The Procedure may eventually lead to the imposition of a sanction in the form of an interest-bearing deposit which is converted into a fine in cases of repeated failure to comply with the Council's recommendations. Both penalties are decided by reverse qualified majority vote of the Council acting on the Commission's recommendation.

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. – The Treaty was signed by all the EU countries except the United Kingdom and the Czech Republic at the European Council of 2 March 2012 and enters into force no later than 1 January 2013 if at least twelve of the euro-area members have ratified it by that time.

The part of the Treaty known as the Fiscal Compact requires its signatories to introduce in their legal systems, preferably at constitutional level and within twelve months of the Treaty's entry into force, a rule requiring them to achieve and maintain national budgets that are structurally in balance or in surplus and to introduce an automatic correction mechanism, based on common principles proposed by the Commission, that is triggered in the event of deviation. The annual structural deficit must not exceed 0.5 per cent of GDP; it may reach 1.0 per cent in the case of countries with a debt-to-GDP ratio significantly below 60 per cent and where the risk to the long-term sustainability of the public finances is low.

The Fiscal Compact also extends the reverse voting mechanism to all phases of the excessive deficit procedure where it is not yet envisaged by the Six-Pack, including the opening of the procedure itself in the event of non-compliance with the deficit criterion.

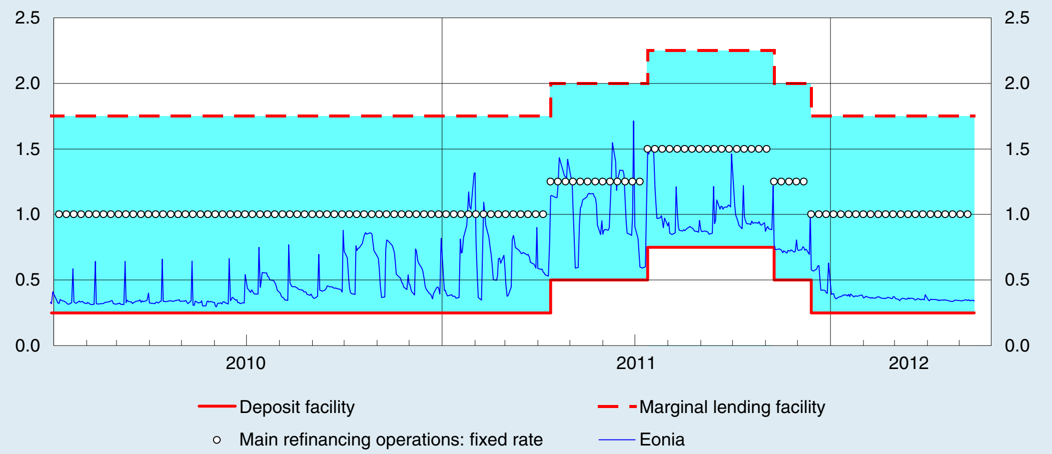
The Treaty also requires countries with an excessive deficit to submit to the Commission and Council a detailed programme of structural reforms designed to bring about a rapid and permanent correction of the imbalance. It assigns a major role to Eurosummits in the coordination of economic policies and strengthens that of the European and national parliaments.

7. THE SINGLE MONETARY POLICY

Against the backdrop of a modest improvement in the euro-area economy and increasing inflationary pressures stoked by sharply rising raw materials prices, in April and July 2011 the Governing Council of the European Central Bank, while maintaining extremely accommodating monetary conditions, raised its policy rates by a total of 50 basis points above the all-time low registered in the spring of 2009. The rate on main refinancing operations was increased to 1.5 per cent (Figure 7.1).

Figure 7.1

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



Sources: ECB and Thomson Reuters Datastream.

Over the summer months the sharp worsening of the outlook for global economic growth, the slow progress within the EU of policies to counter the crisis and the uncertainties generated by the announcement of the involvement of the private sector in the solution to the Greek crisis triggered renewed tensions in the financial markets, in particular in the sovereign debt markets of some euro-area countries. These strains impacted directly also on Italy and Spain. The aggravation of the sovereign debt tensions extended to the banks of the countries most affected by the crisis, whose international funding became more costly and quickly dried up.

In this context, in order to support banks' liquidity and safeguard the monetary policy transmission mechanism, between August and October the ECB Governing Council announced that it would continue to supply liquidity through full allotment tender operations at least through the first half of 2012. It extended the maturity of its longer-term refinancing operations up to one year; it resumed government bond purchases under the Securities Markets Programme; and it adopted a second Covered Bond Purchase Programme (CBBP2).

In November conditions in the financial markets deteriorated significantly. The disparities between monetary conditions in different euro-area countries were accentuated. Intensifying capital outflows from the countries most severely affected by the crisis and a sharper segmentation of funding markets along national lines heightened the risk of a systemic bank funding crisis and a consequent credit crunch, which would have had serious repercussions on the macroeconomic outlook and price developments in the euro area.

In November and December the Governing Council lowered its policy rates by a total of 50 basis points, bringing the fixed rate on main refinancing operations to 1 per cent. At the start of December the Council took new measures for vigorous liquidity support. Two new longer-term refinancing operations were announced with a three-year maturity and full allotment. The range of eligible collateral assets was extended. The reserve ratio was lowered from 2 to 1 per cent. With the two three-year operations in late December and at the end of February the Eurosystem injected around €1,000 billion into the euro-area banking system (more than €500 billion net of the decline in demand for shorter-term refinancing), which went directly to a large number of banks.

These measures averted the risk of a systemic crisis. Together with the steps taken by individual countries to stabilize public finances and initiate pro-growth reform (those by the Italian government were on a particularly large scale), the progress in European governance and the agreement on the restructuring of the Greek public debt, these monetary policy actions helped to restore confidence in financial markets and revive trading (see the box "The effects of the three-year refinancing operations", *Economic Bulletin*, April 2012). Monetary policy transmission became more uniform once again. The liquidity injected circulated within the area, affecting the function of the financial markets, modifying yields and removing obstacles to a return to normality in credit supply conditions.

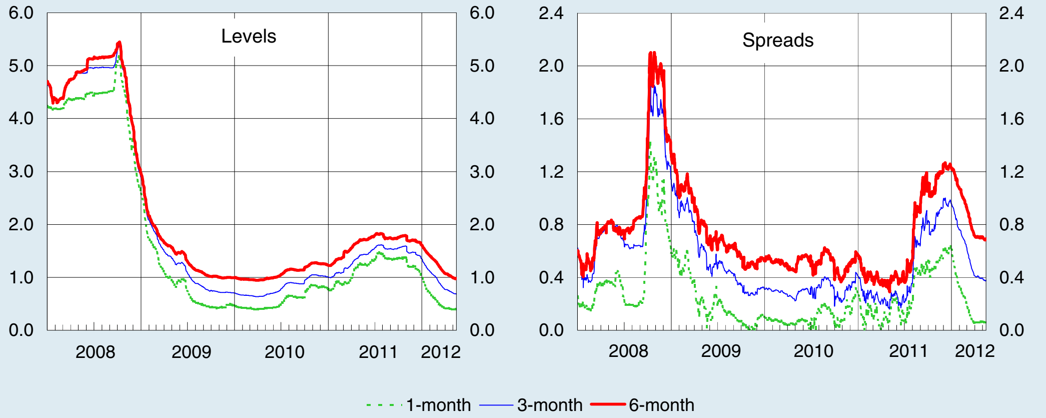
However, tensions re-emerged in mid-March, reflecting fears of a downward spiral of low growth, deteriorating public finances and a weak banking industry in some countries. These fears were exacerbated in May by the political deadlock following the elections in Greece, with the attendant risks for the euro area as a whole.

Interest rates and the exchange rate of the euro

Short-term interest rates. – Throughout 2011 short-term euro interest rates were very low in nominal terms and negative in real terms. The gradual rise in money-market rates that had begun in the second half of 2010 continued in the first half of 2011, owing in part to the 50-basis-point increase in the ECB's official rates from April through July and the progressive mopping-up of excess liquidity. In the first week of July the rate on unsecured three-month interbank loans (Euribor) reached 1.6 per cent, compared with 1.0 per cent in December. The spread vis-à-vis three-month overnight indexed swaps (OISs) – a gauge of the risk premium in the interbank market – narrowed from 40 to 20 basis points (Figure 7.2).

Figure 7.2

Euribor rates and spreads with corresponding rates on overnight indexed swaps
(daily data; per cent)



Source: Thomson Reuters Datastream.

The sovereign debt strains worsened significantly in the second half of the year and affected the interbank market. The deterioration in confidence was quickly reflected in higher risk premiums. Despite the lowering of official interest rates by a total of 50 basis points in November and December, at the end of the year three-month Euribor was about the same as at mid-year, while the spread vis-à-vis OISs had widened to 100 basis points.

In the wake of the measures decided by the Governing Council late last year, especially the massive injection of liquidity through the two three-year refinancing operations, the interbank market strains eased considerably in the first few months of 2012. Three-month Euribor fell to 0.7 per cent and the spread over OISs was more than halved to around 40 basis points. The difference between national overnight rates and Eonia, which had gone above 1 percentage point in some euro-area countries in November, was erased.

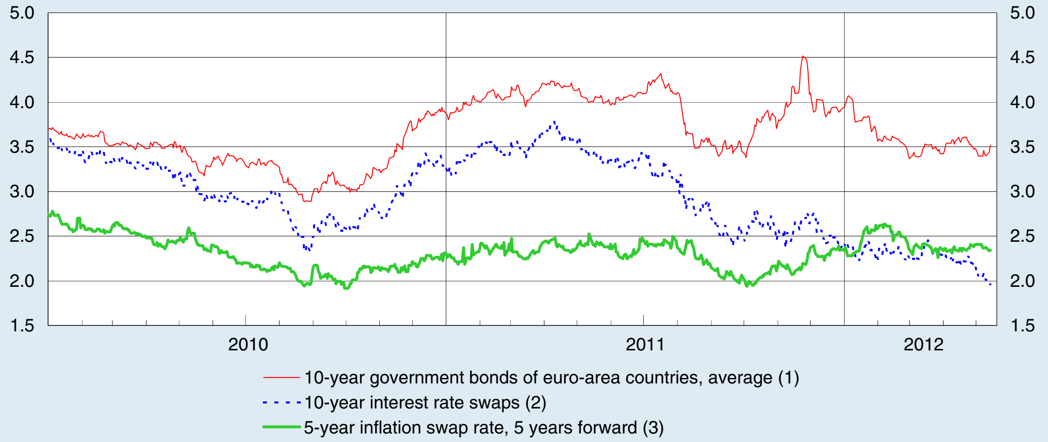
In the first quarter of 2011 real short-term interest rates were at their lowest since the inception of the third stage of EMU (negative by1.6 per cent); in March 2012 they were negative by 1.4 per cent.

Long-term rates. – Measured on the basis of ten-year swap contracts in euros, long-term interest rates rose to 3.7 per cent in the first half of 2011 owing to the improved outlook for growth and higher inflation expectations in the area. During the summer, as the economic situation worsened, they turned back down, declining to 2.4 per cent at the end of the year (Figure 7.3).

Government bond yields fluctuated more sharply as investors' confidence in the outlook for sovereign debt ebbed again. The yield spreads between the government bonds of some area countries and those of Germany widened significantly during the year. From the summer onwards the tensions affected not only the debt of Greece, Ireland and Portugal but also that of Italy and Spain. In November the government security yield spreads between the latter two countries and Germany were the widest since the adoption of the single currency (550 and 470 basis points respectively).

Figure 7.3

Long-term nominal yields and inflation expectations
(daily data; per cent)



Source: Based on Bloomberg data.
(1) Average yields on benchmark 10-year government bonds of Austria, Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal and Spain, weighted according to GDP at constant 2010 prices. – (2) Fixed-rate yield on 10-year interest rate swaps. – (3) Fixed-rate 5-year yield, 5 years forward, implied by 10-year and 5-year euro-area inflation swaps.

These tensions resulted in a significant rise in ten-year government bond yields in the euro area as a whole. The average yield on government securities peaked at the end of November as the crisis worsened. It fell back late in the year and early in 2012, when the measures adopted by the Eurosystem and the governments of the countries most exposed to the crisis, together with progress in European governance and the agreement on Greek sovereign debt, helped restore more relaxed conditions in these markets.

However, the strains mounted again starting in mid-March, and by mid-May the spread on ten-year Italian BTPs over German Bunds had widened to about 440 basis points, while that on Spanish securities recorded a new high of 490 basis points.

Long-term inflation expectations during 2011 remained consistent with the objective of price stability. The yields on five-to-ten-year swap contracts on the euro-area inflation rate, which also include a risk premium, fluctuated around 2.3 per cent. The Consensus Economics surveys and the ECB's survey of professional forecasters produced comparable findings.

The exchange rate of the euro. – Until the spring of 2011 the higher yields on short-term assets denominated in euros and expectations of diverging monetary policy stances between the Eurosystem and the Federal Reserve favoured the strengthening of the euro. Between the start of the year and the end of April the currency appreciated by 11.3 per cent against the dollar and by 5.3 per cent overall in nominal effective terms. This trend ended in May and reversed during the summer, when the steady aggravation of tensions within the area was accompanied by sharp depreciation of the euro. In mid-May of this year the euro/dollar exchange rate was 3.9 per cent lower than it had been at the start of 2011; the overall nominal effective exchange rate was 3.4 per cent lower.

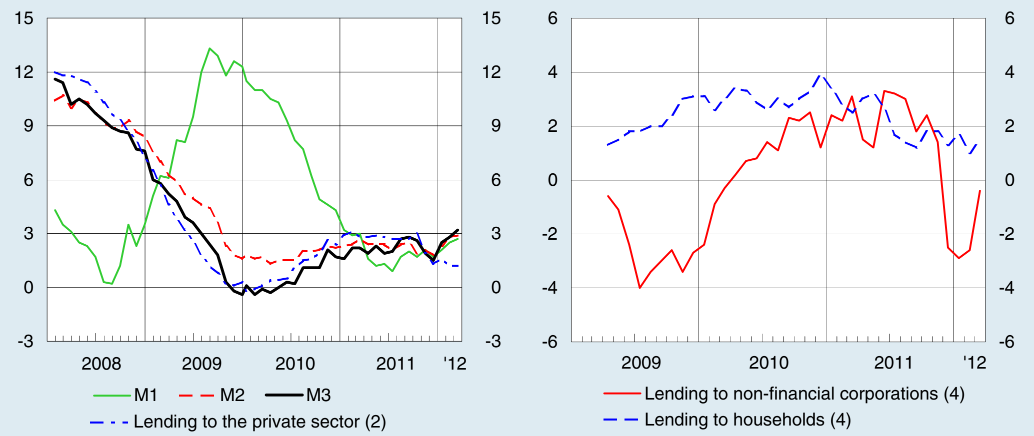
Money and credit

Money. – The twelve-month rate of growth of M3 was very modest throughout 2011, falling to 1.5 per cent in December (Figure 7.4). This pattern reflected the contraction in the countries most severely affected by financial tensions, with a decline in firms' bank deposits as credit conditions tightened, a reduction in collateralized interbank transactions via central counterparties (which are included, statistically, in M3), and in some countries a shift of funds from monetary to other financial assets. In the countries least affected by the crisis, however, M3 expanded.

Figure 7.4

Money and credit aggregates in the euro area

(12-month percentage changes) (1) *(3-month annualized percentage changes) (3)*



Source: ECB.
(1) Changes calculated on end-of-month data adjusted for calendar effects. – (2) Loans in euros and other currencies granted by monetary financial institutions. The data are adjusted for the accounting effects of securitizations. The private sector consists of households, non-financial corporations, insurance companies, non-profit institutions serving households, non-money-market investment funds and other financial institutions. – (3) Changes calculated on the basis of end-of-month data, adjusted for seasonal and calendar effects. – (4) Loans in euros and other currencies granted by monetary financial institutions, adjusted for the accounting effects of securitizations; data available since January 2009.

Credit. – The twelve-month rate of growth of bank loans to the private sector, which held steady at around 2.8 per cent through October, came down rapidly in the last two months of the year to 1.3 per cent in December, remaining at that level in the first quarter of 2012 as well (1.2 per cent in March).

This pattern reflects the trend in lending to households and above all to non-financial corporations, whose three-month growth rate declined rapidly starting in the third quarter and turned negative in December (-2.5 per cent on a seasonally adjusted annual basis; Figure 7.4) before recovering in March 2012. The three-month rate of growth of loans to households also diminished in the course of 2011 but remained positive (1.3 per cent in December).

The growth of credit differed widely between euro-area countries. The twelve-month rate of change in loans to firms and households was negative throughout the year in Greece, Ireland and Spain and in the fourth quarter in Portugal as well. In the other countries, while remaining positive on an annual basis, it diminished sharply towards the end of the year, especially in Italy, where the three-month rate of growth in lending to non-financial corporations turned negative.

Lending to firms and households was affected both by demand factors – above all less demand for credit for fixed investment and house purchases as a consequence of the weak economy and real-estate market – and, especially in the closing months of the year, by supply factors. In the second half, the quarterly bank lending surveys for the euro area found a significant tightening of banks' lending standards. The restriction, which occurred in a number of countries, reflected the deterioration in banks' liquidity position and their difficulty in raising funds in the market as well as the darkening expectations for the economy. The stiffening of lending policies translated into wider spreads between lending and borrowing rates and, in the fourth quarter, a reduction in the availability of credit.

The bank lending survey found that the severity of the tightening of credit supply conditions was attenuated appreciably in the first quarter of 2012, thanks above all to an improvement in banks' liquidity and fund-raising capacity, which was boosted by the two three-year refinancing operations.

The cost of credit rose significantly last year, reflecting financial market strains. The interest rate on short-term loans to firms increased by about 80 basis points, while that on new house purchase loans went up by 40 basis points. The upward trend came to a halt in the early months of 2012; in March the rates were respectively 4.2 and 3.6 per cent.

Monetary policy operations

In 2011 the ECB Governing Council continued to flank interest rate management with other monetary policy tools, whose scope was further broadened by decisions taken in the second part of the year.

Refinancing operations continued to be with full allotment. In the first half of the year the improvement in money-market conditions led to a decline in the demand for refinancing, and the amount of funds that banks held in the deposit facility of the Eurosystem central banks, which is a measure of excess liquidity, was modest, averaging €34 billion (Table 7.1 and Figure 7.5). The Eonia rate averaged 30 basis points below that on main refinancing operations, albeit with substantial fluctuations.

The situation changed abruptly in the third quarter as the tensions in the sovereign debt market intensified and spread to Italy and Spain. The uncertainty infected the banking sector, creating funding problems and the risk of a credit restriction. The regular, uniform transmission of monetary policy was imperilled.

In August the Italian and Spanish governments announced additional measures for fiscal consolidation and structural reform. The ECB resumed purchases under the Securities Markets Programme, which had been inactive since March. The Programme had been instituted in May 2010 to support liquidity in the market segments most severely affected by the crisis and to safeguard the monetary policy transmission mechanism. By the end of 2011 total securities purchased amounted to €212 billion, compared with €77 billion at the end of March (Figure 7.5). The liquidity injected by these operations is sterilized by means of seven-day term deposits. The Programme's reactivation helped reduce the volatility of yields and bid-ask spreads in the government securities market, although it did not restore the conditions that had prevailed prior to the summer.

Table 7.1

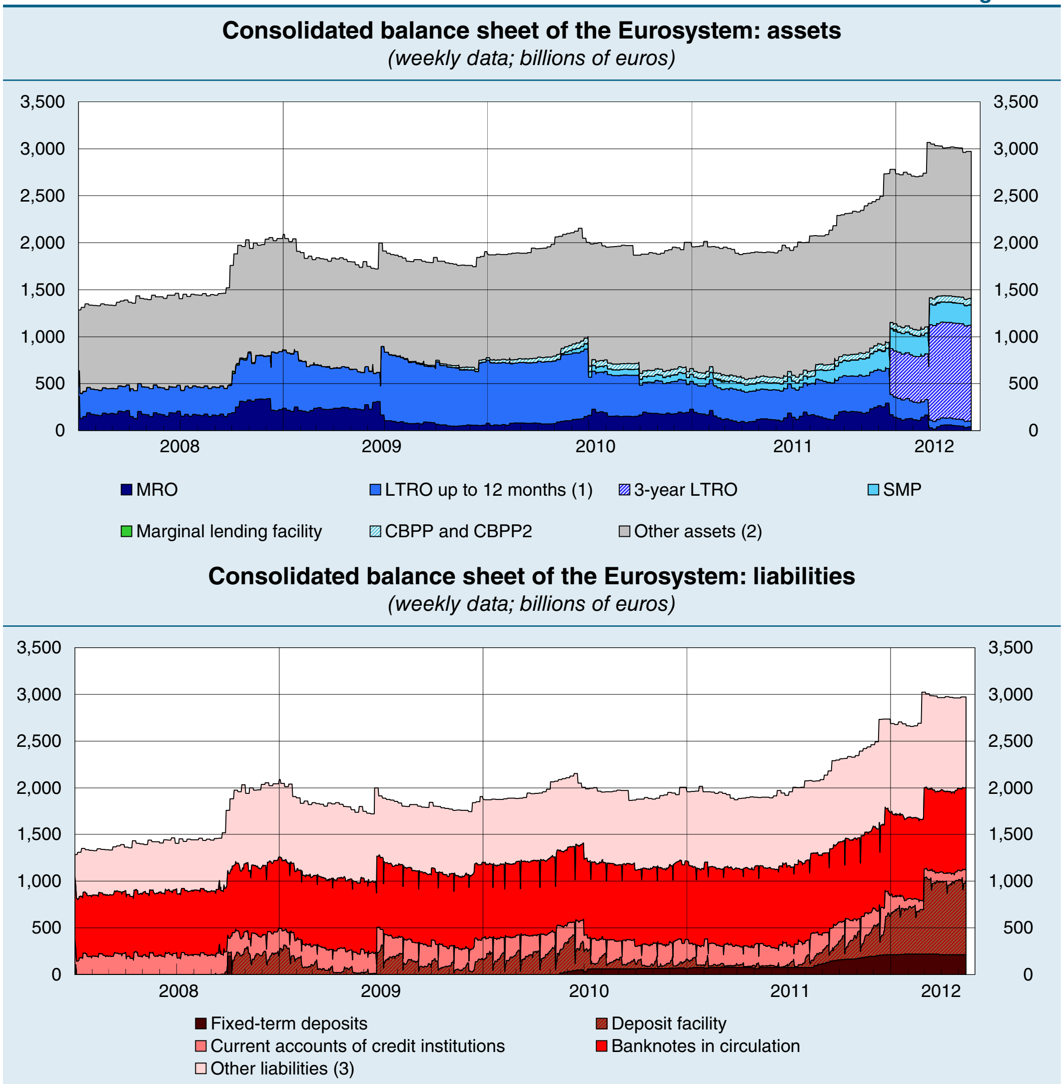
Monetary policy operations and money market interest rates
(daily average data for the period shown)

	8 Dec. 2009 15 June 2010	16 June 2010 7 Dec. 2010	8 Dec. 2010 14 June 2011	15 June 2011 13 Dec. 2011	14 Dec. 2011 8 May 2012
Main refinancing operations (MROs)					
Volume (1)					
Euro area	78.0	171.9	139.7	180.6	99.9
Italy	1.8	6.7	8.5	36.1	27.8
Italy's share (2)	2.3	3.9	6.1	20.0	27.8
Number of participants per tender					
Euro area	85	137	203	181	117
Italy	5	17	26	34	28
Longer-term refinancing operations					
Volume (3)					
Euro area	662.5	417.0	321.6	364.4	859.4
Italy	25.1	24.9	29.7	54.5	201.8
Italy's share (2)	3.8	6.0	9.2	15.0	23.5
Number of participants per tender					
Euro area	34	83	131	110	141
Italy	3	12	24	25	25
Standing facilities (4)					
Marginal lending facility					
Euro area	0.5	0.7	1.5	1.6	3.0
Italy	0.0	0.0	0.0	0.0	0.1
Deposit facility					
Euro area	201.7	93.3	34.2	142.9	601.3
Italy	3.0	0.6	0.5	1.3	14.8
Excess reserves (5)					
Euro area	0.56	0.58	0.72	1.47	4.04
Italy	0.22	0.19	0.16	0.38	1.13
Money market rates					
Eonia	0.35	0.51	0.79	0.94	0.38
Eonia – MRO spread (6)	-65.4	-48.7	-29.1	-47.2	-62.0
Volatility of Eonia – MRO spread (7)	6.6	15.7	24.3	19.9	6.1

Sources: Bank of Italy and ECB.
(1) Daily average of funds disbursed to monetary financial institutions through main refinancing operations; billions of euros. – (2) Funds assigned to Italian counterparties as a percentage of the total allotted. – (3) Daily average stock of funds disbursed to monetary financial institutions through longer-term refinancing operations with a maturity of 3, 6, 12 or 36 months or equal to the length of one maintenance period; billions of euros. – (4) Daily average stock, billions of euros. – (5) As a percentage of required reserves. – 6) Daily average of the spread between Eonia and the fixed rate on main refinancing operations; basis points. – (7) Standard deviation of the spread between Eonia and the fixed rate on main refinancing operations; basis points.

The Governing Council also announced, in August, a six-month longer-term refinancing operation and in October two one-year operations (with full allotment and at an interest rate equal to the average on main refinancing operations over their life). Also in October, it decided the launch of a second Covered Bond Purchase Programme (CBPP2). In this period the Council also reinstituted three-month foreign currency operations (in addition to the one-week operations conducted throughout the year). Later it made the conditions for access to these funds less burdensome.

Figure 7.5



Source: ECB.
(1) Includes special operations with a maturity of one reserve maintenance period and longer-term refinancing operations with a maturity of 3, 6 and 12 months. – (2) Gold, foreign currency assets and other minor items. – (3) Revaluation accounts, foreign currency liabilities, capital, reserves, other minor items.

In November the financial strains within the euro area grew still worse, with the risk of a systemic bank funding crisis and a consequent credit crunch. At its meeting in early December the Governing Council decided (a) two three-year longer-term refinancing operations (again, with full allotment and at the average rate on main refinancing operations over their life, with the option of early repayment after one year); (b) to increase collateral availability, easing eligibility requirements in order to ensure that liquidity reached all banks; and (c) to lower the reserve ratio from 2 to 1 per cent.

In the first three-year operation, conducted on 21 December, the Eurosystem supplied a total of €489 billion. Allowing for the reduction in demand for shorter-term operations, the net injection of liquidity amounted to about €210 billion (Table 7.2). The second operation was carried out on 29 February, assigning total funds of €530 billion, with a net injection of about €310 billion. The funds disbursed by the Bank of Italy to its counterparties in the two operations amounted to €116 billion and €139 billion respectively (about €60 billion and €80 billion on a net basis). At mid-May the liquidity created by these two operations accounted for 91 per cent of total Eurosystem refinancing (some €1.1 trillion); the other longer-term operations accounted for 6 per cent and main refinancing operations for 3 per cent (Figure 7.5).

Table 7.2

Three-year longer-term refinancing operations
(billions of euros)

Tender date	Euro area		Italy (1)	
	Amount allotted	Number of bidders	Amount allotted	Number of bidders
21 Dec. 2011	489	523	116	74
29 Feb. 2012	530	800	139	112

Sources: ECB and Bank of Italy.
(1) Three-year refinancing allotted by the Bank of Italy to banks operating in Italy.

The extension of the range of assets eligible as collateral for Eurosystem financing was intended to make sure that the banks had sufficient collateral for the substantial amount of debt maturing in 2012 and to facilitate access to liquidity for smaller banks, which play an important role in lending to small and medium-sized enterprises. The Eurosystem accordingly lowered the rating requirements for some types of asset-backed securities and ruled that national central banks – on their own responsibility and with the Governing Council's approval of the criteria adopted – could accept as collateral some additional types of credit claims. The selection of the new collateral assets is based on stringent standards and entails severe risk control measures that ensure the soundness of the Eurosystem's balance sheet.

The lowering of the reserve ratio in January increased the availability of unencumbered reserves by about €100 billion for the euro-area and €12 billion for the Italian banking system.

In the aggregate, the liquidity injected into the banking system necessarily translated into an equal increase in the amount of funds held with the Eurosystem's deposit facility. However, most of these funds were not re-deposited by the same banks that had originally received them. This means that the liquidity did not remain idle but circulated within the euro area, with a positive effect on other segments of the financial market as well.

The increased recourse to refinancing came mainly from banks in the countries hardest hit by the crisis. In mid-May the funds disbursed to banks in Greece, Ireland, Portugal, Italy and Spain accounted for around 70 per cent of total Eurosystem refinancing; in mid-2007 the comparable figure had been just 15 per cent. The increase was counterbalanced by lesser recourse to refinancing on the part of banks in the other countries, which received inflows of liquidity owing to the reduction in their short-term financial exposure to the countries under greater strain.

Overall, these developments were reflected in an increase in the national central banks' creditor or debtor balances with the ECB in the TARGET2 payment system which, through the intermediation of the national central banks, settles commercial and financial transactions between euro-area countries. These balances turned negative for the countries under stress (Greece, Ireland, Portugal and, more recently, Spain and Italy) and positive for the reputedly sounder countries (including Germany, the Netherlands and Luxembourg).

THE ITALIAN ECONOMY

8. DEMAND, SUPPLY AND PRICES

Italy's GDP growth slowed to 0.4 per cent in 2011, from 1.8 per cent in 2010. The deterioration in cyclical conditions was especially marked in the second half of the year, when a contraction in economic activity began that continued in the early part of 2012. GDP in the first quarter of this year was down by 6 per cent compared with the previous peak in the first quarter of 2008.

The decline in GDP that began in the middle of 2011 was mainly due to the euro-area sovereign debt crisis, which affected the Italian market from the summer onwards. The increase in financial strains caused problems for banks' fund-raising that impinged on their policies for lending to the private sector and hence on national demand, especially for investment, which was also depressed by the persistence of large amounts of idle capacity and the decline in construction.

Household consumption also contracted in 2011. This was a consequence of the fall in disposable income in real terms and the progressive deterioration in consumer confidence caused by the growing concern over the outlook for the labour market. Exports continued to provide the main stimulus for growth in economic activity, although they were affected by the weakening of the international economic cycle. The contribution of net trade to GDP growth amounted to 1.4 percentage points.

Consumer price inflation rose by more than one percentage point to 2.8 per cent for the year as a whole. The increase was due to the rises in the prices of energy and food products, driven by higher international commodity prices and, in the second half of the year, the raising of indirect taxes. In the early part of 2012 consumer price inflation remained above 3 per cent; excluding changes in indirect taxes, it was about one percentage point lower, broadly in line with the euro-area average.

Household consumption

After recovering moderately in 2010, Italian household consumption stagnated in 2011, rising by 0.2 per cent in real terms (Table 8.1). In addition to the decline in purchases of non-durable goods (-0.8 per cent) and semi-durable goods (-0.3 per cent), purchases of durable goods fell by 1.8 per cent in 2011 and by 12.9 per cent over the last four years. A contribution to the fall in 2011 came from the reduction of nearly 10 per cent in spending on transport equipment, which was offset only in part by the increase in spending on furniture, white goods and high-tech products. Spending on services grew by 1.6 per cent, above all for leisure and cultural activities.

Table 8.1

Sources and uses of income

	As a percentage of GDP in 2011 (volumes at previous-year prices)	2010 Percentage changes: Chain-linked volumes	2010 Percentage changes: Deflators	2010 Contribution to GDP growth (chain-linked volumes)	2011 Percentage changes: Chain-linked volumes	2011 Percentage changes: Deflators	2011 Contribution to GDP growth (chain-linked volumes)
Sources							
GDP	–	1.8	0.4	–	0.4	1.3	–
Imports of goods *fob* and services (1)	28.5	12.7	6.7	-3.1	0.4	7.3	-0.1
of which: goods	*23.3*	*15.0*	*7.1*	*-2.9*	*1.4*	*8.2*	*-0.3*
Uses							
National demand	100.6	2.1	1.5	2.1	-0.9	2.2	-0.9
Consumption of resident households	60.1	1.2	1.5	0.7	0.2	2.7	0.1
Consumption of general government and non-profit institutions serving households	21.2	-0.6	1.5	-0.1	-0.9	-0.1	-0.2
Gross fixed investment	19.2	2.1	1.2	0.4	-1.9	3.3	-0.4
machinery, equipment and transport equipment	*8.3*	*12.1*	*-0.3*	*0.9*	*-0.9*	*2.3*	*-0.1*
intangible assets	*1.1*	*-0.1*	*3.1*	*..*	*-1.3*	*2.7*	*..*
construction	*9.8*	*-4.8*	*2.1*	*-0.5*	*-2.8*	*4.1*	*-0.3*
Change in stocks and valuables (2)	–	–	–	1.2	–	–	-0.5
Exports of goods *fob* and services (3)	28.0	11.6	2.6	2.8	5.6	4.1	1.5
of which: goods	*23.1*	*12.4*	*2.8*	*2.4*	*7.0*	*4.4*	*1.5*
Net exports	–	–	–	-0.3	–	–	1.4

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

Consumer households' spending decisions continued to be influenced by the decline in real disposable income, down by 0.6 per cent in 2011 (Table 8.2 and Figure 8.1) and by 4.9 per cent since 2007. Last year, despite the increase of 2.0 per cent in nominal incomes, households' purchasing power was eroded by the faster rise in prices. When the effects of the increase in expected inflation on the real value of financial assets are considered, the decline in real disposable income becomes more pronounced (-1.8 per cent).

Total wages and salaries grew by 2.2 per cent in nominal terms, mainly as a consequence of an increase in average unit incomes. This was partly due to changes in the composition of employment: the problems affecting the labour market mainly penalize jobs paying lower wages to the advantage of those paying more on average. Self-employment income also continued to grow, rising by 1.4 per cent.

Net property income expanded for the first time since 2008. The increase was mainly due to the acceleration in rents from buildings (included in gross operating profit) and the growth in net interest income payments to households on financial assets, although this only offset the large fall of the two previous years. By contrast, there was a decrease in dividends and other distributed profits as a consequence of the weak performance of the economy.

Table 8.2

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

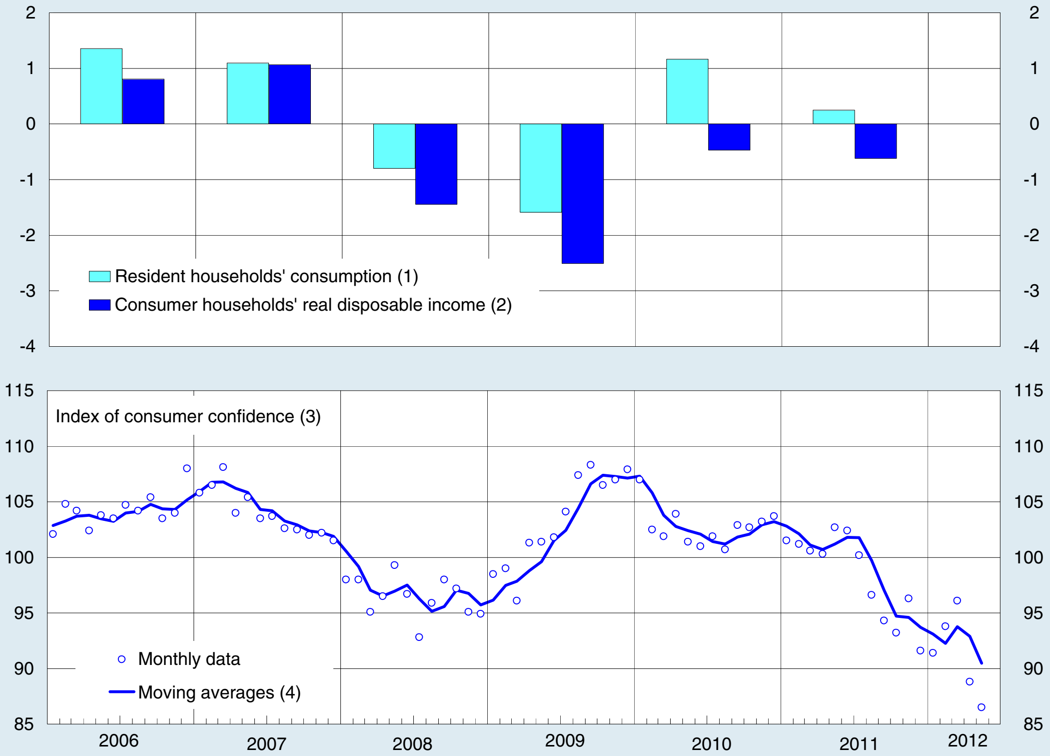
	As a percentage of households gross disposable income in 2011	2009	2010	2011
		Percentage changes		
Earnings net of social contributions charged to workers	42.9	-0.9	1.4	2.2
Income from salaried employment per standard labour unit	–	*1.7*	*2.5*	*1.4*
Total social contributions (1)	–	*0.2*	*0.2*	*0.3*
Standard employee labour units	–	*-2.8*	*-1.3*	*0.4*
Income from self-employment net of social contributions (2)	19.8	-3.9	1.0	1.4
Income from self-employment per standard labour unit	–	*-0.7*	*0.8*	*2.1*
Total social contributions (1)	–	*-0.3*	..	..
Standard self-employed labour units	–	*-3.0*	*0.2*	*-0.7*
Net property income (3)	24.3	-12.4	..	1.5
Social benefits and other net transfers	30.8	5.1	2.3	1.5
of which: net social benefits	–	*4.8*	*2.5*	*2.3*
Current taxes on income and wealth (–)	17.8	-2.9	2.4	0.1
Households' gross disposable income	**100.0**	**-2.6**	**1.1**	**2.0**
in real terms (4)	–	-2.5	-0.5	-0.6
in real terms, adjusted for expected inflation (4) (5)	–	-0.5	-1.6	-1.8
in real terms, adjusted for past inflation (4) (6)	–	-0.3	-2.5	-1.7
Private sector gross disposable income	**–**	**-0.9**	**1.8**	**2.3**
in real terms (4)	–	-0.8	0.2	-0.3
in real terms, adjusted for expected inflation (4) (5)	–	1.8	-1.5	-2.1
in real terms, adjusted for past inflation (4) (6)	–	2.1	-2.6	-2.0
		Percentages		
Consumer households' average propensity to save (7)	**–**	**10.9**	**9.4**	**8.6**
calculated on income adjusted for expected inflation	–	9.9	7.4	5.5
calculated on income adjusted for past inflation	–	10.8	7.4	5.6
Private sector average propensity to save (7)	**–**	**23.9**	**23.2**	**22.8**
calculated on income adjusted for expected inflation	–	24.2	23.9	23.9
calculated on income adjusted for past inflation	–	23.9	23.9	23.9

Sources: Based on Bank of Italy and 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 imputed rents), net rents from land and intangible assets, actual net interest, dividends and other profits distributed by companies. – (4) Deflated using the resident households' consumption deflator. – (5) Gross disposable income net of expected losses on net financial assets due to inflation (estimated on the basis of the Consensus Economics survey). – (6) Gross disposable income net of actual losses on net financial assets owing to inflation, calculated ex post. – (7) Ratio of saving (before depreciation and amortization and not adjusted for changes in net equity of households in pension funds reserves) to the gross disposable income of the sector.

Figure 8.1

Consumption, real income and consumer confidence

(growth rates and indices)



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

Current taxes on income and wealth were virtually unchanged compared with 2010; their ratio to households' disposable income remained high by historical standards. The increase in social security contributions (1.2 per cent) was outpaced by that in social benefits (2.3 per cent).

Consumer households' propensity to save fell by nearly one percentage point to 8.6 per cent, (5.5 per cent when measured with reference to disposable income adjusted for the expected monetary erosion of financial assets; Table 8.2). The propensity to save of the private sector (households and firms) also decreased, albeit less, declining to 18.4 per cent when measured with reference to national gross disposable income; that of the economy as a whole declined to 16.8 per cent. The contribution of general government to national saving was again negative.

In 2011 consumers' growing concern about the economy and their own situations led to a decline in consumer confidence, which has continued this year with the index falling to a historically low level in the spring.

Investment

Gross fixed investment decreased by 1.9 per cent in 2011, cancelling out almost all the increase recorded in 2010 (Table 8.3). Spending on construction contracted by 2.8 per cent, that on machinery and equipment by 1.5 per cent and that on intangible goods by 1.3 per cent; only purchases of transport equipment increased, by 1.5 per cent. The propensity to invest was virtually unchanged at 19.2 per cent of GDP, thus remaining below the average of the last ten years (20.7 per cent). In addition to the still considerable amount of idle capacity, investment was affected by the uncertain outlook for demand and, from the summer onwards, by the heightened financial tensions.

Table 8.3

Fixed investment

(chain-linked volumes, unless otherwise indicated; per cent)

	Percentage share in 2011 (1) (volumes at previous-year prices)	Percentage change			As a percentage of GDP (1) (volumes at previous-year prices)	
		2009	2010	2011	2010	2011
Construction	51.0	-8.8	-4.8	-2.8	9.5	9.8
residential	*24.3*	*-8.1*	*-2.1*	*-2.8*	*4.2*	*4.7*
other	*22.2*	*-9.1*	*-8.1*	*-2.9*	*4.5*	*4.3*
property transfer costs	*4.5*	*-11.0*	*-1.5*	*-1.8*	*0.8*	*0.9*
Machinery and equipment	34.5	-16.1	13.9	-1.5	7.4	6.6
Transport equipment	9.0	-18.9	4.4	1.5	2.2	1.7
Intangible assets	5.5	-0.9	-0.1	-1.3	1.2	1.1
Total gross fixed investment	**100**	**-11.7**	**2.1**	**-1.9**	**20.3**	**19.2**
Total excluding residential buildings	–	-12.9	3.5	-1.5	16.1	14.5
Total excluding construction	–	-15.0	10.4	-0.9	10.7	9.4
Total net fixed investment (2)	**–**	**-53.7**	**9.7**	**-18.1**	**5.9**	**2.0**

Source: Istat, national accounts.
(1) Rounding may cause discrepancies in totals. – (2) Net of depreciation. GDP percentages are calculated using chain-linked volumes.

Investment net of depreciation recorded a much larger decrease (18.1 per cent); as a ratio to GDP it averaged just over 2 per cent in 2009-11, or less than half the figure for the fifteen years 1994-2008.

In the early months of 2012 the branches of the Bank of Italy carried out the usual annual survey of 4,120 firms with at least 20 workers in industry excluding construction and non-financial private services. The survey showed that the reduction in gross fixed investment in 2011 was more pronounced than the plans drawn up by firms at the beginning of the year had suggested (Table 8.4); one contributory factor was the tightening of borrowing conditions. In 2012 firms expect a further large fall of 6.3 per cent in total investment, involving both industry and, to a lesser extent, services.

The fall in investment in construction continued in all the sectors of the industry. Residential building was depressed by the decline in demand: the number of sales dropped by 2.2 per cent, continuing the downward trend that began after the peak in 2006. House prices continued to rise at a moderate pace in nominal terms; between 2007 and 2011 they fell by 5.3 per cent in real terms.

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 2011 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 2011	*-3.6*	*-6.3*	*-7.6*	*2.5*	*-1.6*	*1.9*	*-9.9*	*1.7*	*-11.6*
realization rate (4)	*100.1*	*110.3*	*103.5*	*103.9*	*90.0*	*100.3*	*92.1*	*103.2*	*95.2*
plans for 2012	*-9.8*	*-21.9*	*-14.4*	*-14.7*	*5.7*	*-5.4*	*-6.6*	*-8.4*	*-12.2*
Realized investment in 2011	-2.8	-4.9	-5.3	..	-1.7	..	-6.3	0.3	-7.2
Realization rate (4)	98.3	108.6	102.7	100.6	91.9	98.7	92.1	100.6	95.0
Plans for 2012	-8.1	-21.1	-12.0	-11.1	0.9	-5.2	-5.1	-7.5	-8.8
Services (5)									
Realized investment in 2011	-2.4	-1.3	1.4	-4.2	-4.9	….	….	-2.3	-2.7
Plans for 2012	-4.6	-8.2	-9.1	-8.3	2.6	….	….	-4.1	-5.4
Total									
Realized investment in 2011	-2.6	-2.6	-2.0	-1.7	-3.2	..	-6.3	-1.0	-5.0
Plans for 2012	-6.3	-12.8	-10.5	-10.0	1.7	-5.2	-5.1	-5.8	-7.0

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. 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 2011. – (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 2010 for 2011, both at current prices. – (5) Private sector non-financial services.

The decrease in investment in non-residential construction was partly due to the poor performance of public works. According to the survey the branches of the Bank of Italy conducted from February to April of this year on a sample of 397 construction firms engaged in public works, the volume of new business diminished by 7.2 per cent. Firms expect a further contraction in 2012, continuing the downward trend that the survey indicates has been under way since 2007.

Exports and imports

Exports. – In 2011 exports of goods and services grew by 5.6 per cent in volume, with merchandise exports growing by 7.0 per cent in real terms and those of services stagnating; this was a much slower rate of increase than in 2010. While Italian merchandise exports recovered most of the fall that occurred during the recession, in the last quarter of 2011 they were more than 5 per cent below their level before the start of the international economic crisis. In France they were about 1 per cent lower. By contrast, German merchandise exports in the same period were about 4 per cent above their pre-crisis peak.

On the basis of foreign trade data, the growth in merchandise exports in 2011 was mainly due to sales to non-EU countries; within the EU it was sustained by sales to Germany, although these slowed over the year. In sectoral terms the growth in merchandise exports was driven mainly by machinery and equipment, basic metals and other metal products (Table 8.5). Good export performances were also recorded by traditional products (textiles, clothing and leather), pharmaceuticals and electronic products. In the first quarter of 2012, export volumes held steady.

Table 8.5

Merchandise exports *cif-fob* by sector of economic activity
(percentage changes on corresponding period and per cent)

SECTORS (1)	2010				2011			
		Changes				Changes		
	% composition of value (2)	Value	Export prices	Volume (5)	% composition of value (3)	Value	Export prices	Volume (5)
Manufacturing products	95.0	16.5	2.8	13.2	95.7	11.5	4.0	7.3
of which:								
Textiles, clothing and leather	*11.3*	*12.8*	*0.7*	*12.0*	*11.1*	*12.3*	*2.9*	*9.1*
Pharmaceuticals, medicinal chemicals and botanical products	*4.2*	*15.0*	*0.7*	*14.2*	*4.1*	*9.6*	*0.9*	*8.6*
Basic metals and metal products, except machinery and equipment	*11.1*	*21.9*	*4.4*	*16.6*	*11.7*	*22.9*	*5.6*	*16.5*
Personal computers, and electronic and optical products	*3.3*	*20.3*	*-1.2*	*21.7*	*3.4*	*11.0*	*1.3*	*9.7*
Machinery and equipment n.e.c.	*18.9*	*9.2*	*-0.1*	*9.2*	*17.8*	*13.9*	*1.4*	*12.3*
Memorandum item:								
Total	100.0	15.6	2.7	12.5	100.0	11.4	4.0	7.3

Source: Based on Istat data.
(1) Merchandise exports are grouped according to the NACE 2007 classification of economic activity used by Istat since January 2009. – (2) Refers to the period January-December 2010. – (3) Refers to the period January-December 2011. – (4) Estimated by deflating the value on the basis of the producer prices of industrial products sold abroad.

Imports. – Imports of goods and services increased by just 0.4 per cent in volume in 2011, held back by the weakness of national demand. The growth of 1.4 per cent in merchandise imports was offset by the contraction of 3.5 per cent in imports of services. Another factor contributing to the stagnation of purchases abroad was the reduction in tax incentives for the production of renewable energy, which in 2010 had boosted imports of photovoltaic products. In the first quarter of 2012, imports of goods and services contracted.

Supply

As in 2010, the growth in GDP last year reflected the increases in the value added of industry excluding construction (1.2 per cent) and services (0.8 per cent), offset in part by the falls in the value added of agriculture (-0.5 per cent) and construction (-3.5 per cent). In 2011 most sectors of industry recorded modest increases or declines in activity; mechanical machinery and equipment, basic metals and electricity generation were exceptions in this respect and achieved significant growth.

In services the increases in the value added of wholesale and retail trade and, in relation to imputed rents, in real-estate services (in both cases by about 1.5 per cent) were accompanied by small reductions in general government services, especially education and healthcare.

Economic activity weakened over the year; in the last two quarters of 2011 Italy's GDP fell by 0.2 and 0.7 per cent respectively compared with the previous quarter. There was a further fall of 0.8 per cent in the first quarter of 2012, reflecting the additional contraction in industrial activity (by about 2 per cent) and that in services.

The performance of industry in the last two years

After recovering about one third of the contraction of nearly 25 per cent during the 2008-09 recession, Italian industrial production began to weaken again in the middle of last year. In the first quarter of 2012 it was more than 20 per cent below the peak recorded in the first quarter of 2008. In France, where the strength of the recovery was similar to that in Italy but the contraction during the recession much smaller, industrial production in the first quarter of this year was about 10 per cent below the peak; in Germany, where the initial contraction was not very different from that in Italy, it was only 3 per cent below the peak, reflecting the effects of an expansion involving almost every sector of industry.

No sector of Italian manufacturing industry has returned to the level of production it enjoyed before the recession. The failure to return to the earlier level of aggregate production is mainly due, however, to the textiles and clothing, non-metallic minerals, metal products and transport equipment sectors.

In Italy exports have been the main stimulus to industrial activity in the last two years, as in the rest of the euro area. In Germany they have imparted a greater impetus than in Italy and the euro area as a whole. The openness of the German economy has been a contributory factor, especially its growing presence in the non-European markets that have driven the recovery in world trade since 2010.

The weak growth in productivity observed in Italy in the last ten years contributed to a reduction in Italian firms' competitiveness. In the ten years preceding the 2008-09 recession the share of Italian merchandise exports in world trade declined in volume terms by about one percentage point to 3.6 per cent; in the domestic market foreign manufacturers competed more fiercely in the sectors of motor vehicles and traditional Italian products (textiles, clothing and leather, furniture and furnishings). In the same period the ratio of imports to consumption in these sectors almost doubled.

Prices and costs

Annual average consumer price inflation in Italy, as measured by the index for the entire resident population, rose to 2.8 per cent in 2011, compared with 1.5 per cent in 2010 (Table 8.6). The harmonized index of consumer prices posted a similar yearly increase (2.9 per cent), although it showed wide fluctuations during the year in connection with the introduction in January of a new method for observing the prices of seasonal products (see *Economic Bulletin*, April 2011).

Table 8.6

Consumer prices

	Percentage changes on previous year		Percentage weights
	2010	2011	2011
Index of consumer prices for the entire resident population	**1.5**	**2.8**	**100.0**
Unregulated goods and services	**1.7**	**2.7**	**88.9**
Unprocessed food	-0.3	2.5	6.2
Processed food	0.6	2.4	10.7
Energy products	11.2	14.6	4.8
Non-food and non-energy products	1.5	1.9	64.3
Services	1.8	2.2	38.5
Tobacco	3.3	4.1	2.2
Regulated goods and services	**-0.3**	**3.3**	**11.1**
Overall index excluding food, energy and tobacco	**1.5**	**1.9**	**73.0**
Harmonized index of consumer prices	**1.6**	**2.9**	**100.0**

Source: Based on Istat data.

Consumer price inflation was driven by the large increases in oil prices, which affected both electricity prices (up by 6.2 per cent, against a fall of 4.9 per cent in 2010) and fuel prices (up by 14.6 per cent, compared with 11.2 per cent in 2010). The latter also rose as a result of the increases in indirect taxes; when these are excluded, fuel prices rose by about 10 per cent. The effect of these increases was more pronounced for less-well-off households, whose spending on energy is a relatively large share of their consumption.

The greater external pressure on prices was accompanied by no more than a small increase in domestic prices: the GDP deflator rose by 1.3 per cent, after remaining almost unchanged in 2010; a recovery in the profitability of private services was a contributory factor. Core inflation (measured by changes in the index net of food and energy products) rose to 1.9 per cent, from 1.5 per cent in 2010, mainly owing to the increase in air fares, partly ascribable to higher fuel costs, and the increase in VAT enacted in September.

According to our estimates the increase in the standard VAT rate from 20 to 21 per cent, which entered into force on 17 September 2011, pushed up the general consumer price index by about 0.4 percentage points, concentrated in the period September-October (see *Economic Bulletin*, January 2012). For the year as a whole the effect amounted to just over one tenth of a percentage point.

The expectations for average annual inflation surveyed by Consensus Economics rose progressively over the year, from 1.7 per cent in January to just over 2.5 per cent from the middle of the year onwards. Those for the whole of 2012, which had remained stable at 2 per cent in last year's monthly surveys, subsequently rose to 3.0 per cent in May. The gap with respect to the lower forecasts for the euro area as a whole is largely due to the impact of the indirect tax increases.

In the first three months of 2012 the twelve-month rate of increase in consumer price inflation remained at 3.3 per cent, sustained by the rise in the prices of energy products; the harmonized index of consumer prices was more volatile, rising to 3.7 per cent in April. Excluding the changes introduced in indirect taxes since the middle of 2011, inflation in April would have been about one percentage point lower; the gap was due almost equally to the increases in excise taxes and VAT.

Producer prices and costs. – In 2011 the producer price index for the domestic market rose by 5.0 per cent on average. The increase from 3.1 per cent in the previous year was due mainly to the components most sensitive to changes in commodity prices – food, intermediate products and energy – and to non-food final consumer goods, whose prices rose by 2.0 per cent after two years of stagnation. In the second half of the year the pressure exerted by the prices of basic materials eased, with the rise in the producer price index progressively slowing to a twelve-month rate of 3.2 per cent in February.

In the quarterly survey conducted in March 2012 by the Bank of Italy and *Il Sole 24 Ore* firms expected list prices to show a moderate increase this year: any upward pressure deriving from cost increases would be offset by the weakness of domestic demand.

In 2011 the producer prices of exported non-energy products rose by 2.8 per cent, in line with the increases introduced by French and German firms. The producer prices of non-energy products sold on the domestic market rose by 4.0 per cent.

In 2011 unit labour costs in the economy as a whole showed a moderate rise of 0.6 per cent, which nonetheless offset the fall recorded in 2010. Hourly earnings rose by 0.9 per cent while productivity was essentially stagnant, reflecting the weakness of the economy. In industry, where the increase in nominal hourly earnings was larger (2.2 per cent), unit labour costs rose at a faster pace (1.8 per cent).

9. THE LABOUR MARKET

After two consecutive years of decline, employment grew in the first nine months of 2011, but in the final part of the year the worsening of cyclical conditions was reflected in a new drop in the number of persons in work. On average, the year registered a modest gain in employment, accompanied by a shift in its composition towards fixed-term and part-time jobs. Feeble economic growth and the still low level of turnover penalized younger workers more than older ones. Labour demand weakened further in the first few months of 2012: in March the number of official residents in work was more than 600,000 below the April 2008 peak; the number of wage supplementation hours requested turned upwards; and the unemployment rate, which had ceased growing in 2011, rose. According to the Bank of Italy's survey of industrial and service firms, in 2012 as a whole businesses expect to reduce staff for the fourth successive year and more sharply than in 2011.

Actual earnings per full-time equivalent worker remained unchanged in the public sector and grew more slowly in the private sector; in the entire economy the increase amounted to 1.4 per cent, two fifths of it due to the change in the composition of the workforce towards higher-wage segments. Actual earnings fell in real terms by 1.3 per cent, the first contraction since 1995. However, unit labour costs began to rise again, though at a lower rate than the average recorded between 1996 and 2010; as in the past, this depended mainly on an abrupt slackening in labour productivity. Wage moderation is expected to persist in 2012.

With a bill submitted to Parliament at the beginning of this year, the Government launched an extensive reform of the main labour market institutions with a view to reducing segmentation and coordinating and boosting the efficiency of the system of social buffers and active policies for re-employment.

Employment and labour demand

After falling by 1.6 per cent in 2009 and 0.7 per cent in 2010, employment measured by the national accounts increased by 0.3 per cent on average in 2011 in terms both of persons employed and hours worked (Table 9.1 and Figure 9.1). The upturn in the overall demand for labour conceals significant differences from sector to sector: employment contracted in agriculture and construction, stagnated in industry and grew in private services. Employment in general government declined for the fifth year in a row.

In the second half of the year the Italian economy slipped back into recession. According to national accounts data, the recovery in employment that had characterized the first three quarters came to a halt in the fourth, with the number of persons in work down by 0.2 per cent compared with a year earlier.

Table 9.1

Labour input in the Italian economy by sector
(percentage shares and percentage changes)

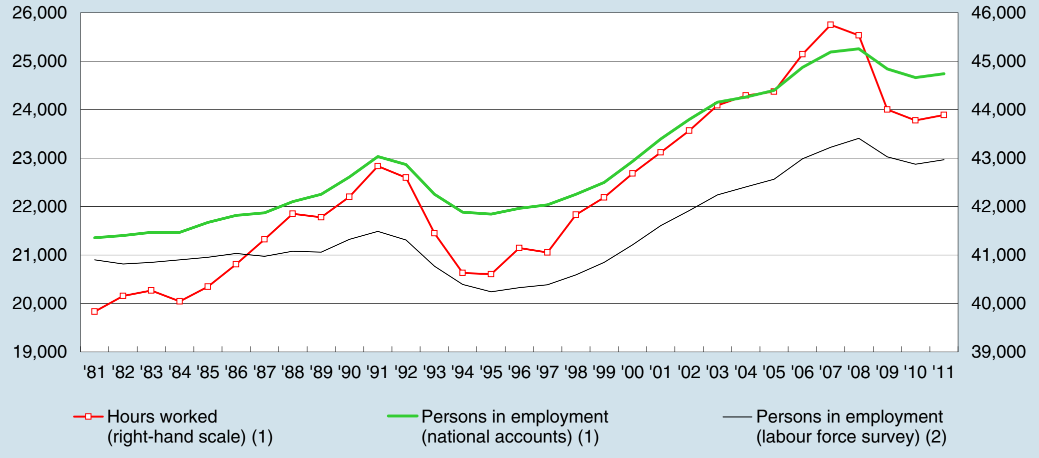
	Persons in employment				Standard labour units				Total hours worked			
	Share		Percentage change		Share		Percentage change		Share		Percentage change	
	2001	2011	2001/ 2011	2001/ 2011	2001	2011	2001/ 2011	2001/ 2011	2001	2011	2001/ 2011	2001/ 2011
Agriculture, forestry, fisheries	**4.7**	**3.9**	**-13.4**	**-2.0**	**6.3**	**5.1**	**-18.0**	**-2.8**	**6.4**	**5.2**	**-16.3**	**-2.4**
Industry excl. construction	**22.0**	**19.4**	**-6.6**	**0.2**	**21.1**	**18.3**	**-12.3**	**0.8**	**21.0**	**18.1**	**-12.4**	**0.9**
Construction	**7.2**	**7.5**	**10.4**	**-3.5**	**7.3**	**7.8**	**8.1**	**-3.1**	**7.1**	**7.7**	**10.8**	**-2.4**
Services	**66.2**	**69.3**	**10.7**	**0.9**	**65.4**	**68.8**	**6.1**	**0.5**	**65.5**	**69.0**	**7.1**	**0.6**
Wholesale and retail trade, repair of motor vehicles and motorcycles	14.9	14.5	3.3	0.4	14.4	14.3	-0.3	..	16.6	15.6	-4.4	-0.5
Accommodation and food services	4.5	5.2	22.7	1.8	5.7	6.4	12.4	1.5	6.0	6.9	18.0	2.4
Transport, storage and communications	7.1	6.9	3.3	1.2	8.1	8.5	5.7	1.1	8.0	8.0	2.3	0.4
Financial and insurance services	2.5	2.6	8.3	0.4	2.5	2.6	8.2	0.6	2.2	2.3	6.7	0.8
Sundry business and household services (1)	10.0	11.7	24.2	1.9	9.5	11.4	21.0	2.1	9.6	11.9	25.2	2.3
General government (2)	6.3	5.4	-8.9	-0.5	6.1	5.5	-9.5	-0.6	5.2	4.5	-11.2	-0.6
Education	6.6	5.9	-5.1	-1.1	6.4	5.9	-6.7	-1.3	4.4	4.2	-2.8	-0.9
Healthcare and social work activities	6.2	6.7	14.3	1.2	6.0	6.5	9.9	0.8	5.4	6.0	13.5	1.3
Other public, social and personal services (3)	3.5	3.8	13.9	-0.9	3.4	3.7	8.5	-1.4	3.3	3.7	12.5	-1.1
Activities of households as employers, production activities of households for own use	4.6	6.5	48.7	3.8	3.2	3.9	24.8	0.5	4.9	5.9	22.7	0.6
Total	**100.0**	**100.0**	**5.8**	**0.3**	**100.0**	**100.0**	**0.9**	**0.1**	**100.0**	**100.0**	**1.8**	**0.3**

Source: Istat, national accounts (NACE 2007).
(1) Real-estate, professional, scientific and technical, administrative and support services. – (2) Includes defence and compulsory social insurance. – (3) Arts, entertainment and recreation; other services.

The number of wage supplementation hours that firms benefited from decreased by nearly 17 per cent in 2011, falling below the 2009 level. As in the previous years, protracted uncertainty prompted firms to take the precaution of applying for more hours than they actually used. The number of benefit hours authorized by INPS, which also declined (by 18.8 per cent), exceeded the 2009 level. Last year firms used 49 per cent of the total authorized (compared with 60 per cent in 2009 and 48 per cent in 2010). Applications for wage supplementation,

Figure 9.1

Measures of employment
(thousands of persons and millions of hours)

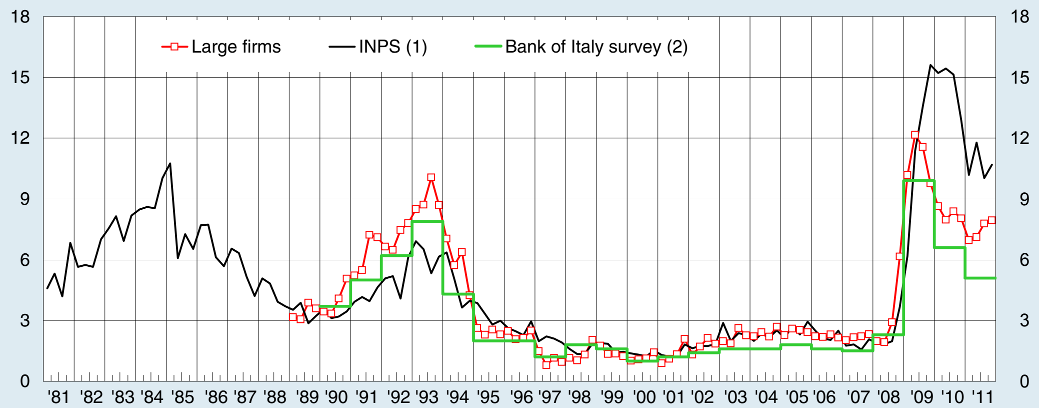


Sources: Istat, national accounts and labour force survey.
(1) Refers to resident and non-resident workers, official and unreported, employed in resident firms. – (2) Number of officially registered residents in work (excluding those living permanently in institutions).

which had been falling since November 2010, rose in the first three months of 2012, when the number of hours requested was 2.2 per cent higher than a year earlier (Figure 9.2).

Figure 9.2

Ratio of wage supplementation benefit hours to total hours worked in industry excluding construction
(per cent)



Sources: Based on data from INPS; Istat, national accounts (NACE 2007) and *Large firms labour indicators*; and Banca d'Italia, *Survey of Industrial and Service Firms*.
(1) Hours authorized (INPS) as a percentage of total hours worked by employees. Until 1991, national accounts are classified according to NACE 2002. – (2) Firms with at least 50 workers in the manufacturing sector.

Turnover – the sum of hirings and terminations – remained low in relation to average employment. There was a further intensification, by comparison with the early phases of the recession, in the propensity to use flexible contract forms.

