BANCA D'ITALIA

EUROSISTEMA

Annual Report

Abridged Version

Ordinary Meeting of Shareholders

2012 - 119th Financial Year

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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 2012 world output expanded by just 3.2 per cent, compared with 4.0 per cent in 2011. The slowdown affected both the advanced economies, where the pace of growth declined from 1.6 to 1.2 per cent, and emerging countries, where it fell from 6.4 to 5.1 per cent.

Lacklustre economic growth in the main advanced economies reflected the fallout from the sovereign debt crisis in the euro area and uncertainty over fiscal policy in the United States. There, as in Japan, GDP growth was modest; it stagnated in the United Kingdom and was negative overall in the European Union.

In the leading emerging and developing countries the rate of expansion of GDP was among the lowest in the last decade, held back by the sharp slowdown in investment expenditure and the weakening of foreign demand. In China, economic activity in the first half of the year continued to feel the effects of the measures taken to cool down the property market in 2011; in the months that followed the decline in confidence among export-oriented firms also weighed negatively. In Brazil and in India investment was affected by supply rigidity, owing essentially to the slowness of structural reform and to regulatory uncertainty. In Russia the fall in oil export revenues led to a slowdown in public expenditure and in investment in the extractive sector.

In the absence of upward pressure on prices, the expansionary stance of monetary policy in the main advanced economies was accentuated further. Reference rates were at extraordinarily low levels; recourse to unconventional measures also increased. Towards the end of the year and in early 2013 the Federal Reserve modified its strategy for conducting and communicating monetary policy to enhance transparency on the future course of the federal funds rate; the Bank of Japan announced bold new monetary stimulus measures to step up and make more credible the fight against deflation.

In the United States the Administration and Congress reached some important agreements on fiscal policy, thus averting the drastic budgetary tightening otherwise due to take place under current legislation at the start of 2013; in March, Congress passed a continuing resolution to keep the government financed through September. The uncertainty about developments in the public finances has not been entirely dissipated, however, given the stalled approval of the budget for the next fiscal year and the lack of any longer term plan to restructure the public finances. In Japan, notwithstanding the high level of public debt, at the start of 2013 the newly elected government introduced expansionary measures equal to around 2 percentage points of GDP. In the United Kingdom the consolidation of the public accounts that began in 2010 continued, albeit more slowly than had initially been predicted.

Monetary policies in the leading emerging economies remained prudent, owing both to the resurgence of inflationary pressures in India and in Russia and to fears of overheating of the property market in China. In Brazil, by contrast, monetary conditions were eased more decisively in order to counter the weakening of economic activity. Support from fiscal policy was provided mainly by built-in stabilizers; in several emerging countries debt resumed a downward path, allowing greater scope for intervention.

The United States

Output in the United States increased by 2.2 per cent in 2012, up from 1.8 per cent in 2011 (Table 1.1). Consumption grew by 1.9 per cent (2.5 per cent in 2011), outpacing households' real disposable income (1.5 per cent). The saving rate accordingly declined from 4.2 to 3.9 per cent. The financial situation of households improved, benefiting from the sharp increase in financial wealth, the pick up in property prices, and a gradual reduction in debt.

Table 1.1

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

	2010	2011	2012	2012				2013
				Q1	Q2	Q3	Q4	Q1
United States								
GDP (1)	2.4	1.8	2.2	2.0	1.3	3.1	0.4	2.5
Domestic demand (1)	2.8	1.7	2.1	1.8	1.0	2.6	..	2.9
Inflation (2)	1.6	3.2	2.1	2.8	1.9	1.7	1.9	1.7
Japan								
GDP (1)	4.7	-0.6	2.0	5.3	-0.9	-3.5	1.0	3.5
Domestic demand (1)	2.9	0.3	2.9	5.0	0.3	-1.0	1.3	2.0
Inflation (2)	-0.7	-0.3	..	0.3	0.2	-0.4	-0.2	-0.6
European Union								
GDP (1)	2.1	1.6	-0.3	-0.3	-0.7	0.4	-1.9	-0.4
Domestic demand (1)	1.6	0.6	-1.5	-1.1	-2.1	-1.2	-1.9	....
Inflation (2)	2.0	3.1	2.6	2.9	2.6	2.6	2.4	2.0
United Kingdom								
GDP (1)	1.8	1.0	0.3	-0.3	-1.5	3.8	-1.2	1.2
Domestic demand (1)	2.3	-0.6	1.2	2.7	1.9	2.2	-0.4	....
Inflation (2)	3.3	4.5	2.8	3.5	2.8	2.4	2.7	2.8
Canada								
GDP (1)	3.2	2.6	1.8	1.2	1.9	0.7	0.6	....
Domestic demand (1) (3)	4.9	2.7	1.9	2.3	1.8	0.9	2.6	....
Inflation (2)	1.8	2.9	1.5	2.3	1.6	1.2	0.9	0.9
Advanced economies								
GDP (4)	3.0	1.6	1.2	….	….	….	….	….
Memorandum item:								
World output (4)	5.2	4.0	3.2	….	….	….	….	….

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.

In 2012 fixed capital investment accelerated to year-on-year growth of 8.7 per cent, from 6.6 per cent in 2011, driven by the recovery in the residential component (12.1 per cent, from -1.4 per cent), which more than offset the slight deceleration in non-residential fixed investment (from 8.6 to 8 per cent). The latter remained equal to 10 per cent of GDP, a historically low level. Growth in gross profits of non-financial firms was still high, despite falling to 8.1 per cent from 9.8 per cent, prolonging a situation in which internal funds exceed capital expenditure. For the second year running, productivity growth was very moderate. The increase in unit labour costs was curbed by the slowdown in hourly wages.

Labour market conditions remained poor, affected by the sluggishness of economic activity. In the last three years only 60 per cent of the jobs lost during the 2008-09 crisis have been recouped. Last year non-farm payroll employment rose by 2.2 million jobs; at the end of 2012 the unemployment rate, though down by 0.7 percentage points, was still at 7.8 per cent. For the first time since 2008, those out of work for at least 27 weeks (the long-term unemployed) made up less than 40 per of the total. The fall in the unemployment rate was in part favoured by declining labour force participation, which in April touched a low of 63.3 per cent for persons over 16 years of age, almost three points less than in 2007. This drop reflects demographics and long-term behavioural trends and – given the current job market conditions – the presence of discouraged workers.

According to preliminary national accounts estimates, in the first quarter of 2013 GDP grew at an annual pace of 2.5 per cent, benefiting from the acceleration in consumption and the slower pace of decline in public expenditure. In the first four months of the year non-farm payroll employment increased again, by 783,000 jobs, and the unemployment rate continued to fall, reaching 7.5 per cent in April.

In the course of 2012, after three years in which prices and volumes stagnated, the property market staged a recovery. Mortgage supply conditions were relaxed, although only for the borrowers deemed soundest, and the stock of residential mortgages increased; the delinquency rate fell, as did that of new foreclosures, which nonetheless remains at historically high levels. Compared with 2011, the number of new building permits and building starts both rose sharply.