According to Istat labour force surveys, the number of newly hired workers in the private sector, which compared with year-earlier levels had been trending upwards since the end of 2009, began to decline again in the second half of 2011. Over the year as a whole, only 30 per cent of new employees were hired on permanent contracts, compared with 33.6 per cent in 2010; even counting conversions of fixed-term into permanent contracts, which increased by some 20 per cent in 2010, just one new employment contract in two was for a permanent job.

The demand for labour waned further in the first quarter of 2012, with the number of employed persons down by 0.6 per cent compared with a year earlier. According to Istat's latest business opinion surveys, more firms expect to reduce employment in the coming months than to increase it. In the Bank of Italy's survey of industrial and service firms, businesses forecast that they would cut back their workforce for the fourth successive year, by 1.1 per cent. The projected reduction, larger than the 0.2 per cent decline recorded in 2011, is expected to be sharper in industry excluding construction and among smaller firms.

The composition of employment of the officially resident population

Employment among men was basically unchanged (-0.1 per cent), while among women it grew by 1.2 per cent (Table 9.2); for the first time since the crisis, the expansion in women's employment involved both resident foreigners and Italians.

The growth in employment of women was in line with the increases in industry excluding construction (1.3 per cent) and services (1.1 per cent), where women make up respectively almost a quarter and more than half of the workforce, and especially in collective and personal services (5.7 per cent), where only one worker in three is a man. In the construction industry, where men make up more than nine tenths of the workforce and the loss of jobs was generally more severe, with a decline of 5.3 per cent in employment, women's employment increased by 12.4 per cent. The concentration of women in sectors hit less hard by the recession is estimated to have accounted for about a third of the gain in women's employment. The increase in employment among single women was due entirely to their greater concentration in service activities, particularly personal services, while that among married women reflected the greater labour force participation of foreigners and the rise in the employment rate of Italian women, who may have increased their participation in order to make up for their spouses' loss of income (the so-called additional worker effect).

The employment rate for the population aged 15-64 remained stable at 56.9 per cent in 2011. The gender gap narrowed but remained significant: the employment rate of women rose from 46.1 to 46.5 per cent, still well below that of men, which slipped from 67.7 to 67.5 per cent. The increase in the female employment rate mainly involved the North of Italy; the fall in male employment was concentrated in the Centre, reflecting a sharper contraction in construction there than in the rest of the country.

The increase in employment of foreigners aged 15-64 (8.0 per cent) was smaller than in the years before the crisis and failed to keep pace with the growth in the corresponding population, so that the employment rate of foreigners declined by 0.8 percentage points to 62.3 per cent, while the employment rate among Italians rose by 0.1 points to 56.4 per cent. The change in employment differed by age group. The

Table 9.2

Labour supply in 2011
(thousands of persons and per cent)

	Centre and North		South		Italy	
	Thousands of persons (1)	Percentage change 2010-11 (2)	Thousands of persons (1)	Percentage change 2010-11 (2)	Thousands of persons (1)	Percentage change 2010-11 (2)
Labour force	**17,881**	**0.4**	**7,194**	**0.5**	**25,075**	**0.4**
Women	7,731	1.0	2,611	1.5	10,342	1.1
Men	10,151	-0.1	4,582	-0.1	14,733	-0.1
Italians	15,649	-0.6	6,864	-0.1	22,513	-0.5
Foreigners	2,232	8.2	329	13.0	2,562	8.8
Total employment	**16,752**	**0.5**	**6,216**	**0.2**	**22,967**	**0.4**
Women	7,159	1.2	2,189	1.1	9,349	1.2
Men	9,592	-0.1	4,026	-0.2	13,619	-0.1
Italians	14,793	-0.4	5,922	-0.3	20,716	-0.4
Foreigners	1,958	7.7	293	11.1	2,251	8.2
Job seekers	**1,130**	**-1.2**	**978**	**2.0**	**2,108**	**0.3**
Women	572	-1.7	422	3.6	993	0.5
Men	558	-0.8	556	0.9	1,114	0.1
Italians	856	-4.7	942	1.2	1,798	-1.7
Foreigners	274	11.2	36	30.4	310	13.1
Participation rate (ages 15-64)	**68.4**	**..**	**51.0**	**0.2**	**62.2**	**0.1**
Women	59.6	0.2	36.8	0.5	51.5	0.4
Men	77.2	-0.3	65.5	-0.1	73.1	-0.2
Italians	67.9	..	50.5	0.2	61.4	..
Foreigners	72.1	-0.4	63.7	-0.6	70.9	-0.5
Employment rate (ages 15-64)	**64.0**	**..**	**44.0**	**0.1**	**56.9**	**0.1**
Women	55.1	0.3	30.8	0.3	46.5	0.4
Men	72.8	-0.3	57.4	-0.2	67.5	-0.2
Italians	64.1	0.1	43.5	0.1	56.4	0.1
Foreigners	63.2	-0.6	56.7	-1.5	62.3	-0.8
Unemployment rate	**6.3**	**-0.1**	**13.6**	**0.2**	**8.4**	**..**
Women	7.4	-0.2	16.2	0.3	9.6	-0.1
Men	5.5	..	12.1	0.1	7.6	..
Italians	5.5	-0.2	13.7	0.2	8.0	-0.1
Foreigners	12.3	0.3	10.9	1.5	12.1	0.5
Youth unemployment rate (ages 16-24)	**23.3**	**1.2**	**40.4**	**1.6**	**29.1**	**1.3**
Women	26.0	1.9	44.6	4.0	32.0	2.6
Men	21.4	0.7	37.7	..	27.1	0.3
Italians	22.6	1.2	41.3	1.8	29.6	1.4
Foreigners	26.7	1.0	21.4	-0.9	26.1	0.8

Source: Based on Istat, labour force survey.
(1) For rates, per cent. The unemployment rate is the number of job-seekers aged 16-74 as a percentage of the labour force aged 16 and over. Rounding may cause discrepancies in totals. – (2) For rates, changes in percentage points.

drop of about 200,000 persons aged 15-34 in work was due largely to demographic losses (193,000 persons) and marginally to longer enrolment in education or training (16,000 persons); the employment rate for this age group decreased by 0.8 percentage points to 44.7 per cent. By contrast, the gain of 143,000 in employment of persons aged 55-64 reflected both an increase of 116,000 in the corresponding population and a rise from 36.6 to 37.9 per cent in the age group's employment rate, due in part to the raising of the retirement age. In the central age groups, the employment rate remained stable at 73.4 per cent.

The progressive tightening of pension requirements for employees has led to a gradual slowing in the labour market exit rate since 2007; if persons born between

1951 and 1953 had retired at the same rate as the cohorts born between 1948 and 1950, the number of retired employees would have been 100,000 greater.

The improvement in employment reflects an increase of 0.8 per cent in payroll employment (against a decline of 1.0 per cent in 2010), only partly offset by the decrease of 0.6 per cent in self-employment (against an increase of 0.2 per cent in 2010; Table 9.3). There was a further expansion in part-time employment (4.1 per cent; 6.4 per cent in the South) and fixed-term employment (5.5 per cent; 7.3 per cent in the Centre and North). The share of part-time contracts rose by 0.5 percentage points to 16.4 per cent of total payroll employment; that of fixed-term contracts by 0.6 points to 13.3 per cent (by 1.7 points to 25.8 per cent for persons aged 15-34). The share of full-time, permanent contracts declined from 74.6 to 73.7 per cent.

Table 9.3

Structure of employment in 2011 (1)
(thousands of persons and per cent)

	Centre and North		South		Italy	
	Thousands of persons	Percentage change 2010-11	Thousands of persons	Percentage change 2010-11	Thousands of persons	Percentage change 2010-11
Employees	**12,693**	**1.0**	**4,547**	**0.2**	**17,240**	**0.8**
Permanent	11,174	0.2	3,763	-0.3	14,937	0.1
full-time	*9,412*	*-0.3*	*3,295*	*-1.0*	*12,707*	*-0.5*
part-time	*1,762*	*2.7*	*468*	*5.5*	*2,230*	*3.3*
Fixed-term and temporary	1,519	7.3	784	2.2	2,303	5.5
full-time	*1,129*	*7.6*	*579*	*0.2*	*1,708*	*4.9*
part-time	*390*	*6.6*	*205*	*8.6*	*595*	*7.3*
Self-employed	**4,058**	**-1.0**	**1,668**	**0.4**	**5,727**	**-0.6**
Entrepreneurs, professionals and own-account workers	3,452	-1.2	1,455	-0.3	4,906	-0.9
Family workers	267	-3.4	94	1.2	361	-2.2
Cooperative members	32	7.3	12	16.5	44	9.6
Collaborators	229	-1.5	80	9.9	309	1.2
Occasional workers	79	14.8	28	6.5	107	12.5
Full-time	3,517	-1.3	1,484	0.4	5,001	-0.8
Part-time	541	0.5	184	0.6	726	0.5
Total employment	**16,752**	**0.5**	**6,216**	**0.2**	**22,967**	**0.4**

Source: Based on Istat, labour force survey.
(1) Rounding may cause discrepancies in totals.

Labour supply and unemployment

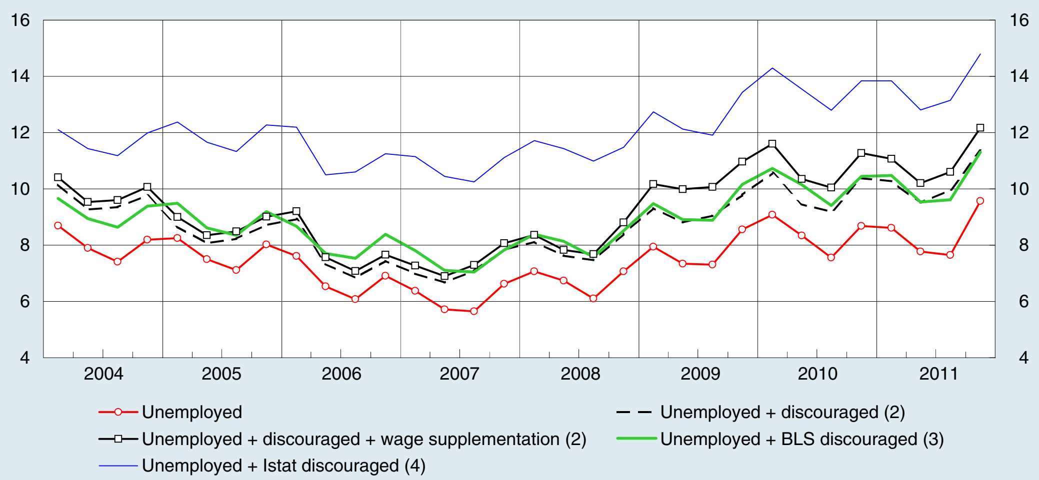
After stagnating in 2011, the labour force – both employed and unemployed persons – resumed growing in line with the increase in the population (0.4 per cent). Accordingly, the participation rate remained unchanged at 62.2 per cent (Table 9.2).

The total number of unemployed persons rose slightly, by 0.3 per cent, to 2,108,000. The number of job seekers fell by 2.0 per cent in the North, increased by about the same amount in the South and remained stable in the Centre. The percentage of unemployed who had been looking for work for at least one year rose by 3.2 points to 51.2 per cent, a historically high level.

The unemployment rate averaged 8.4 per cent in 2011, as in the previous year (Figure 9.3), but the rate among 15-24-year-olds rose significantly, by 1.3 percentage points to 29.1 per cent, owing largely to the jump among young women in the Centre and South (4.8 and 4.0 points respectively). The unemployment rate also rose among foreigners (from 11.6 to 12.1 per cent) and among persons with no more than a lower secondary school diploma (by 0.3 points to 10.6 per cent). Among university graduates it diminished by 0.3 points to 5.4 per cent.

Figure 9.3

Unemployment rate and alternative measures of unutilized labour supply (1)
(per cent)



Source: Based on Istat labour force surveys.
(1) The unemployment rate is the ratio of job seekers to the labour force; the measures of unutilized available labour are calculated by adding to both numerator and denominator the number of discouraged workers by the various definitions and, where relevant, the number of full-time equivalent workers on wage supplementation. – (2) The discouraged workers are persons not in the labour force who have not taken a job search action within the last month, are available to work immediately and have a probability of finding a job that is not statistically different from that of the unemployed. See the box "Estimates of unutilized available labour", *Economic Bulletin*, January 2010. – (3) Definition of the US Bureau of Labor Statistics. The discouraged workers are defined as persons available to work immediately who have taken at least one job search action within the last twelve months but who are not now actively looking for a job because they do not think they can find one. – (4) The discouraged workers are those who are available to work immediately but who are not looking for a job because they do not think they can find one.

In the last quarter of 2011, with the new weakening in labour demand the unemployment rate rose to 9.6 per cent from 8.7 per cent a year earlier. On the basis of preliminary data, in the first quarter of 2012 it increased again to 10.8 per cent, 2.2 points higher than in the same period of 2011.

In 2011 an average of almost 15 million persons between the ages of 15 and 64 were economically inactive. They included a growing number of persons who did not seek jobs but would be available to work and of persons who sought jobs but were not immediately available to work. These components, which together make up the so-called potential labour supply, were equal to 12.1 per cent of the labour force (against an average of 4.6 per cent in the European Union). Family commitments, study and discouragement over the difficulty of finding a job continued to figure prominently among the reported reasons for not seeking work, while the number of those who did not seek work because they were retired or did not wish to work, including for age-related reasons, diminished.

To capture the full extent of the underutilization of available labour, especially during a recession, it is necessary to count not only the unemployed as defined by international standards, but also hours not worked by employees on wage supplementation and the potential labour supply of discouraged workers. Between 2010 and 2011 the unutilized potential labour supply rate is conservatively estimated to have risen further to 11.0 per cent, nearly 3 percentage points above the pre-crisis level and the corresponding unemployment rate (Figure 9.3).

Regulation of the labour market

The recession has underlined some structural problems of the Italian labour market: low female and youth participation rates, large geographical disparities, pronounced dualism between workers with stable jobs and those in precarious employment, the shortcomings of the system of social buffers. In 2011 some measures were introduced to encourage the participation of women and young people, especially those living in disadvantaged areas.

At the beginning of 2012 the Government submitted a draft law to overhaul the main labour market institutions. The measure, which is expected to be fully phased in by 2017, aims at rebalancing the protections among the various types of employment, thereby reducing the market's segmentation while preserving the requisite margins of flexibility in the use of labour. It seeks to create a more equitable and efficient system of social buffers and active labour policies. The reform intervenes on the "atypical" employment contracts, limiting their use where it is inappropriate or is a means to avoid the tax and social security contribution obligations existing for payroll employment. In addition, for most fixed-term contracts it increases the social security contribution charged to employers with a surcharge (equal to 1.4 per cent of earnings) earmarked to finance the social buffers; as with all insurance instruments, this reflects the higher probability that workers on temporary contracts will draw unemployment benefits. The additional cost, which modifies the advantageousness of fixed-term relative to permanent contracts, is partly refunded if the employment relationship is stabilized.

For so-called exit flexibility, the chief intervention concerns Article 18 of the Labour Rights Charter (Law 300/1970), which governs the effects of individual dismissals that a court to which a worker appeals finds wrongful or unjustified. The Government's proposal limits both the cases in which the court can order the employee's reinstatement and the amount of the indemnity; it also introduces a prior conciliation procedure and a speedier judicial process.

Although it is widely thought that rules governing wrongful dismissals may be a deterrent to firms' growth in size, the empirical evidence suggests that the overall effects of Article 18 are limited. By contrast, there is evidence that the excessive length of civil trials can discourage or limit entrepreneurial activity in numerous ways. With reference to labour issues, the reform proposed by the Government acts on both fronts. On the one hand, it circumscribes the situations in which the judge can order the reinstatement of a wrongfully dismissed worker, thereby curbing the organizational consequences of a judgment against the firm. Reinstatement remains the rule only for dismissals found to be discriminatory, for disciplinary dismissals where the alleged infraction is found not to exist or where law or collective contracts provide for less severe sanctions, and for economic dismissals where the reason given is manifestly unfounded. On the other hand, the bill streamlines the procedure for disputes involving dismissals, establishes a ceiling for indemnities and eliminates some associated administrative sanctions, thereby reducing the expected economic cost to the firm of every possible unfavourable outcome of court proceedings. This is likely to loosen the close correlation between the length of the proceeding and the cost to the employer.

The reform of the safety net both for workers who lose their job and for those whose working hours are reduced rationalizes the existing institutions and widens coverage. It hinges on introducing a new system of unemployment insurance (Assicurazione Sociale per l'Impiego, ASpI), and extending wage supplementation to previously excluded sectors. The potential beneficiaries of the new programme would include apprentices and persons with relatively little work experience. Provision is also made for better coordination of passive policies with active policies and with the employment services, whose competence is mainly regional.

Earnings, labour costs and industrial relations

Actual earnings per full-time equivalent employee rose by 1.4 per cent in nominal terms for the entire economy in 2011, almost one percentage point less than in the previous year (Table 9.4). The main factors in this outcome were slower earnings growth in the private sector, particularly in industry excluding construction, and essentially flat earnings in public employment.

The potential scope of company or local-level bargaining, which is still not widely used in Italy, was extended further under agreements reached during the year.

Notwithstanding the weakness of economic activity, earnings increased by 2.1 per cent in the private sector, fuelled in part (0.3 percentage points) by wage drift, the difference between the increase in earnings and the increase determined by national contracts; the contribution was greater in industry excluding construction (0.7 points). As in 2010, the change in the composition of employment due to the reduction in the share of relatively low-wage jobs was a significant factor.

Estimates based on Istat's labour force surveys show that net monthly full-time equivalent earnings, excluding occasional components such as bonuses, increased by 1.4 per cent in the entire economy in 2011: one tenth of this increase depended on the shift in the composition of employees to higher-wage sectors and three tenths on a change in composition towards higher seniority and job grades.

In a context in which consumer price inflation mainly reflected the rise in energy prices and the increase in indirect taxes, actual earnings per full-time equivalent employee diminished in real terms for the first time since 1995, falling by 1.3 per cent. In the private sector the decline essentially involved services, while there was little change in industry (Table 9.4).

Table 9.4

Labour costs and productivity in Italy

(annual percentage changes, except as indicated)

	Value added (1)	Total standard labour units	Value added per standard labour unit (1)	Compensation per standard employee labour unit	Labour costs per standard employee labour unit (2)	Unit labour costs (2) (3)	Labour's share of value added (2) (4)	Real labour costs per standard employee labour unit (2) (5)	Real earnings per standard employee labour unit (6)
				Industry excluding construction					
1996-2000	0.9	-0.2	1.1	3.5	2.6	1.5	63.9	2.6	1.0
2001-2005	-0.2	-0.4	0.2	3.0	3.0	2.8	64.6	1.2	0.6
2006-2010	-1.2	-2.5	1.3	3.5	3.3	2.0	67.0	1.9	1.5
2008	-3.0	-1.4	-1.6	3.9	4.5	6.2	66.7	2.0	0.6
2009	-15.1	-9.5	-6.2	2.9	2.7	9.5	70.1	-1.4	2.1
2010	7.0	-3.1	10.4	3.7	3.5	-6.2	67.9	6.9	2.2
2011	1.2	0.8	0.5	2.6	2.5	2.0	70.3	4.2	-0.1
				Construction					
1996-2000	1.1	1.1	..	3.4	2.2	2.2	72.8	2.2	0.9
2001-2005	2.9	3.3	-0.3	2.6	2.8	3.2	68.6	-1.9	0.2
2006-2010	-2.3	0.1	-2.4	3.4	3.4	6.0	70.2	-0.1	1.4
2008	-2.7	0.1	-2.8	4.2	4.8	7.8	68.8	-0.4	0.9
2009	-8.4	-1.4	-7.1	4.0	3.7	11.6	73.2	-1.2	3.2
2010	-3.0	-2.2	-0.8	3.1	2.7	3.5	75.4	2.2	1.5
2011	-3.5	-3.1	-0.4	2.7	2.2	2.7	74.5	-1.5	-0.1
				Private services (7)					
1996-2000	2.6	2.2	0.5	2.8	1.7	1.2	54.2	1.7	0.4
2001-2005	1.2	1.6	-0.3	2.5	2.5	2.8	51.5	-0.5	..
2006-2010	0.2	0.3	-0.1	2.3	2.3	2.4	53.4	0.7	0.4
2008	-0.9	..	-0.9	2.6	3.3	4.2	53.3	0.3	-0.8
2009	-3.9	-1.5	-2.4	0.9	0.7	3.1	54.0	-1.1	0.1
2010	1.7	-0.1	1.8	2.0	2.0	0.2	54.1	2.1	0.5
2011	1.1	1.0	0.1	1.5	1.3	1.2	53.8	-0.5	-1.3
				Private sector					
1996-2000	2.0	0.9	1.1	3.2	2.2	1.1	60.5	2.2	0.8
2001-2005	0.9	0.9	..	2.7	2.7	2.7	58.2	..	0.2
2006-2010	-0.4	-0.5	0.2	2.8	2.7	2.5	60.1	1.1	0.9
2008	-1.5	-0.5	-1.0	3.2	3.8	4.9	59.8	0.9	-0.2
2009	-7.0	-3.7	-3.5	1.9	1.6	5.2	61.5	-0.8	1.1
2010	2.5	-1.0	3.6	2.6	2.5	-1.0	61.3	3.3	1.1
2011	0.8	0.3	0.5	2.1	1.9	1.4	61.4	0.7	-0.7
				Total economy					
1996-2000	1.8	0.8	1.0	3.4	2.7	1.6	64.9	2.7	1.0
2001-2005	1.0	0.8	0.2	3.2	3.1	3.0	63.2	0.3	0.7
2006-2010	-0.2	-0.3	0.2	2.6	2.6	2.4	64.9	0.9	0.7
2008	-1.1	-0.4	-0.8	3.4	3.8	4.6	64.6	0.8	..
2009	-5.6	-2.9	-2.8	1.8	1.7	4.7	66.1	-0.5	1.1
2010	2.1	-0.9	3.0	2.3	2.3	-0.7	65.9	2.7	0.7
2011	0.6	0.1	0.5	1.4	1.4	0.9	65.8	0.3	-1.3

Source: Based on Istat, national accounts (NACE 2007).
(1) Value added at base prices, chain-linked volumes, reference year 2005. – (2) The introduction of the regional tax on productive activities and the simultaneous elimination of some employers' contributions in 1998 caused a significant break in the series. – (3) Compensation per standard employee labour unit as a percentage of value added per standard labour unit at base prices, chain-linked volumes, reference year 2005. – (4) Percentages; value added at base prices. – (5) Labour income per standard employee labour unit deflated by the value added deflator at base prices. – (6) Compensation per standard employee labour unit deflated by the consumer price index. – (7) Includes wholesale and retail trade and repairs, accommodation and food services, transport and storage, information and communications, financial and insurance, real-estate, professional, scientific and technical, administrative and support services.

Despite the limited gain in earnings per full-time equivalent worker, unit labour costs in the entire economy rose by 0.9 per cent last year after falling by 0.7 per cent in 2010 (Table 9.4). The increase was due to the slowdown in labour productivity growth from 3.0 to 0.5 per cent. Unit labour costs in industry excluding construction increased by 2.0 per cent; after recovering in 2010 productivity in the sector barely grew, as in the rest of the economy.

The distribution of earnings and household income

According to the Bank of Italy's biannual survey of household income and wealth, between 2008 and 2010 the real per capita monthly earnings of full-time employees, net of taxes and social security contributions, rose by 0.8 per cent; the gain was larger for women (2.0 per cent). The percentage of low-paid full-time employees increased by 0.3 points to 9.4 per cent (Table 9.5). With the expansion of part-time jobs, total employees' average net earnings declined by 0.2 per cent, owing entirely to the fall of 1.0 per cent in the South.

Table 9.5

Real net monthly earnings (1)
(in euros at 2010 prices; amounts and per cent)

	2000	2002	2004	2006	2008	2010
			Total employees			
Average earnings	1,410	1,440	1,468	1,489	1,442	1,439
Men	*1,539*	*1,562*	*1,592*	*1,622*	*1,590*	*1,586*
Women	*1,220*	*1,266*	*1,291*	*1,311*	*1,251*	*1,253*
Centre and North	*1,466*	*1,494*	*1,527*	*1,549*	*1,503*	*1,503*
South	*1,267*	*1,305*	*1,307*	*1,332*	*1,289*	*1,276*
Gini index (2)	0.240	0.251	0.242	0.233	0.237	0.237
Inter-decile ratio (3)	3.1	2.9	3.0	2.8	2.8	2.9
Percentage of low-paid workers (4)	16.9	17.8	15.4	16.3	16.5	18.4
Men	*11.2*	*10.7*	*9.7*	*10.0*	*9.2*	*10.4*
Women	*25.4*	*28.0*	*23.4*	*24.7*	*26.0*	*28.5*
Centre and North	*13.3*	*15.0*	*13.2*	*13.8*	*13.0*	*15.6*
South	*26.5*	*24.9*	*21.2*	*22.8*	*25.3*	*25.4*
			Full-time employees			
Average earnings	1,483	1,518	1,531	1,564	1,530	1,543
Men	*1,569*	*1,594*	*1,613*	*1,646*	*1,622*	*1,625*
Women	*1,330*	*1,390*	*1,393*	*1,432*	*1,384*	*1,412*
Centre and North	*1,531*	*1,569*	*1,596*	*1,630*	*1,590*	*1,606*
South	*1,351*	*1,386*	*1,357*	*1,392*	*1,377*	*1,380*
Gini index (2)	0.217	0.228	0.225	0.212	0.212	0.206
Inter-decile ratio (3)	2.4	2.6	2.5	2.4	2.3	2.2
Percentage of low-paid workers (4)	10.6	11.4	10.0	10.0	9.1	9.4
Men	*9.0*	*8.1*	*8.2*	*8.2*	*6.7*	*7.1*
Women	*13.4*	*16.9*	*13.0*	*12.7*	*12.8*	*13.2*
Centre and North	*7.4*	*8.6*	*7.5*	*7.2*	*5.9*	*7.0*
South	*19.3*	*18.4*	*16.7*	*17.1*	*17.1*	*15.7*

Source: Banca d'Italia, *Survey on Household Income and Wealth*, historical archives (version 7.0, January 2012).
(1) Main jobs. Earnings are deflated with the cost-of-living index and are net of taxes and social security and welfare contributions. Amounts in lire up to the year 2000 are converted into euros at the exchange rate of 1,936.27 lire per euro. – (2) The Gini concentration index ranges from 0 (perfect equality) to 1 (maximum inequality). – (3) Ratio of earnings at the 9th decile to earnings at the 1st decile. – (4) The OECD sets the "low-wage" cut-off at two thirds of the median of the distribution of earnings of full-time workers.

Equivalent real disposable household income diminished by 0.7 per cent between 2008 and 2010, less than the 3.6 per cent fall registered in the previous two years (Table 9.6). Households headed by an employee suffered a contraction of 0.5 per cent compared with one of 4.9 per cent in the previous two years, while those headed by a self-employed worker registered a gain of 1.6 per cent, partially recouping the 10.4 per cent decline between 2006 and 2008.

Table 9.6

Equivalent real disposable income of households (1) (2)

(amounts in euros at 2010 prices)

	2000	2002	2004	2006	2008	2010
Average equivalent income	18,358	18,789	19,613	20,375	19,634	19,495
Centre and North	*21,408*	*22,133*	*23,181*	*23,820*	*22,930*	*22,758*
South	*12,980*	*12,838*	*13,178*	*14,054*	*13,478*	*13,321*
Production worker, apprentice, sales assistant	*13,691*	*13,857*	*13,781*	*14,485*	*13,659*	*13,249*
Office worker, supervisor, teacher	*20,308*	*20,576*	*21,091*	*21,344*	*21,104*	*21,311*
Manager	*35,229*	*41,058*	*38,625*	*43,825*	*40,879*	*38,065*
Self-employed	*22,589*	*23,521*	*27,436*	*28,721*	*25,724*	*26,136*
Retired	*17,482*	*17,424*	*17,667*	*18,579*	*19,577*	*19,194*
Not employed, not retired	*7,374*	*6,724*	*10,055*	*7,922*	*7,191*	*7,513*
Gini index (3)	0.335	0.330	0.343	0.337	0.330	0.336
Centre and North	*0.293*	*0.292*	*0.306*	*0.304*	*0.295*	*0.302*
South	*0.357*	*0.329*	*0.334*	*0.324*	*0.326*	*0.331*
Inter-decile ratio (4)	4.6	4.4	4.5	4.4	4.5	4.6

Source: Banca d'Italia, *Survey on Household Income and Wealth*, historical archives (version 7.0, January 2012).
(1) Total income (including imputed rents of owner-occupied homes) net of direct taxes, divided by the national accounts deflator of household consumption and rendered comparable using the OECD-modified equivalence scale. The observations are weighted by the number of persons except in the calculation of the shares of low-income households, which are weighted by households. Amounts in lire up to the year 2000 are converted into euros at the exchange rate of 1,936.27 lira per euro. – (2) Employment status is that of the head of household, who is identified as the household member with the highest income from work or pensions. – (3) The Gini concentration index ranges from 0 (perfect equality) to 1 (maximum inequality). – (4) Ratio of earnings at the 9th decile to earnings at the 1st decile.

In 2010 wages and salaries made up 39.5 per cent of total household income, 1.2 percentage points less than in the survey for 2006. Income from self-employment accounted for 12.8 per cent, 2.3 points less than in 2006. The share of income from pensions and transfers rose by 1.9 points to 25.4 per cent and that of investment income by 1.5 points to 22.2 per cent.

Overall inequality in the distribution of household income as measured by the Gini index remained basically stable between 2008 and 2010, as in the previous ten years.

10. THE PRODUCTIVE ECONOMY AND STRUCTURAL POLICIES

Last year productivity growth in the Italian economy was again below that of the main European countries as has been the case for more than a decade. However, the performance of value added and productivity differed greatly across sectors and also between firms within each sector. A decline in some more traditional industries was counterbalanced by growth in the medium/high-tech sector. Firms already geared towards innovation and internationalization were those that fared best in the face of cyclical weakening.

Starting in the second half of 2011 a vast programme of reforms was undertaken to create the conditions to foster growth. Measures were passed to reduce the burden of bureaucracy and simplify administrative procedures, to make civil justice more efficient, to increase the level of competition particularly in the service sector, and to encourage the development of infrastructure and the use of ICT. Many of these measures require implementing provisions which will determine their overall effectiveness. Various studies indicate that structural reforms of this kind can significantly influence growth in the medium term.

Sectoral dynamics

Reflecting the weakening of the international economic cycle, production, in terms of value added, slowed more markedly in industry excluding construction (to growth of 1.2 per cent from 7 per cent in 2010) than in services (0.8 per cent from 1.4 per cent in 2010); the construction sector suffered a further contraction (-3.5 per cent compared with -5.6 per cent per year in 2008-09; Table 10.1).

In contrast to 2008-10, when almost all sectors were affected first by the recession and then by the recovery, in 2011 the performance of value added differed greatly according to sector. In manufacturing, the upward trend that began in 2010 was confirmed for basic metals and metal products, mechanical machinery and equipment and, to a lesser extent, pharmaceuticals and food products; growth in services was driven by the expansion in trade and the acceleration in accommodation and food services, and in professional and real-estate activities. By contrast, value added contracted sharply in firms producing electrical equipment, transport equipment, textiles and petrochemical products and those providing ICT and financial services.

In the last decade, the reduction in the weight of the traditional sectors (in particular textiles, clothing and leather goods) was to the benefit of medium/high-tech products. In Germany, a significant share of production has moved towards high-tech sectors.

Following a sharp recovery of 6.9 per cent in 2010, last year the value added of the energy sector grew by 3.8 per cent. According to estimates by Gestore dei Servizi Energetici (GSE), the generation of electrical energy from renewable sources reached 84.2 TWh in 2011, a figure more than 9 per cent higher than in 2010 and close to the goal set for 2020 under the national action plan for renewable energies.

Table 10.1

Value added and labour productivity by sector of economic activity
(per cent, annual averages)

	Share of total value added (1)		Value added (2)				Productivity (3)			
	2007	2011	2000-2007	2008-2009	2010	2011	2000-2007	2008-2009	2010	2011
INDUSTRY	**27.7**	**25.1**	**1.1**	**-8.4**	**4.4**	**0.1**	**0.3**	**-4.4**	**7.5**	**0.5**
Industry excluding construction	21.3	19.0	0.8	-9.2	7.0	1.2	0.8	-3.9	10.4	0.5
Mining and quarrying	0.4	0.4	-1.2	-8.8	7.2	2.2	-1.0	-5.5	10.2	1.5
Manufacturing	18.7	16.2	0.8	-10.3	7.0	0.6	0.8	-4.7	10.8	-0.2
Food products	1.8	1.8	-0.6	-4.4	5.4	1.3	-0.9	-2.9	7.4	-1.1
Textiles, clothing and leather	2.0	1.5	-2.0	-9.4	6.5	-3.4	0.8	-2.1	12.9	-1.6
Wood, paper, and publishing	1.3	1.1	-0.3	-8.9	3.0	-2.3	0.7	-4.9	4.9	1.6
Coke and refined petroleum products	0.4	0.1	-4.0	-14.0	21.7	-3.4	-4.2	-11.7	19.7	-4.9
Chemical products	0.7	0.6	-0.9	-10.6	8.2	-3.4	-0.6	-6.8	7.6	-5.4
Pharmaceutical products	0.5	0.4	2.7	-1.6	1.7	2.8	2.8	1.7	5.8	0.8
Rubber, plastic and non-metallic mineral products	1.8	1.5	0.9	-11.3	2.6	0.6	1.4	-4.8	6.0	0.3
Basic metals and metal products	3.3	2.9	2.7	-13.4	9.3	4.1	1.0	-6.7	14.6	0.1
Computers, electronic and optical products	0.7	0.6	1.2	-9.8	9.5	-2.7	0.8	-4.3	12.9	-0.4
Electrical equipment	0.9	0.8	2.4	-9.0	9.6	-5.7	1.8	-3.0	11.0	-8.8
Machinery and equipment	2.4	2.2	2.5	-11.7	13.1	7.9	1.0	-6.6	14.4	2.8
Transport equipment	1.2	0.9	0.5	-13.0	4.2	-3.9	0.8	-3.5	8.7	-5.2
Furniture, other industries, repairs and installation	1.8	1.7	1.0	-10.9	4.6	-0.7	0.2	-6.0	10.0	2.3
Electricity, gas, steam and air conditioning	1.5	1.6	1.8	-0.6	6.9	3.8	4.3	1.6	8.6	5.6
Water, sewerage, waste	0.7	0.9	0.0	-1.9	5.4	7.2	-2.5	-3.5	3.1	6.5
Construction	6.5	6.1	2.5	-5.6	-3.0	-3.5	-0.4	-4.9	-0.8	-0.4
SERVICES	**72.3**	**74.9**	**1.4**	**-1.6**	**1.4**	**0.8**	**0.1**	**-1.1**	**1.6**	**0.3**
of which:										
Trade and repairs	*11.2*	*11.1*	*0.5*	*-6.9*	*5.1*	*1.9*	*-0.2*	*-5.8*	*6.3*	*1.9*
Transportation and storage	*5.6*	*5.8*	*1.4*	*-4.3*	*1.2*	*0.1*	*0.3*	*-3.7*	*1.7*	*-0.3*
Hotels and restaurants	*4.2*	*4.2*	*0.4*	*-0.9*	*1.3*	*2.7*	*-1.5*	*-0.1*	*0.5*	*1.1*
Information and communication	*4.6*	*4.4*	*4.4*	*1.5*	*2.4*	*-1.3*	*2.9*	*0.4*	*5.4*	*-3.8*
Financial activities	*5.4*	*5.5*	*3.2*	*1.7*	*3.3*	*-0.7*	*1.6*	*1.9*	*5.4*	*-1.3*
Real estate activities	*12.8*	*14.1*	*1.0*	*-0.1*	*-1.1*	*1.5*	*-1.5*	*0.8*	*-3.8*	*-0.4*
Professional, administrative and support service activities	*8.6*	*8.7*	*1.4*	*-4.1*	*1.0*	*1.8*	*-1.6*	*-3.3*	*-1.0*	*-0.3*
TOTAL	**100.0**	**100.0**	**1.3**	**-3.4**	**2.1**	**0.6**	**0.2**	**-1.9**	**3.1**	**0.4**

Source: Istat, national accounts.
(1) At basic prices; current prices. – (2) At basic prices; chain-linked volumes. – (3) Value added at basic prices per standard labour unit; amounts at chain-linked volumes.

The growth of value added in the economy as a whole was largely reflected in that of labour productivity. Measured by real value added per standard labour unit, in 2011 productivity increased by 0.4 per cent (3.1 per cent in 2010), as a consequence of a contraction in manufacturing industry (-0.2 per cent) and in construction (-0.3 per cent) offset by the increases in the energy sectors and mining and quarrying industries (5.6 and 1.5 per cent respectively) and in the service sector (0.3 per cent). In the traditional industrial sectors, excluding food, productivity performed better than value added as a result of the reduction in labour input. In the other manufacturing sectors a certain degree of labour hoarding probably prevailed.

The performance of labour productivity, which largely reflects that of total factor productivity, has been unsatisfactory for more than a decade. After growing more than in the other main European countries from 1992 to 2000 (1.7 per cent on an annual average basis against 1.3 per cent in Germany and 1.1. per cent in France), the value added per worker in real terms in the whole economy slowed sharply in the following decade; between 2001 and 2007 it stagnated compared with average annual increases of 1.5 per cent in Germany and 1.1 per cent in France. The inability of the productive economy to increase its efficiency at rates comparable to those of its European competitors was seen in all the main sectors of economic activity and during the various cyclical phases, although it was most pronounced in industry.

Firms and growth

In 2011 the net business birth rate fell to 0.8 per cent, just above the 2008-09 figures, as a result of a marked reduction in new companies and, to a lesser extent, an increase in closures. More than 12,000 firms filed for bankruptcy, 7.4 per cent up on the 2010 figure which was, in turn, 19.8 per cent higher than the previous year. The increase in bankruptcies involved almost all the main productive sectors. In manufacturing, where more than one fifth of the total occurred, there was a slight fall with respect to the 2010 peak for the start of bankruptcy proceedings. The demographic trend for limited companies continued to be positive, in particular in the high-tech manufacturing sectors, confirming the transition of Italy's productive system towards more complex forms of organization.

Analyses based on the Bank of Italy's survey of industrial and non-financial service firms with 20 or more employees show that in all recent cyclical phases (the period 2000-07 with strong growth of the world economy, the recession of 2008-09, and the brief recovery of 2010) the performance of sales revenues and forecasts of future expansion are better for firms that are more export-oriented, innovative, and make large investments in R&D.

According to data from the Bank of Italy's survey limited to firms with at least 50 employees, in 2011 turnover at constant prices rose by 2.2 per cent for firms which had invested in R&D in the three years 2009-11 but remained more or less stable for the others. Growth in turnover was also significantly better for firms with at least 30 per cent of their earnings coming from sales abroad (up by 3.3 per cent against 0.4 per cent for the others). More than half of these growth differentials reflect company characteristics, other than from sectoral specialization, geographical location and company size, and are connected therefore to non-observable factors including, among others, the quality of the work force and of capital and managerial ability.

Despite firms' recent attention to research and innovation, total R&D spending in Italy is still low by international standards: 1.3 per cent of GDP in 2010 against an EU average of 1.9 per cent, 2.3 per cent in France and 2.8 per cent in Germany. This lag is mainly due to the private sector, because of the highly asymmetric size distribution of firms – marked by the small number of big companies and the predominance of small and medium-sized enterprises with inadequate organizational structures, which are unable to start up R&D activities and finance them. R&D spending is distributed much more unevenly in Italy than in other EU countries: in 2009 the top three companies by level of R&D spending generated 43 per cent of the total in the private sector, against 36 per cent in France, 31 per cent in Germany and 24 per cent in Spain.

Using R&D expenditure as an indicator can lead to underestimating Italian firms' efforts at innovating. This is because businesses tend to be small and so they often innovate without officially recording any spending on R&D. This is confirmed by the data published in Eurostat's *Community Innovation Survey,* according to which 40 per cent of Italian firms carried out product or process innovation in 2008 (against 64 per cent in Germany and 35 per cent in France). The innovations introduced by Italian enterprises are characterized, however, by a lower degree of innovative content. For most firms, product innovations are mainly incremental while process innovations consist mainly in the purchase of new machinery, in cases requiring relatively less organizational and financial commitment.

International trade is concentrated among a small number of larger firms. In France and Germany large firms (250 or more employees) account for about three quarters of all industrial exports; 80 per cent of exports originate from about a thousand firms; the ten largest exporting firms sell goods abroad for a value equivalent to 37 per cent of all exports in Germany and to 21 per cent in France. The distribution is more scattered in Italy: large firms account for about 50 per cent of exports, the top thousand exporting firms account for 57.7 per cent. Italy's productive economy, comprising mainly small and medium-sized enterprises, is struggling to diversify sales across more foreign markets and, when it succeeds, to expand them significantly.

The "network contract" (Law 122/2010) aims to mitigate the problem of firms' limited size while preserving their right to take strategic decisions independently. A network contract represents a preparatory stage for agreements between firms to cooperate in various different contexts and is intended to encourage firms to grow in size "by external means", strengthening their competitiveness and ability to innovate and establish themselves on international markets.

With Decree Law 201/2011 (the "Save Italy" decree), converted into Law 214/2011, which aimed to strengthen the capitalization of firms and therefore to foster "internal" growth, the Government provided for the deductibility from taxable income of the normal return on new equity capital according to the ACE (allowance for corporate equity) model, the total deductibility, for income tax purposes, of the regional tax on public activities (IRAP) on expenditure on employees, and an increase in the amount of the deduction from the IRAP tax base for the permanent hiring of specific categories of workers.

The institutional context for business activity

From the second half of 2011 on, numerous measures have been adopted with the objective of creating a more favourable institutional context for business activity. The most important interventions have been in administrative procedures and civil justice, sectors in which significant efficiency gains are possible.

Measures in the field of bankruptcy and company law aim to extend the legal instruments available to economic agents. Important benefits could come from adopting effective measures to fight corruption and thereby reduce the associated distortion to the allocation of resources.

Administrative simplification. – The reform process to reduce the burden of bureaucracy on firms and simplify procedures, under way for some time, took an important step forwards with Decree Law 5/2012 (the "Simplify Italy" decree), converted with amendments into Law 35/2012. The law contains provisions of a general nature to reduce the actual length of administrative procedures and to improve the quality of the regulation of business activity and a broad series of specific measures to reduce the costs. Some of the main measures adopted require the promulgation of implementing regulations. According to the estimates provided by the 2012 National Reform Programme, the measures to reduce administrative costs will generate a cumulative increase in GDP of 0.5 percentage points over a period of nine years.

Civil justice. – The recently approved measures aim to increase the efficiency of the civil justice system with organizational reforms and to reduce the caseload. The July 2011 public finance adjustment package (Law 111/2011 converting Decree Law 98/2011) introduced incentives to increase the productivity of courts' offices. With the second adjustment package of the summer, Law 148/2011 converting Decree Law 138/2011, the Government was mandated to reorganize the distribution of the court offices across Italy. The long-awaited measure is expected to produce economies of scale and of specialization by merging smaller offices. In pursuit of greater specialization, "business courts" will be set up to deal with highly complex litigation (Law 27/2012 converting the "Grow Italy" decree).

To reduce caseloads, in the summer of 2011 the single fee for bringing a case was increased and specific measures regarding social security cases were introduced (Law 111/2011). On 21 March 2012 the mediation/conciliation regulations entered fully into force with the extension of compulsory conciliation to cases involving condominiums and claims for damages as a result of road accidents.

Bankruptcy law. – Law 3/2012 introduced provisions for compositions with creditors for businesses which, due to their size and level of debt, are not subject to the bankruptcy procedures in force. For this reason, a procedure was established based on debt restructuring agreements.

Company law. – Law 27/2012, converting the "Grow Italy" decree, introduced the possibility for people aged under 35 to set up a simplified company limited by shares. This new form of company is characterized by a substantial reduction in the capital requirement, along the lines of the provisions of law in the main European countries (including the United Kingdom, France and Germany), although with no particular age restrictions. To prepare the memorandum of association, which remains a public document, shareholders do not pay any notary's fees.

The regulation of the special powers exercised by the Government over privatized companies in strategic sectors and of national interest (the so-called "golden share") was radically changed by Law 56/2012 converting Decree Law 21/2012. In order to harmonize national with Community law, the new rules reduce the margins for discretion in exercising these special powers.

Prevention of corruption. – A bill containing measures to prevent and suppress corruption has long been under examination by Parliament. In December 2011 the Minister for Public Administration and Simplification set up a commission to study the question and formulate proposals for strengthening the prevention of corruption in the public administration.

To stiffen the sanctions against corruption, the Government recently presented amendments to the bill, increasing the penalties for some illegal activities and introducing some new crimes such as influence pedalling. These measures appear to be in line with the longstanding recommendations of the OECD, the IMF and the Council of Europe.

Regulation and competition in the service sector

The measures to increase the level of competition in the service sector adopted since summer 2011 include broader provisions under Law 27/2012, converting the "Grow Italy" decree. These cover a wide range of areas and, overall, represent an important step forward towards greater competition in sheltered sectors. The National Reform Programme estimates for 2012 show that measures to stimulate competition and reduce entry barriers will produce a cumulative increase in GDP of 1.9 percentage points over a period of nine years.

As regards public services (local transport and public services), the measures have significantly improved the regulatory framework. A new regulatory authority for transport oversees railways, motorways, ports, airports and taxis. It has regulatory and punitive powers to ensure fair and non-discriminatory conditions of access to infrastructure, to foster efficient management, to contain costs for users and to guarantee minimum levels of service quality. Under Law 148/2011, the process of liberalization has begun again for local public services. However, following the June 2011 referendum, the water supply service is excluded. The rules provide for services to be awarded on a general basis through public tenders and to be organized into catchment areas best able to exploit economies of scale and differentiation.

In the gas sector, ownership unbundling was imposed on Eni and Snam (the Eni group holding company responsible for transportation, distribution, storage and regasification), which must be completed before 24 September 2013. Ownership unbundling, as was the case in the electricity sector, is expected to stimulate investment for the development of infrastructure (transportation, storage and regasification terminals), thereby strengthening the security of supply.

The regulation of professional services was the target of various interventions to reduce restrictions on business: the abrogation of compulsory fee schedules; the admissibility of advertising for informational purposes; the broadening of the possibility to do business as a company (even as limited liability companies open to non-professional shareholders, within certain parameters). To facilitate entry to the professions a limit of 18 months was placed on internships, which can also run parallel to the interns' university studies. Provisions were introduced making it obligatory to provide information to clients, even if this was slightly toned down in respect of the August 2011 public finance adjustment package (Law 148/2011) which stated that there must be a written agreement on fees.

In the sectors with formal limits to access (notaries, pharmacies), the Law acted to increase internal competition by increasing the planned number of practitioners and eliminating some restrictions to carrying out the activities. However, strict limits on contestability were upheld.

With the aim of facilitating business initiative, general provisions were introduced to remove some national, regional and local authority regulations, which place unwarranted and disproportional limits on starting up and running businesses. The effectiveness of the measures introduced will depend on the content of the implementing regulations that the central government and local authorities must pass before 31 December 2012. With reference to the retail trade, restrictions on opening hours and trading days were lifted. To ensure greater consistency between national and local regulations, the Antitrust Authority was empowered to take action against general administrative acts, regulations and provisions made by general government in violation of antitrust laws.

In order to eliminate any possible barriers to the full development of increased competition in the credit, insurance and financial markets, deriving from links determined by interlocking positions, a ban was introduced for members of administrative and control bodies and for top managers to hold analogous positions in competitor enterprises or groups.

Physical and technological infrastructure

Infrastructure. – From the summer of 2011 on, numerous measures were adopted to foster the creation of infrastructure in Italy, in particular under Law 106/2011 and the laws converting the "Save Italy" and the "Grow Italy" decrees. Legislative amendments were introduced to rationalize and simplify the official procedures for the award of public contracts as were provisions to improve transparency. Despite the improvement in the legislative framework, there are still many critical areas, in particular relating to the procedures for selecting private contractors and to the fragmentary way in which the sector has been regulated.

Specific attention has been dedicated to the role of private capital, with the introduction of numerous incentives to encourage such investment. Nevertheless, there is considerable room for improvement to ensure the clear and efficient allocation of risks and careful monitoring of works management.

The Italian digital agenda. – The development and dissemination of integrated telecommunications networks – next generation networks or NGNs – and the immediate removal of the digital divide is an essential element of growth and innovation policies, both for their anticyclical nature and for their multiplier effect which, for a group of OECD countries in the period 1996-2007, is estimated at one percentage point of GDP per capita for every increase of 10 percentage points of the broadband penetration rate. In the last few months the government has committed to making policies to modernize communications between general government, citizens and companies, to encourage the development of the demand for and supply of innovative digital services, and to increase the supply of broadband connections.

11. THE ROLE OF WOMEN IN THE ITALIAN ECONOMY

Notwithstanding the advances of recent decades, the economic participation rate of women is still considerably lower than that of men in Italy. In 2011 the country continued to be among the worst performers in the Global Gender Gap Index (ranking 74th out of 145 overall and 21st in the European Union), penalized above all by the economic participation and opportunity category (90th), while the gap in educational attainment was narrower (48th). Italy lags behind in women's access to the labour market, remuneration, career advancement, promotion to positions of leadership and new business initiatives.

The low participation rate of women has various causes. The lack of services for reconciling work and family life continues to hinder women's labour market participation in the early years of children's lives. Within families, even in couples where both partners work, domestic and childcare responsibilities weigh disproportionately on women. If left unacknowledged, attitudinal differences between women and men can lead to involuntary forms of discrimination.

International evidence shows the potential benefits of greater female participation in the labour market, in leadership roles and in boardrooms. A stronger female presence in the public administration coincides with lower levels of corruption and the allocation of resources oriented towards healthcare, social care services and education. Higher female employment is associated with purchases of goods and services otherwise produced at home, in particular for family care, stimulating the expansion of a market that is little-developed in Italy. It can increase the number of households with earned income and reduce the risk of poverty, with a rise in overall GDP. In the youngest segment of the labour force, the greater participation of women would have no negative effect on male participation rates.

The variety of the causes and the potential economic benefits suggest the need for broad-ranging interventions to reduce these gaps; the experiences of other countries in the areas of legislation, taxation and services can provide some useful indications.

The gender gap in the labour market and in firms

Employment and remuneration. – Last year in Italy the female employment rate among people aged 15-64 was 46.5 per cent, 21 percentage points lower than the male rate (the gap in 1993 had been almost 31 points). Even during the crisis the difference has continued to narrow, with a sharper fall in employment among men. The female employment rate is 55.1 per cent in the Centre and North; 30.8 per cent in the South. The North-South divide has gradually widened since 1993, owing to the faster pace of employment growth in the Centre and North. The gender gap is larger in the South, by almost nine percentage points with respect to the Centre and North; it is greatest in the 35-54 age group and is inversely proportional to educational attainment.

Women are more likely than men to be in less stable forms of employment and in the lowest-paid sectors (horizontal segregation). According to the Bank of Italy's surveys on household income and wealth, from 1995 to 2008 the wage differential between men and women averaged 6 per cent; controlling for individual and firm characteristics, at the end of the last decade it was around 13 per cent.

Top management. – Italian women are particularly underrepresented in management positions. Based on the Bank of Italy's survey of industrial and service firms, in firms with 50 workers or more women make up 33 per cent of the total staff, but only 12 per cent of managers. According to the Cerved Group, in the period 2008-11 the share of women board members in Italian firms with turnover in excess of €10 million held constant at around 14 per cent, with a greater proportion among the smaller firms. More modest, at around 9 per cent, was the share of women occupying "top management" positions (CEO or managing director, chair of the board of directors, sole director). Their presence was greatest in the personal services, tourism and fashion sectors, very limited in the finance and insurance sectors. In banks the share of women in the boards of directors, boards of auditors or in the post of director general rose from 2 per cent in 1995 to 7 per cent in 2011, mostly in the boards of auditors.

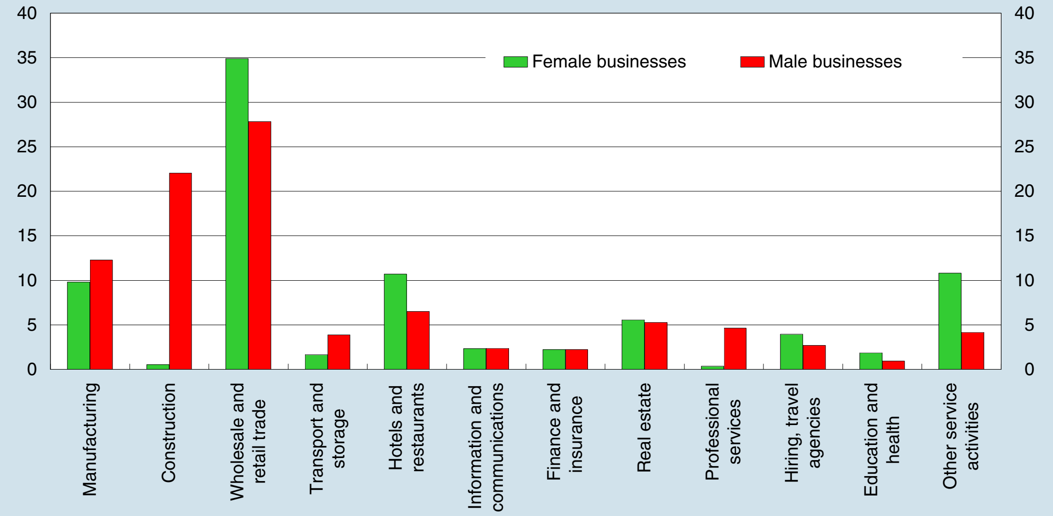
The proportion of women on boards in the subset of listed companies rose from 4.1 per cent in 2000 to 7.4 per cent in 2011. Last year's results may have been influenced by the provisions of Law 120 of 12 July 2011 on gender quotas which, starting in August 2012, requires listed companies to appoint at least 30 per cent of the less represented gender to their boards, albeit gradually (20 per cent in the first year) and temporarily (for three consecutive terms). A greater presence of women in the public administration could also have an impact on the use of public financial resources.

Firms. – At the end of 2011 the Observatory on Female Entrepreneurship established by Unioncamere identified 1,433,863 businesses owned or run by women, equal to 23.5 per cent of those registered (15.3 per cent for incorporated enterprises).

The largest share of women's businesses was in the South of Italy, notably in Molise (30.1 per cent), Basilicata (27.8 per cent) and Abruzzo (27.7 per cent), owing to the strong presence of female firms in the farm sector. By contrast Lombardy (20.2 per cent), Trentino-Alto Adige and Emilia Romagna (both at 20.7 per cent) recorded the lowest shares. The breakdown by sector of firms owned or run by women (Figure 11.1) may reflect differences in access to credit. Controlling for sector and size, the classification into male and female of corporations and partnerships active in Italy in the period 2005-10 does not reveal any significant differences in terms of profitability and productivity.

Figure 11.1

Breakdown of registered firms by sector (1)
(per cent; 2011)



Source: Based on data from the Observatory on Female Entrepreneurship, Unioncamere.
(1) Female businesses are incorporated enterprises in which the simple average of the equity stakes of female shareholders and of female directors exceeds 50 per cent; partnerships and cooperatives in which female partners are a majority; sole proprietorships owned by a woman and the other legal forms in which female directors are the majority.

Credit. – The survey on SMEs' access to finance in the euro area (SAFE) conducted by the European Central Bank provides some evidence on the financing conditions faced by these firms. From mid-2009 to mid-2011, data on over 26,000 non-financial firms in the main European countries are available. Firms in which the owner, director, or CEO is a woman are defined as *female*: these businesses make up about 12 per cent of the total. The data suggest that women's businesses have less recourse to external financing and rely more frequently on simpler forms of financing such as overdraft facilities. They turn to banks less often; the fear of a funding request being rejected is stronger among women than among men. Female entrepreneurs obtain the total amount of funds requested less frequently and are more likely to have a loan application turned down or approved only on terms that they consider unacceptable. No significant differences across countries are observable.

These descriptive statistics do not take account of firms' characteristics: on average those run or owned by women are younger; they operate primarily in the trade and services sectors; they seldom belong to groups; they are mostly small, and take the form of sole proprietorships. From the perspective of the lending bank, these characteristics are less desirable and may provide a plausible explanation for the gender differences in the probability of making a loan application, of obtaining the loan, and of rejecting the conditions offered by the bank.

Our analyses for Italy show that not only are sole proprietorships run by women more frequently obliged to provide personal guarantees, they also pay interest rates that are up to 30 basis points higher on overdrafts.

The roots of the gender gaps

Evidence of the magnitude and variety of gender gaps in Italy suggests a series of causes of varying degrees of persistence.

Education. – According to the population census conducted by Istat, in 1971 men aged 15-64 had on average one year more of education than women in the same age bracket; 40 years later, according to Istat's labour force survey, this gap had been closed. Less marked, but still observable, is the traditional concentration of women graduates in the humanities (47 per cent among women older than 44, 33 per cent among those younger); young female graduates display a greater preference for economics, law and social sciences, as well as for architecture and engineering.

Fertility. – Italy's low female labour market participation goes together with low fertility rates (1.4 children per woman, as in Germany, compared with 2.0 in France and Denmark in 2008). Based on the aggregate data, the employment rate is lower for women with children, by an average of about 6 percentage points for those aged 15-64. Analyses of individual data show, however, that in the long term and taking account of personal characteristics, in line with the estimates for the other countries, there is no negative causal link between motherhood and the female labour supply. The impact of fertility is negative when children are small; it persists in terms of employment type (qualification, working hours and contract) and career continuity.

Cultural factors. – By international standards, Italy is home to widespread prejudices which militate against women in the economy and society. An analysis of the distribution of care and domestic work, which is particularly uneven in Italy, provides further evidence on the role played by cultural factors. While in many other advanced economies, men and women work the same total number of hours – with men working more in the labour market and women more in the home – in Italy men work much less, because women devote more hours to domestic work, including by comparison with other European women. According to Istat's "time use" survey, in 2008-09 women did 76 per cent of work in the home, just 2 percentage points less than in 2002-03, and 9 points less than in 1989.

Our analyses show that work reduces the amount of time mothers spend with their children only marginally. Working mothers compress their free time and that spent on domestic tasks; by the same token, when mothers work, the time fathers spend with their children tends to increase. Work for mothers, therefore, appears to favour a more equitable distribution of childcare.

Reconciling work and family. – The availability of means of reconciling work and family commitments influences the decision on how much to work and where. Owing to the uneven distribution of roles between the sexes, shortcomings in the supply of care services (especially for the very young and the dependent elderly) have a greater impact on female participation choices. For instance, the availability of crèches is positively correlated with women's working hours outside the home.

Another decisive factor in the supply of labour is commute time, which is a work-related fixed cost. These costs can cause people to opt out of the labour market entirely, accept only very well-paid offers, or circumscribe their job search, inducing them to accept less favourable offers. The more pressing the requirements of family care, the greater the burden of home-work travel, as happens when there are small children and for women especially, who shoulder most of the housework. Again, according to Istat's "time use" survey, in 2008-09 working males on average spent 58 minutes commuting to and from work every day, as against 52 minutes for working women and 47 minutes for working women with children. Analyses based on the two surveys conducted in 2002-03 and 2008-09 show that higher average regional commute times are associated with a significant reduction in labour market participation by both men and women, and are a stronger deterrent to women, especially mothers. The time it takes to reach the workplace can also influence the choice of how many hours to work. Our research estimates that the impact of commute times on hours worked is negative for women and null for men.

Attitudinal differences. – Be they biological or cultural, attitudinal differences between the sexes are amply documented. Women have greater risk aversion, less among those in leadership positions; lower self-esteem, leading to a more modest overestimation of their own abilities; and a stronger aversion to competitive environments, which – based on several experiments – is associated with poorer performance in highly competitive environments. In situations where the labour market awards traits more commonly found in men, even when unrelated to specific job requirements, it is possible that "implicit" phenomena of discrimination will be generated, which may explain both the difficulties women experience in gaining access to the labour market and their slower career progression.

Equal opportunities

Legislation. – In Italy equal opportunities legislation was launched following similar initiatives in other European countries and spanned three phases. In the 1970s the law sanctioned the principle of equality in the various spheres of social and working life; the focus was primarily on safeguarding maternity rights and repressing discrimination in the workplace. From the end of the 1980s more incisive measures promoted women's participation in the labour market and active involvement in decision-making; the principle of equal opportunity progressively replaced the more "abstract" criterion of equality.

Finally, in the last decade Italy formally transposed the established European principle of gender mainstreaming, whereby equality is not an objective in itself but must be pursued in all areas. The Italian legislative framework is now formally aligned with that of the other European countries but significant differences remain in terms of actual implementation and therefore in how effectively the law combats gender disparities.

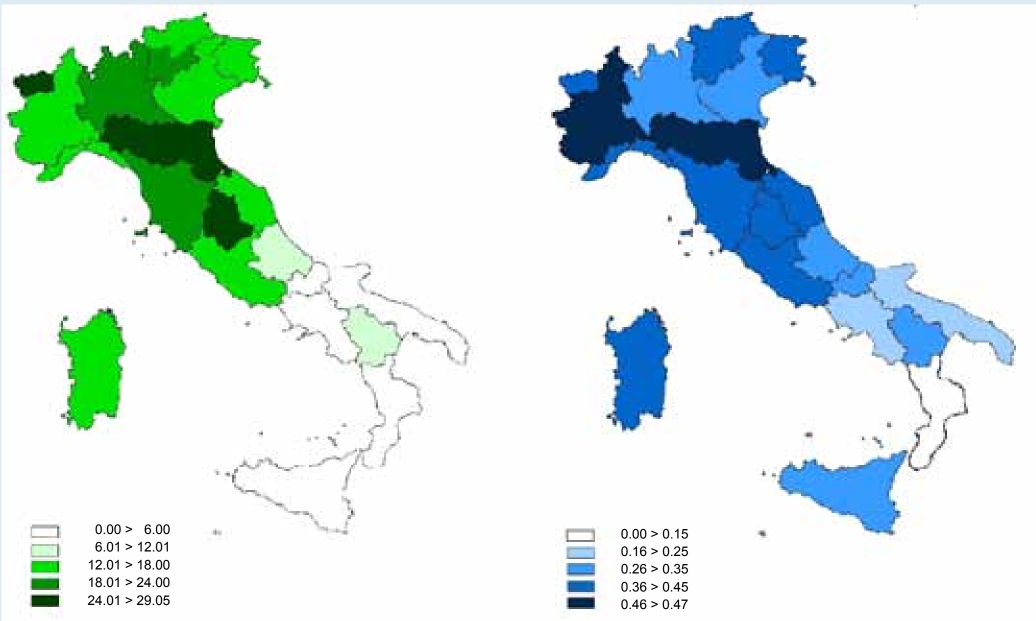
Experiences in other countries demonstrate the important role that certain policies can play in removing obstacles still present in Italy. Compulsory parental leave and educational programmes attentive to gender can attenuate the cultural obstacles: the availability of gender statistics can foster awareness and sensitivity to the issues. Outside of Italy an important role has been played by policies aimed at increasing the availability of care facilities for young children and the elderly (the index of childcare coverage for children aged under 3 is greater than 40 per cent in Belgium, Norway, Denmark, Sweden, France, and the Netherlands) and at creating incentives for the development of private sector services to households, by promoting the supply of quality services at low prices (the voucher model introduced in France, Belgium and the United Kingdom).

Taxation. – Italy taxes income on an individual basis, irrespective of sex or marital status. Tax credits for dependent family members, family allowances and means-tested income support measures can nonetheless be an employment disincentive to married women, increasing the tax rate of the household's second income earner. Estimates based on a structural model of labour supply show that taxation systems can influence female participation rates in the labour market.

Regional policies. – With the constitutional reforms of 2001 and 2003, the regions were given the power to introduce legislation to remove all obstacles to genuine equality between the sexes. The measures taken by the regions are often disjointed and only in some instances part of a comprehensive legislative framework. Policies for salaried employment, female entrepreneurship and reconciling work and family life also vary greatly from region to region.

Figure 11.2

Index of childcare coverage (1) *(per cent; school year 2009-10)*	**Index of gender equality by region** (2) *(per cent)*



Source: Istat, municipal supply of crèches and other socio-educational services for pre-school infants.
(1) Places available in crèches as a share of the population aged less than 3.

Sources: Based on Interior Ministry data; the Regions' websites; Istat, *Time Use Survey* and labour force surveys.
(2) The range of the indicator is from 0 (absence of parity) to 1 (full parity).

With the recession, the emphasis of the policies on employment has gradually shifted from support for women to more generalized help for disadvantaged workers, including women. Policies on start-ups have instead maintained more pronounced gender connotations. Among the conciliation policies, special importance has been assigned to crèches. However, the European objective of 33 places for every 100 resident children aged less than three is still far from being achieved, and the geographical divide has not narrowed; throughout the whole of southern Italy, with the sole exception of Sardinia, levels of coverage remain under 10 per cent (Figure 11.2). The recent Cohesion Action Plan approved by the Government rightly made significant allocations to extend the coverage of childcare services to the southern regions and to improve its quality. Among the other initiatives already in place almost all the Regions have adopted childcare voucher schemes, not least because they are mainly funded by the European Union.

While it is difficult to isolate policy effects, an indicator of the regional situation was constructed (which may also reflect the effectiveness of past regional policies), based on the differentials in labour market participation rates, remuneration, representation in leadership positions (separately for local politics and corporate management) and the use of time within the home. The 2010 indicator (Figure 11.2) shows that all of Italy's regions are far from assuring equality (if the Italian average is compared to that estimated for the other European countries, Italy ranks 21st out of 25) and vary considerably: Piedmont and Emilia Romagna are closest to the European average, Calabria furthest behind. A comparison with the 2005 results reveals only limited progress.

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

In 2011 the deficit on the current account of Italy's balance of payments improved slightly, narrowing from 3.5 to 3.3 per cent of GDP. The improvement was due to the reduction in the trade deficit, which benefited from the large rise in the surplus on non-energy products, especially in the machinery and metal products sectors. More than half the increase in the deficit on income was offset by the decrease in that on services.

The financial account showed significant reductions in the external liabilities of the public sector (€80.8 billion) and the banking sector (€74.4 billion); these decreases gave rise to net outflows that were more than offset by net increases in the external liabilities of the Bank of Italy (€184.4 billion) and the other sectors of the economy (€44.3 billion). Overall, these increases gave rise to net inflows amounting to €73.5 billion, which financed the current account deficit of €51.5 billion; the residual item, "errors and omissions", amounted to -€22.4 billion. The negative sign of this aggregate is consistent with an outflow of capital not captured by the official statistics.

In 2011 Italy's year-end net external debt amounted to 20.6 per cent of GDP, as against 24.0 per cent in 2010. The decrease was due to favourable valuation adjustments, which were larger than the current account deficit to be financed. The valuation of financial instruments at market prices reduced the liabilities of the public sector in the last part of the year, as the prices of Italian government securities fell with the increase in their yields.

The current and capital accounts

The deficit on the current account of the balance of payments contracted by €3.2 billion in Italy in 2011 (Table 12.1). In France it grew from 1.7 to 2.2 per cent of GDP, owing to the large increase of €19.8 billion (1 per cent of GDP) in the deficit on merchandise trade, more than half of which was offset by the increases in the surpluses on services and income. In Germany the overall surplus contracted by €3.0 billion, declining from 6.1 to 5.7 per cent of GDP, owing to the small decrease in the surplus on merchandise trade; the deficit on services continued to grow, while the surplus on income contracted slightly.

Merchandise trade. – The *fob-fob* merchandise trade deficit fell to 1.1 per cent of GDP, after deteriorating sharply in 2010. The growth in exports, fuelled as in the previous year by sales of intermediate products and investment goods, slowed from 15.6 to 11.4 per cent, reflecting the slackening of world demand that began in the first half of the year. The growth in imports slowed more sharply, from 23.1 to 9.5 per cent; the fall in industrial production affected imports of intermediate products, while the decline in fixed investment contributed to the stagnation of imports of investment goods. There was a decrease in imports of electronic products, especially those of photovoltaic cells, which contracted by nearly €2 billion after rising sharply in 2010 in conjunction with the peak in public incentives for renewable energy sources. The energy deficit increased again, rising to a new historical peak of 3.8 per cent of GDP, despite the contraction in import volumes, owing to the rise in the oil price. The surplus on non-energy products increased significantly after declining in 2009-10; this was mainly due to the result for investment goods.

Table 12.1

Balance of payments (1)
(billions of euros)

	2007	2008	2009	2010	2011
Current account	**-19.9**	**-44.9**	**-30.2**	**-54.7**	**-51.5**
Goods	3.2	-2.1	0.8	-20.9	-16.6
Non-energy products (2)	47.9	55.3	41.5	29.5	43.3
Energy products (2)	-44.6	-57.5	-40.7	-50.4	-59.9
Services	-7.1	-8.6	-8.4	-9.2	-7.0
Income	-1.2	-19.4	-10.4	-8.3	-12.0
Transfers	-14.8	-14.8	-12.2	-16.3	-15.9
of which: EU institutions	*-8.4*	*-9.9*	*-7.0*	*-10.1*	*-10.4*
Capital account	**1.8**	**-0.2**	**-0.1**	**-0.6**	**0.4**
Intangible assets	-0.5	-1.0	-0.6	-0.7	-0.4
Transfers	2.3	0.9	0.5	0.2	0.8
of which: EU institutions	*3.3*	*2.2*	*1.6*	*1.5*	*2.7*
Financial account	**29.2**	**31.4**	**37.3**	**86.7**	**73.5**
Direct investment	-38.3	-53.1	-0.9	-17.7	-13.1
Outward	-70.3	-45.7	-15.3	-24.7	-34.0
Inward	32.0	-7.4	14.5	6.9	20.9
Portfolio investment	5.6	75.2	28.1	38.5	-34.4
Equity and investment funds	-5.9	61.9	2.6	-37.9	9.1
Debt securities	11.5	13.3	25.5	76.4	-43.5
Financial derivatives	-2.8	1.9	4.3	-4.7	7.5
Other investment	66.2	13.0	5.7	71.8	114.4
of which: monetary financial institutions (3)	*83.0*	*-18.5*	*-2.4*	*8.3*	*-73.2*
Change in reserve assets (4)	-1.5	-5.6	0.1	-1.0	-0.9
Errors and omissions	**-11.1**	**13.7**	**-7.1**	**-31.5**	**-22.4**

(1) From 2008 onwards the data in the table were obtained using the new system for gathering and compiling Italy's balance-of-payments statistics. The series prior to 2008 have been reconstructed for the sake of continuity with the later data. – (2) Based on Istat foreign trade data. – (3) Excluding the Bank of Italy. – (4) A minus sign indicates an increase in reserves.

In value terms Italian merchandise exports' share of world trade fell by 1 percentage point in the ten years from 2002 to 2011, from 3.9 to 2.9 per cent, which was a tenth of a percentage point down compared with 2010. France recorded a larger fall, from 4.8 to 3.4 per cent, and Germany a smaller one, from 9.4 to 8.6 per cent. By contrast with the

Italian and German declines, the French loss of share was concentrated between 2002 and 2007. Following the revision of the deflators recently adopted for the national accounts with effect from 2002, it is now possible to estimate Italian merchandise exports' share of world trade at constant prices and exchange rates using a comparable methodology to Italy's main European partners. According to this indicator, Italy's share of world trade in volume terms fell in the ten years from 2002 to 2011 from 3.6 to 2.7 per cent, which was the same as in 2010. The fall was in line with that recorded by France, from 4.7 to 3.5 per cent, while Germany maintained its share unchanged at 9.0 per cent.

The reduction in the trade deficit reflected that in the deficit vis-à-vis the other euro-area countries, from €14.9 billion to €11.1 billion, as a result of exports outpacing imports. There was a small increase in the surplus vis-à-vis the remaining EU countries, while the deficit vis-à-vis non-EU countries remained basically unchanged at €15.1 billion.

After marking time for two years, the trade surplus with France jumped by €3.3 billion, renewing the expansion under way since 2004. Contributory factors included the fall in imports and the good performance of exports of electronic products, transport equipment and machinery. The deficit with Germany turned downwards, falling by €2.0 billion: exports of metal goods and machinery grew faster than imports, while the reduction in purchases of photovoltaic cells caused imports of electronic products to decline. The trade surpluses vis-à-vis Spain and the United Kingdom contracted by a total of €1.8 billion owing to the stagnation of Italian exports, which were affected by the weakness of domestic demand in these two countries.

Trade with the OPEC countries contracted by about 1 per cent, powerfully influenced by the fighting in Libya. Excluding this country, Italian exports to the OPEC area grew by 12.4 per cent (one percentage point more than the average) while imports surged by 34.4 per cent, driven by the 25.4 per cent increase in the oil price in euros. The collapse in imports of energy products from Libya was made up for by purchases from Saudi Arabia, Azerbaijan, Angola and Russia. The increase in Italy's trade deficit with the latter was curbed by the growth in exports of machinery and clothing.

Italy's largest trade deficit was again that with China, although it shrank slightly from €19.0 billion to €18.5 billion thanks to the large drop in Italian imports of transport equipment. There was a sharp increase in the trade surplus with Switzerland, from €5.6 billion to €9.3 billion. In addition to the good performance of the exports of traditional Italian products, which benefited from the strengthening of the Swiss franc against the euro, there was a large increase in sales of metal products. In fact Switzerland took more than 71 per cent of Italy's exports of gold, for a total of €6.0 billion, up from €3.0 billion in 2010. There was a further increase in the surplus on merchandise trade with the United States, thanks to the contributions of machining products and transport equipment other than motor vehicles, which were offset only in part by an increase in the deficit on energy.

Services. – After peaking in 2010 the services deficit declined from €9.2 billion to €7.0 billion. The improvement was due to the increase in the surplus on travel and, to a lesser extent, to the reduction in the deficit on "other business services".

The surplus on travel, which accounts for about a third of trade in services, fell sharply from 2007 to 2009 and then stabilized in the following year. Its growth in 2011, from €8.8 billion to €10.3 billion, was almost entirely due to the greater spending of foreign tourists in Italy.

In 2011 international travel receipts at current prices increased by 5.6 per cent, an acceleration on the previous year. Receipts from vacations, which account for nearly three quarters of personal travel, increased by 11.4 per cent compared with the previous year and fuelled the increase in the broader aggregate. After recovering moderately in 2010, receipts from business travel declined by 0.9 per cent. The acceleration in tourism receipts was due above all to flows from the countries that are traditionally the major sources of visitors to Italy (Germany, the largest market, France and the United States), except for Spain, where tourists were discouraged by the country's economic situation, and Switzerland.

The growth in Italian travellers' spending abroad slowed from 2.0 per cent in 2010 to 0.8 per cent last year. The increase in spending on vacations virtually came to a halt, falling from 4.4 per cent in 2010 to 0.2 per cent in 2011, when it was influenced in the second half of the year by the sharp deterioration in consumer confidence. Spending on business travel, which in 2008-09 had fallen by 13.5 per cent compared with 2007, showed a modest increase for the second successive year. Whereas in the years following the outbreak of the international crisis Italians replaced some domestic travel with travel abroad, partly owing to the fall in air fares and the growth in the market share of low-cost carriers, according to Istat, the fall in the number of trips made by Italians in 2011 was the same for both domestic and international destinations.

The deficit on transport services in 2011 amounted to €8.4 billion (0.5 per cent of GDP) and remained just below the historical peak recorded in 2010.

Last year saw a further reduction in the deficit on services other than transport and travel, from €9.5 billion to €8.8 billion, in line with the trend under way since 2008. The main contribution to this result came from the increase in exports of "other business services" (merchanting, other trade-related services, professional services and services between related firms), the largest item in this aggregate, for which the deficit fell to its lowest value since 2005.

Income. – In 2011 the deficit on the income account, mostly in relation to investment income and much reduced in the two previous years, turned upwards, rising to €12.0 billion from €8.3 billion in 2010. The main contributory factor was the decrease of €2.5 billion in the surplus on direct investment income, reflecting a decrease in receipts of profits from abroad accompanied by an increase in interest expense on intra-group loans, both of which are included in this item. In the second half of 2011 the increase in the risk premium on liabilities issued by Italian residents also weighed on the other interest components of income; interest expense on portfolio investment in debt securities and on "other investment" (mainly deposits and loans) grew faster than the corresponding receipts. A positive, and growing, contribution came from portfolio investment in shares and investment funds, for which receipts rose faster than outlays.

Transfers. – The deficit recorded under current transfers declined slightly, from €16.3 billion to €15.9 billion. The deficit on private transfers contracted, despite a new increase in the deficit on workers' remittances, from €6.1 billion to €6.9 billion. The deficit on public transfers also showed a small increase, due almost entirely to the flows to and from Community institutions.

Investment

Direct investment. – The recovery in flows of Italian direct investment abroad gathered pace, especially in the form of intra-group loans. Outflows totalled €34.0 billion in 2011, a historically high level that was marked by the predominant share of other euro-area countries, to an even greater extent than in the three preceding years. Italy's European partners also produced the expansion of inward direct investment (accounting for €16.5 billion out of a total of €20.9 billion) after disinvesting in 2010.

Portfolio investment. – For the first time since 2000 there was a net outflow of portfolio investment amounting to €34.4 billion, after an inflow of €33.1 billion in the first half of the year. This compared with a net inflow of €38.5 billion in 2010.

In the first half of 2011 the flows reflected the return of confidence on the financial markets: Italians made net purchases of foreign assets despite their continuing to reduce their holdings of debt securities, while non-residents made net purchases of equities and bonds issued in Italy.

The worsening of the sovereign debt crisis in the middle of 2011 had a major effect on developments in the second half of the year. Italian households and firms began to sell foreign equities and investment fund units and accelerated their net sales of foreign debt securities, especially those with long maturities. Banks began to dispose of foreign bonds again and repositioned themselves at the short end of the term structure. Last year, for the first time since the 2008 financial crisis, Italians made net disposals of foreign portfolio assets; these amounted to €35.8 billion, of which debt securities accounted for €31.4 billion.

The impact on portfolio liabilities was even more pronounced. In the second half of 2011 non-residents significantly reduced their holdings, especially of medium- and long-term public debt securities. In the year as a whole non-residents made net sales of €74.8 billion of debt securities issued in Italy, of which €43.2 billion with maturities of more than one year. Disregarding price adjustments, these sales were equal to about 20 per cent of the purchases of corresponding securities made in the five previous years.

Other investment. – The "other investment" of the Bank of Italy saw a net inflow of €194.8 billion, most of which was in relation to the TARGET2 balance. Excluding the Bank of Italy and the banking sector, "other investment" saw a net outflow of €7.2 billion. The net ouflow of the banking sector amounted to €73.2 billion, in relation to the large reduction of €45.8 billion in fund-raising, above all on the interbank market, and the growth in lending, mainly in the form of intra-group transactions.

The net international investment position

In 2011, Italy's net external debtor position declined to €325.4 billion, or 20.6 per cent of GDP (Table 12.2). The increase of €73.5 billion in net borrowing on the financial account was more than offset by the €120.6 billion of valuation adjustments. The contraction in public sector liabilities as a result of the fall in market prices in the

Table 12.2

Net international investment position
(billions of euros)

	Stocks at end-2010 (1)	January-December 2011						Stocks at end-2011 (1)
		Flows (2)	Value adjustments			Change in stocks		
			Total	Exchange rate	Other			
	(a)	(b)	(c)=(d)+(e)	(d)	(e)	(f)=(b)+(c)		(a)+(f)
				Resident non-banks				
Assets	1,202.2	-5.6	-23.7	2.1	-25.8	-29.2		1,173.0
Direct investment	296.5	28.4	2.4	..	2.5	30.9		327.3
Portfolio investment	716.7	-48.6	-25.9	1.7	-27.6	-74.5		642.2
of which: equity and investment funds	*324.8*	*-3.2*	*-16.6*	*1.1*	*-17.7*	*-19.7*		*305.1*
Other investment	169.7	15.7	-0.5	0.5	-1.0	15.2		184.9
Derivatives	19.3	-1.2	0.3	..	0.3	-0.8		18.5
Liabilities	1,434.5	-42.1	-109.1	2.0	-111.1	-151.2		1,283.3
Direct investment	229.3	17.4	-9.5	0.1	-9.6	7.9		237.2
Portfolio investment	1,070.3	-69.9	-100.1	1.1	-101.2	-170.0		900.4
of which: equity and investment funds	*116.6*	*4.2*	*-22.9*	*..*	*-22.9*	*-18.7*		*97.9*
Other investment	112.8	8.5	0.5	0.8	-0.3	9.0		121.7
Derivatives	22.0	1.9	0.1	..	0.1	1.9		24.0
Net position	**-232.2**	**36.5**	**85.4**	**0.1**	**85.3**	**121.9**		**-110.3**
				Resident banks				
Assets	439.7	31.7	21.2	1.5	19.7	52.9		492.6
Liabilities	770.6	-42.6	-0.4	0.5	-0.9	-43.0		727.5
Net position	**-330.9**	**74.4**	**21.6**	**1.0**	**20.6**	**95.9**		**-235.0**
				Central bank				
Assets	193.6	6.7	13.7	1.3	12.4	20.4		214.0
Liabilities	3.0	191.1	..	..	..	191.1		194.1
Net position	**190.6**	**-184.4**	**13.7**	**1.2**	**12.4**	**-170.7**		**19.9**
				All sectors				
Total assets	1,835.5	32.9	11.2	4.8	6.3	44.0		1,879.5
Total liabilities	2,208.0	106.4	-109.5	2.5	-112.0	-3.1		2,204.9
Total net position	**-372.5**	**-73.5**	**120.6**	**2.3**	**118.3**	**47.1**		**-325.4**

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

last part of 2011 accounted for €69.2 billion. With the return of the spread on Italian government securities to the levels prevailing before the crisis, the corresponding valuation adjustments will cause a deterioration in Italy's net external debtor position.

Banks' net debtor position improved by €95.9 billion; the interbank deposit component of their assets increased while the corresponding component of their liabilities decreased, in line with the pattern of flows. A much smaller contribution came from the reduction in liabilities in the form of debt securities. The assets of the Bank of Italy grew by more than 10 per cent but its net foreign creditor position shrank from €190.6 billion at the end of 2010 to €19.9 billion, primarily as a result of the reduction in its TARGET2 balance, which shows an amount owing to the Eurosystem. The fall in the foreign liabilities of general government, mainly government securities held by non-residents, to €666.5 billion at the end of the year, was due not only to the value adjustments referred to above but also to the €73.5 billion of sales by non-residents recorded on the financial account.

13. THE PUBLIC FINANCES

General government net borrowing decreased in 2011 for the second successive year to 3.9 per cent of GDP, in line with the target. The impact of the marked deterioration of the economic situation during the year was essentially offset by the adjustment measures decided during the summer.

The improvement with respect to 2010 reflected a reduction in expenditure in relation to GDP, notwithstanding the increase in interest payments. Primary expenditure declined in nominal terms for the second year running. Both in 2010 and in 2011 capital spending declined sharply and current spending increased less than inflation.

In the second half of 2011 – as the economy deteriorated and financial market strains intensified – three budget adjustment packages were enacted, of exceptional overall magnitude (3.1 per cent of GDP in 2012 and 4.7 per cent in 2013). The second package, passed in August, was designed to bring budget balance forward to 2013. The third finally eased the strains in the government securities market. The spread between Italian and German government bonds narrowed until mid-March 2012 before widening again. In mid-May the spread was large but significantly below the maximum recorded in November. The fiscal adjustment had adverse effects on economic activity in the short term but averted a debt crisis.

For 2012, despite the forecast of a significant contraction in GDP, the Economy and Finance Document (EFD) estimates a further sharp drop in net borrowing to 1.7 per cent of GDP. This would more than comply with Italy's commitment to lower the deficit to under 3 per cent of GDP. Revenues are expected to rise by 2.6 percentage points to 49.2 per cent of GDP, an all-time high.

The results for the first four months necessitate close monitoring of the public finances over the next few months. At the end of April the Government began a spending review with the objective of lowering the expenditure projected by the Economy and Finance Document by €4.2 billion in 2012. The savings so achieved will go to meeting the deficit target and easing the tax burden, possibly by avoiding the VAT increase otherwise scheduled for October.

For 2013 the EFD forecasts a small deficit, corresponding to a surplus in structural terms, and an initial reduction of the ratio of debt to GDP. The ratio of revenue to GDP is expected to rise to 49.5 per cent. In 2014 the budget should be essentially in balance. According to the EFD estimates, the accounts will be compliant with the European rules without any additional interventions.

Table 13.1

Public finance objectives, estimates and outturn for the year 2011
(billions of euros and percentages of GDP)

	General Government				*Memorandum items*		
	Net borrowing	Primary surplus	Interest payments	Debt (1)	Real GDP growth rate (%)	Nominal GDP	Net borrowing 2010
Objectives							
Combined Report on the Economy and the Public Finances (May 2010)	….	….	….	….	1.5	1,606.0	78.1
as a percentage of GDP	*3.9*	*1.0*	*4.9*	*118.7*			*5.0*
Public Finance Decision 2011-13 (September 2010)	63.1	12.5	75.7	1.910.0	1.3	1,602.8	77.1
as a percentage of GDP	*3.9*	*0.8*	*4.7*	*119.2*			*5.0*
Economy and Finance Document (EFD) (April 2010) (2)	61.9	14.2	76.1	….	1.1	1,593.3	71.2
as a percentage of GDP	*3.9*	*0.9*	*4.8*	*120.0*			*4.6*
Estimates released in 2011							
EFD Update 2011 (September 2011)	61.7	14.9	76.6	….	0.7	1,582.2	71.2
as a percentage of GDP	*3.9*	*0.9*	*4.8*	*120.6*			*4.6*
Report to Parliament 2011 (December 2011)	60.9	16.4	77.3	….	0.6	1,586.4	72.0
as a percentage of GDP	*3.8*	*1.0*	*4.9*	*….*			*4.6*
Outturn (3)	**62.4**	**15.7**	**78.0**	**1,897.2**	0.4	**1,580.2**	**71.5**
as a percentage of GDP	*3.9*	*1.0*	*4.9*	*120.1*			*4.6*

(1) The estimates and objectives given in the official documents are not fully consistent, as the treatment of the effects of financial support to countries in difficulty and Italy's contribution to the European Stability Mechanism is not uniform. – (2) The EFD includes the Stability Programme. – (3) Sources: Istat and, for the debt, Bank of Italy.

Non-interest expenditure is forecast to decline in real terms this year and over the following two. The spending review must ensure that the targets are attained without jeopardizing the quality of public services. Additional savings and stepped-up action against tax evasion can allow a lowering of the present high tax rates.

THE PUBLIC FINANCES IN 2011

Budgetary policy for 2011: objectives and results

The objective for net borrowing in 2011 set in September 2009 was 3.9 per cent of GDP. To attain it, the three-year budget for 2011-13 (Decree Law 78/2010) called for corrections valued at 0.8 per cent of GDP (€12 billion) in 2011, including a 10 per cent cut in the allocations to ministries and the containment of employee compensation and pension outlays.

Table 13.2

Main indicators of the general government finances (1) *(as a percentage of GDP)*	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Revenue	44.1	44.7	44.3	43.9	45.5	46.5	46.5	47.1	46.6	46.6
Expenditure (2)	47.2	48.4	47.8	48.3	49.0	48.2	49.2	52.5	51.2	50.5
of which: interest payments	*5.6*	*5.1*	*4.7*	*4.6*	*4.6*	*5.0*	*5.2*	*4.7*	*4.6*	*4.9*
Primary surplus	2.5	1.5	1.2	0.2	1.2	3.4	2.5	-0.8	0.0	1.0
Net borrowing	3.1	3.6	3.5	4.4	3.4	1.6	2.7	5.4	4.6	3.9
Borrowing requirement net of privatization receipts	3.0	4.2	4.2	5.3	4.0	2.0	3.1	5.7	4.3	4.1
Debt	105.1	103.9	103.4	105.4	106.1	103.1	105.7	116.0	118.6	120.1

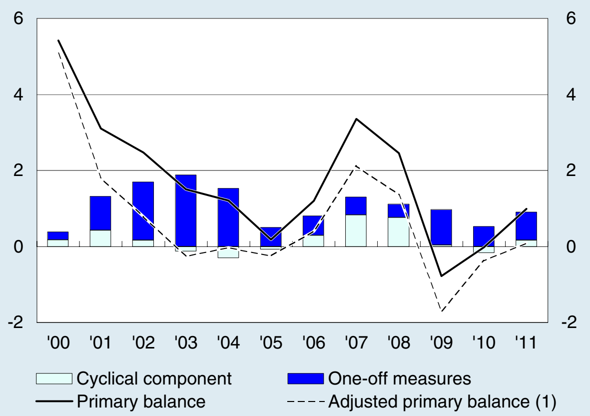
Source: Based on Istat data for the general government consolidated accounts items.
(1) Rounding may cause discrepancies. – (2) The proceeds of sales of public assets are recorded as a deduction from this item.

The revision of the official estimates in September 2011 lowered April's economic growth forecast for the year from 1.1 to 0.7 per cent and cut projected revenue growth accordingly. The revenue reduction was offset by the public finance packages enacted over the summer, whose effect on net borrowing in 2011 amounted to 0.2 per cent of GDP. The most important measures were the increases in the ordinary VAT rate from 20 to 21 per cent and in the stamp tax on securities deposits, together with some changes in the taxation of corporate income.

Net borrowing in 2011 was in line with the objective, with a reduction of 0.7 percentage points of GDP from 4.6 per cent in 2010 (Table 13.2). Net of interest expenditure there was a surplus of 1.0 per cent, compared with balance in 2010. The structural primary surplus, i.e. adjusted for the business cycle and temporary measures, improved by half a percentage point (Figure 13.1; for the methodology, see the Annual Report for 2006, Italian version, *Relazione Annuale sul 2006*, Chapter 11, section on "L'indebitamento netto nel 2006").

Figure 13.1

Primary balance 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.

General government revenue and expenditure

Revenue. – The GDP ratios of total government revenue and of tax plus social security receipts were broadly unchanged in 2011 at 46.6 and 42.5 per cent respectively, following the half-point decline recorded in 2010 (Table 13.3).

Table 13.3

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

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Direct taxes	13.8	13.3	13.3	13.2	14.3	15.0	15.2	14.7	14.6	14.3
Indirect taxes	14.2	13.9	14.0	14.1	14.8	14.6	13.7	13.6	14.0	14.1
Capital taxes	0.2	1.3	0.6	0.1	0.0	0.0	0.0	0.8	0.2	0.4
Tax revenue	**28.2**	**28.6**	**27.8**	**27.5**	**29.1**	**29.6**	**28.9**	**29.1**	**28.8**	**28.8**
Social security contributions	12.2	12.5	12.6	12.6	12.6	13.1	13.7	14.0	13.7	13.7
Tax revenue and social security contributions	**40.5**	**41.0**	**40.4**	**40.1**	**41.7**	**42.7**	**42.6**	**43.0**	**42.6**	**42.5**
Other current revenue	3.5	3.4	3.6	3.5	3.6	3.5	3.6	3.8	3.8	3.9
Other capital revenue	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Total revenue	**44.1**	**44.7**	**44.3**	**43.9**	**45.5**	**46.5**	**46.5**	**47.1**	**46.6**	**46.6**

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

Total nominal revenue increased by 1.7 per cent (€12.3 billion), fuelled by capital tax receipts, which doubled from €3.5 billion to €7.0 billion owing to the introduction of a substitute tax on real-estate leasing and the enlargement in the scope of the substitute tax on the alignment of fiscal and book values. A large part of the revenue increase was temporary. The growth in current revenue (1.3 per cent, or €9.0 billion) was less than the growth of GDP. Direct tax receipts were broadly unchanged (a decrease of 0.1 per cent), while indirect tax receipts rose by 2.0 per cent, owing principally to the rise in oil prices. Social security contribution receipts rose by 1.4 per cent.

The discussion of the individual taxes that follows considers only State budget receipts. Local taxes are discussed in the "Local government" section.

Personal income tax receipts declined by 0.5 per cent (€0.8 billion), reflecting a fall of 9.5 per cent (€2.2 billion) in the self-assessed portion, which was affected by the temporary reduction, decided in November, of 17 percentage points in the payment on account due at the end of 2011 (in 2010 receipts on this count had risen as a consequence of the reduction of the payment on account in 2009). Employee withholding tax receipts were stable, although total wages and salaries increased by 1.8 per cent. Receipts deriving from tax notices (consisting mostly in payments induced by procedures initiated by the tax authorities) increased by 33.1 per cent (€1.0 billion).

Corporate income tax receipts fell by 2.0 per cent (€0.8 billion) as a result of the termination of the effects of some substitute taxes introduced by the Finance Law for 2008 (€1.5 billion). Net of this amount, revenue increased by 2.0 per cent (€0.7 billion). The sharp increase of 44.9 per cent (€0.7 billion) in revenue from tax notices and the rise in payments on balance of 8.7 per cent (€0.6 billion) were partly offset by a 1.9 per cent decline in payments on account (€0.5 billion).

Revenue from withholding taxes on investment income declined by 4.3 per cent (€0.3 billion), far less than the fall registered in 2010. The decline mostly involved withholdings on interest on bank deposits, which fell by €0.6 billion as a lagged effect of the fall in interest rates. Other central government direct tax receipts increased by €2.8 billion, owing above all to the one-off rise in revenue from the substitute tax on the alignment of fiscal and book values (€3.5 billion), whose scope was broadened by the fiscal package passed in July 2011.

The rise in indirect tax receipts was due mostly to the substantial increase in the VAT levied on imports from outside the EU, which went up by 19.3 per cent (€2.7 billion), largely in connection with higher oil prices. However, VAT receipts on domestic transactions slipped by 0.6 per cent (€0.6 billion) despite the one-point rise in the ordinary VAT rate that went into effect in mid-September. Household consumption (the bulk of the VAT tax base) increased by 2.9 per cent, slightly more than the 2.4 per cent rise in total VAT receipts.

Expenditure. – In 2011 general government expenditure increased by 0.4 per cent and came to 50.5 per cent of GDP (Table 13.4). Primary expenditure declined for the second successive year (by 0.5 per cent each time), after having risen constantly since the period immediately following the Second World War. In both 2010 and 2011 current spending rose slightly while the capital component contracted sharply. The more effective spending control of these years may have been due to the adoption, starting in the summer of 2008, of multi-year budgets consistent with the fiscal targets.

Primary current expenditure went up by 0.3 per cent in 2011, reflecting the modest increase in intermediate consumption and the reduction in spending on employee compensation and social benefits in kind. Social benefits in cash expanded by 2.2 per cent. Pensions (accounting for some 85 per cent of this item) increased by 2.5 per cent. The non-pension component was essentially unchanged. The decline in employee compensation, by 1.2 per cent, was due to a decrease in the number of employees. Expenditure on social benefits in kind (90 per cent of it consisting in health care outlays) diminished for the first time in fifteen years, by 2.2 per cent. Intermediate consumption increased by 1.2 per cent. The spending of central government departments, after contracting in 2010, returned to growth of 1.0 per cent.

Capital expenditure, after the sharp decrease of 19.6 per cent in 2010, declined by 3.9 per cent, net of the proceeds (€3.8 billion) of sales of electromagnetic spectrum frequencies, which are entered in the accounts as a reduction in capital expenditure. The ratio to GDP,

Table 13.4

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

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Compensation of employees	10.6	10.8	10.7	10.9	10.9	10.6	10.8	11.3	11.1	10.8
Intermediate consumption	5.1	5.2	5.3	5.4	5.1	5.1	5.4	5.9	5.8	5.8
Market purchases of social benefits in kind	2.6	2.6	2.7	2.8	2.8	2.7	2.7	2.9	2.9	2.8
Social benefits in cash	16.5	16.7	16.8	16.9	16.9	17.0	17.6	19.2	19.2	19.3
Interest payments	5.6	5.1	4.7	4.6	4.6	5.0	5.2	4.7	4.6	4.9
Other current expenditure	3.4	3.6	3.6	3.7	3.6	3.7	3.8	4.2	4.1	3.9
Total current expenditure	**43.6**	**44.0**	**43.9**	**44.2**	**44.0**	**44.1**	**45.4**	**48.1**	**47.7**	**47.5**
of which: current expenditure net of interest payments	*38.1*	*38.9*	*39.1*	*39.6*	*39.3*	*39.1*	*40.3*	*43.5*	*43.2*	*42.6*
Gross fixed investment (2)	1.7	2.5	2.4	2.4	2.4	2.3	2.2	2.5	2.1	2.0
Other capital expenditure	1.9	1.9	1.5	1.7	2.7	1.7	1.5	1.9	1.4	1.0
Total capital expenditure (2)	**3.6**	**4.3**	**3.9**	**4.1**	**5.0**	**4.0**	**3.8**	**4.4**	**3.5**	**3.0**
Total expenditure (2)	**47.2**	**48.4**	**47.8**	**48.3**	**49.0**	**48.2**	**49.2**	**52.5**	**51.2**	**50.5**
of which: expenditure net of interest payments (2)	*41.7*	*43.2*	*43.1*	*43.7*	*44.3*	*43.2*	*44.0*	*47.9*	*46.6*	*45.6*

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.

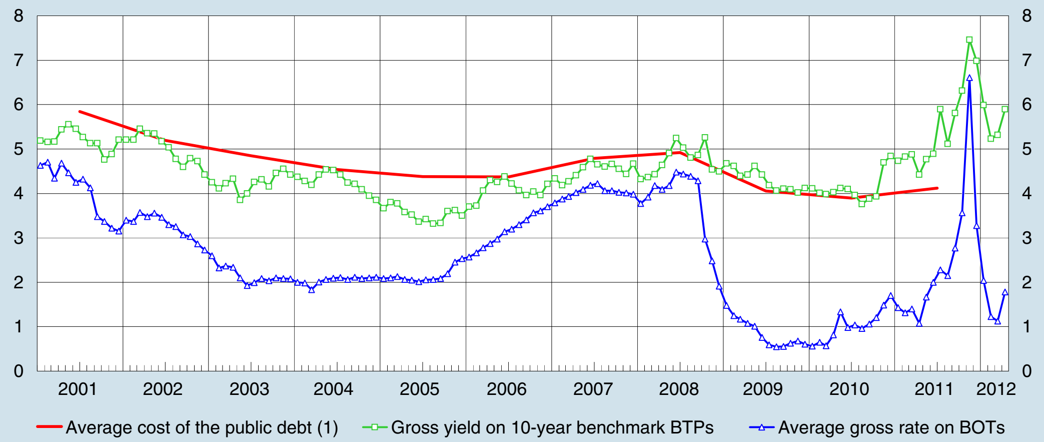
net of those proceeds, was 3.3 per cent, compared with an average of 4.1 per cent over the previous decade. Investment declined slightly (0.9 per cent, net of the proceeds of property disposals).

Interest payments increased by 9.7 per cent, owing mainly to the increase from 3.9 to 4.1 per cent in the average cost of the debt due to the rise in interest rates in the second half (Figure 13.2). Interest expenditure was increased by the effects of derivative transactions carried out starting in the 1990s; this effect amounted to €2.0 billion, as in 2010. Recourse to derivatives had reduced interest outlays by a total of €7.6 billion between 1998 and 2005; the additional spending on this count in the six years since then (€6.5 billion) has practically undone that gain.

At the start of 2012 there was a substantial outlay of about €2.5 billion for the closing-out and restructuring of some financial derivatives that the Treasury had entered into in the past with foreign financial intermediaries. While the payment counts towards the general government borrowing requirement, the effects on net borrowing, under Eurostat's statistical rules, are spread over the entire original duration of the contracts.

Figure 13.2

Gross yield on 10-year BTPs, average gross rate on BOTs and average cost of the public debt
(per cent)



(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.

General government borrowing requirement and debt

The borrowing requirement. – This diminished in 2011 from €67.2 billion to €63.2 billion, or from 4.3 to 4.0 per cent of GDP (Table 13.5), notwithstanding increased support to euro-area countries in difficulty. The central government borrowing requirement, which fell from €67.6 billion to €62.4 billion, was affected by increased payments in support of Greece (€6.1 billion as against €3.9 billion in 2010) and Italy's €3.1 billion share of the loans of the European Financial Stability Facility. In 2011 there were privatization receipts of €1.6 billion (as against practically nothing in 2010), consisting chiefly in banks' repayment of a portion of the bonds subscribed by the central government in 2009 in support of the financial system.

Table 13.5

General government balances and debt
(millions of euros)

	2007	2008	2009	2010	2011
Net borrowing	25,273	42,700	82,746	71,457	62,363
Total borrowing requirement	26,810	48,257	85,893	67,217	63,238
Borrowing requirement net of privatization receipts (1)	30,310	48,276	86,691	67,226	64,798
Debt	1,602,105	1,665,705	1,762,723	1,842,136	1,897,875
Memorandum items:					
Treasury deposits at the Bank of Italy	9,721	20,333	31,731	43,249	24,255
Loans to EMU member states	–	–	–	3,909	13,118
Average residual maturity of the debt (in years)	7.2	7.6	7.7	7.8	7.6

Source: For net borrowing, Istat.
(1) The privatization receipts are those of central government.

The disparity between the borrowing requirement and net borrowing. – The general government borrowing requirement, net of privatization receipts, exceeded net borrowing by 0.2 percentage points of GDP in 2011, compared with an average of 0.4 points from 2002 through 2010 (Table 13.6). The accumulation of financial assets (0.8 per cent of GDP, 0.6 points of which in respect of euro-area countries in difficulty), which increases the borrowing requirement but not net borrowing, more than offset the difference stemming from different accounting standards, as net borrowing (on an accrual basis) was 0.7 points higher than the borrowing requirement (on a cash basis). About half this difference was due to primary expenditure.

The debt. – The ratio of general government debt to GDP rose further, from 118.6 to 120.1 per cent, and from 118.4 to 119.3 per cent excluding the loans to other euro-area countries. The increase reflected the gap between the average cost of the debt and the expansion of nominal GDP (2.9 percentage points), only partly offset by the primary surplus of 1 percentage point and the factors that affect net borrowing but not debt (0.4 points).

Net issues of short-term securities were positive last year by €1.4 billion, compared with net redemptions of €17.5 billion in 2009-10. Those of medium- and long-term securities were negative by €43.8 billion. The share of securities held by non-residents fell from 52 per cent in 2010 to 46 per cent last year. The reduction was sharpest for short-term paper. Taking account of the estimated volume of Italian government securities held on behalf of Italian investors by foreign investment funds and managed portfolios, the effective share attributed to foreign investors is about 40 per cent (*Financial Stability Report*, April 2012, Chapter 4). The increase in the debt was virtually all accounted for by central government debt, which rose from 111.5

Table 13.6

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

		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
(a)	**Net borrowing (Istat)**	**3.1**	**3.6**	**3.5**	**4.4**	**3.4**	**1.6**	**2.7**	**5.4**	**4.6**	**3.9**
(b)	Balance of financial items (1)	0.3	0.3	1.0	1.3	0.6	0.5	0.2	0.6	0.5	0.8
	of which: loans to EMU member states	–	–	–	–	–	–	–	–	*0.3*	*0.6*
(c)	Cash basis minus accrual basis	-0.4	0.5	-0.4	-0.6	0.0	-0.1	0.4	-0.2	-0.7	-0.7
	primary balance	*0.0*	*0.8*	*-0.3*	*-0.4*	*-0.2*	*0.2*	*0.2*	*-0.5*	*-0.8*	*-0.6*
	interest payments	*-0.4*	*-0.2*	*-0.2*	*-0.1*	*0.3*	*-0.2*	*0.2*	*0.2*	*0.0*	*0.0*
(d)=(a)+(b)+(c)	**Public sector borrowing requirement net of privatization receipts (MEF) and including EFSF loans**	**3.0**	**4.4**	**4.1**	**5.2**	**4.0**	**2.1**	**3.2**	**5.8**	**4.4**	**4.1**
(e)=(g)-(d)	Difference between the general government and public sector borrowing requirements	0.1	-0.3	0.1	0.1	0.0	-0.1	-0.2	-0.1	-0.1	0.0
(g)	**General government borrowing requirement net of privatization receipts (BI)**	**3.0**	**4.2**	**4.2**	**5.3**	**4.0**	**2.0**	**3.1**	**5.7**	**4.3**	**4.1**
(h)	Privatization receipts (-)	-0.1	-1.3	-0.6	-0.3	0.0	-0.2	0.0	-0.1	0.0	-0.1
(i)=(g)+(h)	**Total borrowing requirement (BI)**	**2.9**	**2.9**	**3.6**	**5.0**	**4.0**	**1.7**	**3.1**	**5.7**	**4.3**	**4.0**
(l)	Change in the Treasury's deposits at the Bank of Italy	0.0	-0.6	0.2	-0.1	0.6	-0.8	0.7	0.8	0.7	-1.2
(m)	Issue discounts	-1.8	-0.2	0.0	-0.2	0.1	0.3	0.3	0.0	0.0	0.7
(n)	Change in the euro value of foreign exchange liabilities	-0.3	-0.2	-0.1	0.1	-0.1	0.0	0.0	0.0	0.0	0.0
(o)=(i)+(l)+(m)+(n)	**Change in the debt (BI)**	**0.8**	**1.9**	**3.7**	**4.8**	**4.7**	**1.2**	**4.0**	**6.4**	**5.1**	**3.5**
(p)=(a)-(o)	Difference between net borrowing and change in the debt	2.3	1.7	-0.2	-0.3	-1.2	0.5	-1.3	-0.9	-0.5	0.4
(f)=(a)-(g)	*Difference between general government net borrowing and the general government borrowing requirement*	*0.1*	*-0.6*	*-0.7*	*-0.9*	*-0.6*	*-0.3*	*-0.4*	*-0.3*	*0.3*	*-0.2*
(q)=(g)-(o)	*Difference between the general government borrowing requirement and the change in debt*	*2.2*	*2.3*	*0.5*	*0.5*	*-0.6*	*0.8*	*-1.0*	*-0.7*	*-0.8*	*0.6*

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, Combined Report on the Economy and Public Finances, and the Economy and Finance Document (EFD), various years; for loans to Greece and EMU countries via the EFSF, Eurostat; for general government borrowing requirement and debt, change in the Treasury's deposit 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 *Conti Finanziari* data, BI.
(1) Includes the changes in holdings of the following instruments: cash and deposits (net of the Treasury's deposits at the Bank of Italy), debt securities, shares and other equity (net of privatization receipts) and loans. In 2006, the cancellation of claims on TAV S.p.A. (€12,950 million) affected net borrowing but not the borrowing requirement; the discrepancy was assigned to the balance of financial items.

to 113.1 per cent of GDP (Table 13.7). The average residual maturity of the debt shortened from 7.8 years at the end of 2010 to 7.6 at the end of 2011.

General government trade payables. – Under European accounting rules, general government debt does not include trade payables. On the basis of surveys of supplier firms and data from financial intermediaries, the total outstanding trade payables of general government can be estimated to have been about 5 per cent of GDP at the end of 2011. Of this, about a fifth has been assigned to financial intermediaries. The

Table 13.7

Composition of the public debt by issuer (1) *(as a percentage of GDP)*										
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
General government	**105.1**	**103.9**	**103.4**	**105.4**	**106.1**	**103.1**	**105.7**	**116.0**	**118.6**	**120.1**
Central government	*101.4*	*98.6*	*98.0*	*99.3*	*99.0*	*95.9*	*99.0*	*108.7*	*111.5*	*113.1*
Local government	*3.4*	*5.1*	*5.3*	*6.1*	*7.1*	*7.1*	*6.8*	*7.3*	*7.1*	*7.0*
Social security institutions	*0.4*	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*

(1) Rounding may cause discrepancies.

stock of payables expanded by about 8 per cent during the year. Other things being equal, a rise in trade payables related to current spending results in an increase in net borrowing (the current component of which is on an accrual basis) in relation to the borrowing requirement (recorded on a cash basis). For 2011 the estimated rise in trade payables (more than 0.3 percentage points of GDP for current expenditure) is broadly consistent with the part of the difference between the two balances produced by the difference between primary expenditure on an accrual and a cash basis.

The Bank of Italy's surveys of industrial and service firms with at least 20 workers and of construction and public works firms indicate that suppliers' trade receivables vis-à-vis general government (including those assigned to financial intermediaries with recourse) came to about 4.5 per cent of GDP at the end of 2011, an increase of about 8 per cent during the year. In addition, there are the receivables assigned without recourse (which accordingly no longer figure on the supplier's accounts). The data furnished by intermediaries indicate that these claims amounted to about €8 billion (0.5 per cent of GDP) at the end of the year, an increase of 3 per cent.

The average time to payment of claims on general government, according to the survey of industrial and service firms, weighted by the amount of each firm's receivables, was 190 days, about 90 days of which the firms attribute to contractual terms. This estimate of lateness is only slightly greater than that found for Italy by the European Payment Index for 2011, based on a sample of 6,000 firms in 25 European countries. According to the Index, the average lateness of general government payments with respect to the contractual terms was 90 days in Italy in 2011 (86 in 2010 and 52 in 2009). Lateness was estimated at 108 days in Greece, 82 days in Portugal, 65 days in Spain and 36 days in Lithuania; in all the other countries it was under 30 days.

To ease the liquidity problems of suppliers, the Government acted in December (Article 13 of Law 183/2011), making it obligatory, in practice, for local government entities to certify credits and favouring the operations of the factoring company of the SACE Group. In January (Decree Law 1/2012, converted into Law 27/2012) it allocated €5.7 billion to settle part of ministerial trade payables, including by assignment of government securities. On 22 May 2012 the Government approved four decrees: two to standardize credit certification for central and local government entities and two regulating the use of certified credits to offset tax liabilities and their assignment to financial intermediaries.

Parliament is now discussing, as part of the Community Legislation Implementation Law for 2011, an enabling law for rapid transposition of Directive 2011/7/EU, with its more stringent rules on time to settlement of public and private trade payables.

Local government

The deficit of local governments diminished to 0.3 per cent of GDP in 2011, from 0.5 per cent in 2010. Revenue decreased but expenditure decreased more sharply (by 1.3 and 2.7 per cent respectively) for the second consecutive year. Revenue came to €238.5 billion (15.1 per cent of GDP). The decline with respect to 2010 reflected a drop in transfers from other government entities (by 9 per cent, to €102.5 billion); current transfers declined by 7.9 per cent to €94.7 billion and investment grants by 20.3 per cent to €7.8 billion. Local tax revenue increased by 4.9 per cent to €100.7 billion; indirect and direct tax revenues expanded at about the same pace, to €68.0 billion and €32.7 billion respectively.

Local government expenditure amounted to €242.9 billion (15.4 per cent of GDP). Current spending diminished by 1.1 per cent (compared with an average increase of 4.8 per cent over the previous decade), owing to declines of about 2 per cent in employee compensation and social benefits in kind, to €71.1 billion and €43.7 billion respectively. Intermediate consumption, though again decelerating, rose by 2.3 per cent to €65.1 billion. Capital expenditure, not counting property disposals, fell by 12.3 per cent to €31 billion, reflecting a contraction of 4.6 per cent in investment (to €23.8 billion) and of 7.9 per cent in investment grants. Excluding the accounting effect of offsetting transfers among public entities, the reduction in capital expenditure came to 5.0 per cent.

Municipal investment, which accounts for more than half of all local government investment and 40 per cent of total general government investment, decreased by about a quarter between 2004 and 2010.

Local authorities' use of derivatives. – For the third year running, in 2011 the number of local governments with financial derivatives in place with resident banks declined (from 233 to 214). The reduction was due to the ban on these instruments that went into effect in June 2008.

The implementation of fiscal federalism. – The implementation of Law 42/2009 on fiscal federalism will significantly change the way in which local governments are financed. The new system hinges on the introduction of standard costs (or requirements) as the criterion for resource allocation. The drafting of the implementing decrees has now been completed. Nine legislative decrees have been enacted, two of them specifically concerning the financing of local government: one on "municipal federalism" and one on the autonomous powers of taxation of ordinary-statute regions and provinces.

Some of these provisions were applied in 2011. For the municipalities of the ordinary-statute regions, a start was made on the replacement of central government transfers with a portion of the proceeds of property taxes and VAT. These resources are allocated to an experimental rebalancing fund, distributed according to criteria that essentially duplicate the distribution of the abrogated transfer payments. Provinces were given the possibility of instituting an earmarked tax and changing the base rate on the tax on motor liability insurance policies.

The implementing decrees defer the decisions on some crucial aspects of fiscal federalism, such as the determination of essential service levels and, for local governments, the definition of the fundamental functions and the extent of equalization of fiscal capacity in respect of the non-essential functions. The operational procedures for calculating standard costs and requirements are also still largely to be determined.

The savings required by the recent public finance adjustment packages have been distributed among levels of government on a proportional basis. To make the control of public spending more effective without sacrificing service quality, there is a need to speed up the transition to the new decentralized finance arrangements. It is important, from this standpoint, to complete the processes that have been begun, such as the determination of standard costs and requirements, the setting of service levels and the rationalization of the distribution of powers among levels of government.

BUDGETARY POLICY FOR 2012 AND THE MEDIUM TERM

Budgetary policy for 2012-14

The Stability Programme included in the April 2011 Economy and Finance Document (EFD) outlined a strategy of gradual readjustment, with a deficit of 2.7 per cent of GDP in 2012, as planned in the Combined Report on the Economy and the Public Finances in May 2010, and substantial balance in 2014 (Table 13.8). The EFD estimated that no additional measures would be required to hit the 2012 target, which is consistent with Italy's European commitment to bring the deficit below 3 per cent this year. The worsening growth outlook and the severe strains in the sovereign debt market in the second half of 2011 necessitated more ambitious objectives and exceptionally large corrective measures.

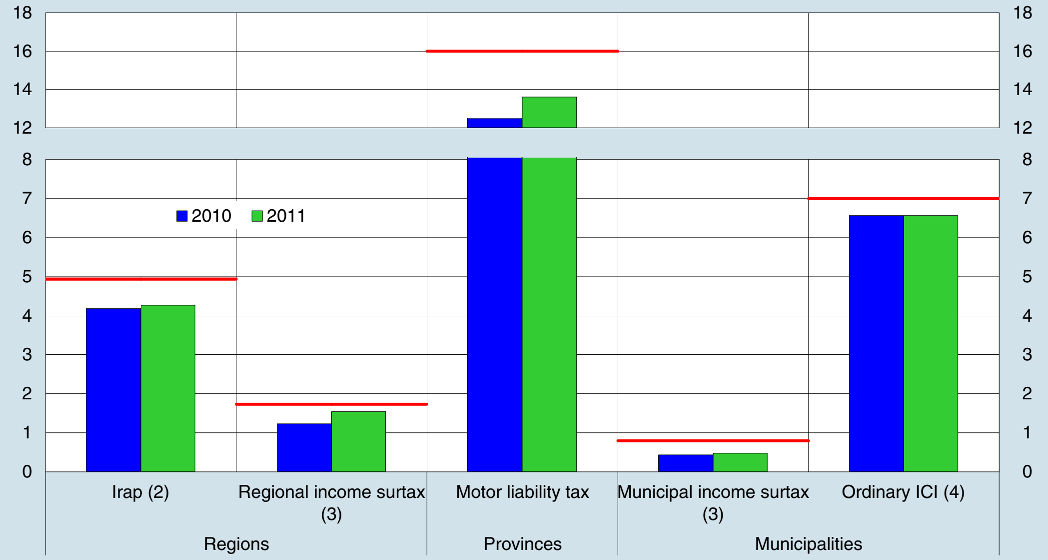
The Government presented its three-year budget ahead of schedule, in July. The impact was to be negligible in 2011 and 2012, and the measures procured virtually all the resources (€17.9 billion) needed to achieve the net borrowing requirement of 1.5 per cent of GDP in 2013 and 60 per cent (€25.4 billion) of those needed to balance the budget in 2014.

The Government also announced its intention to carry out the adjustment still necessary through a tax and welfare reform to be specified in an enabling law. The budget was quickly approved by Parliament, which augmented its effects and also introduced a safeguard clause providing that if the delegated powers are not exercised by 30 September 2013, the required resources (€4.0 billion in 2013 and €20.0 billion in 2014) will be procured by means of a flat across-the-board cut in tax exemptions, deductions and allowances.

As the conditions for the placement of government securities worsened, in August the Government passed a second budget package to bring the achievement of a balanced budget forward by one year to 2013. The package was passed by Parliament in September. The deadline for exercising the delegated powers was brought forward to

Figure 13.3

Main local government tax rates: 2010 and 2011 (1)
(per cent; for ICI, per mille)



Sources: Based on local government and Ministry of Economy and Finance data.
(1) The red line represents the maximum rate allowed by the law for each local tax. The Irap and regional income surtax rates can exceed that ceiling in the case of large health care deficits. – (2) The Irap rate is calculated as the average of sectoral rates weighted by each sector's share in the total tax base of private-sector persons derived from tax returns. – (3) Weighted averages according to the rate set by each local government for the tax base derived from income tax returns. – (4) Municipal Property Tax. Average of rates set by each municipality weighted according to proceeds derived from accounts certifications.

Table 13.8

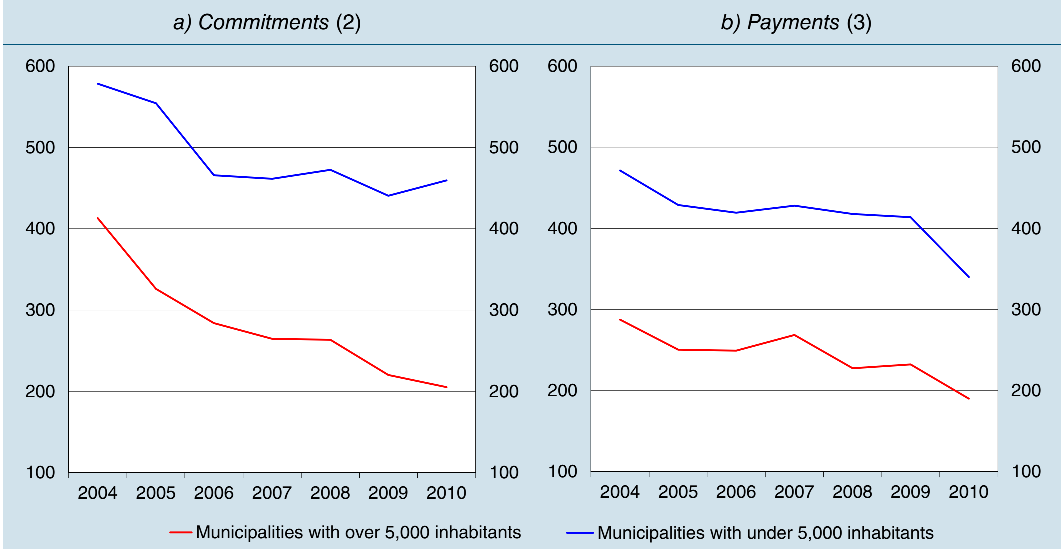
Public finance objectives and estimates for the year 2011
(billions of euros and percentages of GDP)

	General government				*Memorandum items*			
	Net borrowing	Primary surplus	Interest payments	Debt (1)	Real GDP growth rate (%)	Nominal GDP	Net borrowing 2011	Debt 2011
Objectives								
Public Finance Decision 2011-13 (September 2010)	44.3	35.8	80.2	1.956.4	2.0	1,664.9	63.1	1,910.0
as a percentage of GDP	*2.7*	*2.2*	*4.8*	*117.5*			*3.9*	*119.2*
Economy and Finance Document (EFD) (April 2011) (2)	44.9	39.2	84.0	….	1.3	1,642.4	61.9	….
as a percentage of GDP	*2.7*	*2.4*	*5.1*	*119.4*			*3.9*	*120.0*
EFD Update 2011 (September 2011)	25.3	60.5	85.8	….	0.6	1,622.4	61.7	….
as a percentage of GDP	*1.6*	*3.7*	*5.3*	*119.5*			*3.9*	*120.6*
Report to Parliament 2011 (December 2011) (3)	….	….	….	….	-0.4	1,612.3	60.9	….
as a percentage of GDP	*1.2*	*4.6*	*5.8*	*120.1*			*3.8*	*119.8*
Estimates								
Economy and Finance Document 2012 (April 2012) (2)	27.2	57.0	84.2	1.959.6	-1.2	1,588.7	62.4	1,897.2
as a percentage of GDP	*1.7*	*3.6*	*5.3*	*123.4*			*3.9*	*120.1*

(1) The estimates and objectives given in the official documents are not fully consistent, as the treatment of the effects of financial support to countries in difficulty and Italy's contribution to the European Stability Mechanism is not uniform. – (2) The EFD includes the Stability Programme. – (3) The data on which the Report to Parliament is based. Except for GDP, they were published in the Economic and Finance Document 2012.

Figure 13.4

Municipal investment expenditure (1)
(euros per capita)



Source: Based on Interior Ministry accounts certification data.
(1) Municipalities of ordinary-statute regions and those of Sicily and Sardinia to which the general rules of the Domestic Stability Pact apply. – 2) Capital account commitments net of financial items (equity participations, capital contributions, concession of loans and advances). – (3) Capital payments (on an accrual basis plus budget expenditure carryovers) net of financial items.

September 2012. All together, taking both these decree laws into account, the deficit reduction expected from the exercise of the powers delegated under the enabling law came to €4 billion in 2012, €16 billion in 2013 and €20 billion in 2014.

The 2011 EFD update, presented in September, takes account of the budget measures enacted during the summer; it revised the net borrowing target for 2012 down to 1.6 per cent of GDP, despite halving the Document's GDP growth projection to 0.6 per cent. In October the Government presented its draft Stability Law for 2012 (Law 183/2011), which made a marginal correction to the projected balances.

Despite the substantial adjustments approved during the summer, the interest rates on government securities rose further. At the end of October, in an official communication to the European Commission, the Government pledged to attain the objectives set in the summer and to undertake a broad reform plan to sustain economic growth, necessary to successful fiscal consolidation.

At the end of November, in exceptionally grave circumstances, a new executive was formed with the support of a large majority in Parliament. The new Government submitted a report on the public finances that estimated the current-legislation deficit (including the effects of the enabling act for tax and welfare reform) would be 2.5 per cent of GDP in 2012, 1.3 per cent in 2013 and 1.1 per cent in 2014. At the same time the Government approved a correction with structural effects to ensure attainment of the budget targets, officially estimating that it would reduce projected net borrowing by 1.3 percentage points of GDP in each of the three years.

The corrective measures involving pensions essentially bring to completion the revision of the system begun in the early 1990s by extending the contributions-based award formula, on a pro rata basis, to all workers in 2012. In addition, seniority pension eligibility standards were made stricter – by increasing the service requirement in 2012 to 41 years and 1 month for women and 42 years and 1 month for men, regardless of age, thus abrogating the eligibility standard consisting in the sum of service and age – and the old age pension requirements for women in the private sector were stiffened. The system was made more transparent by aligning the requirements for retirement with those for the payment of benefits. The measure abrogated the inflation indexation of pensions larger than three times the minimum in 2012 and 2013. The pension package will produce increasing savings in the years after 2014.

The measures also procure resources (€4.0 billion in 2012) to diminish, without altering the budget balance, the planned effects of the exercise of the delegated powers for tax and welfare reform, eliminating them entirely in 2012 and reducing them to €13.1 billion in 2013 and €16.4 billion in 2014. Most of the resources in respect of 2012 will derive from an increase in the intermediate VAT rate from 10 to 12 per cent and in the ordinary rate from 21 to 23 per cent as of 1 October 2012. The safeguard clause in connection with the enabling law is defined more precisely, with the provision that if the implementing measures or reductions in tax allowances sufficient to raise the expected resources are not in place by September 2012, the 2-point VAT increases will be permanent, with a further rise of 0.5 points in 2014 as well.

Overall, the measures approved from July to December – the three correction packages and the Stability Law – will make a fiscal adjustment estimated at €48.9 billion in 2012, €75.7 billion in 2013 and €81.3 billion (almost 5 per cent of GDP) in 2014 (Table 13.9).

The macroeconomic effects of the public finance adjustment. – The April 2012 EFD gives estimates of the repercussions on economic activity of the public finance adjustments enacted in the second half of 2011. One assessment, assuming that interest rates and economic agents' expectations are not altered by the measures, puts the cumulative recessive effect at 2.6 percentage points of GDP from 2012 through 2014. If instead the European Commission's Quest III Italy model is used to factor in the possible positive effect of improving expectations concerning the level of taxation, the recessive impact is reduced to 2.1 points.

The fiscal consolidation succeeded in stemming the fall in investors' confidence in Italy's ability to honour its debt, warding off much direr economic scenarios than those now foreseen.

It is estimated that a 100-basis-point reduction in the spread will result in additional GDP growth of about 1 percentage point in three years.

The latest estimates for 2012

The April 2012 EFD updated the public finance forecasts. By comparison with the planning estimates on which the December Report to Parliament for 2011 was based, it revises net borrowing in 2012 upwards from 1.2 to 1.7 per cent of GDP, owing mainly to the sharper contraction of GDP (by 1.2 instead of 0.4 per cent). The reduction in the projected primary surplus (by 1.0 percentage point) is expected to be only partly offset by a 0.5-point reduction in interest payments.

Tavola 13.9

Effects of the 2011 public finance measures on the general government consolidated accounts
(millions of euros)

	2011	2012	2013	2014
PROCUREMENT OF RESOURCES	**5,627**	**70,176**	**89,555**	**97,578**
Measures that increase revenue (A)	**3,655**	**45,460**	**60,448**	**63,570**
Tax/welfare reform and/or safeguard clause (1) (2) (4)	–	–	13,119	16,400
Increase in VAT rates (2) (4)	700	7,516	4,236	4,236
Municipal property tax + revaluation of assessments (4)	–	10,660	10,930	11,330
Gaming and excise taxes (1) (2) (4)	443	9,974	9,638	9,762
Stamp tax on securities and financial instruments (1) (4)	725	2,546	5,021	3,262
Tax on investment income (2)	–	1,421	1,534	1,915
Regional income surtax (4)	–	2,215	2,215	2,215
Corporate income surtax in energy sector (2)	–	1,800	900	900
Tax on assets under foreign asset disclosure scheme (4)	–	1,461	1,987	559
Municipal waste and services tax (4)	–	–	1,000	1,000
Alignment of fiscal and book values (4)	–	–	903	1,889
Increase in Irap in banking and insurance (1)	–	912	493	493
Revision of depreciation rates (1)	–	–	–	1,312
Increase in self-employed social security contributions (4)	–	1,063	1,471	1,886
Fight against tax evasion and new rules on collection (1)	145	2,779	3,836	3,826
Other measures (1) (2) (3) (4)	1,642	3,113	3,165	2,585
Measures that reduce expenditure (B)	**1,972**	**24,716**	**29,107**	**34,008**
Pensions (1) (2) (4)	–	3,491	8,462	10,547
Local governments (1) (2) (4)	–	6,985	9,185	9,185
Ministries (1) (2)	1,700	7,400	6,300	5,000
Health care rationalization (1)	–	–	2,500	5,000
Public employment (1)	–	–	64	1,104
Other measures (1) (2) (3) (4)	272	6,840	2,596	3,172
USE OF RESOURCES	**2,785**	**21,264**	**13,804**	**16,251**
Measures that reduce revenue (C)	**1,051**	**5,211**	**8,304**	**9,911**
Deductibility of normal return on new equity (4)	–	951	1,446	2,929
Deductibility of Irap from corporate and personal income tax (4)	–	1,475	1,921	2,042
Deductibility of Irap for women and young people (4)	–	149	1,690	994
Other measures (1) (2) (3) (4)	1,051	2,636	3,247	3,946
Measures that increase expenditure (D)	**1,734**	**16,053**	**5,500**	**6,340**
Local public transport and infrastructure fund (1) (4)	400	1,450	1,700	2,000
Road haulage (3) (4)	–	1,496	1,087	1,087
Other measures (1) (2) (3) (4)	1,334	13,107	2,713	3,253
Net change in revenue (E=A-C)	**2,603**	**40,249**	**52,142**	**53,659**
Net change in expenditure (F=D-B)	**-237**	**-8,663**	**-23,605**	**-27,668**
Change in net borrowing (G=F-E)	**-2,840**	**-48,912**	**-75,747**	**-81,327**
of which: DL 98/2011	*-2,108*	*-5,578*	*-24,406*	*-47,973*
DL 138/2011	*-732*	*-22,698*	*-29,859*	*-11,822*
2012 Stability Law	–	*-391*	*-162*	*-102*
DL 201/2011	–	*-20,245*	*-21,320*	*-21,430*
as a percentage of GDP				
Change in net borrowing (G=F-E)	**-0.2**	**-3.1**	**-4.7**	**-4.9**
of which: DL 98/2011	*-0.1*	*-0.4*	*-1.5*	*-2.9*
DL 138/2011	*0.0*	*-1.4*	*-1.8*	*-0.7*
2012 Stability Law	–	*0.0*	*0.0*	*0.0*
DL 201/2011	–	*-1.3*	*-1.3*	*-1.3*

Source: Based on official data published in the Economy and Finance Document 2012.
(1) Decree Law 98/2011, converted into Law 111/2011. – (2) Decree Law 138/2011, converted into Law 148/2011. – (3) Stability Law for 2012 (Law 183/2011). – (4) Decree Law 201/2011, converted into Law 214/2011.