Inflation, measured by the twelve-month rate of increase in the consumer price index, more than halved in the first seven months of 2012 to 1.4 per cent in July; in April 2013 it stood at 1.1 per cent (1.7 per cent excluding food and energy products). Measured by the consumption deflator, inflation fell from 2.4 per cent at the end of 2011 to 1.0 per cent in March 2013.

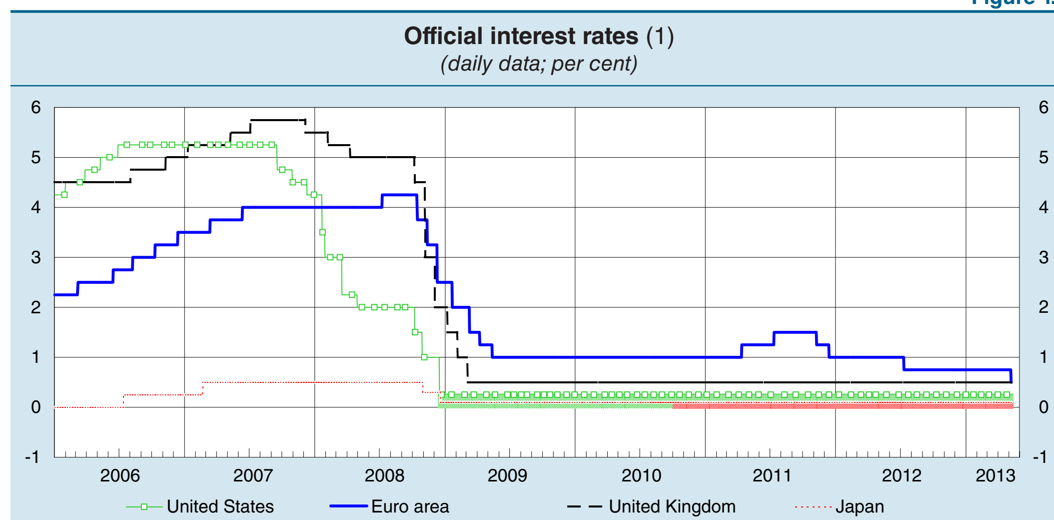
The monetary policy stance became even more expansionary in 2012. While the target range for the federal funds rate was kept at between 0.0 and 0.25 per cent (Figure 1.1), recourse to unconventional measures intensified. The size of the central bank's balance sheet, which remained largely unchanged in 2012 at 18 per cent of GDP, began to expand again at the beginning of 2013 (Figure 1.2).

In June the Federal Reserve's portfolio restructuring programme designed to extend the average maturity of its Treasury securities (Operation Twist) was extended until the end of 2012. In September the Fed announced a new plan for mortgage-backed securities purchases of $40 billion a month with immediate effect and with no limits on amount or duration; these purchases came on top of those already approved, involving the reinvestment of income from the redemption of MBS in similar instruments. In December it was also decided to make outright purchases

of longer-term Treasury securities at a pace of €45 billion a month starting in 2013, to replace Operation Twist, which had expired; finally, on the same date the central bank reinstated its policy of rolling over maturing Treasury securities.

Figure 1.1

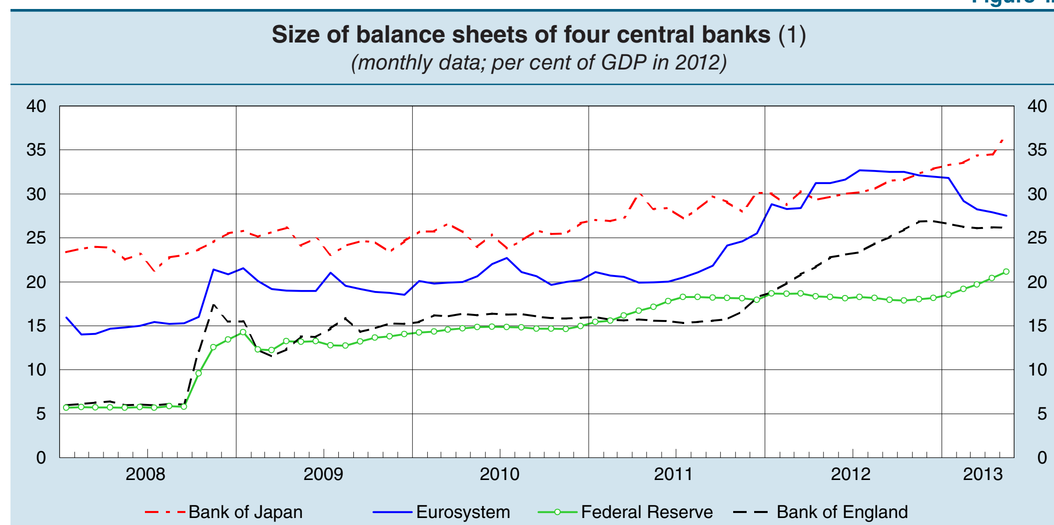
Official interest rates (1)
(daily data; per cent)



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.

Figure 1.2

Size of balance sheets of four central banks (1)
(monthly data; per cent of GDP in 2012)



Sources: ECB and national statistics.
(1) Total assets. The movements in this aggregate also reflect factors not directly related to monetary policy decisions.

The Federal Reserve also made important changes in its presentation of monetary policy conduct. In January 2012 a specific inflation target of a twelve-month rate of increase in the consumption deflator of 2 per cent was adopted and publication commenced – together with the quarterly forecasts on GDP, unemployment and inflation – of the range of monetary reference rates deemed appropriate by the members of the Federal Open Market Committee (FOMC) for the next three years and in the longer term (see the box "Recent changes to the Federal Reserve's monetary policy strategy", *Economic Bulletin*, April 2012).

Increasing use was made of “forward guidance”, i.e. indications on the likely future path of policy rates. During 2012 the timeframe within which the FOMC expected economic conditions to require maintaining exceptionally low interest rates was extended for two years to the first half of 2015. In December, to enhance the transparency of these indicators with respect to macroeconomic trends, it was announced that the federal funds target rate would be kept at current levels for as long as the unemployment rate remained above 6.5 per cent, on condition that in the meantime the inflation forecast for one to two years ahead did not exceed the 2 per cent target by more than half a percentage point, and that longer-term inflation expectations continued to be well anchored.

The 2012 fiscal year ended on 30 September closed with a deficit of $1,087 billion, equal to 7 per cent of GDP and 2 percentage points less than in FY 2011. To obviate the failure to approve the 2013 budget, in March Congress approved an appropriations bill to fund government operations through the remainder of FY 2013. The Congressional Budget Office (CBO) estimates that the federal deficit will narrow to 4 per cent of GDP this year.

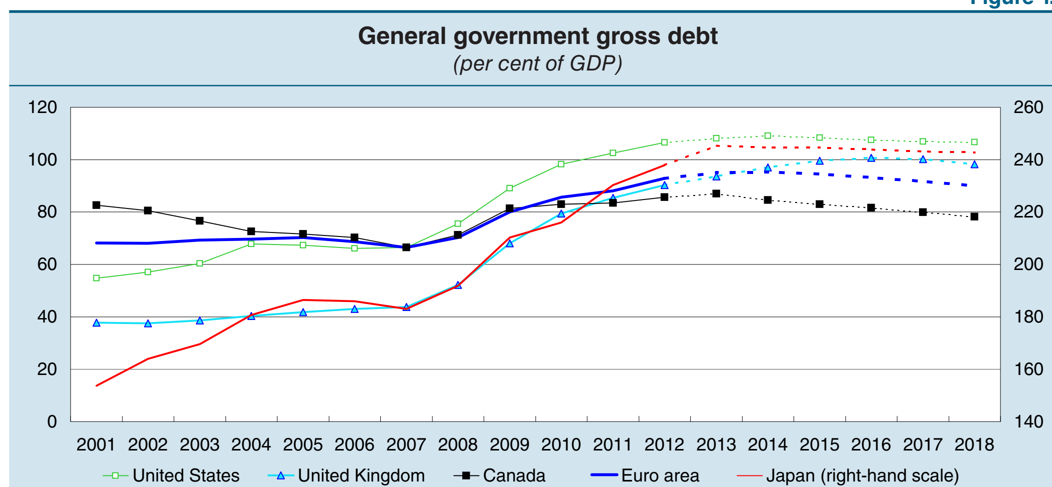
With the approval of the American Taxpayer Relief Act of 1 January 2013, the Administration and Congress reached a compromise to avert the “fiscal cliff”, the severe tightening that would otherwise have resulted from the automatic expiry of the tax cuts introduced in 2001 and in 2003 and from the public expenditure cuts introduced in August 2011. According to the CBO these measures will lead to an overall correction in the deficit of 2 per cent of GDP (around $330 billion), 1.3 percentage points less than under unchanged policies.

Since no agreement was reached in Congress, last March budget sequestration – the automatic cuts in public expenditure programmes that had been previously approved – took effect; as a result, the CBO estimates that expenditure for the current fiscal year will be reduced by a further $44 billion or by about 0.3 per cent of GDP.

The IMF forecasts that general government gross debt will climb to 109.2 per cent of GDP by the end of 2014, from 106.5 per cent at the end of 2012, before declining gradually in subsequent years (Figure 1.3).

Figure 1.3

General government gross debt
(per cent of GDP)



Sources: IMF, *World Economic Outlook*, April 2013 and *Fiscal Monitor*, April 2013

Japan

In 2012 Japan's GDP returned to growth, expanding by 2.0 per cent, after falling by 0.6 per cent in 2011 following the major earthquake that struck the country (Table 1.1). Economic activity was buoyed by the acceleration in private consumption (to growth of 2.3 per cent, from 0.4 per cent in 2011), the recovery in government investment (up by 12.5 per cent after a contraction of 7.5 per cent in 2011) and the faster pace of expansion in current public expenditure (2.6 per cent as against 1.4 per cent). For the second consecutive year net exports subtracted almost 1 percentage point from growth. During the year the unemployment rate remained unchanged, at slightly more than 4 per cent, while employment continued to decline, by almost 1 percentage point, owing in part to the reduction in labour market participation. In the first quarter of 2013 economic growth picked up to 3.5 per cent on an annualized basis, owing to the acceleration in private consumption and the substantial contribution of net exports.

The deflationary pressures that have plagued the country since the late 1990s show no signs of abating. On average for 2012 the consumer price index remained unchanged (in 2011 it declined by 0.3 per cent); excluding energy and food products, it fell by 0.6 per cent (-1.0 per cent in 2011). Since last summer the decline in prices has intensified, reaching a rate of 0.9 per cent in March.

The expansionary impulse of monetary policy became progressively stronger. While maintaining its overnight call rate target in a range of 0.0 to 0.1 per cent (Figure 1.1), in 2012 the Bank of Japan repeatedly bolstered its asset purchase programme. In April this year the central bank's balance sheet amounted to 35 per cent of GDP, 5 points higher than in December 2011 (Figure 1.2).

With a view to combating deflation more vigorously, the Bank of Japan introduced major changes to its conduct of monetary policy at the beginning of 2013. In January it announced an explicit price stability target of 2 per cent, replacing the short-term reference value of 1.0 per cent indicated the previous year. It also announced that the current asset purchase programme would be replaced on expiry by a new open-ended buying programme with no upper limit on purchases. Following the appointment of the new Governor and two new Deputy Governors, in early April the Policy Board terminated the asset purchase programme ahead of schedule and replaced it with a new programme of quantitative easing, designed to meet the inflation target within two years. Under the new system, in a two-year horizon the bank will double the monetary base (which replaces the uncollateralized overnight call rate as the operational target of monetary policy), double the size of its portfolio of Japanese government bonds, and more than double their average residual maturity.

According to the latest IMF estimates, the Japanese general government deficit came to 10.2 per cent of GDP in 2012, as against 9.9 per cent in 2011, and will remain high in the years to come, owing to the expansionary measures introduced by the new Government at the start of 2013 (equal to around 2 percentage points of GDP). General government gross debt, which last year reached 237.9 per cent of GDP, is forecast to increase further in 2013, to 245.0 per cent (Figure 1.3).

The European Union

In 2012 output in the European Union shrank by 0.3 per cent (it had expanded by 1.6 per cent in 2011); in the euro area the contraction was sharper (-0.6 per cent).

The United Kingdom. – The expansion of the UK economy all but halted in 2012, slipping from 1.0 to 0.3 per cent (Table 1.1), despite such exceptional factors during the summer as the Queen's diamond jubilee celebrations and the London Olympics, which helped to sustain consumption. While domestic demand picked up slightly, net exports subtracted almost 1 percentage point from growth, above all owing to the recession in the euro area; in 2011 net exports had contributed 1.4 percentage points to growth.

Notwithstanding the slack economic activity the pace of private-sector employment growth was very brisk (4.0 per cent, from 1.0 per cent in 2011), triggering a further drop in labour productivity.

According to preliminary national accounts estimates, in the first quarter of 2013 GDP expanded at an annualized rate of 1.2 per cent. Consumer inflation, which in September had reached a low of 2.2 per cent, in part benefiting from the slowdown in private sector wages, climbed back up to 2.8 per cent in March this year.

The Bank of England kept its reference rate unchanged at 0.5 per cent, extending its use of unconventional expansionary measures; its balance sheet accordingly reached 26 per cent of GDP, as against 18 per cent at the end of 2011 (Figure 1.1). In 2012 the resources earmarked for its asset purchase programme increased by a total of £100 billion, reaching £375 billion at the end of the year. Last July, in conjunction with the Treasury, the Funding for Lending Scheme was launched to support bank credit.