Despite the economic contraction, the consolidation of the public finances is expected to gather momentum this year. The budget deficit is projected to diminish by 2.2 percentage points of GDP as the net result of an increase in revenue (2.6 points), unchanged primary expenditure and an increase in interest payments from 4.9 to 5.3 per cent of GDP.

Revenue is projected to rise to 49.2 percent of GDP, widening the already substantial difference with respect to the rest of Europe.

After the presentation of the EFD the Government initiated a spending review aimed at cutting outlays by a further €4.2 billion in 2012, with the objective of helping to attain the budget targets and limit the tax burden, possibly by avoiding the VAT increase otherwise scheduled for the fourth quarter. Each minister was to submit a spending containment plan consistent with the Government's targets by 31 May. In addition, a spending review coordinating committee chaired by the prime minister has been instituted and a special advisor for procurement rationalization appointed. If the spending curbs conform to target, primary expenditure will hold stable in 2012 at 1.0 per cent less than in 2009.

The Government forecasts that structural net borrowing will diminish by 3.2 percentage points this year to 0.4 per cent of GDP. The debt ratio will rise again, from 120.1 to 123.4 per cent, owing to the modest increase in nominal GDP and payments in support of euro-area countries in difficulty, estimated at 2.2 per cent of GDP. Loans to Greece, Ireland and Portugal (disbursed via the EFSF) are estimated at a total of €29.5 billion in 2012. In 2011 this support amounted to €9.2 billion: €1.6 billion each to Ireland and Portugal through the EFSF and €6.1 billion directly to Greece. In addition, payments of capital to the European Stability Mechanism will begin; Italy's contribution for 2012 is estimated at €5.6 billion.

The Commission's latest forecasts are a bit less favourable than those of the Italian Government. The decrease in net borrowing is put at 2.0 per cent of GDP this year and 1.1 per cent next. The primary surplus is projected to keep rising, to 3.4 and 4.5 per cent of GDP in the two years. The structural improvement in the primary surplus is projected at 3.4 percentage points in 2012 and 0.8 points in 2013. The Commission too expects the debt ratio to begin coming down in 2013.

The data for the first four months show the effects of the particularly poor economic conditions. The general government borrowing requirement, net of privatization receipts, came to €47 billion, nearly €4 billion more than in the corresponding period of 2011. The requirement was significantly increased by payments to other euro-area countries (about €14.5 billion, entirely as Italy's share of EFSF loans, compared with €4.7 billion in 2011). It was reduced by measures affecting the single State Treasury service, by which local government entities shifted about €9 billion that they had held with the banking system into deposits with the central Treasury. Net of these two factors, the increase in the borrowing requirement came to nearly €3 billion.

The requirement will be reduced significantly in the second half by the measures enacted at the end of last year (in particular the increase in the tax on property and the raising of VAT rates). It should also benefit from the stabilization of macroeconomic conditions.

Programmes and prospects for 2013-15

The April 2012 EFD estimates that the improvement in the public finances will continue over the next three years against a backdrop of slowly recovering economic growth (0.5, 1.0 and 1.2 per cent in 2013, 2014 and 2015). Net borrowing will decline to 0.5 per cent of GDP in 2013, and the budget will be broadly in balance in the following two years. The small deficit projected for 2013 (against the balance announced by the previous Government last summer and confirmed by the new one in December) reflects the sharp cyclical worsening of recent months. On a structural basis, in any event, there will already be a surplus in 2013 (0.6 per cent of GDP). The primary surplus is expected to rise to nearly 5 per cent in 2013 and to 5.7 per cent in 2015.

With the primary surplus steadily over 5 per cent, the reduction in aid to other European countries to €10.8 billion in 2013 and €3.9 billion in 2014 (including Italy's EFSF contribution), and the exit from recession in 2013, the ratio of debt to GDP will begin to decline next year, and by 2015 it should be down to 114.4 per cent, 9.0 points below the 2012 peak. Not counting financial support to the countries in difficulty, in 2015 the debt ratio would be 110.8 per cent. The EFD puts Italy's share of EFSF lending at €5.2 billion in 2013 and €1.1 billion in 2014. Capital contributions to the EFSF are estimated at €5.6 billion and €2.8 billion in the two years.

According to the EFD, nominal primary spending will be lower in 2013 than it was in 2009, which implies a cut of nearly 9 per cent in real terms. The decline could be more pronounced if the Government's spending review were to achieve significant gains in efficiency.

A series of measures have been introduced since the summer of 2011 to intensify the fight against tax evasion and bring concealed tax base into the light, and controls have been stepped up in recent months. Notwithstanding the gains registered starting in 2010, evasion remains widespread. Continued progress on this front will make it possible to lower tax rates even without diminishing the overall ratio of revenue to GDP.

In April 2012 the Revenue Agency released new estimates of evasion of VAT and Irap drawn from a comparison of those tax returns with national accounts data adjusted to approximate the bases of the two levies. It found that in 2010 VAT evasion was the lowest in the last thirty years; the undeclared tax base, after peaking at nearly 20 per cent of GDP in 2006, declined to 16.5 per cent in 2009 and 15.0 per cent in 2010. The amount of VAT evaded thus fell to 27.7 per cent of potential revenue, from 34.4 per cent in 2006 and 30.3 per cent in 2009. A contribution to the reduction came from the introduction on 1 January 2010 of stricter rules on tax credit offsets. As to Irap, the undeclared tax base was estimated in the three years 2007-09 at 21.6 per cent of the potential base (excluding general government, where evasion is nil by definition).

Compliance with the European budget rules. – According to the 2012 EFD, Italy's public finances will be in compliance with the European budget rules in the next few years with no need for additional corrections. Bringing the deficit below 3 per cent of GDP in 2012 will make it possible to close the excessive deficit procedure initiated in 2009. The structural adjustment (amounting to 3.2 percentage points of GDP in 2012 and 1 point in 2013) is well above the minimum of 0.5 per cent that the Stability and Growth Pact imposes on the countries that have not yet achieved their medium-term objective (for Italy, budgetary balance). A structural surplus of 0.6 per cent is projected for 2013 and about that amount over the following two years as well. According to these projections Italy will also be in compliance with the new spending and debt constraints introduced in December 2011.

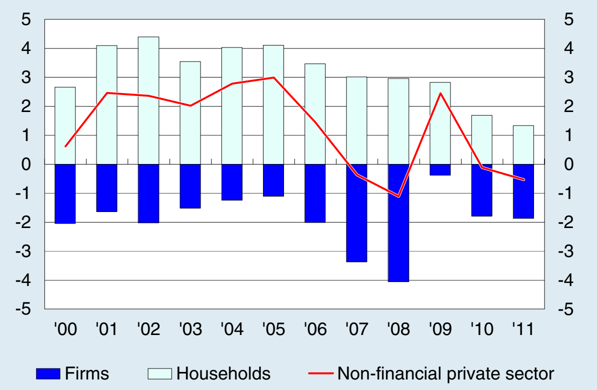
Finally, in April the principle of general government budgetary balance, net of cyclical effects, was inserted into the Constitution. This amendment is in line with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (including the so-called Fiscal Compact) subscribed in March and awaiting ratification by the member countries. The new principle will apply starting in 2014. The implementing rules are to be set by February 2013. They will govern the mechanism for correcting overshoots and the institution in Parliament of an independent body to monitor the public finances and assess compliance with the budget rules.

14. THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

The decline in household saving in 2011 pushed down the sector's financial surplus below the corporate sector's broadly unchanged external funding requirement. As a result, the overall non-financial private sector's financial balance was negative for the second year in a row, with a deficit equal to 0.5 per cent of GDP (Figure 14.1).

Figure 14.1

Financial balances of the non-financial private sector
(as a percentage of GDP)



Source: ISTAT.

The fall in securities prices was reflected in a contraction in households' financial wealth. The flow of financial investment was smaller than in the previous year and went mainly to government securities and bank bonds. Households' bank debt expanded less rapidly than in 2010, primarily as a consequence of the slowdown in loans for house purchases. This was due both to demand-side factors and to tighter supply conditions, consisting mainly of markedly greater margins on new loan contracts. The share of households whose debt servicing burden exceeded 30 per cent of income remained stable. The distribution of net wealth among households has become more unequal during the crisis and the financial situation of young households has worsened considerably.

Firms' financial condition began to deteriorate again in the summer as sales fell and the cost of money rose. Corporate balance sheets, made fragile by the prolonged weakness of the economy, are weighed down by a historically high level of debt in relation to both value added and equity. The sovereign debt crisis has been transmitted to firms mainly by the worsening of bank lending conditions, with higher interest rates and more severe customer screening. The percentage of firms reporting that they got less than the full amount of credit requested reached its highest level since the start of the crisis. The Government and trade associations revived or strengthened some measures adopted in the past years to facilitate access to credit. Firms' financial difficulties were reflected in an increase in anomalies on debt repayment and a marked rise in the number of bankruptcies.

Households' financial saving and wealth

The saving rate of consumer and producer households continued to decline in 2011, falling to 12.0 per cent of disposable income (8.6 per cent for consumer households alone).

With investment in real assets about the same as in 2010, the lower propensity to save was reflected in a reduction in households' financial surplus to 1.3 per cent of GDP, a historically low level (Figure 14.1). Gross financial wealth diminished by 3.1 per cent, falling from 3.4 to 3.2 times disposable income, owing largely to the drop in securities prices. Thanks to the stability of the value of real estate, total wealth net of liabilities decreased by a modest 0.9 per cent, remaining equal to nearly eight times disposable income, a high level by international standards.

Investment in financial assets. – In 2011 net purchases of financial assets amounted to €41 billion, less than in 2010 (Table 14.1). Investment was largely in government securities, mainly medium- and long-term paper (€47 billion), made attractive by high yields particularly in the second half of the year. The share of financial assets consisting of government securities rose over the year to almost 6 per cent, though this was still low by historical standards (in the second half of the 1990s the share averaged 14 per cent). Households' portfolios of bank bonds also resumed growing, chiefly in response to banks' supply policies. By contrast, sight deposits, deposits redeemable at notice and repos all diminished, especially in the second half of the year, offset only in part by the expansion in deposits with agreed maturity. Overall net investment in financial instruments issued by banks turned positive and these instruments again made up about 28 per cent of total assets.

The percentage of financial wealth invested in shares and other equity diminished from 23 to 20 per cent owing to the fall in equity prices; the volume of net purchases was also very small. Disposals of units of investment funds, especially Italian funds, exceeded purchases by €23 billion, but investment fund units continued to account for about 6 per cent of total financial assets.

The distribution of household wealth. – The Bank of Italy's survey on household income and wealth indicates that the concentration of financial wealth has increased. The share of financial assets held by the wealthiest 10 per cent of households rose from 44 per cent in 2008 to 47 per cent in 2010. More than 60 per cent of all financial assets are held by households whose head is older than 55. The share held by those whose head is younger than 35 has continued to diminish, falling below 4 per cent in 2010, more than 10 percentage points lower than the level recorded in the first half of the 1990s (Figure 14.2).

The vulnerability indicators also worsened more sharply for young households. The percentage lacking sufficient liquid financial assets to maintain a standard of living above the poverty line for at least six months in the event of total loss of income rose in 2010 to 17 per cent, nearly four points more than in 2008. For the total sample the corresponding increase was smaller, from 9 per cent in 2008 to 10 per cent in 2010.

Table 14.1

Households' financial assets and liabilities (1)
(millions of euros and per cent)

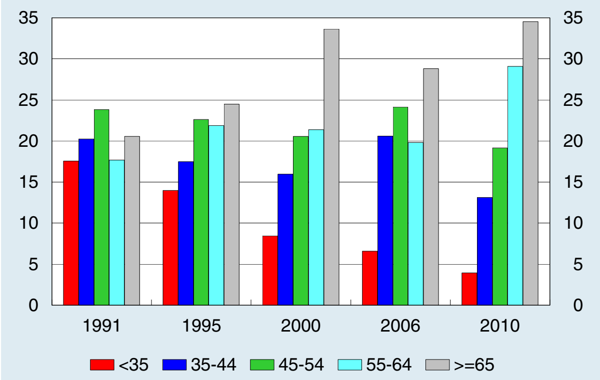
	End-of period stocks			Flows	
	2011	Percentage composition		2010	2011
		2010	2011		
ASSETS (2)					
Cash	118,303	3.1	3.3	5,304	6,363
Instruments issued by banks	1,014,505	27.7	28.5	-23,960	6,544
of which: sight deposits	*497,836*	*14.0*	*14.0*	*-10,140*	*-6,244*
other deposits	*143,010*	*3.6*	*4.0*	*-4,152*	*-757*
medium- and long-term securities	*373,659*	*10.0*	*10.5*	*-9,669*	*13,545*
Postal deposits and other postal savings (3)	330,151	8.9	9.3	11,904	4,363
Government securities	200,011	4.3	5.6	-17,635	61,329
of which: short-term	*24,294*	*0.3*	*0.7*	*-13,355*	*14,064*
medium- and long-term	*175,717*	*3.9*	*4.9*	*-4,280*	*47,265*
Medium- and long-term corporate securities	2,990	0.1	0.1	4,577	-17,388
Investment fund units	208,355	6.4	5.9	-1,968	-22,661
of which: Italian	*118,821*	*3.9*	*3.3*	*-19,300*	*-26,601*
foreign	*89,534*	*2.4*	*2.5*	*17,332*	*3,940*
Shares and other equity	703,864	22.7	19.8	53,375	11,459
of which: Italian	*663,688*	*21.6*	*18.7*	*51,811*	*9,447*
foreign	*40,176*	*1.1*	*1.1*	*1,564*	*2,012*
Other external assets	177,566	5.5	5.0	-1,425	-14,365
of which: deposits	*29,841*	*0.9*	*0.8*	*-3,153*	*847*
short-term securities	*402*	*0.0*	*0.0*	*11*	*43*
medium- and long-term securities	*147,323*	*4.5*	*4.1*	*1,717*	*-15,256*
Insurance, pension fund reserves and severance pay entitlements	678,878	18.4	19.1	27,711	4,687
of which: life insurance	*417,497*	*11.4*	*11.7*	*23,837*	*10*
Other financial assets (4)	119,507	3.2	3.4	4,092	653
Total assets	**3,554,132**	**100.0**	**100.0**	**61,975**	**40,985**
LIABILITIES					
Short-term debt (5)	60,151	6.2	6.4	852	1,318
of which: bank	*58,403*	*6.0*	*6.2*	*1,969*	*1,628*
Medium- and long-term debt (6)	658,342	70.2	70.3	32,611	17,968
of which: bank	*559,557*	*58.7*	*59.8*	*36,847*	*20,313*
Other financial liabilities (7)	217,423	23.6	23.2	5,157	1,463
Total liabilities	**935,916**	**100.0**	**100.0**	**38,620**	**20,749**
BALANCE	**2,618,216**			**23,355**	**20,236**

Source: Bank of Italy, financial accounts.
(1) Consumer households, producer households and non-profit institutions serving households. Rounding may cause discrepancies in totals. – (2) Individually managed portfolios are not shown. Their assets are included in the individual investment instruments. – (3) Postal current accounts, savings accounts and certificates. – (4) Accounts receivable and other minor items. – (5) Includes finance provided by factoring companies. – (6) Includes securitized loans, finance provided by leasing companies, consumer credit from financial companies and loans from other residents. – (7) Accounts payable, severance pay and pension provisions, and other minor items.

Household debt

Figure 14.2

Financial wealth by age group
(percentage composition)



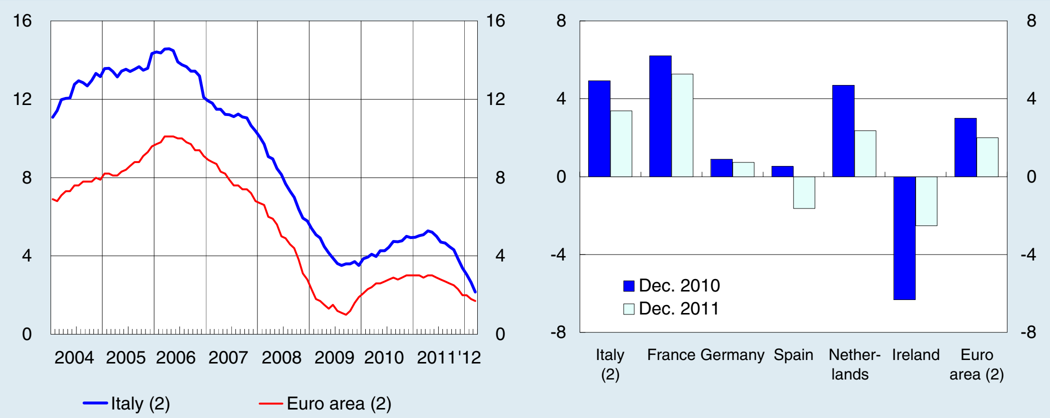
Source: Bank of Italy surveys on household income and wealth.

At the end of 2011 Italian households' financial debt stood at approximately 65 per cent of disposable income, a fairly low level by international standards; as regards loans for house purchases the ratio was particularly low.

Bank debt grew by 3.4 per cent, compared with 4.9 per cent in 2010, and decelerated progressively during the year. This trend continued in the first few months of 2012, bringing the twelve-month growth rate down to 2.2 per cent in March. The slowdown was sharper than in the euro area, where the growth rates in bank lending to households differed markedly from country to country (Figure 14.3). For consumer households alone it was less pronounced (Table 14.2), although the pace of lending other than loans for house purchases and consumer credit did slacken considerably. According to the surveys of banks, the let-up in lending was due both to demand-side factors and to a tightening of supply conditions in connection with banks' greater difficulty in obtaining funds because of the sovereign debt crisis. In the early part of 2012 banks reported less rigid credit supply conditions.

Figure 14.3

Bank lending to households (1)
(twelve-month percentage changes)



Sources: Based on supervisory reports and ECB data.
(1) Consumer households, producer households and non-profit institutions serving households. Loans include repos and bad debts. The percentage changes are calculated net of the effects of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. – (2) The percentage changes are calculated net of the effects of securitizations.

Loans for house purchases. – The stock of loans for house purchases by consumer households expanded by 3.6 per cent, slowing in the final part of the year. Its rate of growth continued to diminish in the first few months of 2012, falling to 2.6 per cent at the end of March. New loans for house purchases amounted to €49 billion, 12.0 per cent less than in 2010.

Table 14.2

Lending to consumer households (1)
(end-of-period data; millions of euros and per cent)

	Twelve-month percentage changes					Stock March 2012 (2)
	December 2009	December 2010	June 2011	December 2011	March 2012	
			Loans for house purchases			
Banks	1.8	3.4	4.2	3.6	2.6	338,335
			Consumer credit			
Banks	5.2	0.3	0.1	0.0	-0.9	57,919
Financial companies	-0.3	-0.2	0.4	1.0	-1.1	58,847
Total banks and financial companies	2.6	0.1	0.3	0.5	-1.0	110,766
			Other loans (3)			
Banks	7.3	8.5	4.4	1.9	0.4	86,381
			Total loans			
Total banks and financial companies	2.8	3.5	3.4	2.7	1.4	535,483

Source: Supervisory reports.
(1) Loans exclude repos and bad debts. The percentage changes are adjusted for the effects of securitizations and reclassifications. The data for March 2012 are provisional. – (2) Includes securitized loans. – (3) Other loans consist mainly of lines of credit and loans for purposes other than the purchase, construction or restructuring of residential property.

During the year the banks considerably tightened their lending conditions for loans for house purchases, mostly by sharply increasing margins for all customers, not just the segments deemed riskier. Demand slumped in response both to the worsening of the economic cycle, which was reflected in an abrupt drop in household confidence, and to the sizeable increases in interest rates. On new loans, the contractual conditions other than interest rates did not worsen substantially. According to the regional survey on bank lending conducted by the Bank of Italy's branches, the percentage of loans with a loan-to-value ratio above 80 per cent was similar to that of the previous years (5.9 against 5.2 per cent); the percentage of loans with a maturity of 30 years or more rose from 21.9 to 25.0 per cent, the average duration of new loans, about 22 years, did not diminish. However, the average loan-to-value ratio declined by just over one percentage point to 60 per cent, and the share of loans allowing the borrower to extend the duration or temporarily to suspend repayment at no additional cost fell by more than a half, to 13.1 per cent.

Interest rates on mortgage loans. – The interest rates on new mortgage loans rose in the early months of 2011 in response to the increases in the reference rates (Euribor and IRS). In the second half of the year, with the cost of funding, particularly bond funding, increasing as the sovereign debt crisis spread, banks began to adjust the margins above the reference rates sharply upwards. The increase has been larger for new variable-rate contracts, whose cost rose to 3.9 per cent in March 2012 (1.4 points more than in December 2010 and twice as high as in the euro area; Figure 14.4.a). Over the same span of time the interest rate on new fixed-rate mortgages for a term of at least ten years went up by 0.9 points (against 0.2 points in the euro area) to 5.2 per cent in March 2012.

Consumer credit. – Consumer credit expanded by 0.5 per cent in 2011. It lost pace in the first quarter of 2012, with the twelve-month growth rate turning negative in March by 1.0 per cent both for banks and for financial companies, which divide the market about evenly (Table 14.2). Loans for the purchase of durable goods continued to diminish owing to the weakness of demand, especially for motor vehicles. Consumer credit continued to expand both in the form of personal loans and in that of loans backed by the assignment of one fifth of salary, which serve to finance more general types of expenditure not necessarily connected with the purchase of a good.

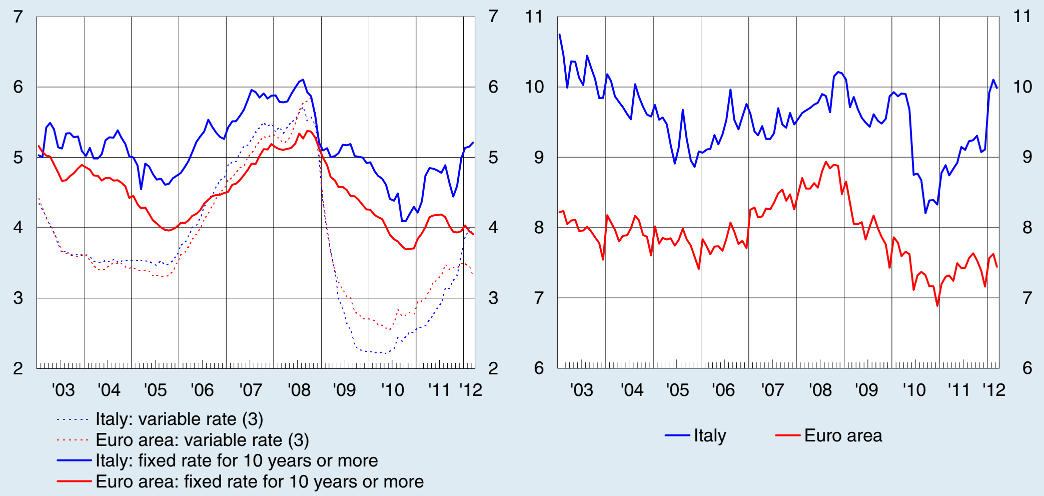
Interest rates on consumer credit. – The annual percentage rate of charge on new consumer credit granted by banks rose by 0.8 percentage points in 2011 and then jumped by a further 0.9 points in the first three months of 2012, reaching 10 per cent. The increase, linked to banks' funding difficulties, was much larger than that recorded in the euro area (Figure 14.4.b).

Figure 14.4

Interest rates on bank loans to households (1)

(monthly data referring to new transactions; per cent)

(a) *Loans for house purchases* | (b) *Consumer credit* (2)



Source: Based on ECB data.
(1) Consumer households, producer households and non-profit institutions serving households. Contracts concluded during the reference period or which constitute a renegotiation of previous terms and conditions. – (2) APRC on new loans. 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. From June 2010 interest rates on credit cards are not included. – (3) Variable rate or renegotiable within one year.

Indebted households' vulnerability

On the basis of the Bank of Italy's survey on household income and wealth, it is estimated that vulnerable indebted households – those whose debt servicing exceeds 30 per cent of income – remained stable at the end-2010 level of about 10 per cent of all indebted households, or 2.2 per cent of all households. The share of income going to pay house purchase loan instalments is also estimated to have been about the same as in 2010 (15.8 per cent for the median household). A factor in this, in a year that saw interest rates on new loan contracts increase, was the large share (70 per cent) of outstanding variable-rate mortgages indexed to Euribor, which remained at a moderate level and declined in the final part of the year.

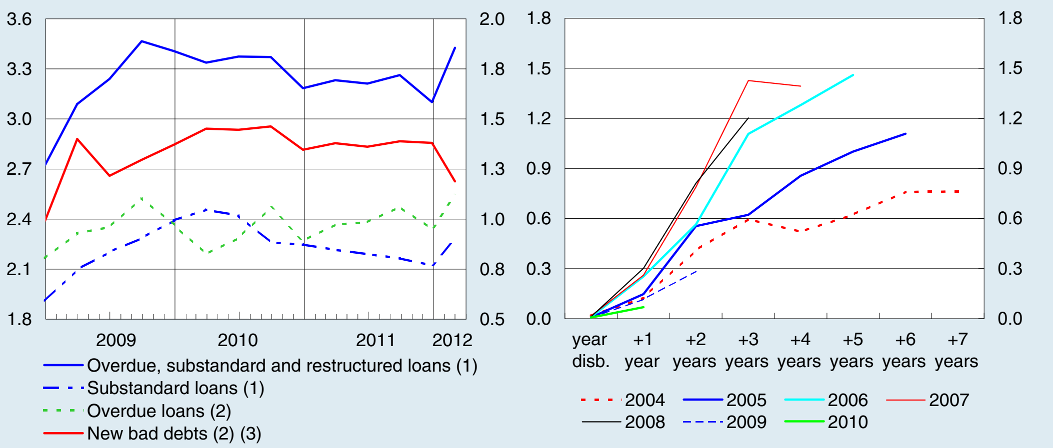
During 2011 the risk indicators for loans to households fluctuated around the levels they had reached at the end of 2010, high by comparison with the period before the crisis. In the first three months of 2012 the share of overdue loans and that of substandard loans (for which banks report temporary repayment difficulties) edged up to 1.1 and 2.3 per cent respectively, while the ratio of new bad debts to performing loans decreased slightly, to 1.2 per cent (Figure 14.5.a). Banks' greater selectiveness in granting loans for house purchases was reflected in a pronounced decline in the default rate on mortgage loans concluded in 2009 and 2010 compared with those granted in the previous three years (Figure 14.5.b).

Figure 14.5

Vulnerability of indebted households

(a) *Impaired loans*
(as a percentage of loans excl. bad debts)

(b) *New mortgage loans in default by year of disbursement*
(as a percentage of the number of contracts)



Sources: Supervisory reports for overdue, substandard and restructured loans; Central Credit Register for new bad debts; Central Credit Register, analytical survey of interest rates on new loans in default by year of disbursement.
(1) Left-hand scale. – (2) Right-hand scale. – (3) Quarterly data, seasonally adjusted. Flow of adjusted bad debts as a percentage of loans not classed as adjusted bad debts at the end of the previous quarter, calculated on an annual basis.

FIRMS

Profitability and financing needs

The recession that began in the summer of 2011 hit firms whose financial situation had been made fragile by the prolonged weakness of the economy. Cerved company accounts data indicate that fewer than half of firms had returned to pre-recession levels of turnover in 2010. The deterioration in economic conditions caused a new decline in profitability: on the basis of national accounts data, in 2011 the gross operating profit of non-financial corporations diminished by 1.1 per cent and its ratio to value added fell to the lowest level since the turn of the 1990s (33.6 per cent). Profitability was also dented by the higher cost of money: net interest expense rose as a proportion of gross operating profit by three percentage points to 21.0 per cent.

The reduction in profitability in 2011 led to a slight decline in firms' ability to use internally generated funds to cover new investment, even though the latter diminished. The external funding requirement amounted to €33 billion, only a little more than the previous year (Table 14.3).

Table 14.3

Financial assets and liabilities of firms (1)
(millions of euros and per cent)

	End-of-period stocks			Flows	
	2011	Percentage composition		2010	2011
		2010	2011		
ASSETS					
Cash and sight deposits	226,527	15.4	14.9	896	-5,014
Other deposits	20,836	1.2	1.4	3,097	2,238
Short-term securities	1,004	0.0	0.1	-709	422
Medium- and long-term securities	68,352	6.0	4.5	5,599	-30,169
of which: Italian government	*35,746*	*3.1*	*2.4*	*15,583*	*-5,920*
Italian corporate	*1,730*	*0.8*	*0.1*	*-10,269*	*-12,534*
foreign issuers	*15,123*	*1.1*	*1.0*	*-712*	*-1,691*
Shares and other equity	489,581	33.0	32.3	15,065	32,029
of which: foreign	*225,561*	*14.0*	*14.9*	*9,401*	*13,611*
Investment fund units	1,665	0.1	0.1	-268	-369
Accounts receivable	590,149	37.0	38.9	47,708	32,204
Short-term foreign financial credits	33,326	2.1	2.2	-1,940	903
Other financial assets (2)	83,813	5.0	5.5	5,792	7,833
Total assets	**1,515,254**	**100.0**	**100.0**	**75,241**	**40,078**
of which: external	*386,258*	*24.3*	*25.5*	*6,338*	*19,190*
LIABILITIES					
Total financial debt	1,270,358	36.0	37.4	29,068	19,307
of which: external	*129,463*	*4.1*	*3.8*	*97*	*-4,454*
Short-term debt (3)	404,777	10.9	11.9	5,209	18,875
of which: to Italian banks	*337,526*	*9.1*	*9.9*	*1,705*	*11,596*
Medium- and long-term debt (4)	774,803	22.3	22.8	11,451	965
of which: to Italian banks	*556,731*	*15.6*	*16.4*	*17,912*	*11,736*
Securities	90,778	2.8	2.7	12,408	-534
Shares and other equity	1,382,005	43.5	40.6	22,115	21,366
of which: held abroad	*233,287*	*6.8*	*6.9*	*-1,462*	*18,242*
Accounts payable	574,341	15.5	16.9	58,819	30,888
Other financial liabilities (5)	174,403	5.0	5.1	-4,369	2,009
Total liabilities	**3,401,108**	**100.0**	**100.0**	**105,633**	**73,571**
of which: external	*402,015*	*12.0*	*11.8*	*6,523*	*16,918*
BALANCE	**-1,885,854**			**-30,392**	**-33,493**

Source: Bank of Italy, financial accounts.
(1) The data refer to the non-financial corporations sector. Rounding may cause discrepancies in totals. – (2) Insurance technical provisions, domestic derivatives and other minor items. – (3) Includes finance provided by factoring companies. – (4) Includes securitized loans and finance provided by leasing companies. – (5) Postal current accounts, severance pay and pension provisions, domestic derivatives and other minor items.

The need of many firms for external financing continued to reflect the large delays in payment of business transactions. On the basis of data from the Bank of Italy's survey of industrial and service firms, the overall time to payment of accounts receivable averaged 104 days, about 8 days more than in the period before the crisis; with the contractual terms of payment almost unchanged, the increase chiefly reflected the increase in payment lateness (57 days in 2011).

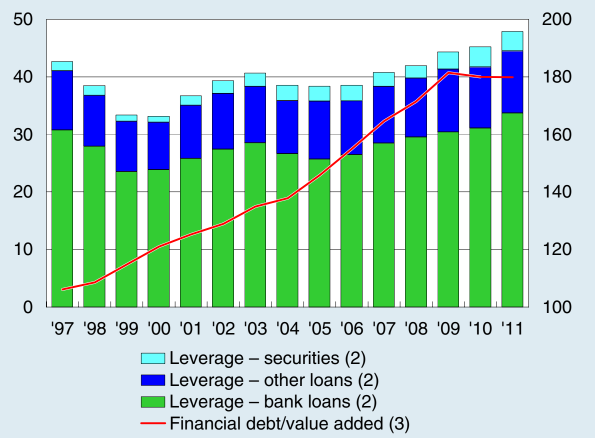
Firms' debt and financial structure

In 2011 firms' financial debt grew by €19 billion (0.7 per cent); short-term loans accounted for the bulk of the increase (Table 14.3). The ratio of financial debt to value added, which had risen steeply in the past decade, remained basically unchanged at around 180 per cent (Figure 14.6). Leverage, defined as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices, also remained high by historical standards; in 2011 it rose by nearly three points to 48.0 per cent, mainly reflecting the reduction in the market value of equity.

The ratio of firms' financial debt to GDP is markedly lower in Italy than in France, Spain, the United Kingdom and Japan. Owing to the lower value of equity, however, leverage is higher than in France and the United Kingdom. Bank loans make up a much larger share of firms' total financial debt than in the other industrial countries (70 per cent). In recent years firms have remained heavily dependent on bank financing in Italy, while such reliance has diminished in the euro area and the Anglo-Saxon countries in conjunction with stepped-up recourse to the bond market. Loans with an original maturity of less than 1 year make up 38 per cent of firms' bank debt in Italy, compared with 24 per cent in the euro area. The level and composition of Italian firms' bank debt made them particularly vulnerable to the interest rate and refinancing risks arising from the tightening of banks' lending conditions.

Figure 14.6

Corporate debt (1)
(per cent)



Sources: Bank of Italy and Istat.
(1) The data relate to the non-financial corporations sector. – (2) Left-hand scale. Leverage is calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices. – (3) Right-hand scale.

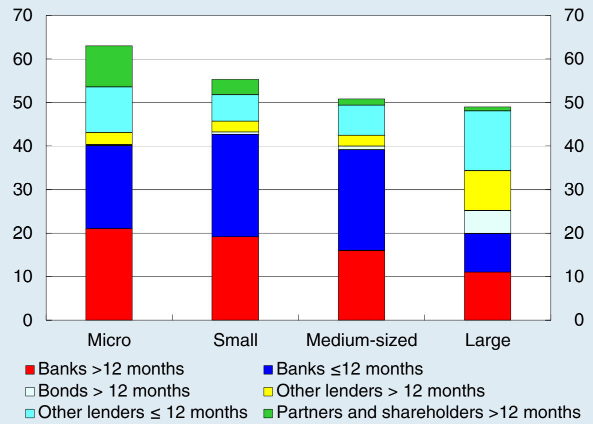
Businesses with fewer than ten workers, which account for more than 30 per cent of value added and about half of employment in Italy, are more highly leveraged than other firms. An analysis of more than 400,000 company balance sheets in the Cerved database in 2010 shows that they had a leverage ratio of 63.0 per cent, 11 points higher than the sample average (Figure 14.7). The dispersion is greater in this size class as well: a relatively larger number of firms have either no financial debt (20 per cent, against 9 per cent in the other size classes) or a leverage ratio exceeding 75 per cent (33 per cent, against 31 per cent).

Cerved data referring to some 5,000 company balance sheets show that large companies have below-average leverage (Figure 14.7), but also that prior to the crisis they increased it more sharply than smaller firms (by 3.0 and 1.5 percentage points respectively between 2002 and 2007).

Figure 14.7

Leverage and the composition of financial debt by firm size in 2010 (1)

(per cent)



Source: Cerved.
(1) Leverage is the ratio of financial debt to the sum of financial debt and shareholders' equity. Micro firms have fewer than 10 workers and turnover or assets of less than €2 million. The corresponding figures for small firms are 50 workers and €10 million, for medium-sized firms 250 workers, €50 million of turnover and €43 million of assets. Above these cut-offs firms are classified as large.

In 2010 some 50 per cent of large firms' debt consisted of financing other than bank loans and bonds, mostly intra-group debt to the companies charged with raising or managing funds for all the affiliates. Debts contracted directly with the banking system made up about 40 per cent of the total. The financial structure of large companies also reflects the access of major industrial groups to financing from international banks and the financial markets; in 2010 bonds represented more than 10 per cent of their on-balance-sheet financial liabilities.

The financial market strains connected with the sovereign debt crisis did not reduce Italian firms' access to the bond market in 2011, as happened in 2008, but they did worsen issuance conditions considerably. According to Dealogic data, companies belonging to nine industrial groups made gross bond issues totalling €19 billion in 2011, compared with 14 issuers and €14 billion in 2010. Investors' greater risk aversion and their preference for highly liquid securities were reflected in an increase in yields and a shortening of the maturity of issues.

Credit

Volumes and interest rates. – The growth in bank loans to firms, net of repos and bad debts, began to slow from the middle of 2011 and turned negative in the early months of 2012, with a contraction of 2.3 per cent in the twelve months ending in March (Table 14.4). Unlike the previous phase of reduction in credit in 2009, the contraction of the past few months was greater for small firms and it was more even geographically (Figure 14.8). The differences across sectors remained ample, with a significant decline in lending to construction businesses and a large increase for firms in the energy sector.

Table 14.4

Lending to firms (1)
(end-of-period data; per cent)

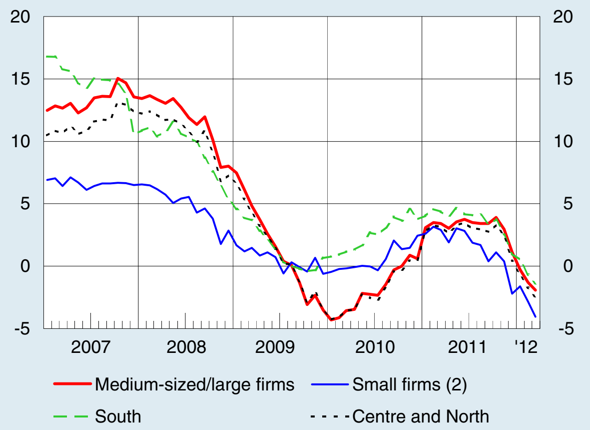
	Twelve-month percentage changes					Percentage composition
	2008	2009	2010	2011	March 2012	March 2012
				Banks		
Branches of economic activity (2)						
Manufacturing	5.9	-7.8	-1.6	0.8	-3.7	20.9
Construction	13.2	1.9	0.1	-2.7	-4.7	15.0
Services	6.7	-4.5	-0.8	2.1	-2.3	41.4
Other	9.2	6.2	7.8	8.5	5.0	10.3
Technical forms						
Advances and current account loans (3)	8.5	-19.0	-1.2	0.5	-3.3	24.2
Term loans	7.4	5.7	5.0	0.5	-0.9	41.7
Other loans	5.7	3.6	-4.2	1.0	-3.8	21.7
Total	**7.0**	**-3.0**	**0.9**	**0.5**	**-2.3**	**87.6**
				Financial companies (4)		
Leasing	9.5	-4.0	0.7	0.4	0.4	8.7
Factoring	13.1	-14.7	4.6	15.3	10.8	3.1
Other	14.1	-22.6	62.4	-9.0	-10.4	0.6
Total	**10.5**	**-7.8**	**3.8**	**3.3**	**2.1**	**12.4**
				Banks and financial companies (4)		
Total	**7.7**	**-3.6**	**1.3**	**0.9**	**-1.8**	**100.0**

Sources: Supervisory reports and Central Credit Register.
(1) Data refer to the sectors of non-financial corporations and producer households. Loans exclude repos and bad debts. The data for March 2012 are provisional. The percentage changes are adjusted for the accounting effects of reclassifications and securitizations (except for those broken down by technical form). – (2) Data taken from the Central Credit Register. – (3) Up to December 2008, advances are included in "Other loans". – (4) The data for financial companies refer to intermediaries entered in the register under Article 107 of the Consolidated Law on Banking and, up to 2008, are taken from the Central Credit Register.

The rising trend of bank interest rates for firms, under way since the middle of 2010, gained pace during the year: the rates on outstanding loans at the end of 2011 averaged 4.0 per cent, almost 1 percentage point more than a year earlier (Figure 14.9). The increase reflected the particular funding difficulties of Italian banks and was greater than the average for the euro area: the rates on new loans other than current account loans rose above the average euro-area level from July and by January 2012 the gap exceeded 80 basis points. Subsequently, thanks to the improvement in banks' liquidity

Figure 14.8

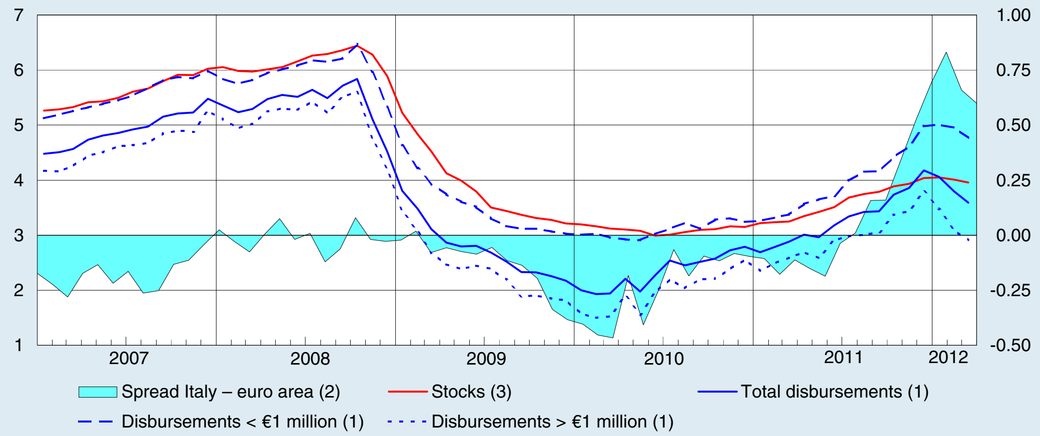
Bank loans by geographical area and firm size (1)
(twelve-month percentage changes)



Source: Supervisory reports.
(1) Loans exclude repos, bad debts and several minor items that are included in the Eurosystem's harmonized definition. The percentage changes are calculated net of the effects of securitizations and reclassifications. – (2) Limited partnerships, general partnerships, informal partnerships, de facto companies and sole proprietorships with fewer than 20 workers.

Figure 14.9

Interest rates on bank loans to firms
(monthly data; per cent)



Source: ESCB harmonized statistics.
(1) Left-hand scale; new transactions other than current account loans. – (2) Right-hand scale; spread on interest rates on new transactions other than current account loans. – (3) Left-hand scale.

conditions, signs of an easing of interest rates for firms emerged, especially for new loans larger than €1 million.

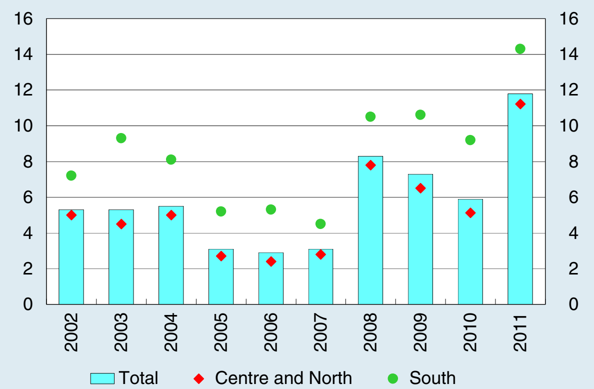
Credit demand and supply. – According to the Bank's survey of industrial and service firms, in the second half of 2011 the balance between businesses that increased their demand for credit and those that reduced it reached 17 percentage points (it was 9 points a year earlier). Firms' liquidity strains ranked ahead of the need to finance investment plans as a reason for applying for credit.

On the supply side, the financial strains engendered by the sovereign debt crisis caused a significant tightening of bank lending conditions. On the basis of the same Bank of Italy survey of firms, some 40 per cent of businesses reported a worsening of access to credit in the second half of 2011, twice as many as in the corresponding period of 2010. The leading reason cited for the deterioration was the cost of credit, but the share of firms that had trouble getting the desired amount of financing also rose significantly.

Credit rationing during the crisis. – In the survey of industrial and service firms, the percentage of businesses reporting that they had not obtained the full amount of credit requested doubled to 11.8 per cent (Figure 14.10), higher than in the past and

Figure 14.10

Percentage of credit-rationed firms (1)
(per cent)



Source: Bank of Italy, surveys of industrial and service firms.
(1) Firms that reported not obtaining the full amount of credit requested. Before 2010 the questions on the difficulties of access to credit referred to the period in which the survey was conducted; from 2010 onwards the data refer to the entire year.

corresponding to more than a third of all the firms applying. The increase was moderate only among firms with 250 or more workers.

Since 2008 the difficulties of access to credit have increased especially for manufacturing firms and businesses located in the South. Firms' economic and financial conditions have remained decisive for their ability to access credit: the incidence of credit rationing among companies with a sound balance sheet according to the Z-score assigned by Cerved continued to be virtually nil, while for risky firms it exceeded 15 per cent.

Many measures were put in place during the crisis to support firms' financial conditions and assist their access to credit. The recent worsening in the economic situation and banks' lending conditions has spurred the Government and trade associations to renew or strengthen some of these measures.

Financial fragility and repayment difficulties

The crisis of the past years has made firms' balance-sheet situation fragile. Their financial condition worsened substantially in 2011 even though the economy's performance was less negative than in the period between 2008 and 2009. The ratio of interest expense to gross operating profit, a commonly used gauge of firms' ability to repay debt, remained at high levels compared with the pre-crisis period, even though the cost of debt is much lower today.

Firms' increased financial fragility has been reflected in delays in business-to-business payments, in the still rapid rise in bankruptcies and in the difficulties of repaying bank debt.

The share of business loans for which financial intermediaries report repayment anomalies reached 19.3 per cent in March 2012 (Figure 14.11.a). In the first quarter of 2012 the annualized flow of new bad debts in relation to the stock of performing loans hit the highest level since the start of the crisis (2.9 per cent).

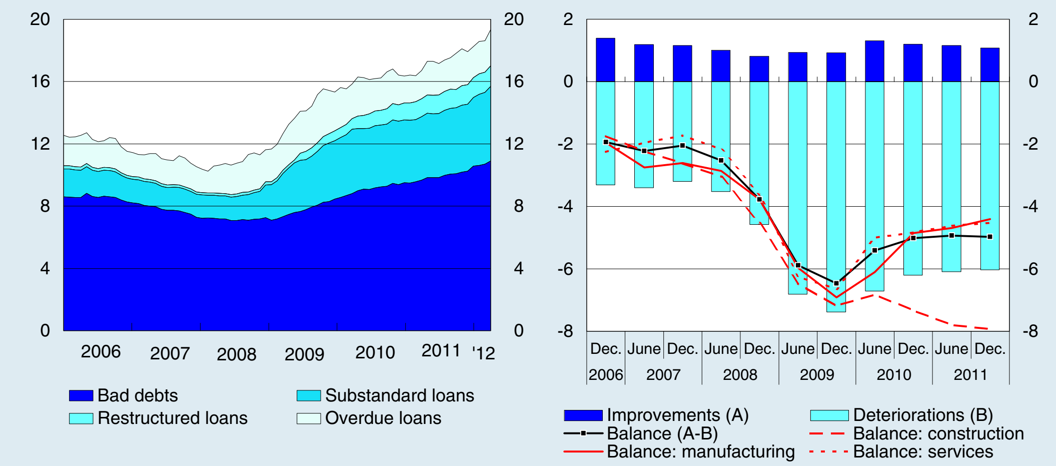
An indicator of firms' financial difficulties, based on movements of loans between the different categories of repayment anomaly, shows downgrades were again the rule in 2011 (Figure 14.11.b). The balance between improvements and deteriorations (-5.0 percentage points overall) was more heavily negative for firms in the construction industry and businesses based in the South (-7.9 and -6.3 percentage points, respectively).

Equity capital

The increase in corporate shareholders' equity amounted to €21 billion in 2011, about the same as in 2010 (Table 14.3). There were six initial public offerings (compared with eight in 2010), concentrated in the stock markets reserved to small and medium-sized enterprises.

Figure 14.11

Firms' bank loan repayment difficulties
(percentage of loans)



Source: Central Credit Register.
(1) Movements of loans between the following categories (in increasing order of anomaly): performing loans, significant breaches of overdraft limits, overdue loans (more than 90 days past due), substandard or restructured loans, bad debts, losses; as a percentage of loans at the beginning of the period.

According to data published by the Italian Private Equity and Venture Capital association (AIFI), investment by companies of the sector exceeded €3.6 billion in 2011, up considerably from the previous two years. The bulk of the resources were again employed in leveraged buy-outs (63 per cent) and for firms with 250 or more workers (70 per cent). Transactions that could have a greater impact on growth accounted for a very small fraction of total investment, low also by international standards: financing to high-tech sectors made up 8 per cent and seed or start-up financing just over 2 per cent. Data from the European Private Equity and Venture Capital Association (EVCA) for the period 2008-10 indicate that for these two types of investment the share in Italy is respectively 5 and 4 percentage points below the European average.

Since the end of 2010 the supply of equity capital for Italian firms has been augmented by the presence of Fondo Italiano di Investimento, endowed with resources of €1.2 billion and assigned the mission of assisting capital strengthening and consolidation among firms with turnover of between €10 million and €250 million. Through April 2012 this fund had approved 22 direct investments amounting to €225 million and 12 indirect investments in equity funds totalling €245 million.

15. THE FINANCIAL MARKETS

The tensions on the euro-area financial markets became systemic in the summer of 2011, spreading to Italian government securities. Contagion was abetted by the signs of a slowing of global economic growth, uncertainty regarding the evolution of the public debt crisis in Greece and Portugal and doubts about the efficacy of the measures adopted by national and European authorities. In Italy it was futher aggravated by investors' concerns about the high level of debt and continuing lack of growth; the rating agencies downgraded Italian government securities several times.

The liquidity of the Italian government securities market was sharply reduced. Non-resident investors made huge disposals of securities, which were matched by purchases by residents, especially households. The interest-rate spreads between Italian and German government securities reached their highest level since the introduction of the euro and in November topped 550 basis points for ten-year maturities. Despite exceptionally severe tensions on the markets, the Italian Treasury managed on every occasion to place a sufficient volume of securities to finance both redemptions and the borrowing requirement while keeping the average residual life of the debt long.

The close link between sovereign issuers and financial intermediaries in the advanced economies affected the situation of Italian banks. Their share prices plummeted, risk premiums on bank bonds became significantly higher and fund-raising on the wholesale markets contracted sharply. Issues by Italian non-financial corporations were less affected by the sovereign debt tensions although their risk premiums increased on both the bond and the share market.

Conditions on Italy's financial markets showed evident improvement in December thanks to the adoption of liquidity support measures by the Eurosystem, the Government's public finance adjustment measures and progress in European cooperation.

In the second half of March Italy's interest-rate spreads with respect to Germany began to widen again. A contributory factor was the re-emergence of fears about the euro area's cohesion as a result of the deteriorating prospects for Spain's public finances, the persistent weakness of economic activity in the area and the outcome of the Greek elections.

Public sector securities

Supply and demand. – Net issues of Italian public sector securities fell to €46 billion last year, partly owing to the use of the Treasury's liquid balances. At the end of

2011 the stock outstanding was equal to 101.6 per cent of GDP, up from 99.8 per cent twelve months earlier, and the total debt-to-GDP ratio was 120.1 per cent.

Despite exceptionally severe tensions on the markets, the Italian Treasury consistently managed to place sufficient securities to cope with the massive volume of redemptions and to finance the borrowing requirement. At the same time, it managed to avoid excessively shortening the average residual life of the debt as this would have further exposed the Italian government securities market to a liquidity crisis. Issuance became easier from January of this year. The cover ratio has been well over one at all the auctions; between October and April it averaged 1.4 for ten-year BTPs.

The average residual maturity of government securities remained long, decreasing only slightly during the year, by three months to six years and ten months. The average duration shortened more, by seven months to four years and five months, but this was partly due to the rise in interest rates. Net issues of BOTs turned positive by €2 billion, against €10 billion of net redemptions in 2010, while those of BTPs fell from €89 billion to €70 billion. Net redemptions of CCTs decreased from €14 billion to €7 billion, while CTZs and Republic of Italy bonds went from net issues of €6 billion and €2 billion respectively to net redemptions of €7 and €4 billion. Within the BTP segment net issues of ten-year paper rose from €29 billion to €30 billion, while for shorter maturities they declined from €20 billion to €10 billion and for longer maturities from €38 billion to €16 billion. Net issues of securities indexed to euro-area inflation increased from €1 billion to €13 billion.

From the summer on, heightened market tensions prompted foreign investors to make substantial net disposals of Italian government securities (€73 billion over the entire year), mainly BTPs and BOTs. During the year the proportion of public sector securities held by non-residents fell by 7 percentage points to 46 per cent, the lowest level since 2005. Italian households, insurance companies and banks made substantial net purchases of BTPs (€39 billion, €28 billion and €20 billion respectively). BOTs were purchased mainly by households and banks (€14 billion and €7 billion respectively). Italian investment funds made net disposals of government securities (€19 billion) as a result of substantial redemptions of units.

Including Italian government securities held in individually managed portfolios and by investment funds run by non-residents for Italian savers (*Financial Stability Report*, November 2011), the proportion of securities in the hands of foreign investors at the end of 2011 was 40 per cent, 7 percentage points less than the year before.

Although the percentage of Italian government securities in residents' total financial assets has increased, it is still below the peaks recorded in the past. It rose from 6.4 per cent at the end of 2010 to 6.9 per cent a year later, compared with 13.2 per cent in March 1999. For banks in particular, the percentage decreased by almost two thirds between March 1999 and the end of 2011, from 14.2 to 5.0 per cent. This suggests there is ample scope for increased purchases of Italian government securities by resident investors.

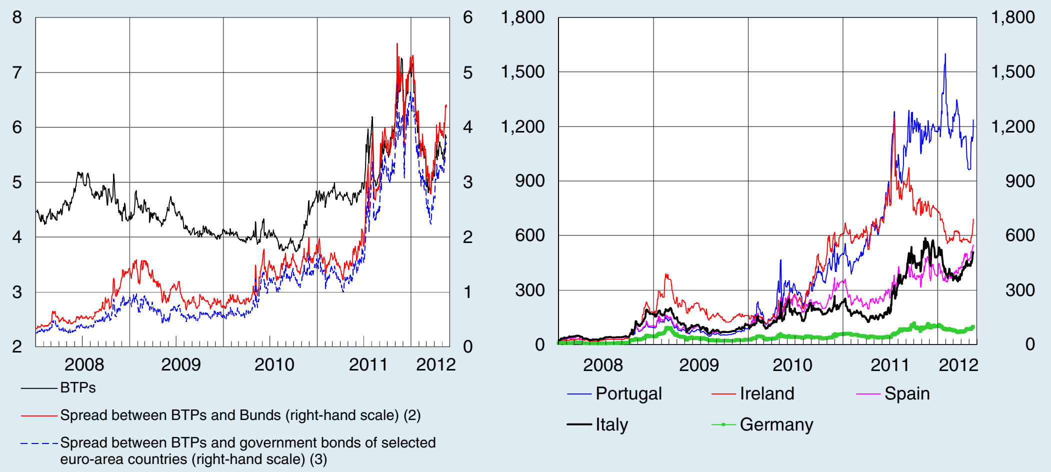
In the first two months of 2012 foreign investors continued to make net disposals of medium- and long-term Italian government securities, which were partly offset by net purchases of short-term paper. In the first quarter of 2012 the Italian banks made substantial net purchases, amounting to €70 billion.

Interest rates. – Rates on Italian government securities rose rapidly from the summer of 2011, reaching their highest levels since the creation of the European monetary union. Over the year, ten-year yields rose by 2.3 percentage points, to 7.1 per cent, before falling back to 5.8 per cent in the latter part of May (Figure 15.1).

Figure 15.1

Gross yield on 10-year BTPs and main interest rate spreads (1)
(daily data; per cent and percentage points)

Premiums on 5-year CDSs on government securities of selected euro-area countries
(daily data; basis points)



Sources: Based on Bloomberg and Thomson Reuters Datastream data.
(1) Yields on benchmark ten-year bonds. – (2) Spread between the yield on BTPs and on the corresponding Bund. – (3) Spread between the yield on BTPs and the simple average of yields on corresponding government securities of the euro-area countries that were rated AAA by all of the main agencies at the end of 2010 (Austria, Finland, France, Germany and the Netherlands).

The rise in interest rates on Italian government securities reflected the sharp increase in risk premiums. The yield spread between the benchmark ten-year BTP and the corresponding German Bund increased by more than 3.4 percentage points and in November was higher than at any other time since the introduction of the euro; at the end of the year it stood at 5.3 points. Subsequently it began to decline, albeit with wide fluctuations, and was equal to 4.4 points in the latter part of May. The premiums on five-year CDSs on Italian government securities followed a similar pattern (Figure 15.1).

The financial strains lead to a brusque contraction in the trading and liquidity of Italian government securities on the secondary market. Between June and September the average daily volume on the MTS market decreased by around 70 per cent. The bid-ask spreads on the BTP market rose on average by almost 100 basis points to around 120 points. In Italy and other euro-area countries the diminished functionality of the government securities market may have discouraged some investors and so aggravated the tensions. Since the turn of this year, and especially following the three-year refinancing operations of the Eurosystem, conditions on the secondary market have improved substantially, although without regaining the previous summer's levels.

The sharp increase in the compensation demanded by investors for buying Italian government paper reflected systemic factors. The spread of financial tensions to the euro-area sovereign debt markets was caused by the signs of a generalized slowdown of global growth in the summer, by concerns about its repercussions on the public finances and the situation of the banking systems of several euro-area countries, and by doubts regarding the efficacy of the EU authorities' response. Italy's vulnerability in two areas, the high level of public debt and the particularly poor outlook for economic growth, also contributed however. These factors prompted the main rating agencies to downgrade Italian government securities between September 2011 and February of this year. The negative expectations led to a further shift of portfolios in favour of the securities of countries to which the agencies assign the highest rating.

Corporate bonds and bank bonds

Issuance. – The Italian private sector made net issues worth €61 billion in 2011, consisting almost entirely of bank bonds (Table 15.1). Other financial corporations and non-financial corporations made modest net redemptions.

Table 15.1

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

	Net issues (2)			Stocks			Percentage of GDP
	2009	2010	2011	2009	2010	2011	2011
Banks	79,081	-11,800	66,330	819,601	807,045	873,618	55
Other financial corporations	44,337	-36,458	-4,376	279,767	243,371	239,050	15
Non-financial corporations	14,544	12,408	-534	77,121	89,776	89,487	6
Total	137,962	-35,850	61,420	1,176,489	1,140,192	1,202,155	76
Memorandum item:							
International market (3)	73,531	15,339	28,574	641,810	657,794	687,041	43

(1) The nationality and sector refer to the issuer and not to its parent company. Includes securities with a maturity at issue of more than one year, except as indicated. – (2) Difference between the face values of issues and redemptions. – (3) Based on BIS data. 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.

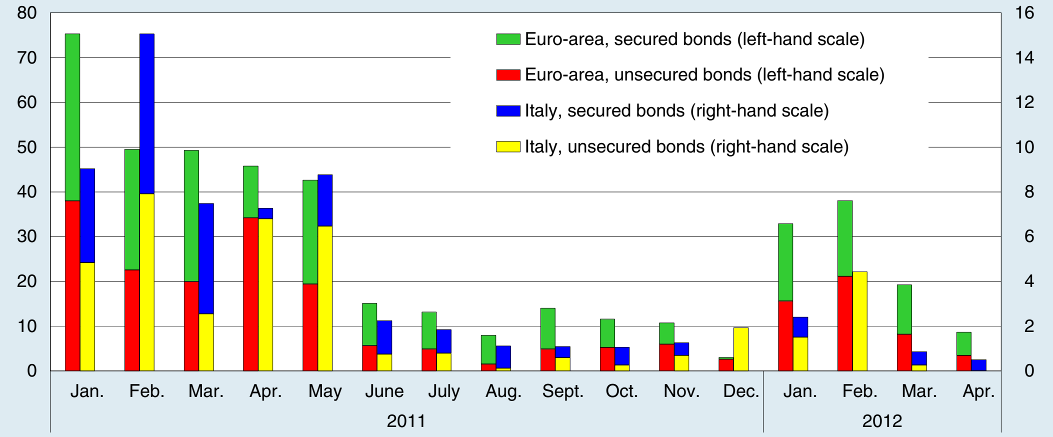
Banks' bond issuance varied markedly during the year. Until May the banks made substantial recourse to the market, but from June issues (except bonds with public guarantees) contracted sharply as financial strains spread to all the wholesale funding markets (Figure 15.2).

Gross issues by non-financial corporations amounted to €7 billion in 2011, slightly less than redemptions. This outcome was almost certainly due to the increased cost of financing and the slack performance of investment. More than four fifths of new issues were accounted for by just four groups (Eni, Pirelli, Telecom Italia and Terna). Thanks to the improvement in financial market conditions, net issues in the first quarter of 2012 totalled €4 billion. According to Dealogic data, gross issuance on the international market by issuers forming part of Italian non-financial groups reached a high level of €19 billion against €14 billion in 2010, indicating leading Italian firms' ability to maintain access to the market, albeit at higher costs. In the first four months of 2012 gross issuance increased further to €6 billion.

Figure 15.2

Gross issues of secured and unsecured bank bonds in Italy and the euro area (1)

(monthly data; billions of euros)



Source: Dealogic.
(1) Bonds issued by private banks classified according to the location and sector of the parent bank. Does not include private placements, government-backed bonds, retained bonds and self-funded bonds.

Net issues of Italian asset-backed securities (i.e. securities issued by special purpose vehicles and covered bonds) increased sharply to €34 billion, against net redemptions of €23 billion in 2010. The result reflected not only the lack of incentive for banks to raise funds on the international market by issuing unsecured bonds, but also the opportunity to use securitized instruments as collateral in Eurosystem refinancing operations. In particular, net covered bond issues increased from €11 billion to €38 billion in 2011 and remained buoyant in the first four months of 2012, when they came to €7 billion.

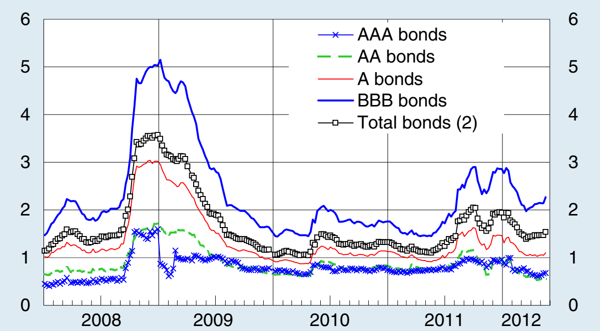
Financial strains in the second half of 2011 affected gross issues of commercial paper and certificates of deposit by Italian companies, which fell from around €200 billion to €130 billion. The decline was particularly significant in the case of banks, whose share of new placements fell from 61 to 53 per cent of the total.

Yields. – The average yield on investment-grade (rated at least BBB- or Baa3) bonds denominated in euros issued by non-financial Italian or foreign corporations remained stationary at 3.3 per cent in 2011 before falling to 2.6 per cent in the latter part of May this year. The fall in the yield on the government securities of the euro-area countries considered less risky offset the widening of risk premiums from 1.3 to 2.0

Figure 15.3

Yield spreads between euro-denominated corporate bonds and government securities (1)

(end-of-week data; percentage points)



Source: Merrill Lynch.
(1) Fixed-rate euro-denominated Eurobonds with a residual term to maturity of not less than one year issued by non-financial corporations resident in countries whose long-term foreign currency debt bears a rating not lower than BBB- or Baa3. The spreads 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).

percentage points (Figure 15.3). The returns on high-yield bonds were more sensitive to the heightening of tensions during the year and rose by 3.9 percentage points, to 12.1 per cent, before falling back to 9.9 per cent in May.

The propogation of the sovereign debt crisis to Italy's financial market in the second half of the year led to a widening of the yield spreads between the bonds of the leading Italian non-financial companies with respect to German and French government securities. The spreads on investment-grade bonds widened on average by 2.2 percentage points during the year, to 3.9 points, compared with an 0.6 point rise recorded for comparable firms in other euro-area countries. Since the beginning of this year the yield spreads have instead narrowed by 1.0 percentage points, more than for other euro-area firms.

The mounting pressure on Italy's sovereign debt worked to the detriment of the yield spreads on the bonds of the main Italian banks, which increased by 3.7 percentage points overall in 2011, against rises of 1.7 and 0.6 points for French and German banks. Since the beginning of this year the spreads for Italian banks have narrowed considerably (by 1.2 percentage points), more than those for other euro-area banks.

The equity market

Share prices. – The general Italian stock exchange index lost 24 per cent in 2011, compared with an average decline of 18 per cent in the share prices of the main euro-area corporations (Figure 15.4). Since the beginning of this year, the Italian index has fallen by a further 9 per cent, against 4 per cent for the euro-area index, with sharp fluctuations.

The fall in Italian share prices involved all the main sectors. Bank shares were particularly hard hit (-44 per cent) owing to banks' lower profitability and greater exposure to tensions on Italian government securities. The shares of automotive and services companies also lost more than the general index, both falling by 32 per cent. The drop in share prices was less marked for public utilities and oil products, which lost 14 and 5 per cent respectively, the latter benefiting from the rise in the prices of energy commodities.

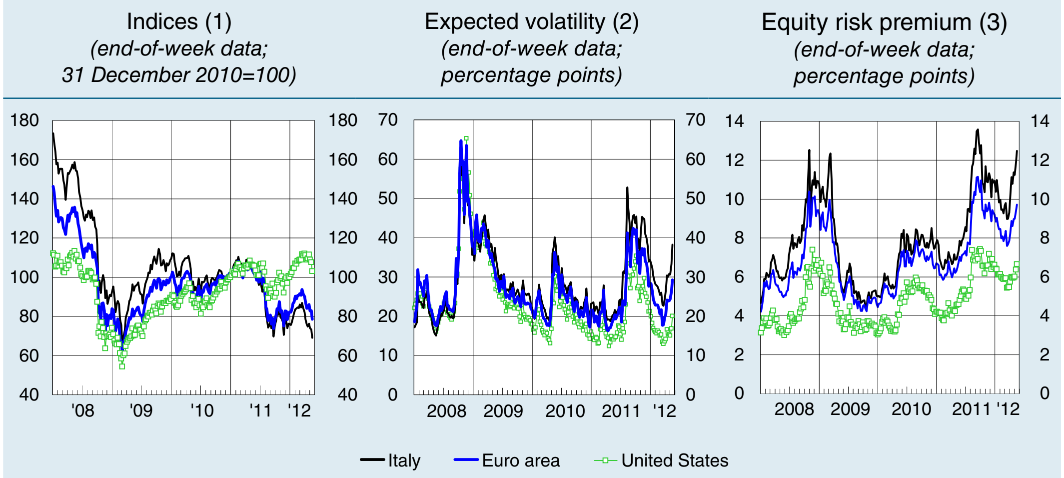
The overall decline in the Italian share index was due to the contraction in the expected earnings of listed companies and to a sharp increase in the risk premium demanded by investors for holding equity. Share prices were buoyed instead by the fall in yields on risk-free assets, proxied by the yields on long-term German government bonds.

The implied volatility of share prices, which had settled in the first half of 2011 at the lowest levels since the start of the financial crisis in the summer of 2007, increased sharply in the second half of the year. It then declined briefly before resuming its rise in March of this year (Figure 15.4).

At the end of 2011, the current earnings-price ratio of Italian listed companies was 9 per cent, more than 1 percentage point higher than at the end of 2010 and 3 points higher than its average since the mid-1980s. According to estimates that take short-term earnings expectations into account, the risk premium demanded by investors for holding Italian shares was 10.9 percentage points, compared with 9.1 points for the euro area as a whole (Figure 15.4).

Figure 15.4

Share markets



Source: Based on Bloomberg data.
(1) Indices: FTSE Italia MIB storico for Italy, Dow Jones Euro Stoxx for the euro area, Standard & Poor's 500 for the United States.– (2) Volatility implied by options on the stock indices of the main stock markets. – (3) The risk premium is calculated as the difference between the ratio of the expected earnings/price ratio for the subsequent 12 months to the nominal yield on 10-year government bonds (German Bunds are used for Italy and the euro area).

Supply and demand. – There were eight initial public offerings in 2011, compared with nine in 2010, seven of which were in the segments for small and medium-sized firms (three in the MAC alternative capital market segment and four in the AIM Italia alternative investment market segment). The amount of funds raised by IPOs was modest, amounting to €0.4 billion, compared with €2.3 billion in 2010. The number of IPOs declined last year in the euro area as a whole, from 85 to 69; in the first quarter of 2012 there were 20.

Fund-raising through capital increases was higher than in 2010, rising from €6.9 billion to €11.9 billion (Table 15.2). As in the previous three years most of this (about 90 per cent) was raised by banks, which continued to strengthen their capital bases.

At the end of the year, 287 Italian companies were listed on Borsa Italiana, four fewer than twelve months earlier, and 41 foreign companies. Because of the drop in share prices, the total capitalization of the Italian companies fell from €425 billion to €332 billion and from 27 to 21 per cent of GDP, widening the gap with respect to the other advanced countries. The ratio of market capitalization to GDP is 37 per cent in Germany, 55 per cent in France, 99 per cent in the United States and 139 per cent in the United Kingdom.

Average daily turnover on Borsa Italiana was slightly smaller than in the previous year, falling from 2.9 billion to 2.8 billion. The volume of transactions in exchange-traded funds and similar instruments rose further, partly as a result of the increase in their number.

Table 15.2

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

	2007	2008	2009	2010	2011
Change in prices (1)	-8.0	-48.7	20.7	-8.7	-24.0
Listed Italian companies (number at end of year)	301	294	291	291	287
of which: in the STAR segment	*82*	*75*	*72*	*75*	*70*
Market capitalization of Italian companies (2)	733,614	374,702	457,126	425,099	332,374
as a percentage of GDP	*47.2*	*23.8*	*30.1*	*27.4*	*21.0*
Percentage composition: (3)					
Industrials	*31*	*33*	*37*	*41*	*45*
Insurance	*10*	*11*	*9*	*7*	*7*
Banking	*30*	*25*	*26*	*20*	*17*
Financials	*4*	*3*	*2*	*3*	*3*
Services	*26*	*28*	*26*	*28*	*29*
Total	100	100	100	100	100
Gross share issues by Italian companies (4)	5,441	7,700	18,541	6,855	11,862
of which: in the STAR segment	*409*	*238*	*97*	*50*	*311*
Market value of newly-listed companies (5)	11,178	464	561	8,060	12,743
of which: foreign companies	..	..	*51*	..	..
in the STAR segment	*4,243*	..	*226*	..	..
Dividends distributed by Italian companies (6)	30,625	39,072	21,309	16,036	17,009
Earnings/price ratio (7)	7.8	15.6	5.3	7.6	9.0
Dividend yield (7)	3.7	8.0	5.0	3.8	5.1
Turnover					
Spot market (8)	*1,513,634*	*993,511*	*645,993*	*715,147*	*683,630*
FTSE MIB index futures (9)	*954,524*	*698,258*	*418,714*	*560,207*	*561,798*
FTSE MIB index options (9)	*368,966*	*268,264*	*140,345*	*174,918*	*162,684*
Turnover ratio of Italian companies (10)	200	179	155	162	181

Sources: Borsa Italiana, Thomson Reuters Datastream and World Federation of Exchanges.
(1) Percentage change in the FTSE Italia MIB storico index over the year. – (2) End-of-period data. – (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. – (5) Sum of the market values of each company on the placement date. – (6) Sources: to the end of 2007, based on Borsa Italiana data; for 2008 and 2009, World Federation of Exchanges data; for 2010 and 2011, Borsa Italiana data. – (7) End-of-period data. Per cent. Current earnings and dividends.– (8) Italian companies. – (9) Starting June 2009, replaces the contract on the S&P MIB index. – (10) Turnover as a percentage of average market capitalization for the year.

BANKS AND NON-BANK INTERMEDIARIES

16. THE FINANCIAL SYSTEM

Developments over the year

The Italian financial system was affected by the intensification of European sovereign debt risk since the summer of 2011, after having benefited in the previous months from the slight improvement in the macroeconomic outlook and the relative stability of financial markets.

For Italian banks the strains in the financial markets and the downgradings of the country's credit rating led to difficulties in accessing international markets and higher funding costs. Over the year wholesale funding as a share of total funding declined by 4.8 percentage points; banks' liabilities to the Eurosystem expanded sharply. The average cost of total funding rose by 33 basis points compared with the previous year.

The difficulty of raising funds, combined with growing uncertainty about the soundness of customers, resulted in a tightening of credit conditions. Against a background of weak demand for credit, the rate of growth in lending to the non-financial private sector fell sharply, before turning negative in December. The contraction was especially pronounced in loans to firms and for lending by the five largest banking groups, hardest hit by the problems of raising funds in the wholesale markets. The weakening of the macroeconomic outlook eroded credit quality: in the second half of the year the ratio of new bad debts to outstanding loans increased; for lending to the corporate sector it reached the same level as in December 2009, the highest since the crisis began.

The measures adopted by the Eurosystem in December, including the two longer-term refinancing operations conducted in December and February, did much to ease strains in banks' liquidity. Banks replaced wholesale funding with Eurosystem refinancing; a portion of the funds was invested in government securities. In the early months of this year there were initial signs of a recovery in international bond market issuance.

The easing of tensions on the funding side had a positive impact on credit supply. The responses of the banks that participated in the euro-area bank lending survey point to a further easing of financing conditions in the first quarter of 2012. In March the pace of the contraction in lending to households and firms slowed: the annualized three-month rate of growth in lending to the non-financial private sector was negative by 0.9 per cent, compared with a contraction of 3.3 per cent in February. The recent resurgence of financial market tensions and the persistent weakness of cyclical conditions could have a negative impact on this trend.

After widening in 2011, the funding gap (the share of loans to resident customers not financed by deposits and bonds held by households) narrowed to 16.5 per cent in the early months of 2012. While funding conditions have improved, banks' balance sheets continue to suffer from the marked deterioration in credit quality; the share of loans to firms in temporary difficulty (substandard and restructured loans) remains high, as does the growth of new bad debts.

In 2011 the profitability of the Italian banking system was strongly affected by the huge one-off write-downs of goodwill made by the leading groups to bring their book values more closely into line with market developments and increase the transparency of their balance sheets. The return on equity was negative (-9.2 per cent). Losses of €24.7 billion were recorded. Net of the write-downs to goodwill banks' profit before tax would have been positive, although significantly lower than in 2010.

Italian banks significantly strengthened their highest-quality capital resources, those best able to absorb losses, thanks to massive capital increases and, to a lesser extent, self-financing. At the end of 2011, the core tier 1 ratio was 9.3 per cent for the banking system as a whole, 8.9 per cent for the five largest groups. The gap in capitalization with respect to the main European banks narrowed. Financial leverage, measured as the ratio of total balance-sheet assets to tier 1 capital, is well below that of the main European banks. In the early months of 2012 banks continued to strengthen their capital bases in order to meet the European Banking Authority's recommendation on banks' capital and the Basel III capital requirements, which are to enter into force next year.

In the specialized credit sector (leasing, factoring, consumer credit), an overall recovery in the volume of business, especially in factoring, was accompanied by an increase in the riskiness of loans.

The asset management sector recorded a net outflow of resources amounting to €43 billion, showing the effects of the contraction in Italian households' saving and of the shift in portfolios towards government securities and banking products. The share of households' financial assets managed by institutional investors declined in relation to GDP, similar to the pattern in almost all the leading countries. The net outflow of savings from Italian investment funds as a whole gained pace; net subscriptions of funds offered by foreign intermediaries fell sharply. Italian banks' share of the domestic investment fund market continued to decline. After the positive results recorded in the years 2009-10, the net flow of resources to individually managed portfolios and insurance companies fell drastically, in concomitance with the growing tensions in the financial markets in the second part of the year. The resources managed by the various types of supplementary pension scheme expanded at a slower pace than in previous years, reflecting the modest returns on the portfolios.

Banking supervision benefited from increased synergies between off-site and on-site controls, as well as from greater information sharing with the other sectors within the Bank of Italy, including the economic research and central banking areas. Dialogue with intermediaries was strengthened, including at meetings held to examine banks' risk profile in greater detail and to increase banks' awareness of specific issues. Special attention was paid to the capital adequacy of the banks, which were called on to maintain or reach tier 1 capital ratios above the minimum regulatory requirements.

Banks and banking groups. – At the end of 2011 there were 740 banks operating in Italy, 20 fewer than a year earlier (Table 16.1). During the year ten new banks began to operate (two small limited company banks, one cooperative bank, one mutual bank and six branches of foreign banks). Thirty banks closed as a result of 23 mergers, takeovers or asset transfers, six liquidations and the conversion of one bank into a financial company. The number of banking groups rose by one, to 77.

Table 16.1

The structure of the Italian financial system

	31 December 2010				31 December 2011			
	Number of intermediaries				Number of intermediaries			
	Banking group members (1)	Investment firm group members	Not members of groups	Total	Banking group members (1)	Investment firm group members	Not members of groups	Total
Banking groups	–	–	–	76	–	–	–	77
Investment firm groups	–	–	–	19	–	–	–	20
Banks	205	–	555	760	188	–	552	740
of which: limited company banks	*178*	–	*55*	*233*	*162*	–	*52*	*214*
cooperative banks (banche popolari)	*17*	–	*20*	*37*	*18*	–	*19*	*37*
mutual banks (banche di credito cooperativo)	*9*	–	*406*	*415*	*8*	–	*403*	*411*
branches of foreign banks	*1*	–	*74*	*75*	*1*	–	*77*	*78*
Investment firms	11	22	78	111	8	23	71	102
Asset management companies and SICAVs	35	6	157	198	31	6	153	190
Financial companies entered in the special register under Article 107 of the Consolidated Law on Banking	69	–	126	195	65	–	123	188
Financial companies entered in the general register under Article 106 of the Consolidated Law on Banking	73	2	1,213	1,288	36	1	745	782
Electronic money institutions	–	–	3	3	–	–	3	3
Payment institutions	–	–	1	1	9	–	25	34
Other supervised intermediaries (2)	–	–	2	2	–	–	2	2

Sources: Supervisory registers and lists.
(1) Italian-owned groups or Italian sub-groups owned by foreign companies; includes parent undertakings (banks or investment firms). – (2) Bancoposta and Cassa Depositi e Prestiti.

The number of bank branches fell slightly, from 33,640 to 33,607. The average number of inhabitants per branch is 1,806 (1,499 in the Centre and North and 2,952 in the South), compared with the European average of 2,168 at the end of 2010.

There are more inhabitants per bank branch in Italy than in Spain (1,065) and France (1,661), fewer than in Germany (2,071) and the United Kingdom (5,053).

At the end of 2011 there were 24 banking groups or solo banks listed on the stock exchange, down by one from a year earlier; seven are cooperative banks. Eight of the top twenty groups by consolidated assets were not listed. The listed groups and banks held 61.2 per cent of system assets, around three percentage points less than in 2010.

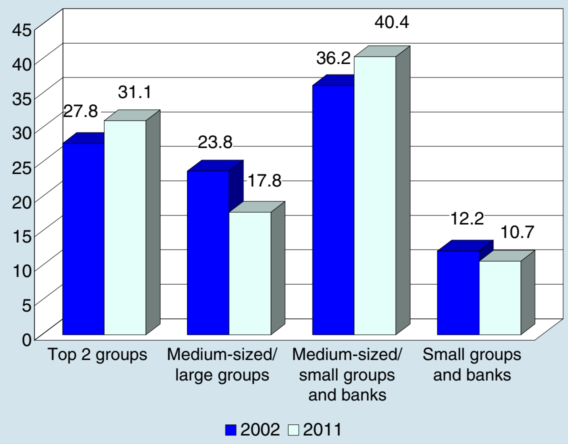
The degree of concentration of the banking system. – At the end of last year the degree of concentration of the banking system, measured by the Herfindahl-Hirschman index calculated on the total assets of the units operating in Italy, was slightly higher than in 2002. The increase in the concentration of the system, recorded between 2006 and 2007 following the merger of Banca Intesa and Sanpaolo IMI and UniCredit's acquisition of Capitalia, has been reabsorbed in part.

Between 2002 and 2011 the concentration of local markets in banking services declined in the deposits and household loans segments. The reduction in concentration was favoured by the expansion of small intermediaries outside their traditional geographical markets, in part through acquisitions of regional or local banks. The degree of concentration rose slightly for business loans. In the same period the average number of banks per province remained unchanged at 27.

Classifying banks according to size and group affiliation, the two largest groups (UniCredit and Intesa Sanpaolo) held 31.1 per cent of system assets at the end of 2011, while the three medium-sized/large groups (Banca Monte dei Paschi di Siena, Banco Popolare and Unione di Banche Italiane) held 17.8 per cent (Figure 16.1). A third category, comprising 67 medium-sized/small groups and stand-alone banks (including specialized banks and subsidiaries of foreign groups), accounted for 40.4 per cent of the total. The remaining 10.7 per cent was held by 563 small banks with predominantly local operations. Between the end of 2002 and the end of last year the portion of system assets held by the top five groups rose from 48.9 to 51.6 per cent. At constant end-2011 group perimeters (counting only the banks that belonged to the five largest groups at the end of 2011), in the same period the share would have diminished by more than 10 percentage points, from 60.7 to 48.9 per cent.

Figure 16.1

Degree of concentration of the Italian banking system (1)
(per cent)



Source: Supervisory statistical 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 degree of internationalization of the banking system. – In 2011 the cash exposures of Italian banks and their foreign subsidiaries to banks and customers abroad decreased slightly as a share of the banking system's total exposures (by 1.5 percentage points to 24.7 per cent); for the five largest groups this share remains high, amounting to about one third. The presence abroad of Italian banks' branches and subsidiaries also diminished; it remains significant in Switzerland, in the countries of the euro-area, particularly Austria, Luxembourg and Germany, and in Central and Eastern Europe.

At the end of 2011 there were 24 subsidiaries of foreign companies or banks operating in Italy, two of which figured among the top ten banking groups, with 9.3 per cent of total assets. The branches of foreign banks numbered 77 and held 8.2 per cent of system assets (8.4 per cent at end-2010). At the close of the year forty foreign shareholders – mainly from EU countries – held equity interests of more than 5 per cent in 49 banks.

Non-bank intermediaries. – At the end of 2011 there were 187 asset management companies in operation, eight fewer than a year earlier, and three Italian SICAVs (Table 16.1); at the beginning of 2012 the three SICAVs were merged with other collective investment undertakings. The deletion of twelve asset management companies during the year was largely the result of mergers; further rationalization measures are expected in the coming months in all segments. Four companies were added to the register, of which three in the real-estate sector.

There were 102 Italian investment firms entered in the register at the end of the year, nine fewer than a year earlier. The twelve deletions followed voluntary liquidations or mergers with banks or other financial intermediaries. The three additions concerned firms primarily active in portfolio management and investment advice. Most of the investment firms were independently owned; the number of bank-controlled intermediaries declined from 20 to 16.

The number of financial companies entered in the special register referred to in Article 107 of the Consolidated Law on Banking, primarily active in leasing, factoring and consumer credit, declined over the year by 7 to 188. The decrease was only partly offset by the addition to the register of new operators, including 8 mutual loan-guarantee consortiums.

There were 34 payment institutions entered in the register referred to in Article 114-*septies* of the Consolidated Law on Banking (intermediaries authorized to provide payment services); almost all of them were added during the year.

Between the end of 2010 and the end of last year the number of financial intermediaries entered in the general register referred to in Article 106 of the Consolidated Law on Banking (authorized to engage in the same activities as the intermediaries entered in the special register but which do not meet the requirements for inclusion therein) declined from 1,288 to 782. The drop reflects the deletion from the register of securitization vehicles and payment institutions, as well as a growing number of cancellations requested by the intermediaries themselves or ordered following the action taken to put an end to operational irregularities. At the end of the year there were 610 mutual loan-guarantee consortiums and 123 credit unions (*casse peota*) entered in the other sections referred to in Article 155.

At the end of 2011 loan brokers (intermediaries between banks or financial intermediaries and customers) numbered 131,855, of which 122,516 natural persons and 9,339 companies. Persons entered in the list of financial agents (individuals authorized to act on behalf of financial companies to promote and conclude finance contracts) numbered 75,869, of which 70,547 natural persons and 5,322 companies; an estimated 29,000 of these engage exclusively in money transfer services. Gold dealers, required to take the form of a limited company, numbered 357.

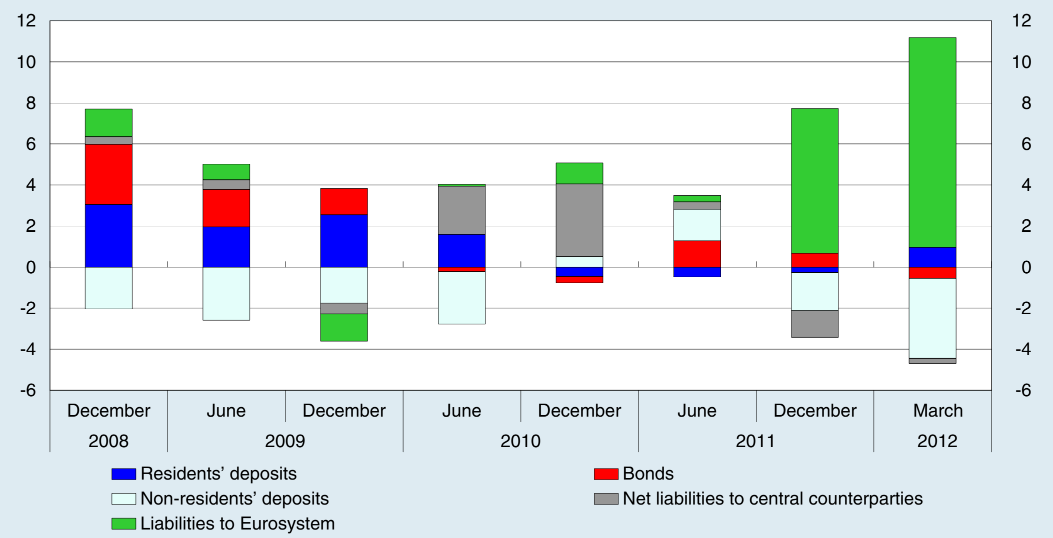
17. THE ACTIVITY OF BANKS AND FINANCIAL INTERMEDIARIES

Funding and liquidity management

The Italian banking system's funding went through two separate phases in 2011. In the first six months, with conditions on the international markets relatively favourable, banks issued sufficient bonds to refinance the whole amount falling due during the year. Non-residents' deposits also increased, and in June were 8.2 per cent above the year-earlier level. However, from the summer onwards the performance and composition of funding were heavily affected by the spread of the sovereign debt crisis to Italy, which led to difficulties in accessing the wholesale market and higher funding costs. In the twelve months to December 2011 Italian banks' total funding, excluding liabilities to other Italian banks, grew by 4.3 per cent, the same as in 2010 (Table 17.1). The increase can be ascribed almost entirely to liabilities vis-à-vis the Eurosystem, which more than offset the contraction in fund-raising on international markets in the second half of the year (Figure 17.1).

Figure 17.1

Growth in bank funding by component (1)
(monthly data; percentage points)



Source: Supervisory reports.
(1) Data for March 2012 are provisional. The sum of the contribution of the various components is equal to the 12-month percentage change in total funding. The percentage changes in the individual components are calculated net of the effects of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions.

Table 17.1

Banks' main assets and liabilities (1)

(monthly data; twelve-month percentage changes and millions of euros)

	Twelve-month flows				Twelve-month percentage change				Stocks at December 2011
	June 2010	December 2010	June 2011	December 2011	June 2010	December 2010	June 2011	December 2011	
					Assets				
Cash	488	-492	-89	361	4.9	-4.2	-0.9	3.2	11,515
Debt securities (2)	53,307	40,629	-9,688	34,781	24.0	18.3	-2.8	10.1	375,706
of which: government securities	*49,535*	*42,932*	*3,868*	*25,648*	*31.1*	*26.1*	*1.8*	*12.4*	*224,114*
Loans	37,305	80,175	86,946	38,904	2.1	4.5	4.7	2.0	1,949,303
Claims on central counterparties (3)	11,089	-5,474	-4,419	-17,040	62.5	-16.2	-13.7	-44.6	21,199
Claims on the Eurosystem	-12,499	-11,716	-1,809	10,485	-35.9	-33.4	-8.1	44.8	33,887
External assets	-17,211	7,011	7,402	31,093	-4.9	2.2	2.2	9.3	366,971
Claims on resident MFIs									
Loans	*-2,213*	*-19,244*	*-1,723*	*39,986*	*-0.4*	*-4.3*	*-0.6*	*11.5*	*374,821*
Securities	*2,957*	*-5,655*	*9,063*	*90,808*	*1.5*	*-2.6*	*4.4*	*44.4*	*294,901*
Shares and other equity	4,166	10,890	10,275	1,035	2.7	7.2	6.9	0.6	135,798
Other assets (4)	26.406	857	-76.641	87.929	6.4	0.2	-17.4	22.6	478,142
					Liabilities				
Deposits of residents in Italy (a)	35,889	-10,043	-10,974	-6,189	3.2	-0.9	-1.0	-0.5	1,150,624
Deposits of non-residents (b)	-57,427	11,578	34,968	-42,739	-12.0	2.7	8.2	-9.8	394,577
Bonds (5) (c)	-5,101	-7,162	29,200	15,815	-0.8	-1.2	4.9	2.6	619,303
Liabilities to central counterparties (3)	63,840	74,577	5,163	-47,292	215.0	197.0	4.7	-40.8	68,580
Liabilities to the Eurosystem (d)	2,110	22,898	7,065	163,959	5.9	79.8	18.7	317.9	215,544
Liabilities associated with sales of claims (6)	-1,282	-3,372	-15,238	3,556	-10.2	-10.2	-10.2	1.7	159,414
Liabilities to resident MFIs									
Deposits	*4,550*	*-20,864*	*-3,553*	*37,368*	*0.9*	*-4.6*	*-0.8*	*10.6*	*377,941*
Bonds	*2,957*	*-5,655*	*9,063*	*90,808*	*1.5*	*-2.6*	*4.4*	*44.4*	*294,901*
Capital and reserves	13,995	13,143	22,583	26,545	5.0	6.4	4.8	4.3	379,435
Other liabilities	37,557	12,647	-59,371	78,342	3.8	-9.4	9.3	1.0	381,923
Memorandum items:									
Net liabilities to central counterparties (3) (7) (e)	52,751	78,951	8,482	-30,252	::	::	12.8	-39.0	47,380
Total funding (f=a+b+c+d+e)	28,221	96,222	68,741	100,593	1.3	4.3	3.0	4.3	2,427,429

Source: Supervisory reports.
(1) The percentage changes are calculated net of the effects of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. – (2) Excludes bonds issued by resident MFIs. Includes securities deriving from uncancelled securitized loans – (3) Only includes repos. – (4) Money market fund units, movable and immovable assets, and other items of minor importance. – (5) Excludes bonds held by MFIs resident in Italy. – (6) Data are available only from June 2010. – (7) Growth rates are not reported because insignificant.

Wholesale funding. – Wholesale funding – non-residents' deposits and repos and bonds not held by households – reflected the decline in non-residents' deposits (down by 9.8 per cent in the twelve months to December 2011) and in net funding through repos with Cassa Compensazione e Garanzia (CCG), the central counterparty for transactions in the MTS market collateralized by government securities (down by 39.0 per cent). Non-residents' deposits began to contract in the summer, in conjunction with the decrease in the volume of trading on the markets for dollar-denominated certificates of deposit and commercial paper. Net liabilities vis-à-vis the CCG instead began to decline in the autumn after the downgrading of Italy's debt by the main rating agencies and the further depreciation of the government securities used as collateral. These factors led to a raising of the margins requested by the central counterparties. The banks responded to the difficulty in accessing wholesale funding markets and increased cost by stepping up their recourse to Eurosystem refinancing.

As a consequence of these developments, in the twelve months to December wholesale funding declined by 4.8 percentage points of total funding, while the share of Eurosystem refinancing increased by 6.7 points.

Retail funding. – Deposits from resident customers declined slightly between December 2010 and December 2011, by 0.5 per cent. With households' deposits up by just 0.4 per cent, the decrease was due almost entirely to the 4.8 per cent contraction in deposits of non-financial firms.

Bond placements with households increased by 6.9 per cent, contributing to the growth of 2.6 per cent in total bond fund-raising. At the end of last year bonds held by households represented around 16 per cent of total funding.

Italian banks' retail funding remained high by international standards. In December 2011 it accounted for an estimated 65 per cent of total funding, compared with an average of 60 per cent in the other euro-area countries.

The cost of funding and banks' liquidity position. – The average cost of funding, including that of other banks resident in Italy, was 1.6 per cent at December 2011, 33 basis points higher than a year earlier. Greater recourse to Eurosystem refinancing helped to limit the increase, given the rise in interbank interest rates and in the yields on new bond issues and term deposits.

The short-term liquidity position of Italian banks reflected the strains on the wholesale funding markets. The Bank of Italy's weekly poll of 32 banking groups indicated that their net liquidity position, given by the difference between their expected cash flows and the liquidity available within a period of one month, decreased considerably between May and November 2011. It then improved towards the end of the year and in December amounted to 4.5 per cent of total assets, compared with 4.7 per cent at the end of 2010. The result was due to the long-term refinancing operation conducted by the Eurosystem in December 2011 and to the possibility for banks to use bonds covered by a government guarantee scheme (Decree Law 201/2011) as collateral in refinancing operations.

Assets

Lending. – In 2011 lending again followed a different pattern in the first and second half of the year. From January to June lending to residents by banks operating in Italy grew at a faster pace than in the previous two years. In June the twelve-month rate of increase, net of repos and bad debts, was 3.4 per cent (Table 17.2 and Figure 17.2). In the second half of the year the sovereign debt crisis dampened the supply of credit. The slowing of economic activity weakened the demand for loans and caused a deterioration in borrowers' quality. This in turn affected the pace of lending, principally in the last quarter of the year: the twelve-month rate of growth in loans by Italian banks declined sharply, to 0.7 per cent in December (Table 17.2 and Figure 17.2).

Table 17.2

Italian banks' lending by geographical area and economic sector (1)
(twelve-month percentage changes)

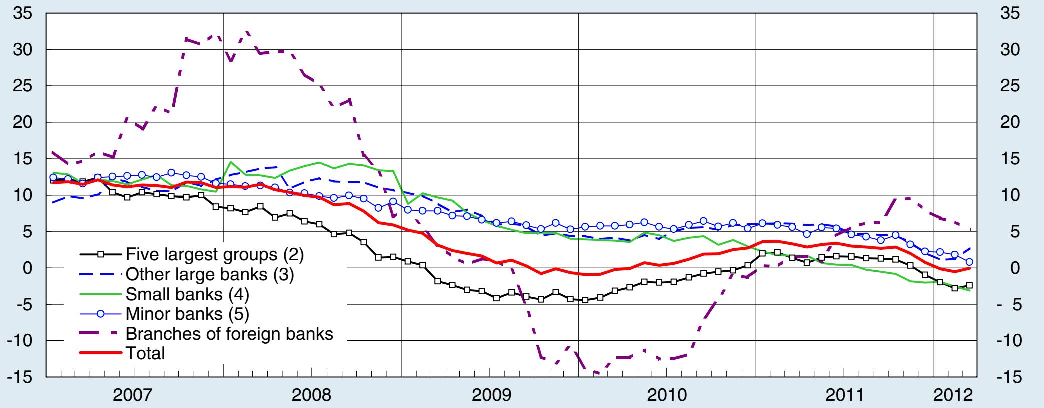
	General govern-ment	Financial and insurance companies	Firms				Consumer households	Non-profit institutions serving households and units n.e.c.	Total
			total	medium-sized, large	small (2)	producer households (3)			
					Centre and North				
2010 – Dec.	4.0	7.2	0.5	0.1	2.6	5.3	3.8	16.2	2.6
2011 – Mar.	3.0	2.5	3.2	3.2	3.1	5.7	3.7	17.9	3.3
June	3.9	0.4	3.5	3.6	3.0	5.9	3.6	11.9	3.3
Sept.	1.5	1.0	2.7	3.2	0.5	2.6	3.6	11.9	2.6
Dec.	-1.0	-1.8	0.4	1.0	-2.3	-0.3	2.8	9.4	0.6
2012 – Mar.	2.6	3.9	-2.5	-2.1	-4.2	-2.0	1.8	5.2	0.0
					South				
2010 – Dec.	0.1	-3.9	3.7	4.5	1.7	2.0	4.4	0.6	3.5
2011 – Mar.	-1.2	-7.3	4.4	5.2	2.0	2.1	4.3	3.9	3.6
June	3.9	-10.8	4.2	5.0	1.9	2.1	4.1	3.5	3.9
Sept.	1.8	-21.6	3.4	4.6	-0.1	0.3	4.0	2.3	3.1
Dec.	3.1	-19.8	1.0	1.9	-1.6	-1.2	2.9	2.4	1.7
2012 – Mar.	0.7	-17.6	-1.4	-0.7	-3.3	-3.0	1.5	-4.0	-0.3
					Italy				
2010 – Dec.	3.6	7.0	0.9	0.6	2.4	4.5	3.9	14.4	2.7
2011 – Mar.	2.6	2.3	3.3	3.4	2.9	4.9	3.8	16.2	3.3
June	3.9	0.1	3.6	3.7	2.8	5.0	3.7	10.9	3.4
Sept.	1.5	0.5	2.8	3.4	0.4	2.1	3.7	10.8	2.7
Dec.	-0.6	-2.2	0.5	1.1	-2.2	-0.5	2.8	8.7	0.7
2012 – Mar.	2.4	3.4	-2.3	-1.9	-4.0	-2.3	1.8	4.2	0.0

Source: Supervisory reports.
(1) Data for March 2012 are provisional. Loans exclude repos and bad debts. The allocation by geographical area is based on the customer's residence. The percentage changes are adjusted for the accounting effects of securitizations and reclassifications. – (2) Limited partnerships and general partnerships with fewer than 20 workers; partnerships, de facto companies and sole proprietorships with fewer than 20 workers. – (3) Partnerships, de facto companies and sole proprietorships with up to 5 workers.

Figure 17.2

Bank lending by size class of bank (1)

(monthly data; twelve-month percentage changes)



Source: Supervisory reports.

(1) Data for March 2012 are provisional. Loans exclude repos and bad debts. Banks are classified according to the composition of banking groups at March 2012 and to unconsolidated total assets at December 2008. Percentage changes are adjusted for the accounting effects of securitizations and reclassifications. – (2) Banks belonging to the groups Banco Popolare, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, Unione di Banche Italiane and UniCredit. – (3) Banks belonging to a group and independent banks with total assets amounting to between €21,532 million and €182,052 million. – (4) Banks belonging to a group and independent banks with total assets amounting to between €3,626 million and €21,531 million. – (5) Banks belonging to a group and independent banks with total assets amounting to less than €3,626 million.

At the end of 2011 the twelve-month rate of growth in lending to firms was down to 0.5 per cent, from 0.9 per cent a year earlier. Loans to firms with fewer than 20 workers decreased by 2.2 per cent, after growing by 2.4 per cent in the previous year. The growth in lending to consumer households slowed from 3.9 to 2.8 per cent.

During 2011 banks progressively tightened the conditions for granting credit to both firms and households. According to the Eurosystem's quarterly bank lending survey, the slowdown in lending in Italy reflected supply factors stemming from the difficulty of raising funds on the wholesale market and from the deterioration in the banks' liquidity position, as well as from a worsening of expectations regarding the outlook for economic activity.

The twelve-month rate of growth in lending by banks belonging to the five largest groups turned negative in December (by 1.0 per cent), with no significant difference between firms and households. Lending by the other large banks and by smaller banks continued to expand but its annual growth slowed from 6.0 to 2.0 per cent for the former and from 5.4 to 2.3 per cent for the latter. During the same period loans granted by branches of foreign banks accelerated sharply (to growth of 7.9 per cent) and in December accounted for 5.6 per cent of total lending and 5.9 per cent of loans to households and firms.

The disparities in the growth in lending by category of bank reflect the different level of constraints encountered in fund-raising. The largest banks were more affected by the turmoil generated by the sovereign debt crisis, mainly because they make greater recourse to international markets for wholesale funding. The slowdown in lending by all categories of Italian banks was partly due to the cyclical deterioration in credit quality.

Securities and other assets. – In 2011 the banks' portfolio of debt securities, excluding uncancelled securitized loans, increased by 11.1 per cent and at the end of the year represented about 6 per cent of total assets. The increase mainly concerned government securities, with banks in every size class, except branches of foreign banks, making net purchases of Italian government stock.

The first months of 2012

The funding difficulties encountered by Italian banks eased in the early months of this year thanks to the longer-term refinancing operations conducted by the Eurosystem. Italian banks made heavy recourse to these and the increase of around €60 billion in refinancing from the Eurosystem between December and March more than offset the decline of €35 billion in wholesale fund-raising. The changed composition of funding led to a small reduction in its average cost, which decreased by about 10 basis points in the three months.

As a consequence the banks' liquidity position improved and in April increased to 8.5 per cent of total assets, about 4 percentage points higher than at the end of 2011. A factor contributing to the improvement was the introduction of a government guarantee on some types of bond issues, which helped to increase available collateral.

In the first five months of this year bonds issued by the 32 largest Italian banking groups matured in the amount of €48 billion, of which €25 billion of wholesale bonds; another €64 billion worth is due to mature later this year, including €37 billion of wholesale bonds. The banks' ability to meet these commitments is assured by the ample liquidity supplied by the Eurosystem. Part of these funds have been invested in government securities to take advantage of the positive spread between their return and the cost of funding. Overall, in the first quarter of 2012 the banks made net purchases of government securities totalling €69.3 billion. As about one third were securities with a maturity at issue of one year or less, the investment is at least in part a short-term one that can be quickly liquidated to redeem bonds maturing in the coming months.

The easing of tensions on the funding side has helped to limit the contraction in lending to households and firms. In March the three-month rate of decrease, adjusted seasonally and for the accounting effects of securitizations, was 0.9 per cent, against 3.3 per cent in February. These results are in line with the responses of the banks taking part in the euro-area bank lending survey, according to which the tightening of standards for lending to firms and households was attenuated in the first quarter of this year. Loan demand remains nonetheless weak.

The renewed flare-up of tensions on the financial markets and the continuing uncertainty about the outlook for the economy could have an adverse effect on the performance of credit in the coming months.

At the end of March the share of loans to resident customers not financed by deposits or bonds held by households, a measure of the funding gap, was 16.5 per cent. The percentage was highest for branches of foreign banks (32 per cent) and for the five largest banking groups (20 per cent) and below the average for smaller banks.

For the purpose of calculating the funding gap, lending includes bad debts at realization value and excludes repos with central counterparties and securitized loans that have actually been transferred to third party investors. Deposits do not include those linked to securitizations and repos with central counterparties. Branches of foreign banks and Cassa Depositi e Prestiti are excluded because of the particular structure of their balance sheets.

Credit risk and country risk

Asset quality. – The quality of credit began to deteriorate in the second half of 2011, mainly in connection with the abrupt slowdown in economic recovery.

The flow of new bad debts of banks and financial companies operating in Italy amounted to €32.2 billion, just slightly less than the €32.9 billion recorded in 2010. While the figure represents a significant increase with respect to pre-crisis values, which averaged €11.3 billion in 2000-07, it is below those recorded after the 1993 recession. On average the ratio of new bad debts to total performing loans outstanding in 2011 was 1.9 per cent, 0.1 percentage points lower than in 2010. After falling in the first six months of the year, the flow of new bad debts began to rise once again in the third quarter. The deterioration in credit quality in the last quarter was particularly pronounced for firms, whose new bad debt ratio reached 2.7 per cent in December, the same level as two years earlier. In the first quarter of 2012 it rose to 2.9 per cent.

For Italian banks and banking groups as a whole, the amount of non-performing loans to customers (bad debts, substandard loans, restructured loans, and overdue exposures or in breach of overdraft ceilings) increased further in 2011, to 13.0 per cent, although at a slower pace than in 2010 (15.4 per cent). The main contributory factor was the growth of 16.3 per cent in bad debts, which account for more than half of total non-performing loans.

At the end of 2011, the ratio of non-performing loans to total exposures to customers was 11.2 per cent, over one percentage point higher than the year before (Table 17.3). It is kept high in part by the slowness of procedures to recover non-performing loans. The cover ratio, i.e. the ratio of loan provisions to gross exposures, declined from 57.2 to 55.7 per cent, well below the level recorded prior to the crisis but higher than in the first half of the 1990s. It is estimated that in order to bring it back to the average level of 2006-07 additional loan loss provisions equal to 0.5 per cent of total loans would need to be made.

The cover ratio of non-performing loans of banks not belonging to groups, including mutual banks and small cooperative banks, was lower than the industry average. However, in relation to their total loan exposure, the share of non-performing positions is below average.

Leading indicators suggest that the quality of credit could again deteriorate slightly in 2012. In December 2011 the probability of default within one year of non-financial firms surveyed by the Central Credit Register was again higher than prior to the crisis (2.2 per cent against 1.7 per cent at the end of 2007). In the first quarter of 2012, the average probability of default increased to 2.3 per cent. In addition, according to Central Credit Register data, in 2011 the proportion of loans to firms that had already shown signs of temporary distress (substandard and restructured loans) increased by 0.7 per cent to 6.4 per cent.

Table 17.3

Credit quality of Italian banks and banking groups (1)
(end-of-period data; millions of euros and per cent)

	Loans (2)	*of which: to residents*	Percentage of total balance-sheet loans to customers		Cover ratio (3)	
	2011 (4)		2010	2011 (4)	2010	2011 (4)
			Banking system (5)			
Loans to customers	**2,139,784**	**80.4**	**100.0**	**100.0**	**4.4**	**4.9**
Performing	1,900,834	79.7	90.1	88.8	0.6	0.6
Non-performing	238,950	85.9	9.9	11.2	39.2	39.2
Bad debts	*132,788*	*85.1*	*5.3*	*6.2*	*57.2*	*55.7*
Substandard loans	*70,470*	*89.0*	*3.1*	*3.3*	*21.5*	*21.3*
Restructured loans	*20,537*	*76.9*	*0.8*	*1.0*	*13.8*	*17.4*
Loans overdue or breach of overdraft limits	*15,155*	*91.2*	*0.7*	*0.7*	*7.1*	*8.3*
Loans to banks	**220,844**	**44.3**			**0.3**	**0.2**

Source: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to groups.
(1) Rounding may cause discrepancies. – (2) Loans are gross of provisions. – (3) Provisions as a percentage of total loans. – (4) Provisional data. – (5) Includes the subsidiaries of foreign banks.

Country risk. – In 2011 the balance-sheet exposure of Italian banks and their foreign subsidiaries and branches to non-residents decreased slightly by 1.4 per cent. At the end of the year it was €658.3 billion, equal to 24.7 per cent of their total exposures. The claims on non-residents of the five largest banking groups, which account for 92.9 per cent of the total foreign exposure, represented 34.6 per cent of their total exposures.

The most substantial of these exposures were to Germany (€181.6 billion), Austria (€78.1 billion), the United Kingdom (€37.3 billion) and Poland (€32.4 billion). Direct exposures to the countries worst affected by the sovereign debt crisis were generally limited: €21.6 billion to Spain, €12.1 billion to Ireland, €2.5 billion to Portugal and €1.7 billion to Greece. The majority consisted of loans to the private sector and securities issued by banks and financial companies.

At the end of 2011 the balance-sheet exposure to the countries of Central and Eastern Europe, for the most part in the hands of the largest banking groups, stood at €164.3 billion, of which €39.9 billion to households and €76.2 billion to firms, equal to 6.1 per cent of the consolidated exposure of the Italian banking system. Faced with an increase in non-performing loans to 9.8 per cent of their total exposures to Central and Eastern Europe, the two largest banking groups adopted a more cautious strategy with regard to loan loss provisions for countries with a higher credit risk (Romania, Hungary and Ukraine).

Profitability

Italian banks' profitability deteriorated in 2011, with ROE turning negative by 9.2 per cent, compared with 3.4 per cent in 2010 (Table 17.4). The year closed with a loss of €24.7 billion, against a profit of €7.9 billion the year before. The results were due entirely to the huge one-off impairments to goodwill for around €29 billion, which the leading groups made in order to bring their balance sheets into line with market developments. These adjustments had no effect on the system's capital adequacy as goodwill is deducted entirely from regulatory capital. Net of these adjustments, gross profit was positive, if lower, amounting to €4.7 billion against €11.8 billion in 2010.

Table 17.4

Consolidated income statement of Italian banks and banking groups (1)
(millions of euros and percentage changes)

	All banks			Main groups (2)		
	2010	2011 (3)	Percentage change	2010	2011 (3)	Percentage change
Net interest income (a)	53,475	54,049	1.1	32,751	32,227	-1.6
Non-interest income (b)	37,761	38,096	0.9	23,154	23,757	2.6
of which: fees	*30,330*	*30,031*	*-1.0*	*18,545*	*18,034*	*-2.8*
Gross income (c=a+b)	91,236	92,144	1.0	55,905	55,984	0.1
Operating expenses (d)	59,415	62,601	5.4	35,668	38,033	6.6
of which: staff costs	*33,260*	*33,767*	*1.5*	*20,241*	*20,687*	*2.2*
Operating profit (e=c-d)	31,820	29,544	-7.2	20,237	17,951	-11.3
Allocations to provisions and net value adjustments (f)	21,632	52,248	141.5	14,601	43,476	197.8
of which: for loan impairment	*18,435*	*19,324*	*4.8*	*12,140*	*12,775*	*5.2*
Ordinary profit (g=e-f)	10,188	-22,706	-322.9	5,636	-25,525	-552.9
Non-recurring profit (h)	1,647	-1,103	-167.0	1,473	-1,088	-173.9
Gross profit (i=g+h)	11,835	-23,808	-301.2	7,108	-26,613	-474.4
Taxes (l)	4,403	333	-92.4	2,071	-1,092	-152.7
Profit from asset classes in the process of being liquidated (after tax) (m)	1,097	61	-94.5	801	37	-95.3
Minority interest profit (n)	632	583	-7.7	413	425	2.8
Parent company profit (o=i-l+m-n) (4)	7,897	-24,664	-412.3	5,426	-25,908	-577.5
Indicators *(per cent)*						
Ratio of non-interest income to gross income	41.4	41.3		41.4	42.4	
Cost/income ratio (5)	65.1	67.9		63.8	67.9	
Value adjustments in respect of loans/operating profit	57.9	65.4		60.0	71.2	
ROE	3.4	-9.2		3.8	-15.8	

Sources: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to groups.
(1) Rounding may cause discrepancies. For the sake of homogeneous comparison, the composition of the banking groups is that at the end of 2011. – (2) Five largest groups by total assets as at December 2011. – (3) Provisional data. – (4) Includes the after-tax profit of banks not belonging to groups. – (5) Ratio of operating expenses to gross income.

Net interest income increased by 1.1 per cent and €573 million. Trading income benefited from the recovery of the financial markets in the first half of 2011, more than offsetting the decline of 1.0 per cent in net fee income. Gross income increased by 1.0 per cent.

Operating profit diminished by 7.2 per cent with respect to the previous year, mainly owing to the 5.4 per cent increase in operating expenses, two thirds of which was due to larger depreciations on intangible assets other than goodwill (but including trademarks and patents). Staff costs and other administrative expenses rose by 1.5 per cent, mainly for one-off items that included the cost of early retirement incentives. The cost of wages and social security contributions remained unchanged. The cost-income ratio was 67.9 per cent, up almost 3 percentage points on 2010.

Provisions and value adjustments reflected the impairments of goodwill by the main banking groups, which accounted for most of the increase. Loan write-downs increased by 4.8 per cent and amounted to 65.4 per cent of operating profit, some 8 percentage points more than in 2010.

Capital

In 2011 Italian banks significantly improved their highest-quality capital resources, the component most able to absorb losses, principally through recourse to the market.

Capital and capital ratios. – At the end of the year consolidated regulatory capital amounted to €238.3 billion, up by 4.5 per cent from the end of 2010 (Table 17.5). The increase reflected the strengthening of tier 1 capital, up by 8.4 per cent to €184.2 billion, following the large capital increases made during the year by some major banking groups. The capital strengthening was only in small part the result of self-financing, which remains limited during this economic phase. Supplementary capital decreased by 7.4 per cent to €59.4 billion owing to the non-renewal of maturing subordinated liabilities. Risk-weighted assets remained stationary; those of the largest banking groups fell by 1.6 per cent.

Table 17.5

Capital adequacy of Italian banks and banking groups (1)
(end-of-period data in millions of euros)

	Banking system		Main groups (2)	
	2010	2011	2010	2011
Allocations to regulatory capital	5,171	2,212	3,195	31
Regulatory capital	227,960	238,253	136,475	142,635
Core tier 1 capital ratio (%)	8.3	9.3	7.4	8.9
Tier 1 capital ratio (%)	9.3	10.0	8.9	10.0
Total capital ratio (%)	12.4	13.0	12.5	13.3
Financial leverage (3) (4)	19	17	22	19
Excess capital	81,531	91,397	49,451	56,888

Source: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to a group.
(1) Excludes the Italian branches of foreign banks. – (2) Five largest groups by total assets as at December 2011. – (3) Ratio of total balance-sheet assets to tier 1 capital. – (4) Provisional data.

Capital strengthening led to an increase in capital ratios compared with the end of 2010. The core tier 1 ratio rose by one percentage point to 9.3 per cent and the tier 1 ratio by 0.7 points to 10.0 per cent. The total capital ratio reached 13.0 per cent, a gain of 0.6 points.

The increase in the capital ratios of the five largest banking groups was the result of capital increases made during the year, for a total value of over €10 billion, and the restructuring of hybrids eligible for conversion into core tier 1 capital (over €2.5 billion), as well as the reduction in risk-weighted assets. At the end of last year the average core tier 1 ratio of these groups was 8.9 per cent, compared with 7.4 per cent at the end of 2010, while the tier 1 ratio and total capital ratio stood at 10.0 and 13.3 per cent respectively, against 8.9 and 12.5 per cent at the end of 2010.

The capital ratios of the two largest Italian groups continue to be low by international standards, although their recent recapitalizations have narrowed the gap with the leading European banks. At the end of 2011 the tier 1 ratio of a sample of eleven large European banks averaged 12.1 per cent, compared with 10.2 per cent for the two Italian groups. However, the leverage of the European banks, measured by the ratio of total balance-sheet assets to tier 1 capital, was much higher than that of the Italian banks: 30 as against 19.

The outlook for capital strengthening. – Following the decision of the European Council of 26 October 2011 to strengthen the capital of banks so as to improve their ability to cope with further shocks and reassure investors of their soundness, on 8 December the European Banking Authority (EBA) issued a recommendation on banks' capital.

In order to achieve the target for capital set out in the recommendation, four of the five banks taking part (UniCredit, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, Banco Popolare and Unione di Banche Italiane) needed to increase their capital by a total of €15.4 billion. In particular, UniCredit needed an extra €8.0 billion, Banca Monte dei Paschi di Siena €3.3 billion, Banco Popolare €2.7 billion and Unione di Banche Italiane €1.4 billion. Only Intesa Sanpaolo did not require any additional capital.

On 20 January of this year the banks notified the Bank of Italy of their proposed plans to achieve the capital target. At the end of May, following discussions with the supervisory authorities, their final plans were submitted to the EBA. At the beginning of this year the UniCredit group made a sufficiently large capital increase to meet its full capital requirements. The other banks intend to take a number of steps, including asset disposals, operations involving hybrid instruments, profit capitalization, and optimization of risk-weighted assets via internal model validation.

Also in January the Bank of Italy reviewed the conditions for authorizing buy-backs, which allow banks to strengthen their capital base by using any gain (due to the buy-back price being lower than the issue price) to increase their core tier 1 capital. It is estimated that the buy-backs conducted by the five largest groups in the first months of 2012 will raise the core tier 1 ratio by 10 basis points on average. Taking into account UniCredit's capital increase at the beginning of the year, the average core tier 1 ratio should rise to 9.7 per cent.

A further contribution to the banks' capital strengthening should come from the entry into force of Basel III on 1 January 2013 and its passage to full operation by 2019. The Bank of Italy's periodic survey of a sample of 13 banking groups, with over 70 per cent of the system's total assets, confirms that the process of adjusting to the prudential requirements of Basel III is proceeding on schedule.

The activity of non-bank intermediaries

Asset management companies. – Asset management companies recorded net profit of €385 million in 2011, 22.6 per cent less than in 2010 (Table 17.6). The decline was largely due to the contraction in assets under management and the consequent drop in fee income. Measures to contain operating costs, including through company and group restructuring, only partly offset the decrease in gross operating profit. The final outturn was also affected to a large extent by losses of around €19 million on participating interests and €36 million of value adjustments to intangible assets. Around one third of asset management companies (65 to be precise) closed the year with a loss; 40 per cent of them specialize in real-estate funds.

Table 17.6

Asset management companies: income statement data
(millions of euros; per cent and percentage changes)

	2010		2011		Percentage change
	Amount	Per cent (1)	Amount	Per cent (1)	
Fee and commission income	4,313	236.5	3,958	236.4	-8.2
Fee and commission expense	2,489	136.5	2,284	136.4	-8.3
Gross operating profit (2)	**1,823**	**100.0**	**1,674**	**100.0**	**-8.2**
Administrative expenses	1,157	63.5	1,141	68.1	-1.4
of which: staff costs	*627*	*34.4*	*612*	*36.5*	*-2.4*
Other operating expenses	22	1.2	20	1.2	-8.4
Total operating costs (3)	**1,237**	**67.8**	**1,227**	**73.3**	**-0.8**
Other operating income	69	3.8	89	5.3	29.5
Net operating profit	**656**	**36.0**	**537**	**32.0**	**-18.2**
Result on financial operations	108	5.9	74	4.4	-31.3
Result on ordinary activities	**764**	**41.9**	**611**	**36.5**	**-20.1**
Taxes	267	14.6	226	13.5	-15.4
Net profit (loss) for the year	**497**	**27.3**	**385**	**23.0**	**-22.6**

Source: Supervisory reports.
(1) Amount as a percentage of gross operating profit. – (2) Individual and collective portfolio management. – (3) Includes value adjustments to tangible and intangible fixed assets.

The ratio of regulatory capital to the overall capital requirements (5.1) showed almost no change with respect to the previous year as both regulatory capital (€1,840 million) and overall capital requirements were virtually stationary.

Investment firms. – Italian investment firms' profitability in 2011 reflected the strains on the financial markets with a reversal of the positive trend recorded in the previous two years. They closed the year with an overall net profit of €68 million, down 41 per cent with respect to 2010. ROE decreased from 13 to 8 per cent.

The deterioration in gross income, which fell by 21 per cent, was largely due to the decrease in net fee income from order collection and execution services. Despite the reduction of 14 per cent in operating costs, the cost/income ratio rose to 76 per cent, from 71 per cent in the previous year.

At the end of 2011 investment firms' regulatory capital, consisting almost entirely of tier 1 elements (capital and reserves), was 7 per cent lower than a year earlier, mainly owing to the closure of two large firms. Judged on a constant sample, overall regulatory capital was basically unchanged.

Financial companies. – Financial companies entered in the register established by Article 107 of the Consolidated Law on Banking recorded an improvement in their volume of operations, although with differences among sectors. During the year the flow of loans granted rose by an average of 11.8 per cent. Overall, there was a worsening in the risk on their assets. The quality of loans granted by financial companies showed signs of a deterioration. Bad debts and impaired assets accounted for 5.9 and 10.4 per cent of total exposures, compared with 5.0 and 9.0 per cent in 2010.

Article 107 companies closed 2011 with profits down by 18.3 per cent with respect to the previous year. Their overall gross income decreased by 9.4 per cent, mainly due to a contraction in interest income and net fee income. The number of loss-making companies rose from 59 to 67, representing 23.1 per cent of the total balance-sheet assets. Again, loss-making companies were most numerous in the leasing and consumer credit sectors.

The solvency ratio was in line with the previous year's figure, standing at 8.0 per cent, which is above the regulatory level of 6 per cent.

18. INSTITUTIONAL INVESTORS

The Italian asset management industry registered a net outflow of resources amounting to €43 billion in 2011, against a net inflow of €3 billion in 2010 (Table 18.1). Net fund-raising declined for investment funds, life insurance products and individually managed portfolios. Owing in part to the negative performance of the financial markets, the value of assets under management fell by 5 per cent to €880 billion, or 56 per cent of GDP. The share of households' financial assets managed by institutional investors remained stable at 24 per cent.

Table 18.1

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

	Net flows		End-of-period stocks			
	2010	2011 (1)	2010	2011 (1)	Percentage composition	
					2010	2011 (1)
Investment funds (2)	-19,886	-30,008	229,278	192,261	18.7	16.5
Insurance companies (3)	21,274	1,295	473,414	476,991	38.6	40.8
Pension funds (4)	5,035	5,246	55,823	60,125	4.6	5.1
Individually managed portfolios	6,133	-15,645	467,761	438,884	38.1	37.6
Total	**12,556**	**-39,112**	**1,226,276**	**1,168,261**	**100.0**	**100.0**
Consolidated total (5)	**2,546**	**-43,056**	**930,127**	**880,050**	–	–
as a percentage of GDP	*0.2*	*-2.7*	*59.9*	*55.7*	–	–

Sources: Based on Bank of Italy, Isvap, ANIA and Covip data.
(1) Provisional. – (2) Italian investment funds and SICAVs. – (3) Technical provisions. Excludes Italian branches of EU insurance companies and includes Italian branches of non-EU insurance companies. – (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 managed on an individual basis by asset management companies, and the technical provisions of insurance companies deriving from the management of open pension funds.

Fund-raising was weakened both by the decline in Italian households' saving and by the shift in the composition of their financial portfolios in favour of government securities and bank products.

Italian investment funds registered massive net redemptions, concentrated in the money market and bond segments. The net flow of resources into funds promoted by foreign intermediaries diminished; at the end of the year these funds accounted for about one quarter of the total net assets of open-end funds distributed in Italy.

After the positive results of the previous two years, net fund-raising for individually managed portfolios and insurance companies fell drastically. Disinvestment was especially large in the second half of the year, in concomitance with the mounting tensions in the financial markets. Among insurance products, the decline regarded in particular index- and unit-linked policies, for which the investment risk is borne mainly by the policyholder. In the supplementary pension fund sector, contributions and enrolments grew at a modest pace, although insurance-based pension products continued to expand.

Investment funds

Fund-raising. – The net outflow from Italian open-end funds increased from €24 billion in 2010 to €34 billion last year (Table 18.2); net redemptions were very substantial for funds that invest mainly in euro-area government securities and money market instruments (€13 billion and €8 billion respectively). The net inflow to foreign investment funds plunged from €30 billion to €1 billion; the decline involved both funds set up by Italian intermediaries and those controlled by foreign groups.

Table 18.2

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

	Number of funds (2)		Net assets		Net fund-raising (3)	
	2010	2011	2010	2011	2010	2011
Harmonized open-end funds	596	608	165,183	131,573	-23,754	-29,691
Equity	173	166	23,952	19,145	-2,130	-1,906
Balanced	53	52	12,726	10,127	-1,655	-1,915
Bond	186	196	74,665	60,116	-2,104	-13,911
Money market	29	27	35,406	25,621	-18,248	-8,082
Flexible	155	167	18,434	16,564	383	-3,877
Non-harmonized open-end funds	246	203	29,376	22,119	-647	-4,795
Hedge funds (4)	145	120	10,586	8,051	-1,562	-1,676
of which: funds of funds	*127*	*98*	*8,540*	*6,558*	*-1,189*	*-1,333*
Other	101	83	18,790	14,068	915	-3,119
of which: funds of funds	*52*	*50*	*6,742*	*6,203*	*1,710*	*-253*
Total open-end funds	**842**	**811**	**194,559**	**153,692**	**-24,401**	**-34,486**
Closed-end securities funds	132	133	6,111	6,994	296	103
of which: reserved to qualified investors	*124*	*126*	*5,869*	*6,797*	*296*	*123*
Closed-end real-estate funds	296	331	28,608	31,575	4,219	4,375
of which: reserved to qualified investors	*269*	*303*	*22,409*	*25,773*	*4,120*	*4,416*
Total closed-end funds	**428**	**464**	**34,719**	**38,569**	**4,515**	**4,478**
Total	**1,270**	**1,275**	**229,278**	**192,261**	**-19,886**	**-30,008**
Memorandum items:						
Foreign funds (5)						
set up by Italian intermediaries (6)	834	901	175,863	176,166	11,886	-3,974
of which: hedge funds	*26*	*26*	*2,614*	*1,849*	*-478*	*-610*
set up by foreign intermediaries	1,923	2,025	90,370	96,913	18,473	5,190

Sources: Bank of Italy and Assogestioni.
(1) Italian investment funds and SICAVs. – (2) For Italian funds, those in operation at the end of the year indicated. For foreign funds, those acquired by Italian investors. – (3) For closed-end funds, net fund-raising is calculated as the difference between new subscription commitments received and any redemptions made by asset management companies, as shown in supervisory reports. – (4) Side-pocket accounts are included in net assets and net fund-raising; they are not included in the number of funds. – (5) Net assets and net fund-raising refer to the value of units held and subscribed, respectively, by Italian investors. – (6) Funds run by management companies resident in Luxembourg or Ireland.

The large outflow of savings from Italian investment funds reflected a greater propensity to invest directly in Italian government securities and medium- and long-term bank products, which in the last months of the year offered high yields to maturity for what were nevertheless considered low risks. Investment funds' modest performance during the year and banks' more aggressive supply policy aimed at increasing direct fund-raising from customers were probably factors in changing the composition of households' portfolios.

The net flow of resources into closed-end real-estate funds was practically unchanged from the previous year at €4 billion, while that into closed-end securities funds (mainly private equity funds) diminished from €296 billion to €103 billion.

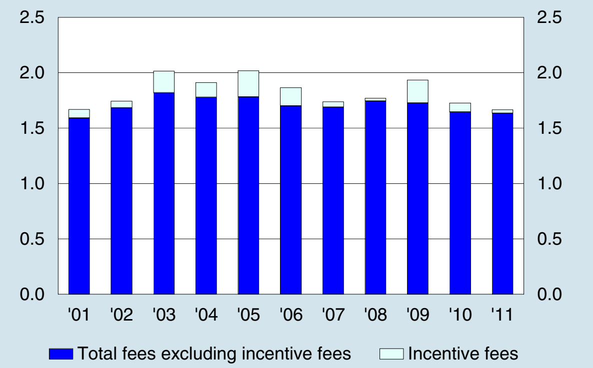
Yields and fees. – Italian harmonized funds' average return net of taxes and fees was negative by 3.2 per cent in 2011, reflecting the performance of the financial markets in the second half of the year. The losses were substantial for equity, flexible and balanced funds (-12.2, -5.9 and -4.8 per cent respectively), small for bond funds (-0.2 per cent). Money market funds returned a slightly positive 0.8 per cent.