In the 2012-13 fiscal year the public sector deficit narrowed, in line with the forecasts, to 5.6 per cent of GDP from 7.8 per cent a year earlier. According to the most recent government estimates, the consolidation under way will reduce the deficit to 3.5 per cent of GDP by FY 2016-17, a much higher level than the 1.2 per cent forecast last year; the objective of achieving budget balance net of the effects of the economic cycle and of investment expenditure was nevertheless confirmed. The start of the reduction of the ratio of public debt to GDP will be postponed for two fiscal years, to 2017-18, chiefly as a result of the worsening economic performance. According to the latest IMF estimates, from 90.3 per cent of GDP at the end of 2012, public sector gross debt is expected to exceed 100 per cent in 2016 (Table 1.2).

Central and Eastern European member states. – Of the ten central and eastern European countries that joined the European Union between 2004 and 2007, three are members of the euro area. In the remaining seven, GDP growth activity slowed sharply from 3.2 to 0.9 per cent, while differing markedly among the various countries: in Latvia and Lithuania economic activity remained brisk; in Poland it braked sharply; in the other countries it stagnated or contracted.

Consumer inflation averaged 3.7 per cent in 2012, compared with 3.9 per cent in 2011; the uneven performance among countries is ascribable in part to temporary factors, especially base effects relating to interventions on indirect taxes and administered

prices and to localized increases in some raw material prices. In the early months of 2013 price dynamics were moderate in all countries, reflecting ample spare capacity.

Table 1.2

Main macroeconomic indicators for the new EU members not in the euro area
(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)
	2011	2012	2011	2012	2011	2012	2012	2011	2012	2012
Bulgaria	1.8	0.8	3.4	2.4	0.1	-1.3	99.1	-2.0	-0.8	18.5
Czech Republic	1.9	-1.3	2.1	3.5	-2.7	-2.4	52.0	-3.3	-4.4	45.8
Hungary	1.6	-1.7	3.9	5.7	0.8	1.6	77.9	4.3	-1.9	79.2
Latvia	5.5	5.6	4.2	2.3	-2.1	-1.7	159.2	-3.6	-1.2	40.7
Lithuania	5.9	3.6	4.1	3.2	-3.7	-0.5	140.3	-5.5	-3.2	40.7
Poland	4.5	1.9	3.9	3.7	-4.9	-3.5	74.7	-5.0	-3.9	55.6
Romania	2.2	0.7	5.8	3.4	-4.5	-4.0	76.6	-5.6	-2.9	37.8
Total	**3.2**	**0.9**	**3.9**	**3.7**	**....**	**....**	**83.6**	**-3.5**	**-3.4**	**51.1**

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

In the early part of 2012, the central banks of the countries with an inflation objective (Poland, Czech Republic, Romania and Hungary) maintained a generally prudent monetary policy stance owing to inflationary pressures and the volatility of exchange rates. Subsequently, Poland, the Czech Republic and Hungary made monetary policy gradually more expansive, lowering their reference rates by 175, 70 and 225 basis points respectively between June 2012 and May of this year. In the economies that maintain a fixed exchange rate with the euro, monetary conditions were eased over the course of the year.

The state of the public accounts continued to improve in 2012, notwithstanding the adverse cyclical conditions. The European Commission estimates that the consolidation measures permitted a reduction in structural deficits (adjusted for the effects of the business cycle and temporary measures) of around 2 points of GDP on average.

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

China. – In 2012 GDP expanded by 7.8 per cent, the slowest rate since 1999 (Table 1.3). The slowdown involved all the components of domestic demand, and net exports again made a slightly negative contribution of -0.2 percentage points. In the first half of the year, in addition to the deteriorating external economic situation, the effects of the restrictive measures on property investment adopted in 2011 also weighed negatively, as did the end of the expansive fiscal measures enacted in 2008 and 2009 (see the box "The growth slowdown in China and the economic policy response", *Economic Bulletin*, October 2012). Towards the end of the year the authorities temporarily supported economic activity by bringing public investment expenditure forward.

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)	
	2011	2012	2011	2012	2011	2012	2011	2012
China	9.3	7.8	5.4	2.6	2.8	2.6	-1.3	-2.2
India (3)	7.3	5.1	9.5	7.5	-3.4	-5.1	-8.4	-8.3
Brazil	2.7	0.9	6.6	5.4	-2.1	-2.3	-2.5	-2.8
Russia	4.3	3.4	8.4	5.1	5.2	4.0	1.5	0.4

Sources: IMF and national statistics.
(1) Per cent of GDP. – (2) Consolidated public sector. – (3) GDP at factor cost; consumer inflation is measured by the wholesale price index.

In the first quarter of 2013, however, total investment slowed again, contributing to the further deceleration in output. By contrast, foreign demand now made a positive contribution of 1.1 per cent, thanks above all to the recovery in exports to the United States.

In 2012 the gradual rebalancing of the Chinese economy continued. On the supply side this process is designed to augment the weight of the services sector and on the demand side, to increase that of consumption, with the objective of reducing the excessive dependence of economic development on exports and fixed capital investment.

Household income in urban areas continued to expand, driven by the increase of 14.0 per cent in the wages of private sector workers, consisting largely of immigrants from the countryside. The saving rate rose by 2 percentage points to 32 per cent, likely reflecting the growing role of remittances to rural areas by immigrant workers in cities.

The sharp growth in the wages of immigrants from rural areas appears to go some way towards explaining the narrowing urban income inequality in recent years. Data published last January by the national statistical office suggest that since 2008 the Gini coefficient has declined in urban areas (to 0.31 in 2012, from 0.34 in 2008) and the gap between incomes at the first and ninth deciles of the distribution has narrowed.

After peaking at 6.5 per cent in mid-2011, consumer inflation slowed sharply to 1.7 per cent in October 2012; last April it stood at 2.4 per cent, driven by temporary increases in food prices.

In the summer of 2012 house prices began to rise again, in response to the easing of monetary and credit conditions: between May 2012 and March 2013 the average increase was 16 per cent. The renewed risk of overheating in the property market led the government to announce new restrictive measures in March to penalize speculative transactions, providing for a 20 per cent capital gains tax on sales of second homes, a property tax and selective restrictions on credit.

Monetary policy was moderately expansive in 2012. In February and May the central bank cut the reserve requirement for banks, by 1 percentage point in total; in

June and July, for the first time since 2008, it lowered the reference rates on bank loans and deposits by a total of 50 basis points (to 6 and 3 per cent respectively).

In 2012 the broad M2 money aggregate expanded by 13.8 per cent (in line with the government objectives), while the flow of new loans to the economy, partly owing to the growth in non-bank credit, increased by 22.8 per cent, thereby reaching 30 per cent of GDP.

The decline of the relative weight of bank loans in funding investment has gathered momentum in the last two years, partly in response to the restrictions on lending to the property sector imposed by the authorities. The funding instruments alternative to traditional bank loans, which increased to 42 per cent of the total sources of financing in 2012 (24 per cent in 2009) are largely intermediated by the banks, but are off-balance-sheet and accordingly not subject to the prudential constraints on traditional loans. Alongside the products intermediated on behalf of nominally separate entities, which in general finance risky borrowers (for example, property development firms) at very high rates, the banks offer their customers so-called wealth management products, unsecured short-term financial products that earn a higher rate of return than deposits, used to fund off-balance-sheet investments, including high-yield cooperate bonds.