The total fees charged to harmonized investment funds (management and incentive fees, depositary bank fees, securities brokerage commission and other minor items) fell from €2.2 billion to €1.9 billion, of which €1.7 billion paid to the funds' management companies. Total fees continued to decline in relation to average annual net assets, from 1.73 to 1.67 per cent (Figure 18.1) owing to the lower incidence of incentive fees. According to Borsa Italiana data, the average ratio of total fees to net assets of exchange-traded funds (ETFs) was 0.4 per cent, low compared with other investment funds.

Figure 18.1

Italian securities investment funds: total fees (1)

(per cent)



(1) Simple average of total fees paid by the individual funds, calculated as the percentage ratio of total annual fees to average net assets for the year. For continuity with the data for 2001-02, securities brokerage commissions are excluded. The data refer to harmonized investment funds and SICAVs. The data for the last two years are provisional.

Supply. – The number of Italian open-end funds fell again in 2011, from 842 to 811. Non-harmonized funds accounted for all of the contraction, which largely reflected mergers between funds, in some cases following corporate reorganizations. Owing to the large outflow of resources, however, the average size of funds in all the main categories shrank further.

By contrast, the number of foreign funds distributed in Italy continued to grow. Those controlled by Italian intermediaries increased from 834 to 901 and those set up by foreign groups from 1,923 to 2,025. Flexible, equity, corporate-bond and emerging-country funds predominated among the new products.

The number of ETFs listed on Borsa Italiana, all of them issued by foreign intermediaries, rose from 480 to 570. The portion of their assets deposited with Monte

Titoli remained virtually unchanged at €17 billion. The number of structured ETFs grew from 57 to 71 and their net assets from €0.8 billion to €1 billion.

Closed-end real-estate funds continued to expand in spite of the market troubles. Between 2003 and 2011 their number rose from 19 to 331 and their assets from €5 billion to €54 billion. A major boost to this growth came from new funds reserved to qualified investors, mostly formed through the contribution of property portfolios belonging to social security institutions, insurance companies or banks. By contrast, the assets of retail funds continued to contract owing to disposals of properties by funds approaching maturity. At the end of 2011 funds reserved to qualified investors accounted for 68 per cent of real-estate funds' total assets, retail funds for 16 per cent and hedge funds for the remainder.

Many reserved funds controlled by individual investors were put into liquidation following the tax reform of May 2011, which made the tax treatment of non-institutional investors with substantial holdings in real-estate investment funds less favourable. This should assist a rationalization of the sector by reducing the number of funds in operation.

The Italian investment fund industry. – The role of domestic intermediaries in the Italian investment fund market continues to shrink. On the basis of data published by Assogestioni, in 2005 the assets of open-end funds belonging to Italian groups made up an estimated 90 per cent of the units subscribed in Italy; in 2011 the proportion fell to 73 per cent. More than 50 per cent of the assets controlled by Italian intermediaries now refer to funds set up abroad, compared with 30 per cent in 2005. The erosion of the Italian fund industry's market share reflects both the differing dynamics of net fund-raising and the consolidation of the financial industry in Europe. At the end of 2011 funds established by Italian groups accounted for about 5 per cent of the assets of European open-end investment funds.

The investment fund industry in Italy has been affected by the supply strategies of the banking groups that play a prominent role both as owners of asset management companies and as distributors of investment funds. In some cases, groups' industrial choices may have limited asset management companies' autonomy and capacity for innovation. In the past, a number of regulatory impediments contributed to the crisis of the sector; these have been substantially overcome by the regulatory measures put in place in recent years.

With effect from 1 July 2011 the tax regime for Italian investment funds changed from annual taxation levied on the accrued income of the fund to a tax levied on the investor at the time income is received, as was already the case for foreign funds distributed in Italy. An analysis of a broad sample of equity funds suggests that the reform has made an economically and statistically significant contribution to reducing the difference between net fund-raising by Italian and foreign investment funds. The analysis takes account of returns, risk profiles and other characteristics of the sample funds. The new rules make it easier for investors to compare the yields before tax published by foreign and Italian funds and allow them to defer payment of taxes on the gains of the fund. In the future, the reform could also contribute to more efficient portfolio management, permitting funds to work off tax credits accumulated under the previous tax regime.

Transposition of the UCITS4 Directive on collective investment undertakings was completed last May with the approval of the amendments to secondary legislation by the Bank of Italy and Consob. The UCITS4 Directive regulates the so-called European passport, simplifies the cross-border marketing of harmonized funds and governs cross-border mergers between funds.

Individually managed portfolios

Individually managed portfolios operated by Italian banks, asset management companies and investment firms registered net redemptions of €16 billion in 2011 after raising net new resources amounting to €6 billion in 2010. The outflows were concentrated in the retail sector and were largest for the portfolios ascribable to banking groups.

The total value of assets under management fell from €468 billion to €439 billion as a result of the outflow of savings together with generally negative financial results. At the end of the year 60 per cent of the assets were managed by Italian banks either directly or by means of subsidiary asset management companies; the remaining 40 per cent were managed by investment firms or asset management companies not affiliated with banking groups.

Individually managed portfolios run by foreign intermediaries, chiefly on behalf of institutional investors, registered a net inflow of €3 billion, compared with €5 billion in 2010. According to Assogestioni data, their share of total assets managed on behalf of residents rose from 2 per cent in 2005 to 19 per cent in 2011, in part following corporate restructuring measures. The largest increase was in portfolios connected with retirement saving and insurance products, where foreign groups increased their share from 6 to 35 per cent and from 2 to 23 per cent respectively. By contrast, their share of the market in portfolios for retail investors remained limited, rising from 1 to 8 per cent.

In 2011 Italian intermediaries' individually managed portfolios made substantial net purchases of medium- and long-term Italian government securities and net disposals of foreign assets. At the end of the year bonds and government securities made up 65 per cent of their holdings, units of largely foreign investment funds 24 per cent, and equities 11 per cent. Their yield — the percentage increase in net assets less net fund-raising – was negative (-2.8 per cent, against a positive return of 2.5 per cent in 2010), in line with the overall return on investment funds.

Insurance companies

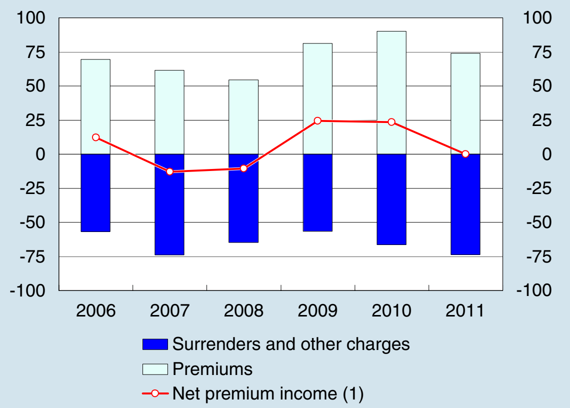
Premiums and technical provisions. – Insurance companies' gross premium income fell by 12.5 per cent to €110 billion. The decline was entirely due to the 18.0 per cent decrease in the life sector, where the outflow was sharpest for riskier financial products and for policies distributed through bank branches. Premiums in the non-life sector showed a slight increase of 1.4 per cent.

After appreciable net inflows of resources in the previous two years, the life sector's premium income net of claims and surrenders was basically nil (Figure 18.2). The downturn can be ascribed not only to lower sales but to the large volume of disinvestment by customers before policies reached maturity (€74 billion, against €66 billion in 2010), with a peak in the last quarter of the year. Net surrenders were recorded for unit- and index-linked policies and for capitalization products. Sales of pension-related insurance products grew more slowly.

Figure 18.2

Life insurance premium income

(annual data; billions of euros)



Source: ANIA.
(1) Premiums less surrenders and charges in respect of claims and payments falling due.

Life insurance premium income was affected by the competition of bank savings products. The share of premium income booked through bank branches, though still high, fell from 61 to 56 per cent, to the benefit of the shares for financial salespersons and agents, which rose respectively from 16 to 18 per cent and from 23 to 26 per cent. The share accounted for by brokers and direct sales remained unchanged.

Insurance companies' technical provisions showed virtually no change, partly as a consequence of modest financial returns. At the end of 2011 they amounted to €417 billion for the life sector and €60 billion for the non-life sector. During the year the share of Italian government securities in the companies' portfolios rose by 6 percentage points to 43 per cent, while the portion invested in foreign securities and investment fund units declined.

Market indicators and profitability. – The market indicators for listed insurance companies showed an overall deterioration of economic prospects, falling back to their lows since the start of the financial crisis (*Financial Stability Report*, April 2012). Similar developments were recorded for insurance companies in the other main European countries. Italian insurance companies' share prices fell by 24 per cent, compared with a drop of 22 per cent for the euro-area insurance sector.

The profitability of the life sector was hit by the weakness of new business and the negative results on financial operations. Many companies availed themselves of a recent regulatory measure that permits them not to record unrealized capital losses on government securities in the financial statements, where they had constituted unavailable reserves. The profitability of the non-life sector was weighed down by slack demand and the high cost of claims but buoyed, on the other hand, by the increase in motor liability insurance rates.

In the last decade Italian insurance companies' profitability has been lower than that of insurers in the other main euro-area countries. On the basis of Bureau van Dijk data, between 2000 and 2010 in Italy the average return on equity was 10 per cent in the life sector (against 11 per cent in Germany and France) and 7 per cent in the non-life sector (against 13 per cent in France and 8 per cent in Germany). The crisis depressed profitability from 2007 on as a consequence of the negative results on financial operations of the life sector and the increase in losses on claims. The same period also saw a significant increase in the dispersion of results across Italian insurance companies. In France and Germany the decline in profitability and the increase in dispersion were less pronounced.

Pension funds

Assets and enrolments. – Reflecting modest returns on operations, the assets of supplementary pension schemes (pension funds and insurance-based individual pension plans) grew by 9.6 per cent in 2011, down from 13.6 per cent in 2010 (Table 18.3). Net fund-raising, defined as the balance between contributions and benefits, remained stable at about €7 billion. At the end of 2011 total assets amounted to €73 billion (4.6 per cent of GDP), with occupational pension funds accounting for 34 per cent, individual pension plans 18 per cent, open pension funds 11 per cent and pension funds set up before the 1993 reform the remaining share.

Table 18.3

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

	Number of funds (2)		Persons enrolled (3)		Total assets	
	2010	2011 (4)	2010	2011 (4)	2010	2011 (4)
Pension schemes set up after the 1993 reform	183	181	4,603,954	4,871,823	41,126	46,828
Occupational pension funds	38	38	2,010,904	1,994,280	22,384	25,272
Open pension funds	69	67	848,415	881,311	7,533	8,364
Individual pension plans	76	76	1,744,635	1,996,232	11,209	13,192
Pension funds set up before the 1993 reform	375	363	668,625	664,957	25,735	26,297
Total	**558**	**544**	**5,272,579**	**5,536,780**	**66,861**	**73,125**

Source: Based on Covip data.
(1) Excludes the Bank of Italy staff pension fund. Figures for the number of funds and total assets do not include data for FondInps. – (2) The data for insurance-based individual pension plans and the total only include plans compliant with the requirements of Legislative Decree 252/2005. – (3) Excludes double-counting due to persons being enrolled simultaneously in individual pension plans compliant with Legislative Decree 252/2005 and in other individual pension plans. For funds set up before the 1993 reform, estimates. – (4) Provisional data.

The total number of persons enrolled rose from 5.3 to 5.5 million, but there was also a further increase in the number of those who temporarily stopped contributing to their pension scheme. As in previous years, the progress of net enrolment differed by type of scheme: a slight decrease of 0.8 per cent for occupational pension funds and a modest increase of 3.9 per cent for open pension funds contrasted with a further large rise of 14 per cent for individual pension plans.

Returns and costs. – Pension funds' financial results reflected the negative performance of the markets. According to Covip data, the average return (net of management expenses and taxes) was practically nil for occupational funds (0.1 per cent) and negative for open funds (-2.4 per cent). Individual pension plans associated with unit-linked products, where a substantial portion is invested in equity sub-funds, returned -5.7 per cent, while individual pension plans implemented through separate accounts recorded a positive return of 3.5 per cent thanks to the large proportion of their portfolios invested in debt securities and the possibility of valuing assets at cost.

The costs borne by subscribers remained unchanged as a whole. For a 35-year holding period the synthetic cost indicator, which measures the reduction in the annual return due to the costs borne by the subscriber (except incentive fees), averaged 0.24 per cent for occupational pension funds, 1.05 per cent for open pension funds and 1.61 per cent for individual pension plans. The large differences in costs stem partly from differences in investment strategies, enrolment procedures and organizational arrangements. Unlike the other supplementary pension schemes, occupational pension funds are non-profit, incur modest fund-raising expenses and may receive contributions to expenses from employers. Nevertheless, the persistence of a high degree of dispersion of costs within the same type of product suggests that other factors play a part in limiting competition among funds, for example the relatively closed nature of distribution networks.

Investment policies. – The composition of pension funds' assets did not change substantially over the year. At the end of 2011, 66 per cent of the total assets of the funds set up after 1993 was invested in bonds and government securities, 28 per cent in shares and investment fund units, and the remainder in money market instruments. In view of economies of scale that characterize asset management and financial risk control, one impediment to funds adopting more complex investment strategies is their small average size, due both to the relative underdevelopment of supplementary pension provision and to the fragmentation of supply. At the end of 2011 occupational pension funds' sub-funds had average assets of €224 million; balanced and bond sub-funds were larger (€314 million and €284 million respectively) and equity sub-funds smaller (€48 million). Gradual innovation in portfolio selection could be fostered by a revision of regulations to relax some of the quantitative limits on investment in financial assets and, simultaneously, provide for an adjustment of funds' organizational structures.

Information campaigns. – Decree Law 201/2011 (the "Save Italy" Decree) directs the Ministry of Labour and Social Policies, the social security institutions and the sectoral authorities to prepare an annual programme of information initiatives on pension issues. It also directs the social security institutions to give workers information on their pension position. These measures can help familiarize workers with the rules and increase the propensity to engage in supplementary retirement saving. Empirical studies based on US data have in fact shown that financial knowledge is positively correlated with an ability to make long-term financial plans.

19. SUPERVISION

In 2011 and in the early months of this year the Bank of Italy, in conducting banking and financial supervision, continued to concentrate on the impact of the economic and financial turmoil on intermediaries' risk exposures, capital adequacy and profitability.

Off-site prudential controls and on-site inspections found a worsening of risk exposures, in particular credit and liquidity risk. Special attention was paid to the analysis of intermediaries' organizational structures, whose improvement is essential to enhancing soundness and the ability to cope with adverse scenarios.

Intermediaries' progress to date in strengthening their capital bases and improving risk management and control processes, thanks in part to the Bank's supervisory activity, shows that the difficulties experienced in the course of the crisis can be overcome without jeopardy to the overall stability of the system.

Supervision of banks

The prudential supervisory controls carried out in 2011 found an increase in the number of banking groups with problematic aspects (i.e. negative overall appraisals of varying degrees), in whose regard the corrective measures required were decided with reference to each bank's overall situation. The number of letters asking for such measures increased by a half compared with 2010.

Approach to the main risks. – In monitoring exposures to the different kinds of risk the Bank has increasingly compared its own analytical models with the risk management methods of the supervised institutions. In many cases the latter were asked to refine their instruments and reinforce their risk management structures.

Special attention was paid to the evolving quality of loan portfolios. The number of meetings with corporate officers on this topic nearly doubled by comparison with the previous year. On-site controls of performing loans with signs of anomaly enabled supervisors to avoid improper asset classifications and specify the scope for improvement in credit processes, in particular in the valuation and monitoring of loans.

Liquidity risk safeguards were strengthened in the second half of the year during the most acute phase of the sovereign debt crisis, which drastically restricted access to some funding channels. Where necessary, the Bank of Italy asked banks' boards of directors, by letter, to take prompt corrective action. Following the extraordinary measures taken by the Eurosystem and the introduction of government guarantees of banks' fund-raising, which significantly improved liquidity positions, the Bank focused on the actions that banks must undertake in order to increase the share of the more stable sources in their funding in the medium term.

In the current context, strategic risk is becoming increasingly important. Banks must perceive and respond promptly to the changing market situation, adapting and renovating their business models. They are accordingly called on to reinforce their capacity for strategic planning and the efficacy of their decision-making by improving governance and setting specific targets for overall risk taking.

Checks on internal models for quantifying capital requirements for Pillar 1 risks. – With respect to internal credit risk assessment models already validated by the Bank of Italy, a comparative analysis has recently been initiated at the main banking groups to detect discrepancies between them in ways of calculating capital requirements against risk assets with similar characteristics. This will enable the Bank to contribute to the Basel Committee's inquiry into international differences in regulations and in methods of calculating risk-weighted assets.

The controls checked the adequacy both of already-validated and of pre-validated models. In the first part of 2012 two banking groups were authorized to use their internal models for prudential purposes.

The size and degree of internationalization of the banking groups determines how complicated it is to supervise the models, which to this end can be classed in two main families: group-wide and local. The former are developed and managed centrally by the parent company and applied uniformly to all group members. The latter are developed and managed independently by the individual subsidiaries with the parent company's oversight. In the last year the Bank of Italy has reinforced coordination with the authorities in other countries to serve reciprocal information needs and share assessments of group-wide and local risk measurement models.

Strengthening capital and improving profitability. – The Bank of Italy continued to call on banks to increase their level of capitalization, especially for high-quality capital with better loss-absorption capacity. The necessity to continue with capital strengthening stemmed in part from the results of the process of prudential revision and evaluation and in part from the imminent entry into effect of the Basel III rules. Based on the banks' levels of Pillar 1 and Pillar 2 risk as determined by the Internal Capital Adequacy Assessment Process and additional analyses, the Bank of Italy asked banks' management to take the necessary steps to maintain or achieve capital ratios well above the regulatory minimum, setting appropriate trigger or target ratios. The main banking groups' compliance with the European Banking Authority's December recommendation was also monitored. Where capital weakness was detected, the banks were called on to allocate the entire profit for the year to reserves and to limit or eliminate the variable component of staff compensation.

Maintaining adequate profitability is a necessary condition for self-financing, the prime means of capital strengthening. The Bank of Italy has repeatedly urged banks to step up their efforts to improve operational efficiency, in part by streamlining and rationalizing corporate structures and distribution networks. Further gains on this front can derive from the desirable improvement in risk management, for example from a reduction in losses due to operational risk.

Governance, organizational and control structures, compensation. – The Bank of Italy urged the supervised intermediaries to work to improve the quality of their boards of directors, whose members, individually and collectively, need to have skills and competence adequate to the size and operations of each bank. The boards are called on to play a more active role, notably through closer engagement with the main corporate functions, first and foremost risk management.

The banks were asked to keep working on their organization, with a clearer distinction of roles and responsibilities, more fruitful and transparent interaction between the management and control functions, and greater authority and independence for the internal control functions, in particular internal audit and risk management.

The entry into effect of the Bank of Italy's measures on staff compensation – transposing Directive 2010/76/EU (CRD3) and the EBA's guidelines – consolidated the regulatory framework in this sphere. Examination of banks' adaptation to the regulations found substantial compliance, albeit with room for improvement in identifying the staff members who are risk takers and in setting correct risk objectives. Compensation policies and practices were also examined in the course of inspections, with special reference to the incentives for sales networks.

Supervision of Italian-controlled international groups and Italian subsidiaries of foreign banks. – The work of the supervisory colleges of which the Bank of Italy is a member was devoted primarily to setting up the first Joint Risk Assessment and Decision procedure, through which cross-border banking groups were examined jointly by home and host supervisory authorities during 2011. There were problems in producing uniform assessments of the groups and of their national components, ascribable mainly to the different supervisors' use of different criteria and methodologies and to the importance, especially for the two most highly international groups, of some subsidiaries in the foreign markets where they do business. The largest subsidiaries in the host countries, in fact, are frequently subject to especially stringent prudential requirements based in some cases on local supervisory rules or practices.

Supervision of foreign banks' Italian subsidiaries brought out the need for an increase in capital endowments and an improvement in liquidity positions. The related interventions, after consultation with the home authorities and the parent banks, involved requests to modify compensation policies and to strengthen the safeguards against money laundering.

Supervision of specialized banks. – The protracted crisis has had repercussions on practically all the specialized banks operating in Italy. For those engaged solely in the provision of credit, supervisory action concentrated on the quality of the loan portfolio and funding problems. For those specialized in investment services, there was close attention to new forms of risk exposure; the reduction in fee income – due to the shift of funds from asset management products to securities custody accounts – led these banks to seek new sources of income in the form of lending to their larger customers.

Supervision of local banks. – These small intermediaries operating mainly at regional or interregional level are supervised by Bank of Italy branches. Their situation showed signs of deterioration in 2011. Profitability, which was undermined by an increase in credit risk and by funding difficulties, is one of the most vulnerable areas for these banks, whose earnings depend heavily on interest income but whose operating expenses are particularly rigid. Their main strength remains their good capital endowment, as was confirmed by the first estimates of the impact of Basel III on mutual banks, which make up the majority of Italy's local banks.

The supervisory action of the branches focused on the evolving quality of loan assets. The local banks were asked to refine their strategic planning with a view among other things to improving operational efficiency and rationalizing cost structures. In addition, liquidity controls were stepped up on the banks showing signs of strain, which were subsequently allayed by the issue of government-guaranteed liabilities.

Inspections. – On-site controls were directed primarily at assessing banks' exposure to credit and liquidity risk. Strategy guidelines and governance were also carefully considered. There was special emphasis on the quality of borrower screening and credit disbursement, management and recovery. Inspections targeted at liquidity profiles were conducted simultaneously at a number of different banking groups, whose governance and management processes were analysed. Inspections were intensified during the most acute phase of the sovereign debt crisis. For greater effectiveness, compliance checks (on money laundering, transparency and customer relations) were combined and coordinated with the traditional prudential inspections.

The number of inspections during the year was increased from 159 to 169; most (125) were broad-spectrum. There were also 27 targeted inspections, 3 follow-up inspections, 5 thematic inspections focused on performing loan portfolios with indicators of anomaly, and 9 for validation of internal risk measurement models. The proportion of unfavourable judgments increased, and there was a worsening of credit and liquidity risk profiles.

Supervision of non-bank intermediaries

Asset management companies. – In the closing months of 2011 the sovereign debt strains and the worsening growth outlook heightened investors' risk aversion; their choices penalized the investment fund sector. The asset management industry, already facing structural problems, was further burdened by the funding needs of banks, the main marketing channel for investment funds.

As regards open-end funds, the dubious prospects for a recovery of asset volume raised problems of strategic positioning and maintenance of technical balance, especially for the smaller funds. The large number of corporate restructurings carried out in recent years, some of them consequent on the crisis, required the attention of the Bank of Italy in screening the proposed transactions.

As regards closed-end funds, operations were affected by the decreased availability of bank financing and the risk aversion of institutional and individual investors, especially non-residents. The approach of the maturity date of some closed-end funds, in particular retail funds, required their managers to decide whether to maintain the original date and proceed to dispose of a substantial share of their assets in an unfavourable market, or to extend the maturity pending better market conditions. The Bank of Italy reminded managers to plan the liquidation of funds' portfolios carefully, according to the funds' original maturity dates.

The private equity sector was affected by the volatility of the financial markets and the protracted stagnation of the economy. Many operators had trouble carrying out their original business plans or launching new funds; the substantial write-downs since 2008 have essentially wiped out the gains accumulated since they began operations. Supervisory action was directed at monitoring the corrective measures taken. In particular, the Bank weighed the credibility and consistency of plans for relaunching or, alternatively, for the orderly close of business.

The real-estate fund sector – which continued to expand above all in the segment of reserved funds, thanks to property portfolios conferred by social security institutions, insurance companies and banks – suffered from the weak real-estate market, difficult access to finance, and investors' mounting risk aversion. The Bank of Italy continued to call for a reinforcement of company structures, better management skills and stronger control systems as indispensable conditions for the expansion of the funds' business.

Investment firms. – The financial market strains widened the gap between the few investment firms with established growth strategies and good capacity to cope with the possible contraction of business volumes and the rest of the industry, consisting mostly of small intermediaries that find it hard to adjust to an adverse phase of the cycle.

Supervision concentrated on vulnerable firms, prompting their corporate bodies to design more effective strategies and adopt governance and organizational arrangements adequate to the complexity of their business operations and their exposure to the various risk factors. These interventions were also based on inspections that had found weaknesses in strategy and business planning. The decrease in turnover and profitability required the investment firms to carry out strategic repositioning and capital strengthening, which in some cases involved a change in shareholders.

The drive for economies of scale produced a series of mergers, including by the incorporation of some investment firms into other intermediaries, generally within the same banking group. In some cases the deteriorating situation resulted in firms leaving the market.

Intermediaries in the special register. – Supervision of intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking focused on household credit and the intermediaries hardest hit by the recession. Examination of their instruments for controlling liquidity risk was also undertaken. Based on specific liquidity monitoring of a sample of financial intermediaries selected on the basis of volume of business, meetings were held with corporate officers to discuss the problems detected.

Within the special register, the relative importance of mutual loan-guarantee consortiums increased further last year. Supervisory interventions were designed to reinforce organizational structures and internal risk control systems. Special attention was paid to capital adequacy, which depends in many cases on public grants from regional governments or chambers of commerce, and to monitoring the positions guaranteed and the possible underestimation of loan risk, in view of the consortiums' difficulty in obtaining information on the state of the underlying credit relationships.

The impact of the market crisis on securitizations necessitated stepped-up supervisory activity vis-à-vis servicers.

Payment institutions. – Supervisory activity in this field was particularly complicated in that it was directed at initiating interaction with institutions that only recently became subject to the Bank of Italy's oversight. Supervisory action was directed at acquiring information on their business, strategies, organization and internal control systems.

Intermediaries in the general register, loan brokers, financial agents and gold dealers. – The revision of Title V of the Consolidated Law on Banking, begun by Legislative Decree 141/2010, lent impetus to the changes, under way for years now, in the intermediaries entered in the general register referred to in Article 106 of the Law, with the progressive reduction in their number. One factor was a crackdown on irregular situations, which are more common in times of crisis.

The systematic checks on the capitalization of individual operators resulted in better compliance with requirements. Most of those out of line either regularized their position or were induced to exit the market.

Control activity was continued with regard to the most severe problem areas, such as the issue of guarantees, a market segment characterized by the presence of operators that are unauthorized or fail to meet the capital requirements.

Controls were stepped up on financial agents and loan brokers, which under Legislative Decree 141/2010 no longer had to be entered in the Bank of Italy's registers starting on 30 June 2011. The number registered fell sharply, in part because the imminent reform led many – especially those that had been listed in both registers or that had not been continuously conducting the business of financial agency or loan broking – to request deletion. In fact the new rules not only lay down more selective standards for access to the market but also make the two professions incompatible and, for loan broking, require formal incorporation and the payment of yearly fees.

Crisis procedures involving banks and non-bank intermediaries

Thirteen crisis management procedures were initiated in 2011 and four more in the first four months of 2012. In one case maintaining business continuity necessitated recourse to provisional administration of a bank controlled by a Libyan entity subject to the international asset freeze proclaimed as a consequence of the political crisis in that country. The intermediary was subsequently put into special administration, which was terminated in March 2012 with its return to ordinary operation.

Eight banks were subjected to crisis procedures in 2011, including four mutual banks and one publicly owned bank specializing in lending to sporting and recreational organizations. The non-bank intermediaries subjected to special procedures included three asset management companies and the Italian branch of a French investment firm in whose regard the action was taken as a consequence of the liquidation of the parent company ordered by the French authorities. The crisis procedures begun in 2012 involved two asset management companies, one regional bank and one mutual bank.

The special measures were taken as a consequence of grave operational irregularities and regulatory violations owing to shortcomings in governance and control structures, often combined with violations of anti-money-laundering obligations or the requirements of correct customer relations. Only four of the ten cases of special administration and provisional administration in 2011 and the first four months of 2012 were characterized by grave capital losses.

Ten special administration procedures were closed during the year: in six cases with a return to ordinary management, in one with merger into another bank, and in three with the initiation of compulsory administrative liquidation, carried out with the intervention of intermediaries that by various procedures safeguarded the rights of depositors and customers.

At 30 April 2012 there were 53 crisis procedures in progress: 12 special administrations (10 banks and 2 asset management companies) and 41 compulsory administrative liquidations (18 banks, 5 asset management companies, 17 investment firms, and 1 branch of a French investment firm).

Transparency, customer protection and financial education

The Bank of Italy worked on several fronts to improve intermediaries' relations with customers. There were intensive checks on intermediaries' compliance with the rules for transparency and fair conduct. The activity of the Arbitro Bancario Finanziario (ABF) expanded and financial education was reinforced.

To ensure efficient, consistent oversight while limiting the costs to the supervised institutions and guaranteeing effective consumer protection, the Bank of Italy and the Antitrust Authority signed a memorandum of understanding on the exercise of their respective powers regarding transparency and correctness in relations between intermediaries and customers, on the one hand, and unfair commercial practices vis-à-vis consumers on the other. The two institutions also took part in the "EU consumer credit sweep" to monitor the websites of intermediaries offering consumer credit for compliance with EU rules and intervene as necessary. A second exercise ("sweep plus") focused on pre-contract disclosure requirements in the consumer credit sector.

Checks on compliance with the transparency rules and complaints handling. – Oversight was directed, in part through the refinement of methodologies, at the constant monitoring of compliance with the rules on transparency. Increasing attention was paid to organization and internal controls, as well as to ensuring the correctness – substantial as well as formal – of intermediaries' relations with customers. Trasparency and fairness checks, including those carried out as part of regular supervisory activity, numbered 277, bearing on units of 145 different intermediaries (265 branches belonging to 133 banks, 7 branches belonging to 7 intermediaries listed in the Article 107 register and 5 intermediaries listed in the Article 106 register).

During the year the Bank of Italy received 6,560 complaints (an increase of 16 per cent), 46 per cent of them concerning credit management (current account credit, loans, consumer credit). In addition, there were about 1,100 complaints of alleged misreporting of customer data to the Central Credit Register.

Bank fees and the cost of current accounts. – The annual survey of the cost of current accounts covered a representative sample of 218 banks and some 11,500 accounts. Bank statements were used to determine the costs actually sustained by account-holders in 2011. The average cost of having a current account was €105.80, €4.40 less than in 2010.

The same survey also measured the cost – over and above interest expense – of overdrafts and current account loans. The average quarterly cost of overdrafts without a current account loan agreement came to 1.7 per cent of the amount of credit drawn. For current account loans, the fee for making the funds available, which is applied to 85 per cent of these loans, amounted to a quarterly cost equal to 0.5 per cent of the credit granted. In the other cases, the old maximum overdraft free was applied, producing an average quarterly cost of 1.3 per cent of the amount of credit drawn.

Usury. – Again in 2011 the quarterly survey of average overall effective rates for anti-usury purposes was accompanied by assistance to reporting intermediaries and other operators in order to resolve their questions of interpretation.

Alternative dispute resolution. – A growing number of appeals were submitted to the Arbitro Bancario Finanziario (ABF) in 2011, its second full year of activity. A total of 3,578 appeals were lodged with the ABF last year, compared with 3,409 from October 2009 through to the end of 2010. Consumers lodged 2,874 of the appeals; 704 were lodged by firms or professionals. Those involving banks numbered 2,408; those against non-bank intermediaries listed in the Article 106 and Article 107 registers, respectively 57 and 581; those against other operators, 532. The most common type of appeal involved current accounts (502), loans (459), credit cards (404), and ATM and debit cards (381). The number of disputes concerning loans against pledge of one fifth of salary increased from 58 in 2010 to 150 last year and those concerning improper reporting to private credit registers from 161 to 247. About two thirds of the 2,760 cases decided during the year had a favourable outcome for the customer (either the ABF found in the customer's favour or a satisfactory settlement was reached in the course of proceedings that were then terminated).

Financial education. – Promoting financial education is essential to effective customer protection in banking and finance. To upgrade its activity in this field, the Bank of Italy has created a special unit with the task of promoting financial literacy and customers' awareness of their rights and responsibilities. Particular attention is devoted to young people. During the 2010-11 school year the project involved more than 15,000 elementary, middle and high school students, compared with 9,000 in 2009-10. Test results showed significant improvement in knowledge after classroom teaching. The 2011-12 school year saw a further increase in participation and in the training of teachers by the Bank's branches.

Money laundering and terrorist financing

In July 2011 Italy took over the annual presidency of the Financial Action Task Force (FATF). The Bank of Italy provided substantial collaboration in the revision of the FATF's recommendations. The new standards, approved in February 2012, call for more effective application of the risk-based approach and include tax crimes among the money laundering predicate offences. At European level the Bank cooperated in the work of the Anti-Money-Laundering Committee, whose task is to assist national supervisors in ensuring uniform application of the regulations.

At national level, the Bank stepped up its commitment in terms of regulations, controls and institutional cooperation. The regulations, now in course of completion, require intermediaries to have appropriate organizational arrangements and procedures to deal with the risk of being involved, even unwittingly, in money laundering. The Bank's measure regarding organization, procedures and internal controls went into effect on 1 September 2011. Among other things, banks are required to institute a specific anti-money-laundering function.

Examinations of intermediaries' anti-laundering arrangements were conducted as part of the Bank's broad-spectrum inspections and targeted inspections (7 of which were carried out in 2011). The programme of controls at bank branches, selected using the risk-based approach, also continued. From May through December anti-laundering inspections were carried out at 74 branches (belonging to 26 different banks) located in Liguria, Puglia and southern Lazio.

Collaboration with the various authorities engaged in combating and preventing money laundering was intensified. Cooperation with the judicial authorities helped to orient control activities, focusing on the most problematic intermediaries, and to intervene promptly in cases of serious irregularities, in some cases with quick decisions to impose special administration.

Sanctions

In some cases, controls on banks and other financial intermediaries found irregularities for which the Bank imposed sanctions. The most common infractions involved administrative organization and internal control systems, inadequate checks by boards of auditors, and problems in the credit process. About a fifth of the sanctions were for violation of the consumer protection and transparency regulations.

The total amount of fines levied in 2011 was €15.7 million, compared with €18.2 million in 2010. The measures numbered 116, compared with 145 in 2010. The fines were levied on more than 1,100 natural and legal persons. Another 24 sanction procedures were terminated with no action taken. The relatively large amount of the fines, notwithstanding their reduced number, reflects the particularly serious nature of the infractions, which in some cases resulted in the adoption of special measures.

The Bank of Italy has undertaken a broad reform project of its own to simplify and rationalize the sanction procedures. On 27 June 2011 the Governor issued instructions providing that the inquiry be conducted entirely by a single unit; the collegial judgment of the Bank's committee for the examination of infractions is restricted to the more complex cases, i.e. those that do not have precedents or that are systemically important.

Deletions from the register. – In 2011 the Ministry for the Economy and Finance, at the Bank of Italy's proposal, ordered the deletion of 19 intermediaries from the general register under Article 106 of the Consolidated Law on Banking. The irregularities that resulted in the procedures included such violations as unauthorized raising of funds from the public, repeated non-compliance with reporting requirements to the Bank of Italy, and lack of the minimum capital and liquidity to engage in the granting of credit in the form of guarantees.

Controls also resulted in the Ministry's deletion of 53 financial agents or loan brokers. The Bank of Italy itself directly ordered the cancellation of another 82 for continuing non-fulfilment from the time of registration of the requirements for entry, ascertained in the course of subsequent checks. Following detection by the Finance Police of violations of the laws on money laundering or public safety (such as the requirement to report money transfers by non-EU citizens lacking a residence permit to the Prefect), 5 money transfer agents were deleted from the register.

International cooperation

Last year the Group of 20 continued with the implementation of the broad programme of regulatory reform for finance agreed in 2008. After the approval in 2010 of the reform of capital and liquidity requirements for banks (Basel III), last year at Cannes on 4 November the G20 heads of state and government adopted a set of recommendations to deal with the risks posed by systemically important financial institutions. They recognized the progress made in reforming derivatives markets, gave impetus to the work on the shadow banking system, and renewed their commitment to implementing the principles of the Financial Stability Board on compensation policies and the reduction of mechanical reliance on credit rating agencies.

Acknowledging the key role of the FSB in coordinating and monitoring the processes of reform of the international financial system, the G20 agreed to strengthen the Board's independence and its governance.

Regulation of systemically important financial institutions. – The FSB continued its work on systemically important financial institutions (SIFIs) in the five areas for action that had been specified in 2010. The measures that the FSB submitted to the G20 in November 2011 were designed both to reduce the probability of an SIFI failing and to attenuate the possible impact of any such failure. Measures to increase the SIFIs' loss absorption capacity and for more intensive and effective supervision will contribute to achieving the first objective. Improvements to crisis management systems and resolution regimes will help on the second.

The loss absorption capacity of global systemically important banks (G-SIBs) will be increased by imposing capital surcharges of between 1 and 2.5 per cent of risk-weighted assets, increasing with the bank's systemic importance. This requirement can only be satisfied by common equity tier 1 capital. There is also provision for an initially empty "top bucket" subject to a 3.5 per cent surcharge, in order to discourage banks from increasing their relative systemic importance. The new requirements, which will apply to the G-SIBs that have been identified by November 2014, will be phased in starting in 2016 and become fully operational in January 2019. The FSB named the first group of 29 G-SIBs in November 2011; the list will be updated annually.

The G20 also approved the FSB recommendations on the key instruments and powers that must be attributed to national authorities to create effective resolution regimes for SIFIs without exposing taxpayers to the risk of loss. These must include the power to (a) appoint an administrator to manage the firm with a view to restoring viability; (b) constitute a bridge bank to which to transfer the bank's assets and liabilities with a view to subsequent sale on the market; (c) create a company (bad bank) as receiver for impaired or hard-to-value assets; and (d) impose losses on some classes of creditors sufficient to restore solvency (bail-in). An FSB peer review of the state of transposition of these key attributes into national law is scheduled to be conducted by the end of 2012.

For every global SIFI, specific recovery and resolution plans will be required.

The orderly resolution of SIFIs should be facilitated by the creation of crisis management groups, collegial bodies for coordination and information exchange between the main home- and host-country authorities involved in supervision and resolution (supervisors, central banks, finance ministries). Cooperation and information exchange will be governed by ad hoc agreements for each institution.

Progress in other areas of reform. – The FSB's work to strengthen oversight and regulation of the shadow banking system continued. After defining this system as "credit intermediation involving entities and activities outside the regular banking system", the Board devised a process for monitoring the possible risks to the financial system as a whole, with special reference to maturity transformation, liquidity mismatches, credit risk transfer and leverage. The first monitoring exercise identified some areas requiring analysis, on which the FSB is now working. It will release its regulatory proposals by the end of this year. The monitoring will continue annually.

Revision of the international accounting standards. – The International Accounting Standards Board and the Financial Accounting Standards Board continued their work on convergence between the international and American standards (IFRS and GAAP), which are still not perfectly aligned. The common project on credit impairment provides for the release of a new exposure draft in the second half of 2012. The new rules are based on the concept of expected rather than incurred loss. Credit exposures are to be classified into three categories ("buckets"), with incremental write-downs consistent with the extent of the deterioration in the borrower's creditworthiness. The revision of hedge accounting is also proceeding.

Other activities of the Basel Committee. – In the interests of consistent application of the Basel III rules worldwide, the Committee published its answers to frequently asked questions. Under the definition of capital, significant questions are those concerning deferred tax assets, investments in insurance companies and some additional tier 1 instruments.

The Committee explained that deferred tax assets that derive from different accounting and fiscal treatment of some balance-sheet items and do not depend on the bank's future profitability (such as those envisaged in Italy under Law 214/2011) can be weighted at 100 per cent and not deducted from capital. It further explained that significant holdings in insurance companies can be consolidated instead of being deducted from capital, provided that the method of consolidation does not produce an advantage, by comparison with deduction, in terms of capital requirement. For additional tier 1 instruments recorded as liabilities which, under Basel III, must either be converted into shares or written down to cover losses, the Committee specified that a) the trigger level for write-down/conversion must be at least 5.125 per cent of common equity tier 1 (CET1); b) the write-down/conversion must generate CET1 under the relevant accounting standards; and c) the aggregate amount to be written down/converted must be at least the amount needed to immediately return the bank's CET1 ratio to the trigger level or, if this is not possible, the full principal value of the instruments.

In December 2011 the Committee released its consultative paper on revised "Core principles for effective banking supervision" and the associated "Core principles methodology". The aim of the revision is to strengthen banking supervision and ensure greater stability of the financial system at national and global level. The revised principles stress the need for (a) greater intensity and resources to deal effectively with systemically important banks; (b) effective risk management and robust bank governance; (c) the application of a system-wide, macro perspective to the microprudential supervision of banks for pre-emptive action to address systemic risk; and (d) fostering crisis management, recovery and resolution measures (including emergency plans).

The European Commission

Transposition of Basel III. – On 20 July 2011 the Commission presented its proposal for the transposition of Basel III into EU law. The proposal consists of two legislative acts: a Capital Requirements Directive (CRD4), to be transposed by the member states, containing provisions on authorization to engage in banking, the freedom to provide services, cooperation between home and host banking supervisors, the supervisory review process (Pillar 2), and capital buffers; and a Capital Requirements Regulation (CRR) on prudential requirements, directly applicable within member states. The specification of prudential supervisory rules in a regulation responds to the need for a single European rulebook in this sphere. Talks are nearing conclusion in the Council and the Parliament as part of the co-decision procedure, with definitive approval of the two acts slated for June 2012.

Among the most hotly debated themes in the transposition of Basel III were which instruments to include in CET1 and the rules on liquidity and leverage.

The principle of maximum harmonization underlying the Regulation allows for some exceptions for purposes of financial stability. It is acknowledged that differences between member states in terms of economic cycle and the structure of financial systems may necessitate specific interventions.

It is envisaged that for a period of up to two years, possibly extendable, member states may subject banks and investment firms to stricter regulatory requirements (on own funds, large exposures, transparency, capital conservation buffers, liquidity, and the weighting of assets backed by commercial or residential property). The Commission also has the power to impose, for one year, more stringent requirements in a delegated act valid for all member states. The member states may set the level of the countercyclical buffer for banks and investment firms within their jurisdictions and also require a CET1 capital buffer against long-term, systemic macroprudential risks (the buffer can also be imposed on only a part of the financial system). Under the second pillar, national authorities can adopt prudential measures applicable to selected sets of intermediaries that are subject to similar risks.

Crisis management. – The Commission continued its work to reinforce and harmonize the regulatory framework for crisis management, which will result in a proposal for legislation. In April 2012 the Commission released a discussion paper on the power of the authorities to mandate the write-down or conversion into shares of debt (bail-in) in the case of severe difficulties and in the absence of alternative solutions for loss absorption and recapitalization.

Revision of MiFID. – In October 2011 the Commission presented a proposal for revision of the directive on the markets in financial instruments. There are two legislative proposals: a directive for minimum harmonization and a regulation for maximum harmonization. The purpose is to enhance the efficiency, soundness and transparency of markets and strengthen investor protection, making sure that trading in every type of financial instrument is conducted in regulated and perfectly transparent fora: regulated markets, multilateral trading facilities, or organized trading facilities.

Revision of the Credit Rating Agencies Regulation. – In November the Commission released its proposal for revision of the rules governing credit rating agencies, in order to resolve, in line with the FSB's recommendations, the main problems that emerged with the recent crisis: overreliance on the ratings by markets and in financial regulation, the highly concentrated nature of the ratings market, the difficulty of establishing the ratings agencies' liability vis-à-vis investors, the conflicts of interest inherent in the "issuer-pays" model and in the agencies' ownership, and the process of assigning sovereign debt ratings.

The European supervisory authorities and cooperation agreements

The European Banking Authority. – In the first half of 2011 the EBA conducted stress tests on European banks and monitored the impact of the forthcoming application of Basel III in Europe. Then, in December, the EBA issued a recommendation on banks' capital. The measures form part of a broader package designed to restore market confidence, agreed by the European Council on 26 October and confirmed by the Ecofin Council on 30 November. The EBA recommendation calls on national supervisory authorities to require banks, where necessary, to strengthen their capital position by constituting an exceptional, temporary capital buffer. The buffer should be such as to bring the core tier 1 ratio to 9 per cent by the end of June 2012, valuing the sovereign exposures in being at the end of September 2011 at market prices on that day.

The most important regulatory development was the mandate given to the EBA under CRD4/CRR to determine binding technical standards for subsequent adoption by the Commission. The new standards should facilitate uniform application of the rules and the development of the single European rulebook. The EBA must prepare most of the standards by the end of 2012.

European Systemic Risk Board. – The ESRB, which became operational on 1 January 2011, has examined questions relating to foreign currency claims, dollar-denominated loans and the mandates of macroprudential authorities. It issued recommendations on all three questions. In its January recommendation on the macroprudential mandates, the Board called on member countries to recognize the macroprudential function in national legislation, specifying its objectives, and to designate an independent authority – with a primary role for the central bank – endowed with appropriate powers and instruments.

Bilateral and multilateral supervisory cooperation. – The Bank of Italy worked closely with the supervisory authorities of a number of non-EU countries throughout 2011 and the first few months of 2012. General memoranda of understanding for supervisory cooperation were signed with the central banks of Albania and Brazil.

Considerable progress was made in developing the instruments of cooperation among authorities engaged in the supervision of international banking groups. Multilateral agreements were signed for the colleges of supervisors of eight Italian banking groups (Banco Popolare, Unione di Banche Italiane, Banca Monte dei Paschi di Siena, Credito Emiliano, Banca Popolare dell'Emilia Romagna, Banca Mediolanum, Banca Leonardo and Mediobanca) and three international groups for which the Bank of Italy is host authority (Deutsche Bank, State Street Bank and RBC Dexia). Agreements were already in place for the two main Italian groups (UniCredit and Intesa Sanpaolo) and for other major European groups.

Italian legislation

Transposition of CRD3. – The transposition of Directive 2010/76/EU, the third Capital Requirements Directive, into the Italian regulations governing prudential and reporting requirements for banks and investment firms was completed in December 2011 with the revision of the provisions concerning regulatory capital requirements, credit risk, securitizations, market risks, information requirements and covered bonds.

The rules for calculating regulatory capital have been made stricter. In particular, the directive introduces a capital charge for additional value adjustments to assets recorded at fair value in the banking book, extending the standard previously applied only to the trading book.

Under the standardized approach to credit risk calculation, a less burdensome fixed risk weight of 20 per cent was introduced for exposures to regional and other local governments of EU member states denominated and financed in local currency, even when the ratings applied to supervised intermediaries, to which the risk weight is ordinarily linked, would produce a higher weight.

Provisions on securitizations were designed to overcome some regulatory weaknesses that emerged in the course of the financial crisis. In particular, the possibility of regulatory arbitrage was eliminated and the treatment of securitized positions was made to correspond more closely to their actual risk.

The directive introduced significant corrections to the rules on market risk, both under the standardized approach and under the advanced internal ratings-based method, for better correspondence of prudential treatment to the actual underlying risks.

On information requirements, the new rules make it obligatory for intermediaries to divulge to the market all the information needed to assess their degree of risk, if necessary over and above the minimum disclosure requirements already in being. Further, specific information obligations were laid down concerning (a) re-securitizations; and (b) the remuneration policies and practices of banks and banking groups.

Regulatory capital buy-backs. – In January 2012 the conditions for authorizing redemptions or buy-backs of instruments included in the regulatory capital of banks and banking groups were modified in order to eliminate a potential competitive disadvantage of Italian banks with respect to those of other European countries and to facilitate liability management operations in the framework of the strengthening of high-quality capital. The general requirement for prior replacement of the instruments redeemed or bought back with others of at least equal quality was removed. Such operations are now allowed as long as the bank's economic and financial situation and capital adequacy are not compromised. The Bank of Italy retains the power to require replacement based on case-by-case assessment within the framework of the authorization procedure.

In view of the reputational and legal risks deriving from the fact that buy-backs may involve various types of investor, including non-professionals, the provisions reminded banks of the need for full compliance with the general obligations concerning transparency, correct conduct and management of conflicts of interest.

Governance and ownership. – At the start of 2012 the Bank of Italy issued a clarification on the application of the provisions concerning banks' governance and organization as regards the professional qualifications of members of corporate bodies, the composition of these bodies, the process of self-evaluation by boards of directors and, under the EBA guidelines, risk management and control.

To avoid situations that might work to the detriment of competition, Decree Law 201/2011 prohibited corporate officers in credit, insurance or finance from taking or holding positions in competitor firms or groups. To ensure uniform application, the Bank of Italy, Consob and Isvap, with the cooperation of the Antitrust Authority, developed common standards on which to base their respective evaluations.

Banks' eligible equity holdings and related-party lending. – In December 2011 a set of closely interrelated provisions were issued concerning the equity interests that banks are allowed to hold and their risk asset exposures to related parties.

Compensation and incentives practices within banks. – Law 217/2011 (the Community Legislation Law for 2010) made the amendments to the Consolidated Law on Banking and the Consolidated Law on Finance necessary to include compensation practices expressly within the sphere of intermediaries' organization and governance arrangements and to give the Bank of Italy powers of intervention in this matter, including the power to set limits on the variable component of pay.

In March 2012 the Bank of Italy issued a communication reminding banks that in determining their dividend and compensation policies for 2011 they should take account of the need to sustain the economy in the present difficult circumstances and, in the future as well, to maintain adequate capital and prudent liquidity risk management. The Bank set out the criteria it will follow in assessing banks' policies in this area and specified the dividend policies to be adopted: (a) the banks that need to strengthen their capital in accordance with the EBA recommendation of December 2011 should retain their entire earnings; and (b) those that at the end of 2011 had not met the target ratios specified by the Bank of Italy at the conclusion of the annual process of prudential review and assessment should distribute dividends only if accompanied by capital management operations that ensure the rapid attainment of the objectives.

Government guarantee for Italian banks' liabilities. – Article 8 of Decree Law 201/2011, converted into Law 214/2011 on 22 December, empowered the Ministry for the Economy and Finance up to 30 June 2012 to grant a government guarantee covering new liabilities issued by Italian banks for maturities between three months and five years (seven years for covered bonds). These liabilities in turn are eligible as collateral for Eurosystem refinancing. In exchange for the guarantee, banks pay a commission that depends on their risk profile. The calculation of the commission, which is harmonized at European level, is based on market indicators and the banks' credit ratings. The commission charged to Italian banks averages around 1 per cent of the issue amount.

Under the Decree Law, eligibility for the guarantee is subject to the Bank of Italy's evaluation of the issuing bank's capital adequacy and ability to discharge the obligations undertaken. In December 2011 the Bank laid down the rules for applying for guarantees, reminding the banks that the guarantees had to be limited to the amount strictly necessary to restore their medium- and long-term funding capacity and that they must not abuse the support or gain undue advantage from it, in particular in communications to the public.

Consumer protection and transparency. – A number of initiatives were undertaken last year to enhance the protection of bank customers, stimulate competition in banking and finance and foster financial inclusion.

Decree Law 70/2011, converted with amendments into Law 106/2011, revised the provisions of the Consolidated Law on Banking concerning powers to modify contractual conditions (*ius variandi*) and the portability of loans, differentiating the treatment of consumers and microfirms from that of other customers. The latter are not covered by the preclusion of unilateral changes in interest rates in fixed-term contracts or by the provisions on loan portability.

The Decree Law also revised the criteria for determining the usury threshold rate in order to avoid the possibility of credit rationing in a context of low interest rates. The threshold rate is now calculated by increasing the average effective medium-term interest rate not by half, as previously, but by a quarter, plus a fixed margin of 4 percentage points. In any case, the threshold usury rate cannot be more than 8 points above the average rate.

A series of legislative measures implementing the newly introduced Article 117-bis of the Consolidated Law on Banking regulated the charges applicable to current account loans, overdrafts and credit lines, in order to make these charges simpler and more readily comparable, thereby stimulating competition and efficiency. Under the new rules for current account loans, in addition to the interest rate on the amounts of credit actually drawn, banks can only charge a single, all-inclusive commission on the amount of credit made available of at most 0.5 per cent per quarter. For overdrafts and overuse of current account loans, the interest due may be supplemented only by a rapid credit examination fee, of fixed amount.

For purposes of financial inclusion, Decree Law 201/2011 obliges banks, Poste Italiane S.p.A., payment institutions and electronic money institutions to offer a basic account, free of charge for the socially disadvantaged. The characteristics of these accounts have been specified in a convention between the Ministry for the Economy and Finance, the Bank of Italy and trade associations.

Asset management. – In May 2012, following the entry into force of the amendments to the Consolidated Law on Finance enacted by Legislative Decree 47/2012, both the Bank of Italy and Consob issued the amendments to secondary legislation on asset management, plus a joint regulation on the organization and controls of asset management companies implementing Directive 2009/65/EC on harmonized collective investment undertakings (the "UCITS4" directive) and the guidelines of the European Securities and Markets Authority. On this occasion, a comprehensive revision of the rules was carried out in order to produce a more consistent regulatory framework.

The main modifications involved (a) the new regime for cross-border business of UCITS management companies (the "European passport"); (b) simplification of the rules on the marketing of harmonized investment funds in other member states; (c) the rules on cross-border mergers of harmonized funds; (d) the creation of "master-feeders," whereby one investment fund invests most of its assets in another fund; and (e) the rules on funds' risk management. The new rules also specify the division of competence between home and host authorities, determining the rules that apply in various cases and laying down certain obligations for cooperation.

Reform of non-bank intermediaries. –The consultation on the implementing rules for Title V of the Consolidated Law on Banking, as amended by Legislative Decree 141/2010, was concluded in March 2012. The rules, which outline a consistent regulatory framework, subject the financial intermediaries in the register kept by the Bank of Italy pursuant to Article 106 of the Consolidated Law on Banking to a supervisory regime equivalent to that for banks and investment firms. At the same time, the regulations were laid down in accordance with the principle of proportionality, taking account of the size, organization and operational complexity of the intermediaries and the nature of their activity. That is, the need to ensure that the activity of granting credit be restricted to reliable operators was balanced against that for a regulatory system flexible enough not to create unwarranted barriers to market entry while allowing the development of business models compatible with sound and prudent management. The industry's participation in the consultation was ample; the Bank is now examining the comments received.

THE PAYMENT SYSTEM, THE MARKETS AND THEIR INFRASTRUCTURES

20. THE LARGE-VALUE PAYMENT SYSTEM, MONEY MARKET AND FINANCIAL MARKET INFRASTRUCTURES

In 2011 the authorities continued to reinforce financial market infrastructures by defining shared international standards. Monitoring of the implementation of reforms in the various jurisdictions was intensified, consistently with the commitments made at global level.

Last April the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions published a report entitled "Principles for financial market infrastructures", which defines a set of principles to be applied globally to the infrastructures for post-trading, payment and settlement systems, central depositories, central counterparties and trade repositories. The objective is to tighten the existing standards, introduce new ones for types of risk not previously considered and make the regulation and supervision of infrastructures more uniform across countries.

The Financial Stability Board (FSB) has kept attention focused on the initiatives serving to implement the commitment entered into by the Heads of State and Government of the G20 countries at the Pittsburgh summit in September 2009 to increase the transparency of OTC derivative transactions and reduce the related risks. By the end of 2012 contracts will have to be notified to a trade repository and, if standardized, cleared by a central counterparty. In order to encourage the registration of contracts with trade repositories and in compliance with the mandate received from the G20 in 2011, the FSB is coordinating the work to establish a global legal entity identifier for all the legal entities involved in financial transactions.

In 2011 and the early months of this year the OTC Derivatives Regulators' Forum continued its work, promoting arrangements for the cooperative oversight of central counterparties and trade repositories operating on a global basis.

In Europe, the Commission, the Council and the Parliament reached political agreement in February of this year on the regulatory proposal put forward by the Commission in 2010 on OTC derivatives, central counterparties and trade repositories. The resulting European Market Infrastructure Regulation (EMIR), which gives effect in the EU to the decisions of the G20 referred to above, should be published before the summer. The Regulation introduces a harmonized authorization and supervision regime for central counterparties with their registered offices in the EU. The issue and revocation of central counterparty authorizations will be carried out by the competent national supervisory authority, which will also be required to establish, manage and chair a college of supervisors. The Regulation also charges the European Securities and Markets Authority (ESMA) with approving and revoking the registration of trade repositories and with carrying out their supervision.

Last March the European Commission adopted a proposed regulation on central securities depositories (CSDs) designed to create a single market for central depository and securities settlement services in Europe and diminish the settlement risks associated with transactions involving financial instruments. Provision is made for all CSDs to be authorized to engage in the activity and for harmonized prudential controls on their compliance with capital, organizational and corporate governance requirements.

The new European regulation on short selling and credit default swaps (CDSs) on sovereign issuers (Regulation (EU) No. 236/2012 of the European Parliament and of the Council) will come into force on 1 November. The Regulation sets out to enhance the transparency of significant net short positions in shares and sovereign debt securities, introduces some restrictions on uncovered short sales of shares and sovereign debt securities and prohibits the creation of positions in CDSs on sovereign issuers in the absence of an exposure to the underlying sovereign debt.

In October the European Commission presented a proposal for the revision of the MiFID Directive on markets in financial instruments (Directive 2004/39/EC of the European Parliament and of the Council). The proposal provides for a regulation and a minimum harmonization directive to increase the efficiency, reliability and transparency of the markets and strengthen investor protection. A start has been made in the EU Council on the drafting of both measures.

Recent developments

In 2011 the payments handled by the TARGET2 gross settlement system were up on the previous year by 3.7 per cent in value and 1.5 per cent in volume. The operational availability of the system remained at a very high level (99.89 per cent), thereby contributing to the maintenance of financial stability in the periods of the year in which tensions re-emerged in euro-area financial markets.

In the Italian component of TARGET2 from August 2011 onwards there was a significant reduction in cross-border flows, mainly as a result of the sharp contraction in cross-border interbank transactions. This reduction was offset by the growth in payments for the settlement of refinancing operations and overnight deposits with the Eurosystem.

The cross-border transactions settled in TARGET2 result in bilateral imbalances between central banks that, cleared by novation with the ECB on a daily basis, lead to each central bank having a net position in the balance sheet of the ECB (multilateral imbalance); this, in turn, is the counterpart of the net credit or debit entered in the balance sheets of individual central banks. From the second half of 2011 onwards the multilateral imbalances have grown significantly. This can be attributed to the large net outflows of liquidity from the countries most affected by the sovereign debt crisis as a result of foreign investors' net sales of government securities and domestic commercial banks' difficulty in raising funds on the market. The greater need for liquidity has driven these countries' banks to resort to refinancing from their central banks more frequently.

As regards the Eurosystem's infrastructure projects, aimed at increasing the financial integration of the euro area, work proceeded on TARGET2-Securities (T2S), the platform, developed by the Bank of Italy, Banco de España, Banque de France and Deutsche Bundesbank, for the settlement in central bank money of securities transactions denominated in euros and other European currencies. By harmonizing and standardizing operational processes, T2S will foster competition among central depositories, thus lowering cross-border securities transaction costs. In October 2011 the Governing Council of the ECB decided to delay the go-live date of T2S to June 2015, instead of September 2014, in view of the increased technical and functional complexity of the project. On 8 May of this year nine European central depositories (including the Italian Monte Titoli, the German Clearstream and the Spanish Iberclear), which together account for about two thirds of the volumes settled in the euro area, agreed to participate in T2S by signing the T2S Framework Agreement with the Eurosystem. It is expected that other depositories in the euro area will sign the agreement by June 2012.

Progress was also made on the creation of a cooperative framework for the oversight and supervision of the future T2S platform. During the development phase a preliminary assessment has been made of the project to verify its reliability and efficiency and propose possible adjustments; the results have been sent to the T2S Programme Board, the manager of the project.

The Collateral Central Bank Management (CCBM2) infrastructure project, entrusted to the central banks of Belgium and the Netherlands for the creation by the end of 2013 of a common platform for managing collateral in Eurosystem credit operations, encountered difficulties in 2011 that made an interruption necessary. By 2014 the Eurosystem will nonetheless have made some improvements to the existing collateral management system, CCBM.

On the domestic front, work continued on the creation of the clearing mechanism of the Bank of Italy (Centro Applicativo Banca d'Italia – CABI), which will be phased in gradually starting in June this year. The mechanism will allow the Bank of Italy to manage the payments of the public administration using the Single Euro Payments Area (SEPA) format.

Settlement in central bank money

In 2011 there was a further increase in the number of EU central banks using the TARGET2 gross settlement platform. On 4 July the non-euro-area central bank of Romania joined the system, taking the total number of participating central banks (including the ECB) to 24.

The total number of payments settled via TARGET2 in 2011 rose to 89.6 million and their value to approximately €631 trillion; on a daily average basis the number of payments exceeded 348,500 and their value was nearly €2.4 trillion (up on 2010 by respectively 1.5 and 3.7 per cent).

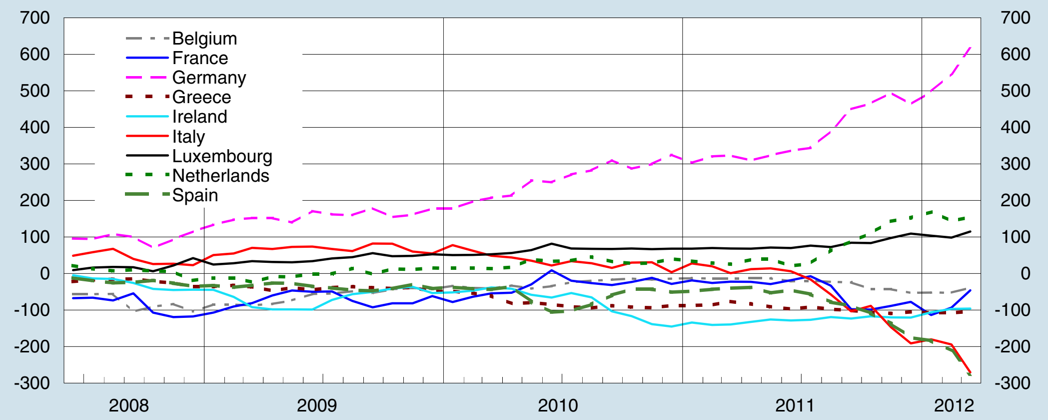
TARGET2 confirmed its position among euro-area high-value payment systems, continuing to handle more than 90 per cent of the total value of the transfers in central bank money. The remaining share was settled via the Euro1 system operated by EBA Clearing, which in 2011 settled a daily average of more than 242,000 payments worth some €249 billion.

The TARGET2 multilateral imbalance, which records the net value of cross-border flows, swung for Italy from close to zero at the end of 2010 to a negative value of about €270 billion at the end of March 2012; over the same period Spain's net debtor position increased from €50 billion to nearly €280 billion (Figure 20.1). By contrast, Germany's net creditor position rose to more than €615 billion and that of the Netherlands to more than €150 billion.

Figure 20.1

TARGET2: multilateral imbalances of selected countries

(end-of-month data in millions of euros)



The performance of the multilateral imbalances in TARGET2 was reflected in the unequal disbursements of credit by the Eurosystem, which allowed the banks of the countries where the financial crisis was most severe to satisfy their liquidity needs previously met by borrowing on the market. The financial risks are borne by the Eurosystem as a whole and are associated with the supply of liquidity for the conduct of monetary policy; they are mitigated by the provisions of the ESCB's Statute and, more specifically, by the Risk Management Framework, which requires monetary policy operations to be fully collateralized with adequate collateral, valued at market prices and subject to haircuts. Any remaining risk is divided among all the participating central banks on the basis of the shares of each in the ECB's capital key.