To regulate the expansion of alternatives to traditional bank loans and to reduce liquidity risks – stemming from mismatches between the maturities of banks' assets and liabilities – and moral hazard, which are implicit in expectations of a tacit government guarantee, in April the banking supervisory authority required credit institutions to adopt transparent criteria for the use of the funds raised by the issue of wealth management products. It also set a ceiling on the portion of these funds that could be allocated to bond purchases and loans.

Fiscal policy remained moderately expansive in the early part of 2012 and more geared towards the funding of social expenditure programmes than in the past. In the second half of the year, the government speeded up the approval of some infrastructure investments, which in nominal terms resumed growth at a twelve-month rate of 13 per cent. In 2012 the general government deficit expanded to 2.2 per cent of GDP, from 1.3 per cent in 2011, a level which the IMF estimates will remain unchanged in 2013.

After peaking at 33.5 per cent in 2010, public debt declined to 22.8 per cent of GDP in 2012. It is likely that the official data underestimate the size of the debt, not accounting in full for liabilities incurred by local governments through special purpose vehicles created to raise capital on the market to fund infrastructure projects. Based on the supervisory authority's latest estimates, at the end of 2012 bank loans relating to these companies amounted to ¥9.2 trillion or 18 per cent of GDP.

India. – Growth in the Indian economy lost momentum in 2012, falling from 7.3 to 5.1 per cent, the lowest level for a decade. The slowdown also involved the services sector, which accounts for more than 60 per cent of total output. The pace of expansion of consumption expenditure was halved; investment stagnated. Net exports made a modest positive contribution, thanks to the sharp slowdown in imports.

Economic growth was markedly lower than the 9.0 per cent forecast by the government in its five-year plan for 2007-12, owing not only to cyclical factors but also to structural problems. The Reserve Bank of India recently lowered its estimate of potential growth from 9 to 7 per cent.

The failure to reach the growth targets mainly reflects supply-side rigidities and bottlenecks, including inadequate infrastructure, especially in energy (where supply disruptions are frequent), transport and communications. In order to revive private investment, which in recent years has gradually come to a halt, the government launched structural reforms, including major financial sector liberalizations, to improve the climate of confidence. Moreover, to boost private sector participation in infrastructure projects, it set up a special commission to speed up the procedures for approving major projects, raised the ceilings on foreign investor's purchases of bonds issued by Indian companies operating in the infrastructure sector and simplified the rules for selling off public land.

While easing, inflation – as measured by the variation in the wholesale price index that is the reference for monetary policy – remained high (7.5 per cent, down from 9.5 per cent in 2011). In the early months of 2013 the persistent weakness of domestic demand and the fall in international food and energy prices favoured a marked reduction in inflation, which in April stood at 4.9 per cent, the lowest level in three years, and back within the central bank's tolerance threshold (set at around 5.5 per cent for 2013).

In 2012 and in the early months of 2013 monetary policy was kept accommodative in order to combat the slump in investment. Between April 2012 and May 2013 the Reserve Bank cut the reference rate by a total of 125 basis points, to 7.25 per cent.

The general government deficit remained at the high level of 2011 (8.3 per cent of GDP), suffering from lower-than-expected revenues and the continued substantial outlays on public subsidies for food and energy consumption. According to the IMF's estimates, the deficit will remain at these levels in 2013 and in 2014 and the public debt will stabilize at about its 2012 level of 66.8 per cent of GDP.

Brazil. – After the sharp slowdown to 2.7 per cent recorded in 2011, last year Brazilian GDP virtually stagnated (0.9 per cent). The contraction in investment, which together with the decumulation of stocks subtracted about 2 percentage points from growth, reflected the worsening climate of confidence owing to weakening foreign demand and uncertainties over the economic policy stance. Consumption, instead, continued to grow at a brisk pace of 3.1 per cent (4.1 per cent in 2011), benefiting from the still highly favourable conditions in the labour market, with the unemployment rate falling to a record low of 4.6 per cent.

In the course of the year the government introduced a number of tax relief measures to favour a recovery of competitiveness in the manufacturing sector; a positive impulse to growth could derive above all from the new stimulus plan to spur investment in infrastructure approved in 2012 and launched in 2013.

Brazil's saving rate, measured by gross fixed capital expenditure as a share of GDP, stands at 18 per cent, a low level by international standards and more than 4 percentage points lower than the average for the main South American countries. The lag in adapting Brazil's stock of fixed a capital is greatest in the infrastructure and construction sectors (residential and commercial), to the grave detriment of productivity and the growth potential of the economy (estimated at around 4 per cent). In 2012 the government approved a programme of concessions in the transport and energy sectors which, together with tax breaks and subsidized loans, is designed to stimulate new private investment amounting to 10 per cent of GDP, half for the upgrading of

transport infrastructures (roads, motorways, ports and airports) and the remainder for the energy and extractive sectors (oil and natural gas). The plan was launched this year.

Consumer inflation rose again from the autumn onwards, from 4.9 per cent in June to 6.5 per cent in April, the top of the central bank's target-range of 4.5 ± 2 per cent. This reflected the increases in food and service prices, which were transmitted to wages – up 10 per cent in nominal terms from a year earlier – through the automatic indexation mechanisms.

Monetary policy was expansive, reflecting concerns about the weakening of economic activity. In 2012 the central bank repeatedly cut its Selic reference rate, by a total of 375 basis points, until it reached a record low of 7.25 per cent in October. In April 2013, following the deterioration of inflation expectations, including medium-term expectations, it changed tack and raised Selic by 25 basis points.

The enlarged public sector deficit rose to 2.8 per cent of GDP in 2012 (2.5 per cent in 2011). The decline in the primary surplus to 2.4 per cent, from 3.1 per cent in 2011, is mainly ascribable to the measures supporting economic activity adopted by the government (including the reduction of VAT on some consumer durables and investment goods, and the enlargement of the set of sectors qualifying for reduction of the tax wedge on labour). The public debt rose from 64.9 to 68.5 per cent of GDP.

Russia. – The growth of the Russian economy slowed from 4.3 to 3.4 per cent in 2012, affected by the persistent supply strains and the fall in proceeds from oil and natural gas exports. Domestic demand continued to grow strongly, however, supported by the favourable conditions of the labour market and the sharp expansion of credit to households and firms.

Inflation breached the upper limit of 6 per cent set by the monetary authorities in autumn 2012 and reached 7.2 per cent in April, driven by increases in food prices and numerous regulated tariffs. Monetary policy took on a moderately restrictive tone, with just one increase in the reference rate, from 8.0 to 8.25 per cent, last September.

In 2012 the general government budget surplus declined to 0.4 per cent of GDP, from 1.5 per cent in 2011, reflecting lower tax revenues from the energy sector. Net of these receipts, the deficit rose from 10 to 11 per cent. To reduce the vulnerability of the public finances to fluctuations in oil revenues, the government adopted new rules to adapt expenditure to developments in crude oil prices.

2. THE FINANCIAL AND FOREIGN EXCHANGE MARKETS

Sovereign debt tensions temporarily worsened once more in several euro-area countries in 2012. In the first few months of the year conditions on the international financial markets had improved, partly as a result of the three-year refinancing operations conducted by the European Central Bank, but they deteriorated again thereafter. International investors' concerns over Greece and the difficulties of Spain's banking system were compounded by the impression that the European authorities were not addressing the euro-area crisis consistently and by doubts regarding developments in US budgetary policies. Fears over the reversibility of monetary union emphasized the fragmentation of the money and bond markets along national lines. These tensions were eased significantly by the ECB's announcements in August and in September of its new procedures to contain redenomination risk premiums and reduce the serious disruption of the transmission mechanism of the single monetary policy. In the last few months of 2012 the general reduction in risk aversion on the international markets benefited from progress made in the definition of the single supervisory mechanism in Europe and the restructuring of Spain's banking system, and also from the success of the Greek debt buyback operations in December.

Developments in the emerging countries' financial markets reflected changing global conditions. There was a generalized improvement from the summer connected with the rapid recovery of international portfolio investments. Over 2012 as a whole, however, private capital flows were less substantial than the preceding two years as a result of the negative performance in the first part of the year and the persistent weakness of the banking component.

New tensions emerged on the global financial markets in the first quarter of 2013 in conjunction with persistent weak growth in Europe, the worsening banking crisis in Cyprus, and the results of the Italian general election. Financial conditions, although better than last year, are still fragile.

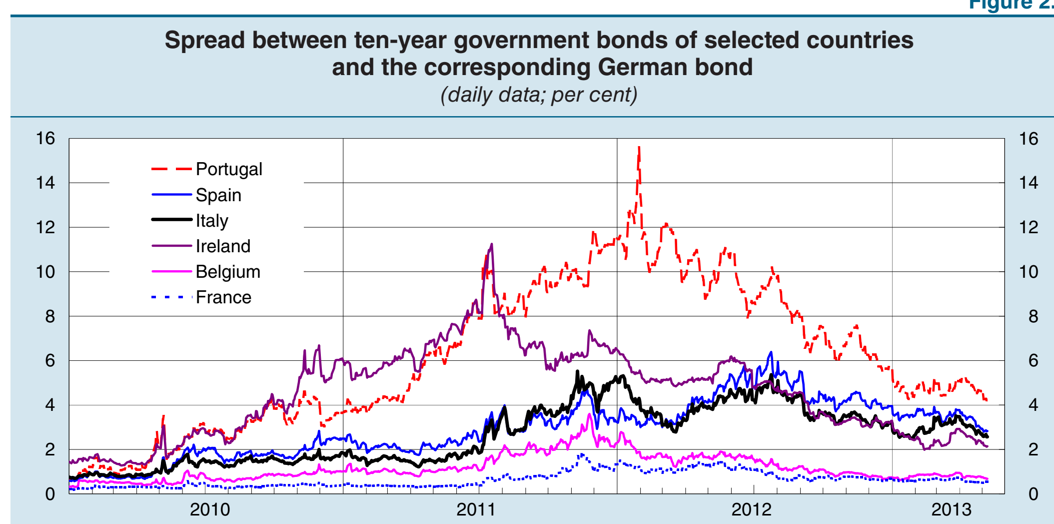
Industrial countries

Following an improvement in the first quarter of 2012, tensions on the financial markets began to build up in April. There was a sharp increase in risk premiums on government securities issued in Ireland, Italy, Portugal and Spain; yields increased on corporate bonds in both the euro area and the United States. Share prices fell in all the leading economies and the volatility of the bond and equity markets increased. From August, however, the tensions were gradually reabsorbed: risk premiums on public and private bonds diminished, falling below the levels observed at the start of 2012; share prices rose, reaching historical peaks in some countries; volatility turned back down.

The spreads between the ten-year government bonds of Portugal, Spain, Italy and Ireland and those of Germany, which had narrowed in the first three months of 2012, began to increase again in the spring, and at the end of July they had reached 970, 640, 540 and 490 basis points respectively in the four countries (Figure 2.1). At the beginning of September the Governing Council of the ECB announced it was introducing a new monetary policy measure – Outright Monetary Transactions (see the box "The European Central Bank's Outright Monetary Transactions", *Economic Bulletin,* October 2012) – to contain the risk premiums related to fears of the reversibility of the euro and to reduce serious disruptions in the single monetary policy transmission mechanism. This triggered a downward movement in the risk premiums in the European countries most affected by the tensions until the spreads stabilized at the start of 2013 at values lower than those observed a year earlier but still very high compared with the start of 2010.

Figure 2.1

Spread between ten-year government bonds of selected countries and the corresponding German bond
(daily data; per cent)



Sources: Based on Thomson Reuters Datastream and Bloomberg data.

Starting in April 2012 the ten-year government bond yields of Germany, Japan, the United Kingdom and the United States were squeezed by the weakening of global economic growth prospects, the expansionary monetary policy stance of the leading advanced countries and increased risk aversion. Between the beginning of August 2012 and the end of February 2013 the yields rose following the abatement of fears over developments in the sovereign debt crisis in the euro area.

Massive injections of liquidity by all the main central banks in the advanced countries helped ease conditions on the interbank markets. In 2012 the interest rate spreads between unsecured three-month interbank deposits and three-month overnight index swaps – a measure of interbank market risk premiums – were reduced, stabilizing at values only slightly higher than those observed pre-2007.

Bank lending to firms remained slack overall albeit with differences from country to country. This was due to weak demand and continuing supply strains.

Risk premiums on private non-financial firms' bonds, which had increased between the spring and the summer of 2012 above all in the euro area, then returned to values

well below those observed at the beginning of the year. Between June and December 2012 the yield spreads between the dollar- and euro-denominated investment grade bonds of non-financial firms (BBB or better) and ten-year government bonds fell by 76 and 84 basis points respectively, to 185 and 153 points; those in relation to high-yield bonds fell by 186 and 343 basis points respectively, to 530 and 548 points. The considerable demand for high-yield bonds in the United States and the difficulties in obtaining bank credit in Europe spurred non-financial firms to issue bonds. In 2012 total net issues in the euro area, the United States and the United Kingdom came to about $450 billion, four times the 2011 figure.

In 2012 the share market indices recorded substantial gains in the euro-area (15 per cent), the United States (12 per cent) and the United Kingdom (9 per cent). Growth has continued this year in both the United Kingdom and the United States, where indices reached an all-time high in May. In Japan, the rise in share prices in 2012 was more pronounced (23 per cent) and achieved entirely in the last part of the year; in early 2013, the Nikkei 225 index increased by a further 32 per cent, benefiting from the expansionary economic policy measures announced by the central bank and the government. Since the start of 2012 the volatility implicit in the Standard & Poor's 500 index gradually diminished, stabilizing in February at levels similar to those observed in mid-2007.