The flows handled by the Italian clearing and settlement systems run by the Bank of Italy (TARGET2-Banca d'Italia and BI-Comp) amounted to about €45.8 trillion in 2011, up by 2.7 per cent on the previous year and equivalent to 29 times GDP (Table 20.1).

Starting in August 2011 there was a significant decrease in the cross-border transactions settled through the TARGET2-Banca d'Italia system. Whereas in the first seven months of the year the average daily value of cross-border payments had exceeded €54 billion and accounted for 41 per cent of the total value of the flows settled, in the other five months it was close to €45 billion (37 per cent of the total flows) owing to the sharp contraction in activity on the interbank market. The reduction was offset by the growth in payments for the settlement of refinancing operations and overnight deposits with the Eurosystem. In the first quarter of 2012 there was a further reduction in cross-border payments, to less than €40 billion a day, amply offset by the sizeable growth in domestic flows deriving from new operations with the Eurosystem.

Table 20.1

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

	Clearing systems (1)			Gross settlement (2) (c)	Total flows	
	BI-COMP gross flows (a)	Multilateral clearing balances				
		BI-COMP	Securities settlement and Express II (b)		(d)=(a+b+c)	(d)/GDP
2008	3,449	444	4,111	46,476	54,036	34.4
2009	3,094	426	2,858	36,256	42,208	27.8
2010	3,048	469	2,568	38,984	44,600	28.8
2011	3,098	504	2,090	40,608	45,796	29.0

Sources: Based on SIA, Istat and Bank of Italy data.
(1) Including transactions of the Bank of Italy, provincial treasury sections and Poste Italiane S.p.A. From 19 May 2008, with the migration to TARGET2, the balances of the provincial treasury sections are included in those of the Bank of Italy. Express II began operations on 8 December 2003 and the old securities settlement procedure was terminated on 23 January 2004. – (2) Transactions net of the multilateral balances of ancillary clearing systems. Includes incoming and outgoing cross-border payments net of transactions with the Bank of Italy. Does not include transactions settled on centralized accounts outside BI-REL/TARGET2-Banca d'Italia.

The estimate for cross-border overnight money market transactions settled via TARGET2-Banca d'Italia in 2011 shows that in the first seven months of the year fund-raising exceeded lending, with average daily values that in some months amounted to €7 billion for fund-raising and nearly €5 billion for lending. From August onwards cross-border fund-raising contracted considerably, declining to a minimum of about €1 billion a day in December; although lending also contracted, it amounted to about €3.3 billion a day, primarily in relation to transactions within banking groups. The interest rates applied to lending transactions were systematically below the Eonia rate; by contrast, the interest rates on fund-raising transactions, after being below the Eonia rate in the first half of the year, rose above it on many days in the second.

During 2011 the volume of intraday liquidity available to banks (measured by the value of the collateral posted net of that pledged to monetary policy operations) decreased slightly compared with 2010, declining on average from €54 billion to about €50 billion; subsequently, in March 2012, it rose to €80 billion. By contrast, recourse to intraday credit contracted significantly compared with 2010, declining on average from €7.3 billion to €4.9 billion (and to €3 billion in the first quarter of 2012).

As in the last few years, the peak drawing of intraday credit, which averaged around €11 billion (as against €14 billion in 2010), continued to occur in the first few hours of the trading day when the balances from the night cycle of Express II are settled and some Italian branches of foreign banks store up on behalf of their parent banks. The use of intraday credit was again concentrated among just a few banks; in fact three intermediaries accounted for more than 85 per cent of the total.

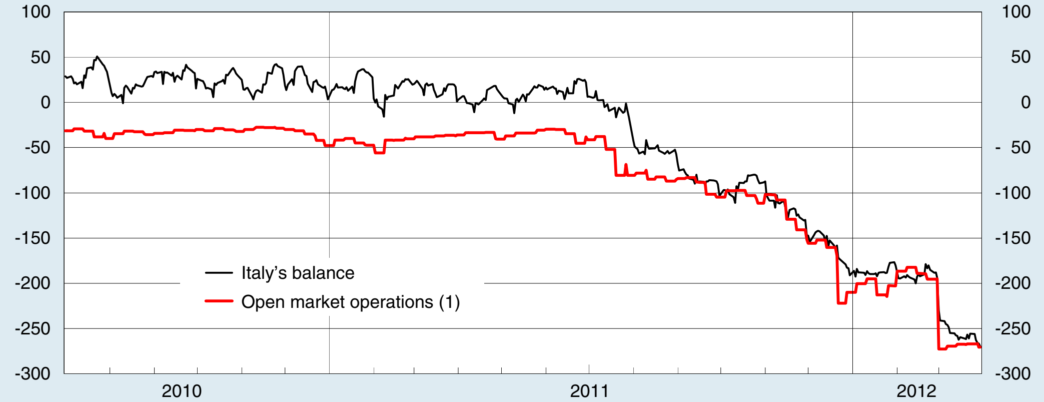
Collateral assets. – The collateral posted at European level against Eurosystem lending amounted to €2,440 billion at the end of 2011, 12 per cent more than a year earlier. Cross-border collateral accounted for 30 per cent of the total, of which 18 per cent via the Correspondent Central Banking Model (CCBM), 7 per cent via links between central depositories, and 5 per cent via direct access to central depositories abroad. Recourse to cross-border collateral continued to fall, both in absolute terms and as a percentage of total collateral.

In March 2012 banks located in Italy had collateral posted with the Bank of Italy to guarantee Eurosystem credit operations amounting to about €363 billion net of haircuts, up more than four times from the figure of €86 billion for March 2011. The strains on the wholesale fund-raising markets made it difficult for these banks to raise funds on the interbank market, forcing them to have more recourse to borrowing from the Bank of Italy. The flows of funds abroad led to a steady increase in the net external debtor position of the Bank of Italy and, to a similar extent, in the borrowing of banks located in Italy from the Bank of Italy (Figure 20.2). About half the outflows were due to net disposals of Italian securities by non-residents and another quarter to flows of liquidity within banking groups operating in Italy.

Figure 20.2

Multilateral imbalance in TARGET2-Banca d'Italia and open market operations

(stocks in billions of euros; 1 July 2010-30 March 2012)



(1) Negative values indicate borrowing from the Bank of Italy by banks located in Italy.

Banks located in Italy increased collateral mainly by providing government securities, government-guaranteed bank bonds, guaranteed private and bank bonds, and bank loans (up by €97 billion, €77 billion, €36 billion and €27 billion respectively). The composition of the total value of the collateral pool consequently changed radically: at 31 March 2011 the largest shares consisted of asset-backed securities (ABSs) (41 per cent) and bank loans (31 per cent); a year later the largest shares consisted of government securities (29 per cent, as against 12 per cent twelve months earlier) and government-guaranteed bank bonds (21 per cent, as against nothing twelve months earlier). The shares of ABSs and bank loans fell to 14 and 15 per cent respectively (Figure 20.3).

The money market

In 2011 trading in unsecured monetary deposits on the e-MID market contracted for the fifth successive year, declining to a daily average of €4.7 billion, 8 per cent less than in 2010 and 81 per cent less than in 2006, the last year before tensions appeared on the liquidity market. The downward trend became more pronounced in the second half of the year, reflecting the increased perception of the counterparty risk connected with banks' exposure to European sovereign debt, which was also reflected in an increase in the interest rates prevailing on the Italian platform compared with the corresponding European interest rates. The massive injection of liquidity by the two three-year refinancing operations that the Eurosystem conducted in December 2011 and February 2012 contributed to a further decline in trading, to a daily average of €1.7 billion in March of this year. The plentiful availability of liquidity fostered a realignment of Italian interest rates with the corresponding European levels.

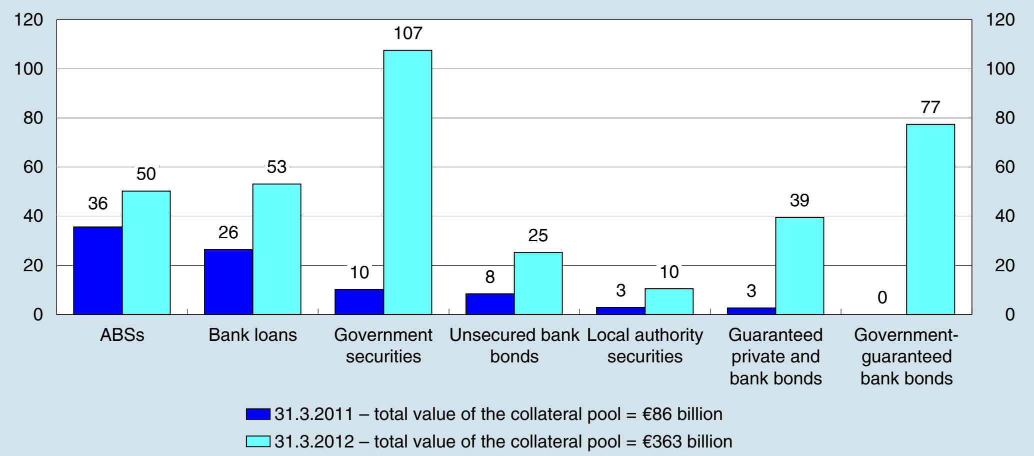
Trading on the MTS General Collateral repo market also declined. Factors contributing to the contraction included the increase in the last quarter of 2011 in the margin requirements of the central counterparties operating on that market (Cassa di Compensazione e Garanzia and LCH.Clearnet SA). Contrary to what occurred on the uncollateralized market, in the first quarter of 2012 the volume of trading on the General Collateral market turned upwards slightly as a result of the central counterparties' decision in December to reduce their margin requirements and the easier conditions recorded from January onwards on the MTS cash market for Italian government securities.

By contrast activity remained at a low level in the other segments of the guaranteed money market, New MIC and e-MID Repo. New MIC derives from the Collateralized Interbank Market (MIC), which was launched in 2009 at the initiative of the Bank of Italy to restore the orderly functioning of the interbank market at the longest maturities. The e-MID Repo segment is a new market for repo transactions that began operations in September 2011; it was created by e-MID SIM S.p.A. to meet intermediaries' preference for forms of trading on the money market backed by a guarantee scheme.

Italian banks' activity in the OTC segment of the market for unsecured overnight deposits was variable and considerably influenced by large intragroup transfers. Net of that component, trading declined to a daily average of less than €1 billion in March.

Figure 20.3

Distribution of financial instruments in the collateral pool
(net of haircuts; billions of euros)



The wholesale market in government securities

Trading on the MTS cash market in government securities was adversely affected by the strains in euro-area sovereign debt markets. After a short-lived recovery from the minimum reached at the end of 2010, trading progressively decreased in the second half of the year to reach a daily average of €1.4 billion in December, an all-time low. The market became illiquid: the bid-ask spread in the BTP segment widened to more than 100 basis points on average and market makers reduced the quantities for which they provided quotations.

Signs of a recovery emerged in the first quarter of 2012, reflecting the improvement in confidence produced by the measures adopted in the euro area to curb public deficits. Trading increased to a daily average of €2.8 billion and the bid-ask spread on BTPs fell to about 30 basis points, in line with the levels prevailing at the beginning of the summer of 2011.

In parallel with the growth in issues of short- and medium-term government securities, the composition of trading was marked by an increase in the share of BOTs and a reduction in that of BTPs. The share of CCTs contracted further, reflecting investors' diminished interest in this type of financial instrument.

Trading on the BondVision market remained at the levels reached in 2010, thanks in part to the purchases made by central banks under the Securities Markets Programme. Trading in Italian government securities, which accounts for more than 70 per cent of the total, also remained basically unchanged, with an average daily volume of €1.4 billion. Despite the suspension of purchases by central banks under the Securities Markets Programme, in the first quarter of 2012 there was a further increase in trading, driven by the renewed interest shown in Italian securities by institutional investors, especially domestic institutions.

Activity in the Special Repo segment of the MTS repo market was closely correlated with that of the cash market and grew significantly, driven in part by investors' greater propensity to take short positions on government securities against a background of growing price volatility.

The multilateral Continuous Linked Settlement system (CLS)

In 2011 the value of payments settled by CLS, which handles foreign exchange transactions in 17 currencies via a payment-versus-payment mechanism, increased by 15 per cent compared with 2010 and in December the average daily value was of the order of US$4.5 trillion.

CLS is subject to cooperative oversight by a committee chaired by the Federal Reserve Bank of New York (primary overseer) and made up of the central banks of the G10 countries (the euro area is represented by the ECB and the central banks of Italy, Germany, France, Belgium and the Netherlands) and the central banks issuing the other currencies handled by the system. Last December CLS published a self-assessment of compliance with the BIS Core Principles; this showed that CLS complied in full with nine principles but not entirely with that concerning governance.

Central depository, settlement and guarantee systems

The legislative and regulatory reforms under way concerning market infrastructures are aimed mainly at central counterparties, in accordance with the commitment entered into by the G20 to make their use obligatory for the clearing of standard OTC derivatives.

The development of collateral management services guides the business strategies of central depositories, in response to intermediaries' requests for more efficient and flexible management of securities posted as collateral.

In Italy Monte Titoli continued the preparations for its participation in TARGET2-Securities (T2S) in its first migration wave. In May the company signed the Framework Agreement with the Eurosystem. The company continued to broaden the range of services it provides to customers. Monte Titoli intends to use its X-COM platform to provide triparty collateral management services. The new service consists in the transfer, management and administration of financial instruments provided as collateral for credit transactions.

Central depository services. – In 2011 the value of the financial instruments managed by Monte Titoli increased by 5 per cent to €2,840 billion at face value and by 2.8 per cent to €3,063 billion at market prices.

Securities settlement system – The average daily value of transactions handled by the Express II settlement system was €171 billion, down by 8.2 per cent from 2010; in the first three months of 2012 it declined further, by 13.4 per cent compared with the year-earlier period. Last year the average daily number of transactions also decreased, falling by 8.0 per cent to about 88,000; by contrast, in the first three months of 2012 it increased by 5 per cent compared with the year-earlier period, reflecting the growth in turnover on the markets.

The transactions entered into the net settlement system, most of which were concluded on the markets, decreased in number from 87,000 to 77,000 and in value from €144 billion to €124 billion; transactions guaranteed by central counterparties increased from 57.7 to 64.3 per cent of the total.

Settlement in the gross settlement cycle continued to grow: the average daily value of transactions rose from €42.0 billion to €46.4 billion and the number of transactions from 9,000 to 12,000. Contributions to this growth came from the increase in overnight repos traded on MTS, from €16.6 billion to €18.1 billion, and the expansion in OTC trading, where the average daily number of transactions rose from 4,800 to 6,200.

At the request of the authorities, in September Monte Titoli introduced a new system of penalties for fails in the Express II settlement system. The previous penalties had not provided an effective deterrent against failure to deliver securities on the dates agreed by participants, with a consequent increase in the risks for the settlement system. The new approach is based on the application of penalties to individual positions for which securities are lacking and is independent of the overall activity of the settlement system.

Clearing and guarantee services. – In 2011 the high volatility of share markets and the tensions affecting European government securities had a significant influence on the activity of Cassa di Compensazione e Garanzia (CC&G). These factors also had an impact on the activity carried out through the link with the French central counterparty LCH.Clearnet SA: the value of the transactions entered into the settlement system and guaranteed by the two central counterparties decreased by 8.5 per cent.

On the cash share market CC&G guaranteed 72.1 million contracts, 10.0 per cent more than in 2010. The Idem derivatives market followed a similar trend: the number of contracts guaranteed rose by 8.2 per cent to 47.8 million. On the government securities market the value guaranteed rose by 13.1 per cent (as against 35.0 per cent in 2010).

Margin requirements rose significantly, owing both to the strains on the government securities market and to the large increase in margin rates for bonds decided in November by LCH.Clearnet SA and CC&G. Initial margins rose to a daily average of €9.0 billion (as against €6.1 billion in 2010), with a peak of €14.3 billion in November.

21. RETAIL PAYMENT SERVICES AND THE STATE TREASURY SERVICE

Retail payment services and systems in the framework of European harmonization

In 2011 European central banks and other authorities intensified their efforts to speed up the completion of the Single Euro Payments Area (SEPA) in order to enhance the efficiency and reliability of payment services to consumers, firms and the public administration. The wider use of electronic payment instruments in place of cash and cheques provides excellent opportunities to lower transaction costs.

Following a period of slow growth with the onset of the migration of national settlement procedures to the pan-European SEPA Credit Transfer (SCT) and SEPA Direct Debit (SDD) standards, in the second half of 2011 SCTs accounted for over 22 per cent of all the credit transfers executed within the euro area. In Italy the share was 11 per cent, nearly twice as high as in the second half of 2010. However, the use of SDDs, which began in November 2010, was modest in the area as a whole (0.19 per cent of all direct debits) and in Italy (0.10 per cent).

The reinforced commitment of the authorities was confirmed by the entry into force on 31 March 2012 of Regulation EU 260/2012, setting 1 February 2014 as the final deadline for the migration to SCT and SDD. This is an essential step in integrating the European retail payments industry. It radically alters the nature of the SEPA project, which was at first market-originated and market-managed at the behest of the public authorities. The regulation lays down the minimum requirements for the execution of payments within the European Union on conditions that do not vary from country to country.

The regulation complements a ramified legislative framework on payment services (Directive 2007/64/EC) and on electronic money (Directive 2009/110/EC) designed to foster the development of efficient, reliable electronic payments through a substantial increase in competition within a framework of standard rules. This stimulates the drive for innovative solutions that benefit customers in terms of price and ease of access to payment services.

As regards payment cards, there was progress in adapting to SEPA security standards (EMV chip cards for Europay, MasterCard and Visa). In Italy some 70 per cent of the cards in use and 90 per cent of ATMs and POS terminals were compliant with the standard by the end of the year, but there remains a gap with respect to the other Eurosystem countries, which have basically completed the replacement of cards (90 per cent) and terminals (95 per cent), in line with the targets set by the SEPA Cards Framework document of the European Payments Council.

Within Italy the spread of electronic payment instruments has been facilitated by recent governmental measures for payment traceability, supplemented by others to reduce the cost of access to payment services. The measures include the lowering of the limit on the size of cash transactions, the creation of a no-cost "basic account" for low-income households, and the enactment of principles that should lower intermediaries' charges to merchants for payment card acceptance. Together with the actions planned to implement the Digital Agenda for Europe, these measures should significantly improve the speed and economy of money transfers, narrowing the gap that still separates Italy from the more advanced countries in the adoption of efficient, innovative payment solutions.

Payment instruments

Developments during the year. – The number of payments made using bank and postal instruments increased by 3.9 per cent, compared with 1.4 per cent in 2010, but their growth in value slowed from 4.8 to 2.2 per cent, owing in part to the contraction in economic activity.

The use of non-cash retail payment instruments increased overall, while that of paper-based instruments (such as cheques and conventional credit transfers executed in person) continued to decline. The fastest growth was scored by innovative and especially online instruments.

The number of cheques debited to accounts fell again, by 7.5 per cent, while that of non-pre-authorized collection orders – bank receipts and notified payments – rose by 16.1 per cent, owing above all to the 30.7 per cent growth in notified payments of taxes and social security contributions. The growth in automated credit transfers continued (6.8 per cent), but that in direct debits (or pre-authorized collection orders), which are used mainly for utility bills, slowed to 1.3 per cent.

Italian banks settle SEPA credit transfers and direct debits in the national retail payment system and the pan-European STEP2 system. The number of SCTs settled during the year rose by 70 per cent to 38 million; three quarters were settled in STEP2.

The use of all types of payment cards (debit, credit and pre-paid) expanded, if one takes into account organizational changes affecting operators doing business under the freedom to provide services. The fastest growth was registered by debit cards (7.2 per cent) and pre-paid cards (28.4 per cent).

ATM cash withdrawals increased by 2.0 per cent in number and 2.9 per cent in value; the average withdrawal rose to €181, considerably above the European average of €109 (in 2010). Italy's marked propensity for cash transactions thus stands confirmed.

Developments in the retail payment market. – There were an average of 68 cashless payments per capita in Italy last year, compared with 182 in the euro area as a whole in 2010. Not counting paper-based payments (cheques, in-person credit transfers and postal current account deposits) the difference is more pronounced: 51 electronic payments per capita in Italy and 168 in the euro area. The most prevalent non-cash instruments were cards, which accounted for 41 per cent of cashless payments in 2011, in line with the EU average.

International and Italian interregional comparative analysis suggests that the main factors in the lesser utilization of electronic payments in Italy, and in some regions in particular, are low per capita income and the relatively limited acceptance of cards by businesses. Capacity for innovation and security are crucial factors for the diffusion of electronic payments. The factors involved in the underground economy help explain the greater use of cash and the comparatively infrequent use of traceable instruments.

Nevertheless, over the past five years the use of electronic instruments has increased throughout the country, the pace of growth varying according to sector of economic activity. Internet payments numbered 280 million last year, up 23.9 per cent, and accounted for 7 per cent of all transactions using bank or postal instruments. The fastest growth was recorded by online payments using credit and pre-paid cards (27.6 per cent), followed by online credit transfers (20.3 per cent).

Security is crucial to the popularization of electronic means of payment. In Italy the downtrend in fraud continued last year. The ratio of losses due to fraud to the total value of POS and ATM transactions declined from 0.03 to 0.02 per cent, while that for POS transactions alone declined from 0.05 to 0.04 per cent. However, the incidence of fraud perpetrated in "card not present" transactions – online, telephone or postal – increased from 0.09 to 0.11 per cent, highlighting the need to extend to this virtual world the safeguards of real-time, central authentication by the card issuer by means of clauses that shift the liability for losses due to fraud to the least secure operators. Empirical inquiries based on intermediaries' reports have confirmed the benefits of the new anti-fraud technology for ATMs and POS terminals in the physical world: a 10-point increase in the percentage of cards having migrated to chip technology corresponds to a reduction of between 6 and 7 per cent in the ratio of fraud to total transaction value. Other preventive measures include SMS alerts and new standards to protect data at retailers accepting the cards.

The fees for payment services are an essential tool for fostering the use of innovative instruments, especially following transposition of the Payment Services Directive, which bans hidden fees such as those deriving from value dates. For some innovative payment channels, such as the Internet, there has been some decline in average charges to customers, while in the traditional channels, such as bank branches, fees have been increasing.

Bringing the fees for payment services more closely into line with costs is a necessary condition for triggering a replacement process to take full advantage of scale economies in the development of innovative instruments. The findings of a survey of banks and merchants promoted by the Eurosystem and conducted by the Bank of Italy indicate that the cost to banks of providing retail payment services came to €7 billion in Italy in 2009, or some 15 per cent of their total operating expenses; three quarters of this outlay involved cash handling and the management of other paper-based instruments. The same survey found that the cost to a bank of supplying cash in person is seven or eight times greater than via ATM. The relative lack of process automation is one of the main obstacles to improving efficiency. This shortcoming also affects the handling of traditional payment instruments by retailers. A simulation based on the survey suggests that total potential savings estimated at 0.3 per cent of GDP could be achieved if Italy were to equal the more advanced European countries in the utilization of electronic payments in lieu of cash and the traditional transaction technologies requiring paper-based and manual processing.

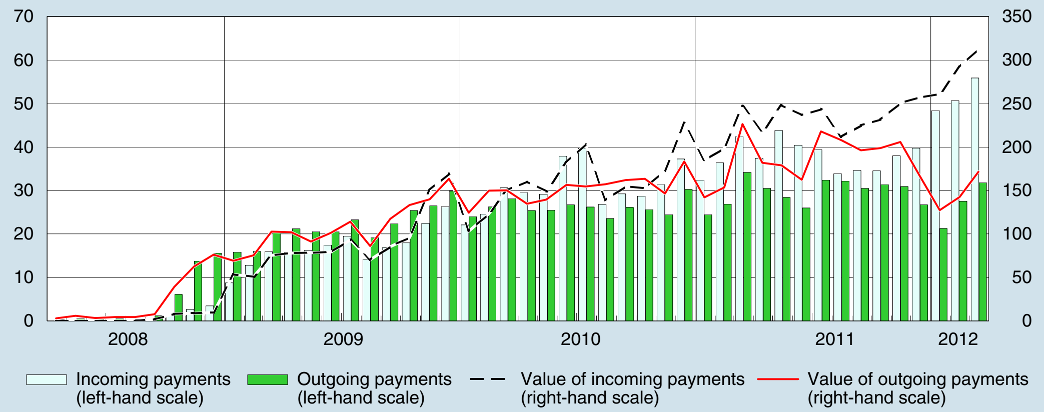
BI-COMP operations. – In 2011 the transactions handled by the Bank of Italy's BI-COMP clearing and settlement system increased in value by 1.6 per cent to €3.1 trillion (Table 20.1), while they increased in number by 3.2 per cent, from 2,041 million to 2,106 million. The shift towards electronic payments continued and they now make up 98 per cent of the total. The number of "paper" payments settled through BI-COMP's local items sub-system (mainly cheques) fell by 21.5 per cent, their value by 16.4 per cent; the contraction has been under way for years now, parallelling the decline in cheque use.

SEPA credit transfers settled through BI-COMP, including SCTs to and from the Dutch clearing mechanism Equens and Austria's Clearing Service International (CS.I), jumped by 60 per cent to over 10 million last year, or 2.5 per cent of all the credit transfers handled by the clearing and settlement system in either domestic or SEPA format (Figure 21.1). The flows to and from banks belonging to Equens and CS.I expanded and accounted last year for 8 per cent of all the SCTs handled by BI-COMP and 11.1 per cent by value. A total of 453,000 payments ordered by participants in the two foreign mechanisms and 354,000 payments ordered by BI-COMP members were settled, for values of €2.75 billion and €2.24 billion respectively.

Figure 21.1

SCT interoperability of ICBPI/BI-COMP with Equens and CS.I

(monthly data; volumes in thousands and millions of euros)



Source: Based on data from Istituto Centrale delle Banche Popolari Italiane.

The interbank database on irregular cheques and payment cards. – Reports on file with the database declined in 2011. The number of persons registered for lack of funds or authorization and the number of bad cheques both declined by 2.8 per cent. In the last three years the decline in the number of persons registered has come to 11.5 per cent. The ratio of bad cheques to those regularly debited to the account-holder was practically unchanged (0.21 per cent, compared with 0.20 per cent in 2010) as both aggregates fell by the same percentage. The total value of the bad cheques registered also declined, to €1.07 billion (0.16 per cent of GDP). At the end of the year the persons registered for bad cheques made up 0.15 per cent of the adult population, down from 0.18 per cent. As in years past, most of the bad cheque reports (50.6 per cent) came from the South, where the persons registered made up 0.23 per cent of the adult population (Table 21.1).

Table 21.1

Interbank database on irregular cheques and payment cards: irregular cheques by geographical area (1)

	Persons banned from cheque issuance	Unpaid cheques				Average value of unpaid cheques
	No.	No.	Composition (%)	Amount (millions of euros)	Composition (%)	Euros
North-West	13,113	36,502	14.2	166.4	15.6	4,557
North-East	6,316	18,830	7.3	107.6	10.1	5,712
Centre	15,254	50,838	19.7	228.0	21.4	4,485
South	39,615	145,141	56.3	539.1	50.6	3,714
Foreign	1,863	6,495	2.5	24.4	2.3	3,757
Total	**76,161**	**257,806**	**100.0**	**1,065.5**	**100.0**	**4,133**

(1) At 31 December 2011. Rounding may cause discrepancies in totals.

The number of persons whose payment cards were revoked for non-payment or lack of funds declined last year after rising by 33.5 per cent from 2008 to 2010.

The State Treasury service and public payments

A new, more sophisticated procedure governing the Treasury's payments account with the Bank was launched in November 2011. Its purpose is to reduce the volatility and improve the predictability of the balance on the account, thereby enhancing the efficacy of Eurosystem monetary policy. The account balance, up to a ceiling of €1 billion, is remunerated.

The revision of the Treasury account procedures, intraday monitoring of the account and the exchange of information and projections with the Ministry for the Economy and Finance have succeeded in stabilizing the balance. There has also been a significant reduction in forecasting errors that depend on government deposits with the Bank of Italy. The situation is now in line with that in the other main euro-area countries, as the ECB has recognized.

Decree Law 1/2012 of 24 January suspended until the end of 2014 the application of the rule that allowed public entities to hold their own resources with treasurer banks, provided they have precedence in use with respect to the liquidity on the State Treasury account. The liquidity held with treasurer banks was transferred to the Treasury account in two instalments (29 February and 16 April 2012).

The reform of the public administration depends crucially on more widespread use of information technology and the creation of infrastructures for electronic communications with individuals and firms. To expedite the completion of the Italian digital agenda, in the early part of 2012 a task force to coordinate and monitor the actions of central and local government bodies was formed. In this framework, tax collection procedures and rules are being modified in order to accommodate additional instruments (debit, credit and pre-paid cards); rules and standards are being defined. These projects affect the Bank of Italy in its role in State Treasury operations and in that of payment system oversight.

In 2011 the State Treasury service and public payments service operated by the Bank of Italy made some 65 million payments, 98 per cent by electronic procedures. With the progressive inclusion of the local offices of central government departments within the computerized expenditure procedure, the Bank's "electronic State Treasury" project can be considered completed. It has made available to central government the payment procedures necessary for the full application of two-way digital communication between general government and individuals or firms by 1 January 2014.

The General Government Transactions Information System (SIOPE) tracks the daily payments and receipts of some 13,000 general government entities, allowing for constant monitoring of the public accounts by the Ministry for the Economy and Finance. The high quality, extensive coverage and timely availability of the System's database have enabled local government entities to replace the quarterly transmission of their accounts to the Ministry with the posting of reports on the SIOPE website. The website, managed by the Bank of Italy, has been redesigned and upgraded to offer new, more flexible access modes, easy availability of the reporting forms required by law and new indicators whereby the entities can compare their own data with suitable benchmarks.

THE GOVERNOR'S CONCLUDING REMARKS

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

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

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

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

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

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

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

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

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

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

The economy and monetary policy

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

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

In Italy the yield on ten-year government securities jumped from 4.8 per cent in June to 7.3 per cent in November; the spread over German sovereign bonds reached 5.5

percentage points. The conditions for rolling over maturing debt in the winter months risked becoming prohibitive. Banks' wholesale funding channels dried up: towards the end of the year their bond issues on international markets almost came to a halt. The tensions were reflected in the cost of funds and in the availability of credit. The flow of loans to firms slowed and turned negative in December. There was a serious and real risk of a large, persistent contraction in bank lending.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The financial system and the Bank of Italy's supervision

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Europe and Italy

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

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

European monetary union has confirmed economic integration in these years, giving it new impetus. The traditionally most virtuous countries have made a special contribution to the rest of the area: the example of sound policies, prudent on public expenditure, attentive to the needs of a structurally competitive productive system;

and a basic national consensus on the objectives of price stability and social cohesion. They have benefited from a strong but not overvalued currency, from the absence of competitive devaluations, from a market larger than the national one and easily accessible. Countries such as ours that came from repeated bouts of inflation and currency crises have obtained stable prices and low interest rates, two basic prerequisites of economic development. We have taken little advantage of it.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

THE BANK OF ITALY'S ANNUAL ACCOUNTS

22. MANAGEMENT REPORT AND ANNUAL ACCOUNTS[1]

The Bank of Italy's annual accounts consist of the balance sheet, the profit and loss account and the notes to the accounts. Amounts are presented in euros in the official accounts and in thousands of euros in the tables of the notes.

In February, the Bank sends the balance sheet to the European Central Bank for consolidation with those of the other Eurosystem central banks.

The draft annual accounts are transmitted to the Ministry for the Economy and Finance under Article 117 of Royal Decree 204/1910 (Consolidated Law on the Bank of Issue).

The annual accounts are audited by an independent auditing company, which certifies their conformity with accounting rules in accordance with Article 27 of the Statute of the European System of Central Banks (ESCB). The auditing company appointed for the years 2010-15 is PricewaterhouseCoopers, which won the public tender announced by the Bank in 2009.

The management report provides information on events in 2011 that influenced the Bank's operations and had an impact on the annual accounts. In addition to the Annual Report, the documents used by the Bank to report on its activity are: the *Report to Parliament and to the Government,* 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, nor is it accompanied by the audit report issued by PricewaterhouseCoopers. The complete Italian version can be found on the Bank of Italy's website (www.bancaditalia.it).

MANAGEMENT REPORT

The year ended 31 December 2011 closed with a net profit of €1,129 million (€852 million in 2010). The gross profit before tax and transfers to/from the provision for general risks was equal to €3,630 million (€3,127 million in 2010). Direct taxes for the year amounted to €1,101 million.

The Bank's institutional structure

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 organization, organization chart and branch network are also available.

Organizational developments

The reform of the Bank's organization continued in 2011, following a plan designed to improve the effectiveness of its institutional functions, the quality of the services provided, and the levels of operating efficiency. With regard to its organizational structure, two major reforms were introduced involving the Accounting and Control Area and the Currency Circulation and General Affairs Area of the Head Office, aimed at reinforcing their functions.

With a view to achieving closer coordination of activities related to the Bank's participation in the Eurosystem and greater identity of approach among the various functions in respect of financial stability, two inter-function committees have been set up, as well as an independent unit, the Technical Secretariat for the Eurosystem and Financial Stability.

The Bank has revised its system of planning, changing from activity and project based programming to one that focuses on strategic objectives, the action plans required to pursue them, and methods of monitoring progress. In 2011, the Governing Board approved the strategic plan for the years 2011-13. Work on drafting the previous long-term plan was interrupted in 2007, when the organizational reform project involving the Head Office, branch network and foreign representative offices of the Bank took priority, providing the strategic framework of reference. The new plan is based on three objectives: more thorough and effective internal and external communication of the results of the Bank's actions and the management of its resources; innovation in the bank's operations management system in order to increase efficiency; and greater commitment to social responsibility, among other things by reducing the environmental impact of the Bank's activities.

Human, logistical and IT resources

At 31 December 2011, the Bank had 6,990 employees: 4,321 working at Head Office and 2,669 at branch offices. Managers and officers accounted for respectively 8.7 and 20.3 per cent of the personnel. The staff's average age was 48.3 years and 35.3 per cent of the Bank's employees were women, whose percentage representation in each career group has risen since the end of 2010.

The total number of staff decreased by 172 compared with the end of 2010. In 2011 there were 296 new appointments, of whom about a third to positions requiring a university degree. Of the 468 terminations, 12 per cent referred to branch employees specializing in cash management who accepted early retirement.

Training involved 6,200 employees in 2011, representing 89 per cent of the staff, rising to 95 per cent when basic training is also included. Overall there were more than 164,000 hours of training, corresponding to about 26 hours per participant (29 hours including basic training).

In performing their functions, the Bank's employees are required to comply with the general principles which are laid down in a code of conduct and which take account of the institution's public nature and the importance of the tasks entrusted to it.

In 2011, projects and activities in the field of information technology focused on enlarging the range of instruments available to support the Bank's institutional activities. In Europe, work continued on building the new European platform for the settlement of securities transactions, TARGET2-Securities and on renewing and strengthening the communications network between the central banks of the ESCB.

In 2012, the Bank's information technology resources will play a role within the Eurosystem also in developing the statistical and financial stability database run by the ECB, which will function as a centralized register of financial and monetary institutions, investment funds and special purpose vehicles.

Table 22.1

Composition of the Bank's staff

	At 31 December 2011					At 31 December 2010				
	Men	Women	**Total**	At branches	At Head Office (1)	Men	Women	**Total**	At branches	At Head Office (1)
Managers	475	132	**607**	130	477	495	124	**619**	135	484
Officers	912	507	**1,419**	386	1,033	935	498	**1,433**	381	1,052
Coadjutors	745	511	**1,256**	495	761	767	510	**1,277**	540	737
Other	2,393	1,315	**3,708**	1,658	2,050	2,504	1,329	**3,833**	1,742	2,091
Total	**4,525**	**2,465**	**6,990**	**2,669**	**4,321**	**4,701**	**2,461**	**7,162**	**2,798**	**4,364**

(1) Includes members of the staff assigned to the Financial Intelligence Unit and the representative offices abroad and those seconded to other organizations.

The objective of the Bank's property administration is to ensure the efficient operation of all premises for institutional use, to improve the security systems, and to guarantee business continuity of technical equipment and the compliance with safety and fire prevention rules.

A real-estate advisor has been selected by public tender for the disposal of Bank buildings no longer needed following the reorganization of the branch network.

Expenditure

The control of expenditure also makes use of management tools such as budgets, which are approved by the Board of Directors, and cost accounting. The latter is based on principles agreed among the central banks of the Eurosystem with the aim of making their costs comparable, facilitating assessments of relative efficiency and contributing to the determination of the charges for the services offered.

The measures taken to reduce costs and simplify expenditure procedures include the project implemented to centralize the management of branch budgets on a regional basis.

The outcome of the spending commitments for 2011 was less than the budget figure and down on the outcome for 2010. The divergence with respect to the budget forecasts was due, in particular, to the postponement of initiatives involving property and banknote production. The divergence with respect to the outcome for 2010, despite the increased cost of the Bank's participation in Eurosystem projects, reflected the effects of the organizational reform and the management actions of the various units. The reduction in expenditure did not include investment.

The profit and loss account showed a reduction of 4 per cent in the item *Administrative expenses*, which was in part the outcome of the measures to rationalize budget management.

In accordance with the Bank's objective of curbing operating costs, the budget for 2012 approved by the Board of Directors entails a reduction of 5.1 per cent with respect to 2011 in the budget allocations for purchases of goods and services in respect of which the individual units have broader discretion.

Note issue

The Bank contributes to meeting the Eurosystem's demand for banknotes and is involved in drafting common guidelines for the quality of the notes in circulation and measures against counterfeiting.

The start of mass production of the first denomination in the second series of euro notes marked a return to an upward trend of Eurosystem note production. The total production requirements forecast for 2012 are therefore once again high and the share assigned to the Bank of Italy has increased accordingly. Production volumes will remain substantial in the years to come as the other denominations of the second series of euro notes are printed. Investment to adapt the production processes continued in 2011.

The Bank produced around 1.2 billion banknotes in 2011. The measures to bring staffing levels at the printing works into line with those envisaged by the new organizational arrangements are nearing completion; this will allow the Bank to reach an annual production capacity of around 1.5 billion notes in fulfilment of its commitments. The Bank's branches put 2.6 billion banknotes into circulation in 2011, for a total value of €94.3 billion. The return flow to the Bank amounted to 2.3 billion banknotes, worth €86.1 billion.

The value of the banknotes in circulation at the end of 2011 amounted to €153.6 billion (17.3 per cent of the Eurosystem total) and was up by 5.6 per cent from €145.4 billion at the end of 2010; the amount recorded in the accounts (€146 billion) represented the 16.4 per cent share of total Eurosystem circulation notionally assigned to the Bank of Italy.

Financial resources

Ownership of the country's official reserves (gold and claims on non-euro-area residents in foreign currency) is assigned by law to the Bank of Italy. The management of 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 ESCB. The foreign currency reserves are managed with the aim of guaranteeing high levels of liquidity and security, while also seeking to maximize the long-term expected yield. 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.

The item *Gold and net foreign currency assets*, the composition of which is detailed in Table 22.2, includes the official reserves plus other claims on euro-area residents denominated in foreign currency held by the Bank and foreign currency liabilities.

Table 22.2

Gold and net foreign currency assets (1)
(millions of euros)

	31.12.2011	31.12.2010
Gold	95,924	83,197
US dollars	18,970 (2)	18,175
Pounds sterling	3,506	3,682
Japanese yen	5,380	5,571
Swiss francs	275	268
Other currencies	4	4
SDRs relating to net assets vis-à-vis the IMF	4,421	1,853
Total	**128,480**	**112,750**

(1) Valued at market exchange rates and prices. The reserves do not include financial assets (ETFs and shares/units of UCITS) denominated in foreign currency representing the investment of ordinary and extraordinary reserves, provisions and other capital funds, as they constitute a separate foreign currency item. – (2) Includes €1,546 million of temporary operations in dollars as part of an agreement between the ECB and the Federal Reserve to offer short-term liquidity in dollars to the banking system.

At 31 December 2011, gold and net foreign currency assets were worth €128.5 billion, compared with €112.8 billion a year earlier. The increase mainly reflected the rise in the price of gold (up by 15.3 per cent, leading to an increase of €12.7 billion in the value of the stock, which was stationary in volume). Other factors were the appreciation against the euro of the main currencies held in the Bank's portfolio, the overall movements in their stocks following the increase in Italy's quota in the IMF (implementing the Board of Governors' Resolution No. 63-2 of 28 April 2008), and the loans granted to the IMF as part of the New Arrangements to Borrow. 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. Limited use was also made of international futures markets.

Net foreign currency assets, excluding Special Drawing Rights and amounts related to temporary operations in dollars, decreased by €1.1 billion compared with the end of 2010 as a result of sales of dollars, sterling and yen. The composition by currency was virtually unchanged.

The Bank also holds a financial portfolio containing assets other than those linked to the management of the foreign currency reserves. The portfolio includes investments of balance-sheet provisions and reserves and of the pension and severance pay provision. Management of the investments is subject to the ban on the monetary financing of member states and euro-area public institutions; accordingly, securities of such issuers are not acquired at issue; investments in bank shares are excluded.

At the end of 2011, the book value of the portfolio was €125.6 billion, compared with €119.1 billion at the end of 2010. The portfolio was invested mainly in bonds (especially Italian and other euro-area-country government securities). The part invested in equities consisted primarily of shares listed in the euro area. Further progress was made in implementing the strategy of geographical and sectoral diversification of the equity portfolio, with an increase in the proportion of euro-area shares with respect to those of Italian issuers.

The Board of Directors decides on the classification of securities as being held to maturity. The bulk of the portfolio (89 per cent) consists of securities held to maturity and is therefore valued at cost, subject to impairment. If all listed financial instruments were valued at market prices, the portfolio would be worth €121.9 billion. In the early months of 2012 the market value of the securities moved back close to their book value.

Table 22.3

Composition of the financial portfolio
(millions of euros)

	31.12.2011	31.12.2010
Government securities	118,775	111,410
Shares and other equity	4,349	5,078
Other bonds	267	187
ETFs and shares/units of UCITS	2,256	2,474
Total	**125,647**	**119,149**

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 balance sheet. The fund constitutes a separate estate for administrative and accounting purposes. Investments are made observing benchmarks. At 31 December 2011 the fund's total assets and liabilities in the Bank's balance sheet amounted to €194 million. Returns on assets and exposure to risk are measured daily.

Monetary policy operations

The Governing Council of the ECB announced in four successive decisions in 2011 (March, June, August and October) that it would continue to provide liquidity at fixed rates with full allotment. In longer-term refinancing operations (LTROs) the rate will be fixed at the average rate of the main refinancing operations conducted over the life of the LTROS.

In August, faced with new tensions on the financial markets owing to the spread of the sovereign debt crisis, it was decided to conduct a further six-month longer-term refinancing operation. At the beginning of October, two LTROs were announced, one with a maturity of twelve months and the other with a maturity of thirteen months. At the same time a second covered bond purchase programme was launched. Finally, in December it was decided to conduct two LTROs with full allotment with a maturity of three years and the option to redeem after one year. Furthermore, the reserve requirement was reduced from 2 to 1 per cent and the list of assets eligible as collateral in Eurosystem financing operations was enlarged.

At the close of 2011, the total volume of refinancing was extremely high owing to the heavy demand for liquidity at the first three-year operation conducted on 21 December. The increased supply of longer-term liquidity led to an increase in the average maturity of monetary policy operations. The share of main refinancing operations (MROs) in total open market operations decreased from 43 per cent at the beginning of the year to 17 per cent at 31 December. The second three-year MRO was conducted on 29 February 2012.

In Italy, banks further increased their recourse to refinancing operations, which had already been on the rise in 2010. The average amount of funds requested and the average number of participants at the tenders increased sharply, for both MROs and LTROs. In the second half of 2011, the Bank of Italy, following the guidelines of the Eurosystem, not only made purchases of covered bonds under the new programme but also stepped up its purchases of government securities on the secondary market as part of the Securities Markets Programme.

Table 22.4

Securities held for monetary policy purposes
(millions of euros)

	31.12.2011	31.12.2010
Government securities	33,217	8,018
Covered bonds (1st programme)	9,629	10,061
Covered bonds (2nd programme)	210	–
Total	**43,056**	**18,079**

In accordance with the decisions of the Governing Council of the ECB, the securities acquired under these programmes were classified as being held to maturity and therefore valued at amortized cost, subject to impairment.

The annual impairment tests conducted at the level of the Eurosystem did not bring to light any losses. The decision of the ECB Governing Council not to devalue the Greek government bonds held by the Eurosystem central banks under the Securities Markets Programme took into account the effects of the Private Sector Involvement initiative launched in 2011 for the voluntary restructuring of the Greek debt. In particular, the Governing Council considered that only the private sector was involved in the initiative and that at the date of closure of the balance sheet there was no evidence to assume that it would not be successfully implemented.

As envisaged for the portfolio of covered bonds purchased under the first programme, the possibility of securities lending was extended to the new portfolio as well.

Financial risks

The Bank of Italy manages financial risks on an integrated basis and assesses and controls the operational risk associated with investments of its own funds, foreign currency reserves and other portfolios in euros and foreign currency.

The *risks associated with managing the foreign currency reserves and the financial portfolio* derive, above all, from exchange rate risk, the price of gold and the fluctuations of the yield curves of the individual markets. Financial risks are managed with reference to the portfolio as a whole, including the component that the Bank holds to maturity. The exchange rate risk for non-euro-denominated assets included in the financial portfolio is hedged through foreign exchange forward sales. The exposure to risk is monitored on the basis of several indicators. For the bond component, the duration is taken into account. Then, the maximum potential loss is estimated, separately for the various classes of financial assets and market segments, using the VaR indicator, both long-term and short-term. Estimates are also made of losses in the event of particularly unfavourable market developments with a low probability but a large impact.

Credit risk is controlled and mitigated by means of a rigorous selection of investment instruments and a prior assessment of the soundness of issuers and eligible counterparties. Category and individual exposure limits are also set and they are monitored daily.

The liquidity of the financial instruments invested in is normally very high. That of one component of the foreign currency reserves, made up of bank deposits, bank paper and commercial paper issued by international agencies and entities, is guaranteed by the maturities of these instruments.

At the end of 2011, the overall riskiness (of gold, the foreign currency reserves and the portfolio of financial assets) measured using VaR was greater than at the end of 2010; this was mainly due to the larger share of the gold component following the rise in the price of the metal and the increased volatility of every class of financial assets as a result of the heightening of the sovereign debt crisis. The overall duration of the bond component denominated in euros shortened over the year.

The Bank of Italy bears the *risks associated with the management of monetary policy operations* as a consequence of its membership of the Eurosystem and on the basis of the decisions taken by the competent bodies of the ECB.

According to the ESCB Statute, lending operations with banks conducted by the Eurosystem must be backed by adequate collateral in the form of the transfer of ownership or pledging of eligible financial assets. The measures to control risk introduced by the ECB Governing Council are designed to protect the Eurosystem central banks from the risk of financial loss when such assets are realized following a counterparty's default.

The national central banks share the risks attached to refinancing operations and the securities acquired under the Securities Markets Programme with the whole of the Eurosystem according to their share in the ECB's capital key.

The progressive increase in the liquidity injected into the banking system, the measures taken to enlarge the list of assets eligible in lending operations, and the purchases of securities for monetary policy purposes increased the risk exposure of the Eurosystem.

Internal audit and operational risk

The Bank of Italy's internal audit system uses a function-based approach, in which each organizational unit is responsible for the management of its own risk exposure, controls, effectiveness and efficiency. The units apply operational control procedures within their own spheres of responsibility.

An advisory committee on internal auditing has been set up with the aim of strengthening the system of controls and the independence and objectiveness of the internal audit function. The committee is made up of three members of the Board of Directors chosen by the Board, which also appoints the chairman. The members of the committee remain in office for three years and may be reappointed once. The purpose of the committee is to provide advice and support to the Board of Directors and the Governor on matters concerning the oversight of the internal audit function; the committee is also required to provide opinions on audit policy and the annual audit plan.

The Board of Auditors is responsible for monitoring the administration of the Bank as regards compliance with the law, the Statute and the General Regulations and for checking the accounts.

The national central banks have for some time focused their attention on operational risk. In accordance with the approach adopted within the Eurosystem, a committee has been set up to assist the Governing Board in drafting policy guidelines and monitoring their implementation. A new organizational unit acts as secretariat to the committee and provides assistance and coordination with all the other units of the Bank.

For legal questions the Bank of Italy has its own team of lawyers, who are listed in a special annex to the professional register. The risk of non-compliance with tax law is overseen by an ad hoc unit.

Environmental policy and workplace safety

Reducing the environmental impact of the Bank's activities is one of the objectives of the Strategic Plan for 2011-13, part of a broader commitment to social responsibility.

Several projects were carried out in 2011, including a further increase in the supply of electricity coming from renewable sources, the start of tender procedures for the installation of a photovoltaic system, plans to optimize the data centre with a view to reducing energy consumption, and the purchase of substantial quantities of recycled paper. According to the environmental indicators summarized in the *2011 Environment Report*, available on the website, the Bank reduced its overall carbon footprint, above all by cutting back, in absolute terms, on the consumption of electricity, water and paper.

Further measures to protect the environment will be taken in 2012, notably in the field of sustainable mobility. Plans are also being drawn up for the gradual adoption of eco-compatible architectural and technological solutions that will progressively reduce energy consumption and encourage the use of alternative energy sources.

In 2011, as part of the arrangements governing workplace safety, the Bank implemented a System of Workplace Safety Management within the printing works that obtained international certification.

Highlights of the annual accounts

The reclassified accounts shown in Table 22.5 provide information on the main factors that influenced the results for the year.

In 2011, gross profit before tax and transfers to/from the provision for general risks came to €3,630 million (€3,127 million in 2010). The result does not include the return on investment of the ordinary and extraordinary reserves (€316 million), which, although included in the Bank's corporate income tax base, is allocated directly to the reserves pursuant to the Bank's Statute and therefore does not contribute to the formation of profit.

The profit on ordinary operations, consisting of interest and dividends, rose from €4,205 million to €4,749 million, as a result of the increase of €656 million in net interest income, due mainly to the larger average stock of securities denominated in euros, which was partly offset by the decrease of €112 million in dividends due to the smaller dividend paid by the ECB.

The contribution from trading and the valuation of financial positions in euros and foreign currency was positive but smaller than in the previous year (€34 million, compared with €173 million). The result for 2011 reflected the increase of €257 million in write-downs for the prices of securities denominated in euros, which was only partly offset by the increase of €118 million in profits from trading, especially in respect of sales of securities denominated in yen and dollars.

Table 22.5

Summary of the annual accounts - Reclassified (1)
(millions of euros)

	Balance-sheet aggregates	Profit and loss account			
		Interest and dividends	*Results and write-downs*	*Other components of income*	*Contribution to net profit*
2011 FINANCIAL YEAR					
Gold	95,924				
Position in foreign currency	32,556	*288*	*468*		*756*
Portfolio of financial assets	129,433	*4,565*	*-611*		*3,954*
Lending to euro-area credit institutions	209,995	*929*			*929*
Securities held for monetary policy purposes	43,056	*1,180*	*1*		*1,181*
Banknotes in circulation	-146,010				
Deposits for minimum reserve system	-19,762	*-319*			*-319*
General government deposits	-23,529	*-910*			*-910*
Net intra-Eurosystem claims	-191,254	*-461*			*-461*
Revaluation accounts	-83,004				
Capital, reserves and provisions	-39,968				
Other net income		*-31*		*489*	*458*
Operating expense and other costs				*-1,863*	*-1,863*
Transfer from the provision for monetary policy operations				*226*	*226*
Extraordinary income and expense				*-5*	*-5*
Transfer of investment income to statutory reserves (Article 40 of the Bank's Statute)		*-492*	*176*		*-316*
GROSS PROFIT		**4,749**	**34**	**-1,153**	**3,630**
Transfer to the provision for general risks				*-1,400*	*-1,400*
Taxes on income for the year and productive activities				*-1,101*	*-1,101*
NET PROFIT		**4,749**	**34**	**-3,654**	**1,129**
2010 FINANCIAL YEAR					
Gold	83,197				
Position in foreign currency	29,553	*372*	*236*		*608*
Portfolio of financial assets	123,031	*4,088*	*-80*		*4,008*
Lending to euro-area credit institutions	47,635	*303*			*303*
Securities held for monetary policy purposes	18,079	*525*			*525*
Net intra-Eurosystem claims	-42,488	*-692*			*-692*
Banknotes in circulation	3,805	*358*			*358*
Deposits for minimum reserve system	-138,324				
General government deposits	-20,226	*-265*			*-265*
Revaluation accounts	-70,206				
Capital, reserves and provisions	-38,063				
Other net income		*-4*		*380*	*376*
Operating expense and other costs				*-1,921*	*-1,921*
Transfer from the provision for monetary policy operations				*324*	*324*
Extraordinary income and expense				*-34*	*-34*
Transfer of investment income to statutory reserves (Article 40 of the Bank's Statute)		*-480*	*17*		*-463*
GROSS PROFIT		**4,205**	**173**	**-1,251**	**3,127**
Transfer to the provision for general risks				*-1,350*	*-1,350*
Taxes on income for the year and productive activities				*-925*	*-925*
NET PROFIT		**4,205**	**173**	**-3,526**	**852**

1) The annual accounts data refer to the end of the year. They are reclassified as follows: the *Position in foreign currency* includes securities and other assets denominated in foreign currency (Items 2 and 3 on the asset side) net of the corresponding liabilities (Items 6, 7 and 8 on the liability side); the *Portfolio of financial assets* includes bonds, shares and other equity, and other assets denominated in euros and foreign currency allocated to Items 4, 6, 7.2, 8 and 11.2 It also includes the equity interest in the ECB (Item 9.1); the *Intra-Eurosystem claims* (Items 9.2 and 9.4 on the asset side, 9.3 on the liability side) are shown net of the debt related to the adjustment of the note issue (Item 9.2 on the liability side). With reference to the balance-sheet aggregates that include shares and other equity, the column *Interest and dividends* includes income from ETFs and shares/units of UCITS. Net income from fees and commissions, the pooling of monetary income and other withdrawals from provisions are included under *Other net income.*

Other net income grew by €82 million, basically owing to the increase in the pooling of monetary income. Operating expense and other costs decreased by €58 million, partly as a result of measures to improve efficiency and other initiatives taken by the Bank to contain costs.

In 2011, the profit and loss account again benefited from an extraordinary contribution (€226 million, compared with €324 million in 2010) stemming from the reduction in the size of the provision for counterparty risk deriving from monetary policy operations created in 2008 throughout the Eurosystem.

A transfer of €1,400 million from gross profit to the provision for general risks was approved by the Board of Directors in view of the need to strengthen the capital protection against the risks involved in the Bank's activities and take account of the withdrawals that had been necessary in earlier years.

Taxes for the year amounted to €1,101 million (€925 million in 2010). Consequently net profit for 2011 amounted to €1,129 million (€852 million for 2010).

The balance-sheet total at the end of 2011 amounted to €538,978 million, an increase of €206,018 with respect to the end of the previous year. On the asset side, contributions to the result came from the marked increase in refinancing operations with banks and the substantial investment in euro-denominated securities; the value of gold and foreign currency holdings also rose. On the liability side, increases were recorded in the Bank's intra-Eurosystem exposure, mainly in respect of its participation in TARGET2, in the revaluation accounts, in the deposits of credit institutions and in the banknotes in circulation; general government deposits decreased.

Post-balance-sheet events

In February 2012, the euro-area central banks conducted an operation to swap Greek government securities held in their portfolios for new bonds with the same face value, interest rates and maturities. These securities were not included in the list of those eligible for the voluntary restructuring of Greece's debt under the Private Sector Involvement initiative.

In April, the Board of Directors approved the sale of the Bank's controlling interest in the company Bonifiche Ferraresi S.p.A. consisting of 3,508,533 ordinary shares, equal to 62.4 per cent of the capital.

On 30 April 2011, the exchange rates of the US dollar and yen against the euro stood at $1.3214 and ¥105.85, showing a depreciation co mpared with the values obtaining at the end of 2011 ($1.2939 and ¥100.20). By contrast, the pound sterling and the Swiss franc appreciated, to £0.81295 and CHF1,2018, compared with £0,83530 and CHF1,2156 at the end of 2011.

ANNUAL ACCOUNTS
for the year ending 31 December 2011

BALANCE SHEET

ASSETS	NOTES *	Amounts in euros 31.12.2011	31.12.2010
1 GOLD AND GOLD RECEIVABLES	[1]	**95,923,923,533**	**83,197,329,389**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	[1]	**38,015,748,971**	**35,723,586,322**
2.1 Receivables from the IMF		12,225,011,074	9,463,179,182
2.2 Securities		24,396,793,962	23,617,185,615
2.3 Current accounts and deposits		1,336,205,803	2,116,606,678
2.4 Reverse operations		52,771,870	523,390,279
2.5 Other claims		4,966,262	3,224,568
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	[1]	**2,895,755,394**	**2,064,934,258**
3.1 Financial counterparties		2,895,755,394	2,064,934,258
3.1.1 Securities		*301,919,310*	*352,685,511*
3.1.2 Reverse operations		*1,545,714,506*	–
3.1.3 Other claims		*1,048,121,578*	*1,712,248,747*
3.2 General government		–	–
3.3 Other counterparties		–	–
4 CLAIMS ON NON-EURO-AREA RESIDENTS		**99,097,593**	**6,141,997**
4.1 Claims on EU central banks		–	–
4.2 Securities	[4]	99,097,593	–
4.3 Other claims		–	6,141,997
5 LENDING TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS	[2]	**209,994,950,000**	**47,635,200,000**
5.1 Main refinancing operations		49,389,100,000	16,557,600,000
5.2 Longer-term refinancing operations		160,605,850,000	31,012,600,000
5.3 Fine-tuning reverse operations		–	65,000,000
5.4 Structural reverse operations		–	–
5.5 Marginal lending facility		–	–
5.6 Credits related to margin calls		–	–
6 OTHER CLAIMS ON EURO-AREA CREDIT INSTITUTIONS	[3]	**2,655,438,648**	**2,953,924,041**
7 SECURITIES OF EURO-AREA RESIDENTS		**114,272,718,591**	**84,404,194,819**
7.1 Securities held for monetary policy purposes	[2]	43,055,674,706	18,078,655,667
7.2 Other securities	[4]	71,217,043,885	66,325,539,152
8 GENERAL GOVERNMENT DEBT	[4]	**17,457,614,575**	**17,642,087,699**
9 INTRA-EUROSYSTEM CLAIMS	[5]	**8,351,851,919**	**11,842,591,654**
9.1 Participating interest in the ECB		1,152,995,038	944,718,371
9.2 Claims arising from the transfer of foreign reserves to the ECB		7,198,856,881	7,198,856,881
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem		–	–
9.4 Other claims within the Eurosystem (net)		–	3,699,016,402
10 ITEMS IN COURSE OF SETTLEMENT		**14,452,944**	**6,039,592**
11 OTHER ASSETS	[6]	**49,296,538,753**	**47,484,540,738**
11.1 Euro-area coins		30,610,909	20,565,077
11.2 Financial assets related to the investment of reserves and provisions	[4]	36,873,320,329	35,214,630,881
11.3 Intangible fixed assets		57,055,475	32,700,990
11.4 Tangible fixed assets		3,204,239,948	3,328,644,020
11.5 Accruals and prepaid expenses		3,120,295,019	2,461,808,974
11.6 Deferred tax assets		5,085,032,261	5,574,078,516
11.7 Sundry		925,984,812	852,112,280
TOTAL		**538,978,090,921**	**332,960,570,509**

* References to the comments on the items in the notes to the accounts.

THE ACCOUNTANT GENERAL: Claudio Clemente

THE GOVERNOR: Ignazio Visco

Audited and found correct - 28 March 2012

THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Sandro Sandri, Dario Velo

BALANCE SHEET

	LIABILITIES	NOTES *	Amounts in euros 31.12.2011	31.12.2010
1	**BANKNOTES IN CIRCULATION**	[7]	**146,010,466,680**	**138,324,110,460**
2	**LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS**	[2]	**33,878,095,838**	**22,740,415,968**
	2.1 Current accounts (covering the minimum reserve system)		19,762,153,802	20,225,850,292
	2.2 Deposit facility		12,335,942,036	2,514,565,676
	2.3 Fixed-term deposits		1,780,000,000	–
	2.4 Fine-tuning reverse operations		–	–
	2.5 Deposits related to margin calls		–	–
3	**OTHER LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS**		**–**	**–**
4	**LIABILITIES TO OTHER EURO-AREA RESIDENTS**	[8]	**23,738,508,908**	**42,517,726,431**
	4.1 General government		23,528,524,611	42,488,335,099
	4.1.1 Treasury payments account		*6,291,702,387*	*42,331,626,712*
	4.1.2 Sinking fund for the redemption of government securities		*115,016,111*	*9,037,705*
	4.1.3 Other liabilities		*17,121,806,113*	*147,670,682*
	4.2 Other counterparties		209,984,297	29,391,332
5	**LIABILITIES TO NON-EURO-AREA RESIDENTS**	[9]	**2,691,653,114**	**2,948,762,188**
	5.1 To EU central banks		–	93,350
	5.2 Other liabilities		2,691,653,114	2,948,668,838
6	**LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY**	[1]	**549,064,356**	**623,221,654**
	6.1 Financial counterparties		–	–
	6.2 General government		549,064,356	623,221,654
	6.3 Other liabilities		–	–
7	**LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY**	[1]	**2,346,074**	**2,275,816**
	7.1 Deposits and balances		2,121,756	2,053,973
	7.2 Other liabilities		224,318	221,843
8	**COUNTERPART OF SDRs ALLOCATED BY THE IMF**	[1]	**7,803,871,173**	**7,609,875,892**
9	**INTRA-EUROSYSTEM LIABILITIES**	[5]	**198,452,577,941**	**7,092,746,655**
	9.1 Liabilities in respect of debt certificates issued by the ECB		–	–
	9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem		7,553,481,615	7,092,746,655
	9.3 Other liabilities within the Eurosystem (net)		190,899,096,326	–
10	**ITEMS IN COURSE OF SETTLEMENT**		**41,172,091**	**31,089,617**
11	**OTHER LIABILITIES**	[10]	**1,709,130,745**	**1,949,098,444**
	11.1 Bank of Italy drafts		239,122,557	248,354,656
	11.2 Accruals and income collected in advance		25,846,813	55,282,536
	11.3 Sundry		1,444,161,375	1,645,461,252
12	**PROVISIONS**	[11]	**7,677,679,674**	**7,767,701,469**
	12.1 Provisions for specific risks		1,116,809,999	1,190,689,395
	12.2 Staff-related provisions		6,560,869,675	6,577,012,074
13	**REVALUATION ACCOUNTS**	[12]	**83,004,095,501**	**70,206,178,954**
14	**PROVISION FOR GENERAL RISKS**	[11]	**10,545,675,075**	**9,145,675,075**
15	**CAPITAL AND RESERVES**	[13]	**21,744,578,174**	**21,149,384,999**
	15.1 Capital		156,000	156,000
	15.2 Statutory reserves		14,004,911,253	13,409,718,078
	15.3 Other reserves		7,739,510,921	7,739,510,921
16	**NET PROFIT FOR THE YEAR**		**1,129,175,577**	**852,306,887**
	TOTAL		**538,978,090,921**	**332,960,570,509**

OFF-BALANCE-SHEET ACCOUNTS at 31 December 2011 amounted to **549,204,890,252** euros.