In the United States, compared with the year-earlier period, profit growth fell to 3 per cent in mid-May this year (it had been 17 per cent at the start of 2012). The cyclically adjusted price-earnings ratio appears to be in line with the long-term average. In the euro area, however, earnings growth remained close to zero or was slightly negative; the cyclically adjusted price-earnings ratio, still below the historical average, has been affected by the great uncertainty over economic and financial conditions.

After weakening in the first seven months of 2012 by 3.6 per cent in nominal effective terms, the euro recovered against the major currencies thanks to the subsidence of concerns over the soundness of the monetary union and the more expansive stance of monetary policy in the United States and Japan. The yen instead has progressively depreciated since last summer; this weakness initially reflected first expectations and later the fact of the Japanese authorities' adoption of more decisive measures to counter deflation.

Emerging economies

In 2012, the performance of the emerging economies' share markets reflected the changeable developments in the debt crisis in Europe and the variable expectations of economic growth in China. Over the year, share prices rose but not enough to make good the sharp fall in the second half of 2011. Between the various areas, share index gains (calculated in dollars) were relatively higher for Asia and Central and Eastern Europe.

Sovereign risk premiums, measured as the yield spread between emerging economies' government debt securities denominated in dollars and those of the United States, after increasing to beyond 400 basis points in June 2012, then narrowed to

stand at around 245 points at the end of the year, a level similar to that recorded in the summer of 2007. In the first few months of 2013, premiums rose slightly because of increased uncertainty on the European markets.

The net inflows of private capital to the emerging and developing economies declined from almost $500 billion in 2011 to $145 billion in 2012 – equivalent to 0.5 per cent of the receiving countries' GDP, the lowest since 1988 – following the marked contraction of the *Other investment* item in the balance of payments, which includes movements of bank capital. Direct investment remained relatively stable, despite the moderation of the medium-term growth prospects of numerous emerging economies. By contrast, portfolio investment recorded a marked increase, concentrated in the second half of the year, in a context of reduced risk aversion and fairly low volatility on the international financial markets. Lastly, the *Other investment* item recorded net outflows for the fifth year running, with a fall of $466 billion (equal to 1.7 per cent of GDP) the largest since 2008 and partly due to balance-sheet consolidation by the leading European banks. The fall was even steeper than that following the financial crisis that hit numerous emerging economies at the end of the 1990s ($411 billion between 1997 and 2002).

EPFR Global (Emerging Portfolio Fund Research), a company that provides information on the portfolio activity of the leading international investment funds specializing in the emerging areas, has published data indicating that investment in these economies seems to be increasingly directed towards bonds, especially in Latin America and Central and Eastern Europe. The share of debt securities in the total portfolio of these funds rose from 22 per cent at end-2011 to over 30 per cent in March 2013.

In 2012 the cross-border claims on emerging areas held by BIS reporting banks grew by just $105 billion (0.4 per cent of the GDP of these areas), less than one third of the average over the previous two years ($330 billion). While lending to non-bank borrowers expanded further, new loans to local banks were practically eliminated. One contributory factor was the sharp fall in the international business of the euro-area banks, beginning in mid-2011, as a result of the effect of the sovereign debt crisis on the cost of fund-raising; this mainly affected lending to the emerging economies in Asia. BIS reporting banks' aggregate cross-border claims on Central and Eastern European countries fell by $15 billion (0.8 per cent of their annual GDP), mainly because of a marked contraction in domestic demand and an increase in the proportion of non-performing loans.

Aggregate funding of the private sector in the main emerging economies in 2012 – which includes domestic bank credit, cross-border loans and recourse to the domestic and international debt securities' markets – has slowed slightly, with the important exception of China. This general trend was encouraged both by external factors, such as the decline in international bank lending consequent to financial tensions in the euro area, and internal factors, amongst which the lagged effects of the tighter monetary conditions implemented in many emerging countries in 2011 to counter inflationary pressures. In China, on the contrary, there was a slight acceleration reflecting both the growing role of financing alternative to traditional bank credit and the expansive measures taken by the authorities in the second half of 2012 to avoid an excessive economic slowdown.

The currencies of the emerging countries with flexible exchange rate systems fluctuated widely against the dollar in 2012. They depreciated up to June and then strengthened generally, notably in the case of the Russian rouble and the other currencies of Central and Eastern Europe; in Asia the currencies of South Korea, Singapore and Malaysia strengthened the most, while the appreciation of the Chinese renminbi was limited. But the Brazilian real remained at relatively low levels, continuing to feel the effects of the fall in the reference interest rates and of the central bank's repeated interventions in the foreign exchange markets to boost export competitiveness.

From October on, in conjunction with the new and more expansive monetary conditions in Japan, the main Asian currencies appreciated sharply against the yen, with gains ranging from 22 per cent for the Indonesian rupee to 26.7 per cent for the Thai baht.

3. WORLD TRADE AND PAYMENTS BALANCES

World trade in goods and services slowed markedly in 2012, its annual rate of expansion declining from 6.0 to barely 2.5 per cent, far below the long-term average of about 6 per cent in the last twenty years.

Following their steep increase in the final part of the last decade, oil prices fluctuated in 2011-12, remaining at historically high levels.

In 2012 the slackening of world merchandise trade and the halt in the upward trend of crude oil prices caused a reduction in the current account surpluses of the oil-producing countries and Asian exporters of manufactured goods.

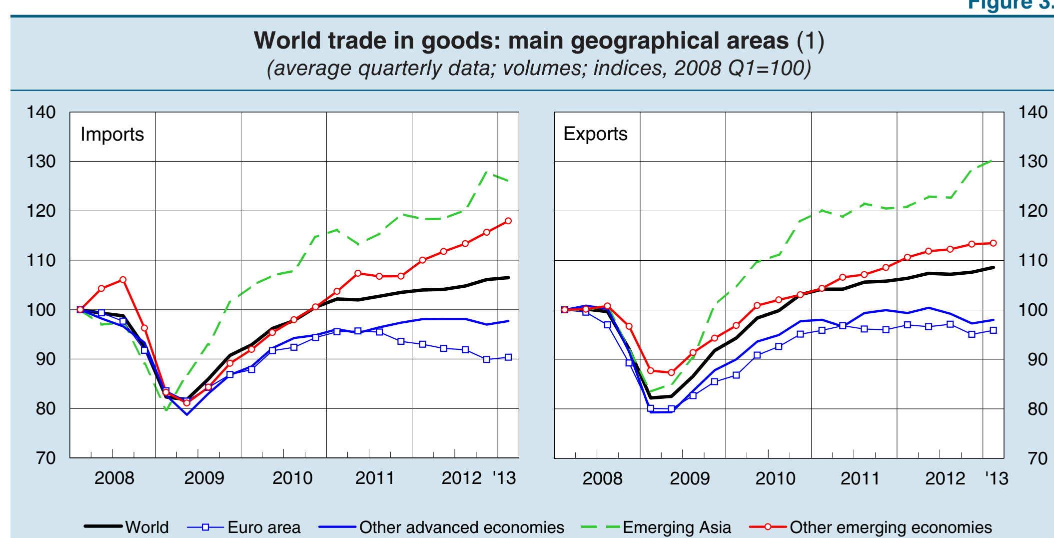
World trade and direct investment

As in the previous year, the pace of world trade was restrained by weak demand in the advanced countries, whose imports of goods grew by only 0.6 per cent, compared with 5.0 per cent in 2011. While the euro area's imports contracted in volume by 1.4 per cent, those of the United States and Japan ceased to expand only in the second half of the year (Figure 3.1). The exports of the main advanced economies also slowed, from annual growth of 5.9 to 1.8 per cent; in the final part of the year they were curtailed by the sharp drop in those of Japan.