THE ACCOUNTANT GENERAL: Claudio Clemente **THE GOVERNOR:** Ignazio Visco

Audited and found correct - 28 March 2012
THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Sandro Sandri, Dario Velo

PROFIT AND LOSS ACCOUNT

		NOTES *	Amounts in euros 2011	Amounts in euros 2010
1.1	Interest income		5,670,887,600	4,246,495,233
1.2	Interest expense		-1,905,144,704	-1,046,659,055
1	**Net interest income**	[14]	**3,765,742,896**	**3,199,836,178**
2.1	Realized gains/losses arising from financial operations		492,609,599	337,418,565
2.2	Write-downs on financial assets and positions		-383,086,734	-196,855,279
2.3	Transfers to/from the provision for general risks for exchange rate, price and credit risks		-1,400,000,000	-1,350,000,000
2	**Net result of financial operations, write-downs and transfers to/from risk provisions**	[15]	**-1,290,477,135**	**-1,209,436,714**
3.1	Fee and commission income		25,546,913	26,718,544
3.2	Fee and commission expense		-9,610,318	-8,276,351
3	**Net income from fees and commissions**	[16]	**15,936,595**	**18,442,193**
4	**Income from participating interests**	[17]	**147,034,395**	**262,501,505**
5	**Net result of the pooling of monetary income**	[18]	**589,957,577**	**613,140,317**
6.1	Interest income		1,066,284,482	951,699,657
6.2	Dividends from equity shares and participating interests		234,402,039	246,933,580
6.3	Gains, losses and write-downs		-251,616,205	14,512,795
6.4	Other components		27,949,087	24,460,021
6	**Net income from financial assets related to the investment of reserves and provisions**	[19]	**1,077,019,403**	**1,237,606,053**
7	**Other transfers from provisions**		**1,227**	**2,582**
8	**Other income**	[20]	**109,315,525**	**72,581,736**
	TOTAL NET INCOME		**4,414,530,483**	**4,194,673,850**
9	**Transfer of investment income to statutory reserves** (1)	[21]	**-315,965,421**	**-462,532,996**
10.1	Staff wages and salaries and related costs		-690,603,941	-693,266,035
10.2	Other staff costs		-63,291,411	-72,077,087
10.3	Transfers to provisions for accrued expense and staff severance pay and pensions		-83,995,951	-107,505,424
10.4	Pensions and severance payments		-387,153,927	-394,021,849
10.5	Emoluments paid to head and branch office collegial bodies		-3,184,453	-3,666,907
10.6	Administrative expenses		-420,139,453	-437,530,099
10.7	Depreciation of tangible and intangible fixed assets		-186,672,525	-185,656,165
10.8	Banknote production services		–	-3,961,291
10.9	Other expenses		-27,471,120	-23,294,391
10	**Expenses and charges**	[22]	**-1,862,512,781**	**-1,920,979,248**
11	**Other transfers to provisions**		**–**	**–**
12.1	Extraordinary income		26,675,437	21,556,011
12.2	Extraordinary expense		-32,313,081	-55,755,331
12	**Extraordinary income and expense**	[23]	**-5,637,644**	**-34,199,320**
	PROFIT BEFORE TAX		**2,230,414,637**	**1,776,962,286**
13	**Taxes on income for the year and productive activities**	[24]	**-1,101,239,060**	**-924,655,399**
	NET PROFIT FOR THE YEAR		**1,129,175,577**	**852,306,887**

(1) Made in accordance with Article 40 of the Statute.

THE ACCOUNTANT GENERAL: Claudio Clemente **THE GOVERNOR:** Ignazio Visco

Audited and found correct - 28 March 2012
THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Sandro Sandri, Dario Velo

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 ECB/2010/20 (published in OJ, L35 of 9 February 2011), 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.

  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 profit and loss account 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 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 2011 are described below. Where provided for by law, they were agreed with the Board of Auditors.

GOLD, FOREIGN CURRENCY ASSETS/LIABILITIES, SECURITIES

At the start of the Third Stage of EMU (1 January 1999) gold, foreign currency assets/liabilities and securities eligible for use in monetary policy operations were adjusted to the market prices and exchange rates at that date, with the resulting unrealized gains assigned to special revaluation accounts. These unrealized revaluation gains are included in the profit and loss account on a pro rata basis in the event of disposals, redemptions and write-downs.

For gold, the unrealized revaluation 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 requires 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;*
– *gold and foreign currency assets/liabilities (excluding the IMF quota paid in national currency and loans granted to the IMF under the New Arrangements to Borrow) are valued on the basis of the year-end gold price and exchange rates 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 profit and loss account;*
– *the IMF quota paid in national currency and loans granted to the IMF under the New Arrangements to Borrow are translated on the basis of the year-end euro/SDR exchange rate announced by the IMF.*

Securities

– *each type of security is valued by applying the method of the "average daily cost", determined in the manner established by the ECB. In the case of bonds, account is taken of the amount of the amortization of the premium/discount, which is recorded daily for those denominated in foreign currency;*
– *the year-end valuation is effected:*
  1. *for securities held to maturity, at amortized cost subject to impairment (verification of lasting reduction in value related to the position of the issuer);*
  2. *for securities other than those held to maturity:*
     a) *equity shares, ETFs and marketable bonds, at the market price available at the end of the year; units of collective investment undertakings at the year-end value published by the management company. Unrealized gains are included in the corresponding revaluation accounts; unrealized losses are covered first by earlier unrealized gains for the relevant security and any amount in excess thereof is included in the profit and loss account. 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, at amortized cost subject to impairment;*

c) *non-marketable shares and equity interests not represented by shares, at cost subject to impairment.*

3. *participating interests in subsidiary and associated companies that constitute permanent investments are valued at cost subject to impairment. The participating interest in the capital of the ECB is valued 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.*

TANGIBLE FIXED ASSETS

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).*

Depreciation begins in the quarter subsequent to that of acquisition both for buildings and for plant and equipment.

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 are 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.

ACCRUALS AND DEFERRALS

Include accrued income and prepaid expenses and accrued expenses and income collected in advance. 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, issue the euro banknotes (ECB Decision No. 29 of 13 December 2010 on the issue of euro banknotes, in OJ, L35 of 9 February 2011).

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.

The ECB is allocated 8 per cent of the total value of euro banknotes in circulation, while the remaining 92 per cent is allocated to the NCBs according to the weighting of each 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. 23 of 25 November 2010 on the allocation of monetary income of the national central banks of member states whose currency is the euro, in OJ, L35 of 9 February 2011). The adjustments recorded in 2011 arise from the entry into the Eurosystem of the central banks of Slovenia in 2007, Malta and Cyprus in 2008, Slovakia in 2009 and Estonia in 2011; they will terminate at the end of 2012, 2013, 2014 and 2016 respectively.*

The interest income and expense on intra-Eurosystem 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 and the income deriving from the securities held in connection with the Securities Markets Programme (SMP) shall be recognized to the NCBs in full with reference to the financial year in which it accrued and distributed in January of the following year in the form of an interim distribution of profit (ECB Decision No. 24 of 25 November 2010, in OJ, L6 of 11 January 2011). The interim distribution of ECB profit is recorded on an accrual basis in the year to which the income refers, by way of derogation from the cash basis applied in general to dividends and profits from participating interests. The Governing Council of the ECB may decide to reduce the amount of seigniorage income to be distributed in respect of expenses incurred in connection with the issue and handling of banknotes; in addition, the Council may decide to retain all or part of the ECB's income arising from SMP securities and, if necessary, all or part of the seigniorage income to the extent necessary to ensure that the amount of the distributed income does not exceed the ECB's net profit for that year. The Governing Council of the ECB may also decide to transfer all or part of the ECB's income arising from SMP securities and, if necessary, all or part of the seigniorage income to a provision for foreign exchange rate, interest rate, credit and gold price risks.

INTRA-EUROSYSTEM ASSETS AND LIABILITIES

For each NCB the intra-Eurosystem balance arising from the allocation of euro banknotes is included under Net claims/liabilities related to the allocation of euro banknotes within the Eurosystem.

PROVISIONS FOR RISKS

In determining the provisions for risks, the riskiness of the various sectors of the Bank's operations is taken into account in an overall evaluation of adequacy.

In particular, the riskiness of the foreign exchange position and the securities portfolio is evaluated on a value-at-risk basis, with consideration also given to the size of the revaluation accounts.

The provision for general risks is also for risks in connection with the Bank's overall activity that cannot be determined individually or allocated objectively.

Transfers to and withdrawals from the provisions are decided by the Board of Directors.

TAX PROVISION

The provision for taxation is equal to the amount of taxes to be paid (including deferred tax liabilities), determined on the basis of a realistic estimate of the foreseeable liability under the tax rules in force and of amounts arising from possible disputes with the tax authorities.

PROVISION FOR MONETARY POLICY OPERATIONS

This provision corresponds to the Bank's share of the provision set up by the Eurosystem for credit and counterparty risks deriving from monetary policy operations.

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 early retirement incentives connected with the reorganization of the Bank's branch network are entered for the amounts determined on the basis of the expected costs;*
- *transfers to the provision for grants to BI pensioners and their surviving dependents are made in accordance with Article 24 of the Rules governing staff severance pay and pensions;*
- *transfers to the provision for severance pay of contract staff, who do not participate in pension funds or who pay only a part of the contributions for retirement benefits, are determined in accordance with Law 297/1982.*

For staff hired from 28 April 1993 onwards a defined-contribution supplementary pension fund has been created (for more details see below under Other assets and liabilities*).*

OTHER ASSETS AND LIABILITIES

Receivables are stated at their nominal value, except in the case of diminutions in value connected with particular situations concerning the counterparty.

Pursuant to Recommendation NP7/1999 of the Governing Council of the ECB, the costs incurred in the production of banknotes are not included in the valuation of stocks.

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 separate 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.*

Securities lending transactions are entered in the balance sheet only if collateral is in the form of a cash deposit in an account of the central bank.

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 profit and loss account.*

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 profit and loss account. 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;*
- *securities used in temporary swap transactions to support market liquidity, lent by the Bank and received as collateral by counterparties, are stated at market value and translated at the year-end exchange rate;*
- *commitments in respect of foreign currency transactions are shown at the contractually agreed exchange rate. The entries are reversed 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

The items *Gold, assets and liabilities denominated in foreign currency, Monetary policy operations* and *Securities portfolio* are aggregated according to their purposes or type. The other items are commented on following the layout of the balance sheet.

[1] Gold and assets and liabilities denominated in foreign currency (Items 1, 2 and 3 on the asset side and Items 6, 7 and 8 on the liability side)

Table 22.6

Gold and assets and liabilities denominated in foreign currency
(thousands of euros)

	31.12.2011	31.12.2010	Changes
Gold (Item 1)	**95,923,924**	**83,197,329**	**12,726,595**
Net assets denominated in foreign currency	**32,556,223**	**29,553,146**	**3,003,077**
Assets denominated in foreign currency	**40,911,504**	**37,788,520**	**3,122,984**
Claims on the IMF (Sub-item 2.1)	*12,225,011*	*9,463,179*	*2,761,832*
Bonds other than those held to maturity (Sub-items 2.2 and 3.1.1)	*24,698,713*	*23,969,871*	*728,842*
Current accounts and deposits Sub-items 2.3 and 3.1.3.)	*2,384,328*	*3,828,856*	*-1,444,528*
Reverse operations (Sub-items 2.4 and 3.1.2)	*1,598,486*	*523,390*	*1,075,096*
Other assets (Sub-item 2.5)	*4,966*	*3,224*	*1,742*
Liabilities denominated in foreign currency	**8,355,281**	**8,235,374**	**119,907**
Counterpart of SDRs allocated by the IMF (Item 8)	*7,803,871*	*7,609,876*	*193,995*
Advances of general government departments (Sub-item 6.2)	*549,064*	*623,222*	*-74,158*
Current accounts and deposits (Sub-item 7.1)	*2,122*	*2,054*	*68*
Other liabilities (Sub-item 7.2)	*224*	*222*	*2*

The increase in the value of gold was entirely due to the rise in the metal's price. The volume remained unchanged at 79 million ounces or 2,452 tons.

The increase in the amount of net assets denominated in foreign currency reflected the growth in stocks and the positive movements in exchange rates.

Gold reserves are valued at the year-end market price in euros per fine ounce. This price was obtained by converting the dollar price of gold at the London fixing on 30 December 2011 using that day's exchange rate of the euro against the dollar. Compared with end-2010, gold appreciated by 15.30 per cent (from 1,055.418 to 1,216.864 euros per ounce).

Compared with the end of the previous year, the exchange rates of the main foreign currencies against the euro showed appreciations of the US dollar (from 1.3362 to 1.2939 dollars per euro), the yen (from 108.65 to 100.20), the pound sterling (from 0.86075 to 0.83530), the Swiss franc (from 1.2504 to 1.2156) and the SDR (from 1.1572 to 1.1867 euros per SDR).

Compared with the end of 2010 there were unrealized gains at the end of the year that were entered in the corresponding revaluation accounts for gold (€12,727 million), for dollars (€371 million), for yen (€204 million), for pounds sterling (€66 million) and for SDRs (€54 million); by contrast, the revaluation accounts for Swiss francs diminished by €10 million owing to the increase in the average cost of purchases. After the above-mentioned movements, at the end of 2011 the exchange rate revaluation accounts amounted to €81,044 million, of which €76,503 million was in respect of gold, €2,082 million the yen, €1,840 million the dollar, €406 million the pound sterling, €192 million the SDR and €21 million in respect of the Swiss franc (see Revaluation accounts*).*

In 2011, the Bank of Italy, acting on behalf of the Ministry for the Economy and Finance, increased Italy's quota subscription in the IMF (from 7,055 million to 7,882 million SDRs) in implementation of the Fund's Board of Governors' Resolution No. 63-2 of 28 April 2008, transposed by Law 144/2009. Of this increase, 25 per cent was paid in SDRs and 75 per cent in national currency (euros). The quota in euros, amounting to €694 million, was entered under *IMF holdings* deposited with the Bank; the smaller increase in the item at the end of 2011 was due to withdrawals by the IMF for lending to borrower countries. Receivables from the IMF also increased in respect of loans granted under the New Arrangements to Borrow.

Table 22.7

Accounts with the International Monetary Fund
(thousands of euros)

	31.12.2011	31.12.2010	Changes
Assets			
Receivables from the IMF (Sub-item 2.1)	**12,225,011**	**9,463,179**	**2,761,832**
a) Reserve Tranche Position in the IMF	2,835,615	1,846,114	989,501
quota in the IMF	*9,352,954*	*8,169,745*	*1,183,209*
IMF holdings	*-6,517,339*	*-6,323,631*	*-193,708*
b) Participation in the PRGF	609,676	441,654	168,022
c) Participation in the NAB	1,680,883	–	1,680,883
d) Special Drawing Rights	7,098,837	7,175,411	-76,574
Liabilities			
Counterpart of SDRs allocated by the IMF (Item 8)	**7,803,871**	**7,609,876**	**193,995**

The portfolio of securities denominated in foreign currency is made up of bonds, issued primarily by government bodies and international organizations. Of the total portfolio 65 per cent consisted of securities denominated in US dollars, 21 per cent of securities denominated in yen and 14 per cent of securities denominated in pounds sterling.

The other foreign currency assets, denominated primarily in US dollars, consisted mainly of fixed-term deposits (€1,395 million), current accounts (€989 million), reverse operations (€1,598 million) and foreign banknotes (€5 million).

Reverse operations are transactions whereby the Bank purchases or sells assets under a repurchase agreement. They are recorded in the balance sheet respectively on the asset or liability side. Sub-item 3.1.2 (Claims on euro-area residents denominated in foreign currency: reverse operations) *includes claims (€1,546 million) in respect of reverse operations with Eurosystem counterparties associated with the short-term dollar refinancing programme. On the basis of this programme the Federal Reserve supplies the ECB with dollars within the context of a foreign currency swap line aimed at providing short-term funding in dollars to euro-area counterparties. At the same time the ECB enters into back-to-back swaps with the NCBs that have adopted the euro, which use the dollar funds to provide liquidity to euro-area counterparties through reverse operations or foreign currency swaps. Transactions involving back-to-back swaps with the ECB are settled on intra-Eurosystem accounts (see* Intra-Eurosystem claims and liabilities*).*

Among the liabilities denominated in foreign currency, primarily in dollars, the most important are the liabilities to general government (€549 million) in respect of advances received for the management of cross-border payments and collections.

[2] Monetary policy operations (Items 5 and 7.1 on the asset side and Item 2 on the liability side)

The operations outstanding at 31 December 2011 carried out by the Bank of Italy within the framework of the single monetary policy of the Eurosystem are shown in Table 22.8.

In 2011, the movements in monetary policy operations were again influenced by the unconventional measures adopted by the Eurosystem to counter the adverse effects of the financial crisis. In particular, purchases under the Securities Markets Programme were stepped up and recourse to refinancing operations increased, reflecting the settlement on 22 December of the first of two three-year longer-term refinancing auctions. In November a new programme of covered bond purchases was launched.

Table 22.8

Monetary policy operations
(thousands of euros)

	31.12.2011	31.12.2010	Changes
Lending to euro-area credit institutions (Item 5)			
5.1 Main refinancing operations	49,389,100	16,557,600	32,831,500
5.2 Longer-term refinancing operations	160,605,850	31,012,600	129,593,250
5.3 Fine-tuning reverse operations	–	65,000	-65,000
5.4 Structural reverse operations	–	–	–
5.5 Marginal lending facility	–	–	–
5.6 Credits related to margin calls	–	–	–
Total	**209,994,950**	**47,635,200**	**162,359,750**
Securities held for monetary policy purposes (Sub-item 7.1)	**43,055,675**	**18,078,656**	**24,977,019**
Liabilities to euro-area credit institutions (Item 2)			
2.1 Current accounts (covering the minimum reserve system)	19,762,154	20,225,850	-463,696
2.2 Deposit facility	12,335,942	2,514,566	9,821,376
2.3 Fixed-term deposits	1,780,000	–	1,780,000
2.4 Fine-tuning reverse operations	–	–	–
2.5 Deposits related to margin calls	–	–	–
Total	**33,878,096**	**22,740,416**	**11,137,680**

The year-end value of the stock of *Main refinancing operations* and *Longer-term refinancing operations* increased significantly, as did the average value, which rose from €4,681 million to €25,252 million and from €25,248 to €46,654 million respectively. *Fine-tuning reverse operations* and the *Marginal lending facility*, for which the year-end value was zero, also recorded an increase in the average figures, respectively from €46 million to €106 million and from €10 million to €23 million. As in 2010 no recourse was made in 2011 to *Structural reverse operations*.

The *Securities held for monetary policy purposes* consisted of covered bonds acquired under the programmes approved by the Governing Council of the ECB in resolutions adopted in May 2009 and October 2011, as well as of government securities issued by some euro-area countries and purchased under the Securities Markets Programme approved in May 2010. The first Covered Bond Purchase Programme closed in June 2010 and the second will be completed by the end of October 2012.

Table 22.9

Movements in securities held for monetary policy purposes (Sub-item 7.1)
(thousands of euros)

	Bonds held to maturity			Total
	Covered bonds (1st programme)	Covered bonds (2nd programme)	Government securities (Securities Markets Programme)	
Opening balance	**10,061,211**	**–**	**8,017,445**	**18,078,656**
Increases	**–**	**209,914**	**25,730,487**	**25,940,401**
Purchases	–	209,762	25,555,408	25,765,170
Net premiums and discounts	–	152	175,079	175,231
Decreases	**-431,882**	**–**	**-531,500**	**-963,382**
Sales and redemptions	-366,200	–	-531,500	-897,700
Net premiums and discounts	-65,682	–	–	-65,682
Closing balance	**9,629,329**	**209,914**	**33,216,432**	**43,055,675**

Under Article 32.4 of the ESCB Statute the risks associated with refinancing operations and securities held under the Securities Markets Programme, should they materialize, may be allocated, in a decision adopted by the Governing Council of the ECB, among the Eurosystem NCBs in proportion to their shares of the ECB's capital (the Bank has a share of 17.8598 per cent). At the end of 2011, the Eurosystem's total refinancing operations amounted to €863,568 million, up from €546,747 million at the end of 2010. The securities purchased by the NCBs under the Securities Markets Programme amounted to €194,155 million, against €60,873 million in 2010.

Securities held for monetary policy purposes are classified as held to maturity, in accordance with the decision of the Governing Council of the ECB, and are valued under Eurosystem accounting rules at amortized cost subject to impairment.

The impairment tests conducted at year-end by the Eurosystem on securities held for monetary policy purposes did not indicate any long-lasting decrease in value. For Greek government bonds purchased under the Securities Markets Programme the Governing Council of the ECB took account of the Private Sector Involvement initiative launched in 2011 for the restructuring of part of the debt issued by Greece to secure debt sustainability in the long term. In particular, given that the PSI was designed to voluntarily restructure debt held by the private sector, the Governing Council did not expect changes in any future contractual cash flows associated with the ECB's holdings of the securities. The Governing Council considered that at 31 December 2011 there was no evidence to assume that the PSI initiative would not be successfully implemented.

On the liability side the deposits held by banks to fulfil their minimum reserve obligations decreased slightly at year-end and in terms of average stock (from €26,116 million to €25,312 million). Banks' holdings in the *Deposit facility* and *Fixed-term deposits* increased at year-end but declined in terms of average stock (from €1,661 million to €1,382 million and from €193 million to €126 million respectively). No recourse was made to *Fine-tuning reverse operations* in 2010.

[3] Other claims on euro-area credit institutions (Item 6 on the asset side)

These claims increased from €2,954 million to €2,655 million. They consisted in large part of repos on securities denominated in euros (€2,447 million) and liquidity in connection with the management of cross-border euro payments and collections for general government (€186 million).

[4] Securities portfolio (Items 4.2, 7.2, 8 and 11.2 on the asset side)

In addition to the securities making up part of the foreign exchange reserves (€24,699 million), commented under *Gold, assets and liabilities denominated in foreign currency,* and those held for monetary policy purposes (€43,056 million), commented under *Monetary policy operations*, the Bank's securities portfolio amounted to €125,647 million, of which €36,873 million comprised investments of reserves and provisions.

Table 22.10

Securities portfolio
(thousands of euros)

	31.12.2011	31.12.2010	Changes
A) SECURITIES DENOMINATED IN EUROS (Sub-items 4.2 and 7.2 and Item 8)			
1. Securities held to maturity	**80,860,434**	**76,893,166**	**3,967,268**
a) Government securities (Sub-item 7.2)	63,268,910	59,240,252	4,028,658
b) Other bonds (Sub-items 4.2 and 7.2)	133,909	44,518	89,391
c) Government securities assigned to Bank of Italy (Item 8)	17,457,615	17,608,396	-150,781
2. Securities other than those held to maturity	**7,913,322**	**7,040,769**	**872,553**
a) Government securities (Sub-item 7.2)	7,913,322	7,040,769	872,553
Total A	**88,773,756**	**83,933,935**	**4,839,821**
B) SECURITIES RELATED TO THE INVESTMENT OF RESERVES AND PROVISIONS (Sub-item 11.2)			
1. Securities held to maturity and other permanent investments	**30,412,266**	**27,790,517**	**2,621,749**
a) Government securities	30,114,145	27,483,324	2,630,821
b) Other bonds	133,214	142,500	-9,286
c) Shares and other equity	164,907	164,693	214
of subsidiary companies and entities	*107,949*	*107,949*	–
of other companies and entities	*2,410*	*2,196*	*214*
of other companies and entities denominated in foreign currency	*54,548*	*54,548*	–
2. Securities other than those held to maturity and other permanent investments	**6,461,054**	**7,424,114**	**-963,060**
a) Government securities	20,987	36,952	-15,965
b) Other bonds	–	–	–
c) Shares and other equity	4,184,313	4,913,502	-729,189
of subsidiary companies and entities	*13,422*	*20,146*	*-6,724*
of other companies and entities	*4,170,891*	*4,893,356*	*-722,465*
d) ETFs and shares/units of UCITS	2,255,754	2,473,660	-217,906
of which: denominated in foreign currency	*694,720*	*677,990*	*16,730*
Total B	**36,873,320**	**35,214,631**	**1,658,689**
Total (A+B)	**125,647,076**	**119,148,566**	**6,498,510**

In more detail:

A) securities denominated in euros consist exclusively of bonds issued in the euro area and are stated in:

   – Sub-item 4.2 (*Claims on non-euro-area residents – securities*). This item consists entirely of bonds issued by international organizations;

   – Sub-item 7.2 (*Securities of euro-area residents – other securities*). This item consists for 49 per cent of bonds issued by the Italian government and for 51 per cent of bonds issued mainly by other euro-area governments;

   – Item 8 (*General government debt*). This item contains the Italian government securities assigned to the Bank following the bond conversion under Law 289/2002 and the termination of the management of mandatory 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. Of the reduction of €151 million, €101 million corresponded to the annual accrued premium/discount on the bonds converted and €50 million to the amount of the annual redemption of securities deriving from the termination of the management of mandatory stockpiling.

At the end of 2010, Item 8 also included claims deriving from the termination of the management of mandatory stockpiling that had not been converted into securities (€34 million), which were redeemed in 2011 by the Ministry for the Economy and Finance under Article 21.11 of Law 111/2011.

B) securities related to investments of reserves and provisions (Sub-item 11.2 – *Financial assets related to the investment of reserves and provisions*) were denominated in euros and to a very small extent in foreign currency. At year-end, 82 per cent of the portfolio consisted of bonds and 18 per cent of shares, participating interests, ETFs and shares/units of UCITS. As regards the issuers of these securities, 66 per cent were Italian and the bulk of the remainder from other euro-area countries. Most of the investments in shares consisted of listed securities. Most of the purchases during 2011 consisted of government securities.

The Bank also invests in ETFs and shares/units of UCITS denominated in foreign currency. The resulting position is hedged against exchange rate risk by forward sales 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 permanent investments 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 is equal to 9.4 per cent of the BIS's capital.

The securities related to investments of reserves and provisions included securities held to maturity whose book value (€65,693 million) was higher than the year-end valuation at market prices (€59,402 million). The securities in question – for which no lasting reduction in value was found relating to the position of the issuers – were stated at amortized cost in accordance with the accounting rules of the Eurosystem. At the beginning of 2012 their market value returned close to their book value.

[5] Intra-Eurosystem claims and liabilities (Item 9 on the asset side and Item 9 on the liability side)

Table 22.11

Positions with the ECB and the other euro-area NCBs
(thousands of euros)

	31.12.2011	31.12.2010	Changes
Assets			
9.1 Participating interest in the ECB	1,152,995	944,718	208,277
9.2 Claims arising from the transfer of foreign reserves to the ECB	7,198,857	7,198,857	–
9.4 Other claims within the Eurosystem (net)	–	3,699,017	-3,699,017
Total	**8,351,852**	**11,842,592**	**-3,490,740**
Liabilities			
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	7,553,482	7,092,747	460,735
9.3 Other liabilities within the Eurosystem (net)	190,899,096	–	190,899,096
Total	**198,452,578**	**7,092,747**	**191,359,831**

On the asset side:

– the *Participating interest in the ECB* increased by €208 million as a result of the payment by the Bank of the second of the three instalments of the increase in the ECB's capital that the Bank subscribed in 2010.

Pursuant to Article 28 of the Statute of the ESCB, the NCBs 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 or when a new country joins the EU. The last periodic five-year adjustment was made on 1 January 2009; at the end of 2011 the Bank of Italy's share of the ECB's subscribed capital was 12.4966 per cent. Considering only the NCBs belonging to the Eurosystem, this share was equal to 17.8598 per cent.

– The *Claims deriving from transfers of reserves to the ECB* were unchanged and amounted to €7,199 million.

The Claims deriving from transfers of reserves to the ECB *represent the interest-earning claim denominated in euros recorded at the start of the Third Stage of EMU against the transfer of gold, foreign securities and foreign currencies to the ECB in proportion to the Bank's share of the ECB's capital, as in the case of the other Eurosystem NCBs (see "Comments on the items of the profit and loss account" –* Net interest income*).*

– *Other claims within the Eurosystem (net)* decreased to zero, compared with €3,699 million in 2010, of which €3,410 million derive mainly from the operation of the TARGET2 system; see the Sub-item *Other liabilities within the Eurosystem (net)*.

On the liability side:

– *Net liabilities related to the allocation of euro banknotes within the Eurosystem* amounted to €461 million (see "Legal basis, methods of preparation and layout of the annual accounts").

– *Other liabilities within the Eurosystem (net)* amounted to €190,899 million (compared with a credit position of €3,699 million in 2010) and represent the Bank's net position vis-à-vis the Eurosystem mainly deriving from the operation of the TARGET2 system. The latter gave rise to an overall debtor position of €191,379 million at the end of 2011 (compared with a credit position of €3,410 million in 2010). At the end of the year the overall position was also reduced by a) a claim of €116 million against the ECB for restitution of part of the seigniorage income pertaining to 2011 and b) a claim of €364 million (€289 million in 2010) deriving from the net result of the redistribution of monetary income in 2011 and the recalculation of monetary income pertaining to previous years.

[6] Other assets (Item 11 on the asset side)

This item consists mainly of securities (see *Securities portfolio*) and *Deferred tax assets*, primarily in connection with prior-year tax losses.

The year-end fair value of the buildings owned by the Bank was estimated to be €4,237 million for those used for its operations and €1,311 million for those related to investments of the severance pay and pension provision.

Deferred tax assets (Sub-item 11.6) decreased by €489 million as a consequence of:

– the offsetting of €416 million of the deferred taxes deriving from the carry-forward of the remaining tax loss for 2002;

– the decrease of €72 million in the deferred tax assets in respect of the provision for Eurosystem monetary policy operations (see *Provisions* and *Provision for general risks*);

– the net decrease of €1 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 are reversed. The bulk of the deferred tax assets included in the balance sheet derive from the carry-forward of the residual tax losses from the bond conversion under Law 289/2002. The rules governing the carry-forward of these losses are laid down in Article 65 of Law 289/2002 as amended by Law 248/2005. The rules state that the losses may be utilized with no time restriction to offset 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.

Sundry (Sub-item 11.7 on the asset side) includes the balance-sheet total of €194 million of the defined-contribution supplementary pension fund for staff hired since 28 April 1993, which is matched on the liability side by an equal amount entered in Sub-item 11.3 of *Other liabilities*. The other components of the sub-item are mainly payments on account of corporate income tax and Irap made in 2011.

[7] Banknotes in circulation (Item 1 on the liability side)

Banknotes in circulation, which represent the Bank of Italy's share (16.4 per cent) of the total Eurosystem note issue (see "Legal basis, methods of preparation and layout of the annual accounts"), increased by €7,686 million (from €138,324 to €146,010 million). The banknotes actually in circulation, without taking account of the adjustments for their distribution within the Eurosystem, increased by €8,147 million (from €145,417 million to €153,564 million). The average stock of banknotes rose from €139,318 to €142,713 million, an increase of 2 per cent compared with 5 per cent for the euro area.

[8] Liabilities to general government and other counterparties in euros (Item 4 on the liability side)

The item, which decreased by €18,779 million, refers mainly to the deposits held by the Treasury with the Bank of Italy (€6,292 million) and the Treasury's fixed-term deposits (€17,000 million) introduced at the end of 2011 under an agreement signed on 22 March 2011, which are included under *Other liabilities*.

Article 47 of Law 196/2009 on public finances and accounting changes the regulations governing the deposits held by the Treasury with the Bank of Italy to manage its cash balances, by introducing an agreed limit on the balance on which interest is paid and an interest rate in line with money market rates. The agreement between the Bank of Italy and the Ministry for the Economy and Finance was approved by ministerial decree of 29 July 2011, which entered into force on 30 November. Accordingly, the Bank of Italy pays daily interest on the funds in the account up to a maximum balance of €1 billion at the marginal rate on Eurosystem main refinancing operations. The agreement also allows the Ministry to invest excess cash balances in fixed-term deposits with the Bank of Italy, on which interest is paid at the Eurepo rate.

The year-end balance on the Treasury accounts with the Bank of Italy decreased and the average balance fell from €40,091 million to €32,040 million. The average balance of the fixed-term deposits was €1,627 million in 2011. Whereas the year-end balance of the sinking fund for the redemption of government securities increased, the average balance decreased, from €471 million to €250 million.

The Sub-item *Other liabilities* includes debtor positions with general government in respect of advances received for the management of cross-border euro payments and collections amounting to €122 million (compared with €121 million in 2010).

[9] Liabilities to non-euro-area residents denominated in euros (Item 5 on the liability side)

The sub-item *Other liabilities* amounted to €2,692 million (€2,949 million in 2010) and referred mainly to accounts held by customers that used the Eurosystem Reserve Management Services.

[10] Other liabilities (Item 11 on the liability side)

As detailed below:

Table 22.12

Other liabilities (Item 11)
(thousands of euros)

	31.12.2011	31.12.2010	Changes
11.1 Cashier's cheques	239,123	248,355	-9,232
11.2 Accruals and deferrals	25,847	55,282	-29,435
11.3 Sundry	1,444,161	1,645,461	-201,300
Lira banknotes	*9,400*	*640,620*	*-631,220*
Supplementary pension fund	*194,006*	*174,195*	*19,811*
Other liabilities	*1,240,755*	*830,646*	*410,109*
Total	**1,709,131**	**1,949,098**	**-239,967**

The sub-item *Sundry* (11.3) includes the equivalent value of the remaining lira banknotes (€9 million) that lapsed under the terms of Law 214/2011 and will be assigned to the Treasury after the appropriate checks. At 31 December 2010 the balance represented the lira banknotes not yet presented for conversion, excluding the payments on account that the Bank of Italy has already made to the Treasury.

Pursuant to Article 26 of Decree Law 201/2011, ratified by Law 214/2011 (Urgent measures for the growth, equity and consolidation of the public finances), by way of derogation from Law 96/1997 and Legislative Decree 213/1998, lira banknotes, notes and coins still in circulation shall lapse and be assigned to the Treasury with immediate effect. Accordingly, the Bank of Italy transferred the sum of €600 million to the Treasury, being the provisional balance of lira banknotes not yet presented for conversion by the deadline, excluding the payment on account made pursuant to Law 289/2002.

[11] Provisions and provision for general risks (Items 12 and 14 on the liability side)

The balances and movements in *Provisions* (Item 12) are shown in Tables 22.13 and 22.14.

Table 22.13

Movements in provisions (Sub-item 12.1)
(thousands of euros)

	Insurance cover	Tax provision (1)	Provision for Eurosystem monetary policy operations	Other provision	Total
Opening balance	**309,874**	**480,036**	**396,765**	**4,015**	**1,190,690**
Increases	**–**	**612,403**	**–**	**18,986**	**631,389**
Allocations	–	612,100	–	18,986	631,086
Other increases	–	303	–	–	303
Decreases	**–**	**-479,111**	**-226,158**	**–**	**-705,269**
Withdrawals	–	-477,491	–	–	-477,491
Other decreases	–	-1,620	-226,158	–	-227,778
Closing balance	**309,874**	**613,328**	**170,607**	**23,001**	**1,116,810**

(1) Other changes include the change in deferred tax liabilities for IRAP.

The reduction in *Provisions for specific risks* (Sub-item 12.1) was due mainly to the decrease of €226 million in the provision for Eurosystem monetary policy operations. In accordance with Article 32.4 of the ESCB Statute, all the Eurosystem NCBs created provisions against the counterparty risk associated with monetary policy operations in proportion to their subscribed capital key shares in the ECB in the year in which the events occur. The Governing Council of the ECB revised the amount of the buffer created by the NCBs in 2008, setting it at €949 million at 31 December 2011 (€2,207 million at the end of 2010). The reduction is entered in the profit and loss accounts of the Eurosystem NCBs, apportioned in the same way as their allocations to the buffer.

The amount pertaining to the Bank of Italy decreased from €397 million to €171 million (see "Comments on the items of the profit and loss account" – *Net result of the pooling of monetary income*).

The provision for charges refers to the costs to be incurred for the restructuring of the Bank's buildings in L'Aquila damaged by the earthquake of 6 April 2009. The Bank has already received final payments from insurance companies for this damage (see "Comments on the items of the profit and loss account" – *Extraordinary income and expense*).

Table 22.14

Movements in staff-related provisions (Sub-item 12.2)
(thousands of euros)

	For staff severance pay and pensions	For staff costs	For severance pay (1)	For grants to BI pensioners and their survivors	Total
Opening balance	**6,402,480**	**169,393**	**2,983**	**2,156**	**6,577,012**
Increases	**–**	**83,782**	**178**	**37**	**83,997**
Allocations	–	83,782	178	36	83,996
Other increases	–	–	–	1	1
Decreases	**-27**	**-100,062**	**-35**	**-15**	**-100,139**
Withdrawals	-27 (2)	-100,062	-24	-15	-100,128
Other decreases	–	–	-11	–	-11
Closing balance	**6,402,453**	**153,113**	**3,126**	**2,178**	**6,560,870**

(1) Includes severance pay of contract staff and of ordinary staff prior to joining the supplementary pension fund. – (2) Includes the transfer of severance pay of staff participating in the supplementary pension fund.

Staff-related provisions (Sub-item 12.2) amounted to €6,561 million. They include:

- the severance pay provision, which was stationary at €6,402 million, representing a small surplus of around €61 million with respect to total commitments for pension and severance pay at 31 December 2011 prudentially allocated to the provision;
- the provision for staff costs decreased by €16 million to €153 million. Of this figure €37 million was in respect of early retirement measures in connection with the reorganization of the Bank's branch network.

The *Provision for general risks* (Item 14) amounted to €10,546 million at the end of 2011, compared with €9,146 million at the end of 2010, following the allocation of €1,400 million approved by the Board of Directors. The allocation for 2011 continues the replenishment of the provision following the withdrawals of previous years.

[12] Revaluation accounts (Item 13 on the liability side)

These include the valuation at market prices of gold, foreign currency, securities and forward operations (see *Gold, assets and liabilities denominated in foreign currency* and *Securities portfolio*).

Table 22.15

Revaluation accounts (Item 13) *(thousands of euros)*				
	Opening balance	Withdrawals	Net revaluations	Closing Balance
Exchange rate revaluations	**67,631,786**		**13,411,948**	**81,043,733**
of which: gold	*63,776,437*		*12,726,595*	*76,503,032*
net foreign currency assets (1)	*3,855,136*		*685,497*	*4,540,632*
financial assets related to the investment of reserves and provisions (1)	*213*		*-144*	*69*
Price revaluations	**2,574,388**		**-614,029**	**1,960,359**
of which: foreign currency securities	*255,346*		*167,265*	*422,611*
securities denominated in euros	*39,433*		*47,089*	*86,522*
financial assets related to the investment of reserves and provisions	*2,279,609*		*-828,383*	*1,451,226*
Revaluations at 1 January 1999	**5**	**-1**		**4**
Total	**70,206,179**	**-1**	**12,797,919**	**83,004,096**

(1) Includes net revaluations relating to forward operations.

[13] Capital and reserves (Item 15 on the liability side)

As detailed below:

Table 22.16

Capital and reserves (Item 15) *(thousands of euros)*			
	31.12.2011	31.12.2010	Changes
15.1 Capital	**156**	**156**	**–**
15.2 Statutory reserves (Article 39)	**14,004,911**	**13,409,718**	**595,193**
Ordinary	6,856,192	6,578,109	278,083
Extraordinary	7,148,719	6,831,609	317,110
15.3 Other reserves	**7,739,511**	**7,739,511**	**–**
Revaluation reserve under Law 72/1983	694,502	694,502	–
Revaluation reserve under Law 408/1990	683,274	683,274	–
Revaluation reserve under Law 413/1991	16,943	16,943	–
Revaluation reserve under Law 342/2000	896,577	896,577	–
Revaluation reserve under Law 266/2005	1,521,240	1,521,240	–
Fund for the renewal of tangible fixed assets	1,805,044	1,805,044	–
Surplus from the merger of UIC (Law 231/2007)	2,121,931	2,121,931	–
Total	**21,744,578**	**21,149,385**	**595,193**

Table 22.17

Movements in ordinary and extraordinary reserves (Sub-item 15.2) *(thousands of euros)*					
	Balance at 31.12.2010	Allocation of 2010 profit under Art. 39 of Statute	Distribution to shareholders under Art. 40 of the Statute (1)	Transfer of 2011 income under Art. 40 of the Statute	Balance at 31.12.2011
Ordinary	6,578,109	170,461	-30,381	138,003	6,856,192
Extraordinary	6,831,609	170,461	-31,313	177,962	7,148,719
Total	**13,409,718**	**340,922**	**-61,694**	**315,965**	**14,004,911**

(1) From the income earned in 2010.

Table 22.18

Shareholders in the Bank of Italy	At end-2011				At end-2010			
	Number	Shares (1)	%	Votes	Number	Shares (1)	%	Votes
With voting rights	58	299,934	100	539	58	299,934	100	539
S.p.A.s engaged in banking, including companies referred to in Article 1, Legislative Decree 356/1990	*51*	*253,434*	*84*	*418*	*51*	*253,434*	*84*	*418*
Social security institutes	*1*	*15,000*	*5*	*34*	*1*	*15,000*	*5*	*34*
Insurance companies	*6*	*31,500*	*11*	*87*	*6*	*31,500*	*11*	*87*
Without voting rights	6	66	..		6	66	..	
S.p.A.s engaged in banking, including companies referred to in Article 1, Legislative Decree 356/1990	*6*	*66*	*..*		*6*	*66*	*..*	
Total	**64**	**300,000**	**100**	**539**	**64**	**300,000**	**100**	**539**

(1) The nominal value of each share is €0.52.

Off-balance-sheet accounts

Table 22.19

Off-balance-sheet accounts
(thousands of euros)

	31.12.2011	31.12.2010	Changes
Orders in progress	**306,768**	**375,949**	**-69,181**
Purchases	276,372	292,159	-15,787
Sales	30,396	83,790	-53,394
Forward operations	**2,212,387**	**653,511**	**1,558,876**
Forward sales of foreign currencies	2,113,461	653,511	1,459,950
Futures contracts purchased	98,926	–	98,926
Securities lending	**16,416,055**	**–**	**16,416,055**
Securities loaned	6,155,166	–	6,155,166
Securities received as collateral	10,260,889	–	10,260,889
Commitments	**15,924,177**	**1,950,185**	**13,973,992**
To the IMF for loans granted	15,924,146	1,950,088	13,974,058
Other	31	97	-66
Collateral received	**370,691,780**	**132,482,268**	**238,209,512**
For refinancing operations (1)	368,352,847	129,723,147	238,629,700
Other	2,338,933	2,759,121	-420,188
Collateral granted	**11,687**	**23,464**	**-11,777**
Third-party securities and valuables on deposit with the Bank	**143,491,822**	**145,600,601**	**-2,108,779**
Memorandum accounts of the supplementary pension fund	**150,214**	**112,413**	**37,801**
Total	**549,204,890**	**281,198,391**	**268,006,499**

(1) Includes securities and bank loans used as collateral.

Forward sales of foreign currency include:

– the commitment to the ECB in respect of reverse operations with Eurosystem counterparties associated with the short-term dollar refinancing programme (see *Gold and assets and liabilities denominated in foreign currency*);

– the commitment arising from operations to hedge the exchange risk on foreign currency investments in respect of reserves and provisions (see *Securities portfolio*).

Futures contracts are entered at their notional value; the guarantee commitments include collateral in the form of securities lodged with the clearer.

Securities loaned and received as collateral refer to operations terminated at the beginning of 2012.

Commitments to the IMF for loans granted relate to existing IMF initiatives with Italy for financing to be disbursed. The increase in this item over the year was mainly due to the increase in the commitments entered into by the Bank of Italy in connection with the New Arrangements to Borrow (see *Gold and assets and liabilities denominated in foreign currency*) pursuant to Decree Law 225/2010 ratified by Law 10/2011.

The Bank participates in the automatic securities lending programmes managed by specialized intermediaries both for securities included among its foreign currency assets and for covered bonds. At the end of 2011, the Bank's lending under these programmes amounted to €1,181 million for foreign currency securities and €1,441 million for covered bonds.

Comments on the items of the profit and loss account

The net profit for the year was €1,129 million, compared with €852 million in 2010.

[14] Net interest income (Item 1)

Net interest income increased by €566 million, from €3,200 million to €3,766 million, mainly owing to the increase in the portfolio of securities denominated in euros, which is remunerated at a higher rate than the other financial assets. The increase also reflected purchases of government securities under the Securities Markets Programme.

Table 22.20

Interest income (Sub-item 1.1) (1)
(thousands of euros)

	2011	2010	Changes
On assets denominated in euros	5,351,774	3,852,025	1,499,749
Securities	*4,243,806*	*3,122,390*	*1,121,416*
Lending operations	*928,902*	*303,033*	*625,869*
Intra-ESCB balances	*152,093*	*414,945*	*-262,852*
Other	*26,973*	*11,657*	*15,316*
On assets denominated in foreign currency	319,114	394,470	-75,356
Receivables from the IMF	*41,695*	*27,494*	*14,201*
Securities	*271,168*	*358,015*	*-86,847*
Other assets denominated in foreign currency	*6,251*	*8,961*	*-2,710*
Total	**5,670,888**	**4,246,495**	**1,424,393**

(1) Interest earned on financial assets related to the investment of reserves and provisions is shown as a separate income item (see *Net income from financial assets related to the investment of reserves and provisions*).

Table 22.21

Interest expense (Sub-item 1.2) *(thousands of euros)*			
	2011	2010	Changes
On liabilities denominated in euros	1,874,258	1,024,260	849,998
Treasury payments account	*894,443*	*685,148*	*209,295*
Sinking fund for the redemption of government securities	*7,237*	*5,499*	*1,738*
Current accounts (covering the minimum reserve system)	*319,301*	*264,252*	*55,049*
Intra-ESCB balances	*612,617*	*57,121*	*555,496*
Other	*40,660*	*12,240*	*28,420*
On liabilities denominated in foreign currency	30,887	22,399	8,488
Counterpart of SDRs allocated by the IMF	*29,692*	*21,986*	*7,706*
Other	*1,195*	*413*	*782*
Total	**1,905,145**	**1,046,659**	**858,486**

[15] Net result of financial operations, write-downs and transfers to/from risk provisions (Item 2)

The result for 2011 comprised:

Table 22.22

Net result of financial operations, write-downs and transfers to/from risk provisions (Item 2) *(thousands of euros)*			
	2011	2010	Changes (1)
Profits (+) and losses (-) on financial operations	492,610	337,418	155,192
Foreign exchange trading	*264,527*	*88,822*	*175,705*
Trading in securities denominated in euros	*-249*	*21,271*	*-21,520*
Trading in securities denominated in foreign currency	*214,031*	*227,163*	*-13,132*
Derivative contracts denominated in foreign currency	*1,644*	*69*	*1,575*
Other transactions	*12,657*	*93*	*12,564*
Write-downs (-) of financial assets and positions	-383,087	-196,855	-186,232
For exchange rate	*-2*	*–*	*-2*
For price			
– securities denominated in euros	*-370,297*	*-116,605*	*-253,692*
– securities denominated in foreign currency	*-12,788*	*-80,250*	*67,462*
Transfers to (-) and from (+) the provision for general risks for exchange rate, price and credit risks	-1,400,000	-1,350,000	-50,000
Total	**-1,290,477**	**-1,209,437**	**-81,040**

(1) Negative changes indicate smaller profits or larger losses/write-downs; positive changes larger profits or smaller losses/write-downs.

[16] Net income from fees and commissions (Item 3)

The net result for the year decreased by €2 million (from €18 million to €16 million). *Fee and commission income* included the charges payable by the participants in TARGET2 (€6 million), fees for financial services on behalf of general government (€5 million), substitute protest declarations (€4 million), fees for Correspondent Central Banking Model services (€2 million) and those for the use of Central Credit

Register information (€2 million). *Fee and commission expense* referred primarily to the centralized securities management service (€7 million).

[17] Income from participating interests (Item 4)

The item *Income from participating interests* decreased by €116 million, from €263 million to €147 million, and comprises:

– the Bank of Italy's share of the ECB profits earned in 2010 and distributed in 2011 (€31 million);

– the Bank of Italy's share of the ECB's income deriving from the seigniorage on banknotes (€116 million). In 2010 the ECB had kept the whole of the income deriving from banknotes and from the holdings of securities under the Securities Markets Programme.

In 2011, the ECB's income deriving from its holdings of securities purchased under the Securities Markets Programme and part of the income deriving from the seigniorage on the 8 per cent share of banknotes allocated to it was all kept by the ECB to strengthen the provision for foreign exchange rate, interest rate, credit and gold price risks. The remainder of the seigniorage income was distributed to the Eurosystem NCBs in the form of an account on their dividend (see "Legal basis, methods of preparation and layout of the annual accounts"). In March 2012, the Bank of Italy received a dividend of €14 million, representing the remainder of that already paid on account.

[18] Net result of the pooling of monetary income (Item 5)

The result for 2011 was €590 million, consisting of:

– the receipt of the Bank of Italy's share of the pooling of monetary income (€357 million, compared with €303 million in 2010);

– the effect, positive for €7 million, of the redetermination of the pooling of monetary income for prior years;

– the reduction of €226 million in the provision in respect of monetary policy operations (see "Comments on the items of the balance sheet" – *Provisions and provision for general risks*).

The result for the pooling of monetary income in 2011 was the difference between the monetary income pooled, €2,445 million, and that redistributed, €2,802 million. The monetary income (to be 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 mainly of: banknotes in circulation; liabilities to euro-area credit institutions related to monetary policy operations denominated in euros; net intra-Eurosystem liabilities resulting from TARGET2 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 mainly of: lending to euro-area credit institutions related to monetary policy operations; securities held for monetary policy purposes; intra-Eurosystem claims equivalent to the transfer of reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 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 and gold receivables in proportion to each NCB's subscribed capital key. Gold is considered to generate no income. The securities held for monetary policy purposes under the Covered Bond Purchase Programme (Decision No. 16 of 2 July 2009 *and Decision No. 17 of 3 November 2011 of the Governing Council of the ECB) are considered to bear interest at the last marginal rate applied to Eurosystem main refinancing operations. 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 last marginal rate applied to Eurosystem main refinancing operations.*

The monetary income pooled by the Eurosystem is redistributed to each NCB according to its subscribed capital key.

[19] Net income from financial assets related to the investment of reserves and provisions (Item 6)

The decrease in the result on this item was due mainly to the write-downs deriving from the adjustment of equity securities and investments in units of UCITS to year-end prices, which was only partly offset by the increase in interest on bonds. Net trading income also declined.

Table 22.23

Net income from financial assets related to the investment of reserves and provisions (Item 6)
(thousands of euros)

	2011	2010	Changes
Interest	1,066,284	951,700	114,584
Statutory reserves	*331,118*	*306,512*	*24,606*
Other reserves and provisions	*735,166*	*645,188*	*89,978*
Dividends	234,402	246,933	-12,531
Statutory reserves	*143,058*	*158,664*	*-15,606*
Other reserves and provisions	*91,344*	*88,269*	*3,075*
Profits/losses from trading and disposals	29,190	88,805	-59,615
Statutory reserves	*17,025*	*39,436*	*-22,411*
Other reserves and provisions	*12,165*	*49,369*	*-37,204*
Write-downs	-280,806	-74,292	-206,514
Statutory reserves	*-193,361*	*-57,110*	*-136,251*
Other reserves and provisions	*-87,445*	*-17,182*	*-70,263*
Other components	27,949	24,460	3,489
Statutory reserves	*18,125*	*15,031*	*3,094*
Other reserves and provisions	*9,824*	*9,429*	*395*
Total	**1,077,019**	**1,237,606**	**-160,587**

[20] Other income (Item 8)

The item *Other income* includes reimbursements by the Eurosystem NCBs in connection with the development of platforms, applications and IT infrastructures by the Bank of Italy in cooperation with the other central bank providers. In particular, in 2011 the item includes the reimbursement for the TARGET2 platform (€22 million), as in 2010, and the reimbursement for the TARGET2-Securities platform (€36 million).

[21] Transfer of investment income to statutory reserves (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 2011 decreased from €463 million to €316 million, mainly owing to the increase in write-downs, which was only partly offset by the increase in interest income (for more details, see *Net income from financial assets related to the investment of reserves and provisions*).

[22] Expenses and charges (Item 10)

This item comprises:

Table 22.24

Sundry expenses and charges (Item 10)
(thousands of euros)

	2011	2010	Changes
Staff wages and salaries and related costs	690,604	693,266	-2,662
Other staff costs	63,291	72,077	-8,786
Transfers to provisions for accrued expenses and staff severance pay and pensions	83,996	107,506	-23,510
Staff severance pay and pensions	–	*23,913*	*-23,913*
Accrued expenses not yet paid	*83,782*	*83,394*	*388*
Other	*214*	*199*	*15*
Pensions and severance payments	387,154	394,022	-6,868
Emoluments paid to head and branch office collegial bodies	3,185	3,667	-482
Administrative expenses	420,139	437,530	-17,391
Depreciation of tangible and intangible fixed assets	186,673	185,656	1,017
Banknote production services	–	3,961	-3,961
Other expenses	27,471	23,294	4,177
Total	**1,862,513**	**1,920,979**	**-58,466**

The item decreased by €58 million partly as a result of the completion of the Bank's reorganization and other measures to contain costs.

Table 22.25

The Bank's staff

	Average number of persons in service		Percentage composition	
	2011	2010	2011	2010
Managerial	2,036	2,066	29.0	28.7
Non-executive	4,081	4,130	58.2	57.4
General service and security	427	512	6.1	7.1
Blue-collar	469	486	6.7	6.8
Total payroll workers	**7,013**	**7,194**	**100.0**	**100.0**
Contract workers	33	32		

Staff costs (including those for contract workers), comprising wages and salaries (including overtime) and related costs (pensions and social security contributions), transfers to the provisions for accrued expenses not yet paid and other staff costs (including per diem expenses for missions and transfers), amounted to €819 million, down from €830 million in 2010. The decrease in staff costs reflects, on the one hand, the containment measures taken by the Bank in accordance with the criteria set out in Decree Law 78/2010, ratified by Law 122/2010, and on the other hand the allowance granted for the contract hiatus. The average number of employees, recalculated as full-time equivalent employees (adding overtime and deducting part-time and unpaid absences) was 7,491. The per capita expense for gross wages and salaries and related costs of staff in service was €92,200 and €109,300 considering all the components of cost referred to above.

In 2011 no annual allocations were made to the severance pay fund (see "Comments on the items of the balance sheet" – *Provisions and provision for general risks*). The decrease in *Pensions and severance payments* was due to the reduction in part relating to severance pay owing to the smaller number of terminations.

The *Emoluments paid to head and branch office collegial bodies* comprise the emoluments paid to the thirteen members of the Board of Directors (€371,020), the five members of the Board of Auditors (€137,430) and to the Governing Board. The emoluments paid to the individual members of the Governing Board were as follows:

- €757,714 to the Governor;
- €593,303 to the Director General;
- €441,057 to each Deputy Director General.

For members of the Governing Board entitled to a pension payable by the Bank, at the time the emoluments referred to above are paid they are decreased by the amount of such pensions, which are included under sub-item 10.4 *Pensions and severance payments*. The amount paid as emolument is decreased by 10 per cent in accordance with the criteria laid down in Article 6.3 of Decree Law 78/2010, ratified by Law 122/2010.

Administrative expenses decreased overall by €17 million, equal to around 4 per cent. Spending on building maintenance costs decreased by €8 million (from €75 million to €67 million), the cost of security services and banknote escort decreased by €6 million (from €75 million to €69 million), equipment rentals decreased by €5 million (from €19 million to €14 million) and the cost of external software leasing and maintenance also decreased by €5 million (from €36 million to €31 million). The cost of electronic transmission instead increased by €1 million (€16 million to €17 million). The following costs were basically unchanged: raw materials and subsidiary materials for banknote production (€30 million), systems assistance (€30 million), utilities (€27 million) and participation in TARGET2 (€9 million).

In 2011 the Bank of Italy did not incur any costs for banknote production outside the Bank (€4 million in 2010).

Other expenses, amounting to €27 million, comprise €17 million for tax, of which €11 million for ICI property tax.

[23] Extraordinary income and expense (Item 12)

Extraordinary income and expense showed a negative balance of €6 million. The income (€26 million) consisted mainly of the final insurance payment received for the earthquake damage to the Bank's buildings in L'Aquila in 2009 (€22 million, which was added to the payment on account of €10 million in 2010) and tax-related income (€2 million). The expense (€32 million) included the amount spent in 2011 on restructuring the Bank's buildings in L'Aquila (€3 million) and the additional transfer to the provision for further restructuring costs not yet disbursed (€19 million). The item also includes tax costs (€6 million).

[24] Taxes on income for the year and on productive activities (Item 13)

Taxes for the year amounted to €1,101 million and comprised both the current taxes due and the change in deferred tax assets and liabilities. Corporate income tax for the year, including deferred taxes, amounted to €896 million (€774 million in 2010).

The regional tax on productive activities (Irap) rose from €151 million to €205 million.

PROPOSALS OF THE BOARD OF DIRECTORS

Pursuant to Articles 38 and 39 of the Statute and after hearing the favourable opinion of the Board of Auditors, the Board of Directors proposes the following allocation of the net profit for 2011 of €1,129,175,577:

	euros
– 20 per cent to the ordinary reserve	225,835,115
– an amount equal to 6 per cent of the share capital to shareholders	9,360
– 20 per cent to the extraordinary reserve	225,835,115
– an additional amount equal to 4 per cent of the share capital to shareholders	6,240
– the remaining amount to the State	677,489,747
Total	1,129,175,577

Pursuant to Article 40 of the Statute, the Board of Directors has also proposed the distribution to shareholders – drawing on the income earned on the ordinary and extraordinary reserves – of an additional € 67,050,000, equal to 0.50 per cent (as in the previous financial year) of the total reserves at 31 December 2010.

If these proposals are approved, the total dividend will be equal to €67,065,600, corresponding to €223.552 per share.

THE GOVERNOR
Ignazio Visco

23. DOCUMENTATION ATTACHED TO THE ANNUAL ACCOUNTS

REPORT OF THE BOARD OF AUDITORS

ON THE 118th FINANCIAL YEAR OF THE BANK OF ITALY
AND THE ACCOUNTS FOR THE YEAR ENDING 31 DECEMBER 2011

To the shareholders,

We have examined the annual accounts of the Bank of Italy for the year ending 31 December 2011, drawn up in accordance with the accounting standards and valuation methods decided by the Board of Directors and agreed by us, described in detail in the notes to the accounts.

We conducted our examination of the annual accounts in accordance with the principles of conduct for the Board of Auditors recommended by the Consiglio nazionale dei dottori commercialisti e degli esperti contabili. Procedures required by Article 19 of the Bank of Italy's Statute were also based on the same principles.

In our opinion the annual accounts of the Bank of Italy for the year ending 31 December 2011 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 made applicable 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 the residual tax losses arising from the government bond conversion under Law 289/2002, 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 €489 million (from €5,574 million to €5,085 million).

The Board of Directors approved the transfer of €1,400 million to the provision for general risks.

The total amount of the Bank's general and specific risk provisions is deemed prudent. In particular, the provision for severance pay and pensions shows a small excess of about €61 million compared with the total commitments at 31 December 2011; for the sake of prudence this amount has been left allocated to the above-mentioned item.

The accounts submitted for your approval show the following results:

Assets	€	538,978,090,921
Liabilities	€	516,104,337,170
Capital and reserves	€	21,744,578,174
Net profit for the year (as shown in the income statement)	€	1,129,175,577

The off-balance-sheet accounts, equal to €549,204,890,252, refer to commitments, forward transactions, guarantees granted and received, and third parties' deposits of securities and sundry valuables.

We have examined the management report accompanying the annual accounts and consider it to be consistent therewith.

Pursuant to Article 39 of the Statute, the Board of Directors proposes the following allocation of the net profit:

– 20 per cent to the ordinary reserve	€	225,835,115
– an amount equal to 6 per cent of the share capital to shareholders	€	9,360
– 20 per cent to the extraordinary reserve	€	225,835,115
– an additional amount equal to 4 per cent of the share capital to shareholders	€	6,240
– the remaining amount to the State	€	677,489,747
Total	€	1,129,175,577

Pursuant to Article 40 of the Statute, the Board of Directors also proposes the distribution to shareholders – drawing on the income earned on the ordinary and extraordinary reserves – of an additional €67,050,000, equal to 0.50 per cent of such reserves at 31 December 2010 and within the limits laid down in the above-mentioned article.

During the year ending 31 December 2011 we attended all the meetings of the Board of Directors 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 2011 that have been submitted to you (the balance sheet, the profit and loss account 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.

Rome, 26 April 2012

THE BOARD OF AUDITORS
Dario Velo (Chairman)
Giovanni Fiori
Elisabetta Gualandri
Gian Domenico Mosco
Sandro Sandri

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

EFD – *Documento di economia e finanza*
Economy and Finance Document

FIU – Financial Intelligence Unit

HICP – Harmonized index of consumer prices

ICI – *Imposta comunale sugli immobili*
Municipal property tax (until 2011)

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

IMU – *Imposta municipale unica*
Municipal property 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
MAC	–	*Mercato Alternativo del Capitale* Alternative Capital Market
MTS	–	*Mercato telematico dei titoli di Stato* Screen-based secondary market in government securities
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 2011

GOVERNING BOARD - DIRECTORATE

Ignazio VISCO	GOVERNOR - MEMBER OF THE GOVERNING BOARD
Fabrizio SACCOMANNI	DIRECTOR GENERAL - MEMBER OF THE GOVERNING BOARD
Giovanni CAROSIO	DEPUTY DIRECTOR GENERAL - MEMBER OF THE GOVERNING BOARD
Anna Maria TARANTOLA	DEPUTY DIRECTOR GENERAL - MEMBER OF THE GOVERNING BOARD
Salvatore ROSSI*	DEPUTY DIRECTOR GENERAL - MEMBER OF THE GOVERNING BOARD

* Since 17.1.2012

BOARD OF DIRECTORS

Franca ALACEVICH[a]
Francesco ARGIOLAS
Paolo BLASI[b]
Ilaria BORLETTI BUITONI[c]
Nicola CACUCCI
Carlo CASTELLANO
Paolo DE FEO
Giovanni FINAZZO
Cesare MIRABELLI
Giovanni MONTANARI
Ignazio MUSU
Lodovico PASSERIN D'ENTREVES
Francesco PERONI
Stefano POSSATI
Giorgio SQUINZI[d]

[a] Since 12.6.2012
[b] Until 11.6.2012
[c] Since 21.6.2012
[d] Until 23.5.2012

BOARD OF AUDITORS

Dario VELO - CHAIRMAN
Giovanni FIORI
Elisabetta GUALANDRI
Gian Domenico MOSCO
Sandro SANDRI

ALTERNATE AUDITORS

Lorenzo DE ANGELIS
Angelo RICCABONI

MANAGING DIRECTORS

Franco PASSACANTANDO [1]	RESPONSIBLE FOR RELATIONS WITH INTERNATIONAL INSTITUTIONS AND G20, EFC AND OECD. OVERSEES T2 SECURITIES AND INFRASTRUCTURE PAYMENT SYSTEM MICRO-PROJECTS
Carlo PISANTI	RESPONSIBLE FOR CURRENCY CIRCULATION
Claudio CLEMENTE	ACCOUNTANT GENERAL
Sandro APPETITI	RESPONSIBLE FOR IT RESOURCES AND STATISTICS
Umberto PROIA [2]	SECRETARY GENERAL
Daniele FRANCO	RESPONSIBLE FOR ECONOMIC RESEARCH AND INTERNATIONAL RELATIONS
Fabio PANETTA	RESPONSIBLE FOR COORDINATING ACTIVITIES CONNECTED WITH THE BANK'S PARTICIPATION IN THE EUROSYSTEM
Marino Ottavio PERASSI	GENERAL COUNSEL
Vieri CERIANI	RESPONSIBLE FOR SERVICE QUALITY
Nunzio MINICHIELLO [2]	RESPONSIBLE FOR PROPERTY AND PURCHASING
Emerico Antonio ZAUTZIK [1]	RESPONSIBLE FOR CENTRAL BANKING, MARKETS AND PAYMENT SYSTEMS
Luigi Federico SIGNORINI [1]	RESPONSIBLE FOR BANKING AND FINANCIAL SUPERVISION

* * *

Giovanni CASTALDI	RESPONSIBLE FOR THE FINANCIAL INTELLIGENCE UNIT

[1] Since 1.3.2012
[2] Since 1.2.2012