Figure 3.1

World trade in goods: main geographical areas (1)

(average quarterly data; volumes; indices, 2008 Q1=100)



Source: CPB Netherlands Bureau for Economic Policy Analysis.
(1) For 2013, average of the first two months of the year.

The exports of the emerging countries as a group expanded at a substantially slower pace than in 2011 (4.2 against 6.3 per cent), reflecting not only weak import demand in the advanced countries but also the slackening of activity in several major emerging economies (Brazil, China and India). Both of these factors also contributed to the abrupt deceleration of their imports of goods (to growth of 4.6 per cent, from 9.5 per cent in 2011), including those of intermediate goods traded as part of international production chains. The closing months of 2012 saw a pick-up in trade among the emerging Asian economies.

Incomplete data suggest that world trade remained slack in the first months of 2013, an indication inferred from the slowdown in export growth and the stagnation of imports in the euro area. According to the IMF's latest estimates, in 2013 as a whole world trade in goods and services will continue to grow at a modest pace (3.6 per cent).

With the Doha Round of multilateral trade liberalization talks at a standstill, regional trade agreements are gaining importance. According to WTO data, some 350 bilateral and regional trade agreements have entered into force since the turn of the 1990s, including 12 last year. A recent development is the spread of agreements among the advanced countries that are not limited to the liberalization of merchandise trade but aim at enhanced economic integration in a wider range of sectors. In this context, on 13 February 2013 the president of the United States and the presidents of the European Council and the European Commission announced the start of the procedures to open bilateral negotiations towards a Transatlantic Trade and Investment Partnership for liberalizing trade and investment flows between the United States and the European Union.

The internationalization of economic activity increasingly involves firms maintaining a direct presence abroad through foreign affiliates. Between 1990 and 2011 the global stock of foreign direct investment (FDI), which gives a gauge of this phenomenon, grew tenfold, outstripping world trade and rising to equal about 30 per cent of world GDP. Intra-group transactions of multinational corporations are estimated to account for more than one third of world trade.

About a third of the global stock of FDI is now located in emerging economies. Since 1990 China's share has more than tripled and Brazil's has grown rapidly. The repercussions of the world financial crisis, relatively heavier for the advanced countries, have hastened the trend towards an expansion of the emerging markets' share of global FDI. In the last three years the share of global FDI flows going to the emerging markets has reached 50 per cent. In 2012 the slowdown in economic activity caused global FDI flows to contract; the decline chiefly involved flows to the advanced countries (down by 28 per cent according to UNCTAD estimates, against a drop of 4.3 per cent in those to the emerging economies).

Though to a lesser extent, the emerging countries are also playing a growing role as a source of investment. Their share of the global stock of outward FDI has risen by about 10 percentage points since 1990, reaching 19.5 per cent in 2011. The increase has come largely from the so-called BRICS countries (Brazil, Russia, India, China and South Africa), which originated nearly 10 per cent of the total world flow in 2012. Investment by the BRICS goes largely to the advanced countries (about 40 per cent) and to neighbouring emerging countries (43 per cent), where

it often finances the regional supply chains of their own manufacturing activities. In addition, BRICS-based multinational corporations are increasingly present in Africa, where they now account for nearly 15 per cent of the overall stock of inward FDI and 25 per cent of the inflows.

Commodity prices

The fluctuations of commodity prices during 2012 reflected heightened uncertainty about the state of the world economy. The initial rising trend came to an end in the spring and prices headed downwards, especially those of cyclically more sensitive energy products and industrial metals, in response to renewed worries about the deterioration of the growth outlook in Europe and signs of slowing in the emerging economies, especially China. The prices of agricultural products were steadier, despite fluctuations due to the impact of changing weather on crops. After touching two-year lows in the summer, the index of the dollar prices of energy and non-energy commodities rose slightly to end the year close to its initial levels.

After hitting a four-year high of $119.2 a barrel in the early months of 2012, the dollar price of crude oil fell back, hovering around $105.1, a relatively high level by historical standards but in line with the average of the last two years.

In 2012, for the first time in seven years, the global oil market registered an excess of supply, ascribable mainly to the increase in extraction in the OPEC countries and the exploitation of unconventional fossil-fuel sources in the United States.

The increase in oil supply in 2012 (2.5 million barrels a day more than in the previous year) came mainly from expanded shipments by Saudi Arabia, Iraq and Libya: the growth in Saudi exports, achieved by reducing spare production capacity, more or less offset the fall in those from Iran. The expansion of production from unconventional sources, equivalent to nearly a million additional barrels a day, boosted the contribution of the United States to world supply, making it the second-largest producer (with 9.2 million barrels a day) after Saudi Arabia. The output of non-OPEC countries other than the United States declined somewhat, owing to the fall in supplies from Norway, the United Kingdom and Syria.

World demand for crude oil rose modestly in 2012: the annual increase of 1.0 per cent (compared with 0.7 per cent in 2011) was practically half the average for the five years before the global crisis and was accounted for exclusively by the emerging countries, whose refining capacity expanded. The result was an increase in world crude oil inventories equivalent to about one million barrels per day.

In Asia, the growth in crude oil consumption in the emerging countries, China above all, was flanked by that in Japan.

As in 2011, last year the price trends of natural gas differed across markets. In the United States, prices fell sharply on average for the year, reflecting the addition to supply from unconventional sources. In Europe, where the market is less competitive, natural gas prices rose instead by about 10 per cent.

Depressed by uncertainty about the durability of the global recovery, and particularly about the speed of the expansion of demand in China, in mid-April of this year the price of Brent crude oil had fallen below $100 and that of WTI below $90. The prices of metals were also down from the start of the year, by 9 per cent, as were those of agricultural products, by 5 per cent, in response to expectations of favourable supply-side developments.

Balance-of-payments disequilibria

The sluggish growth of the global economy and the halt in the upward trend of crude oil prices fostered a significant reduction in the current account surpluses of the main oil-producing countries and Asian exporters of manufactured goods in 2012. In a good number of euro-area countries fiscal consolidation depressed domestic demand, contributing to a marked increase in the area-wide current account surplus.

In 2012 the current account deficit of the United States remained basically unchanged at the level of the previous two years, around 3 per cent of GDP (Table 3.2). The US trade balance also held stable, since the decline in net imports of petroleum products offset the larger trade deficit on other goods. Turning to the geographical composition of the US bilateral balances, the deficit vis-à-vis the oil-exporting countries shrank by $35 billion to $291 billion. Against this improvement, the deficits with China, Japan and the euro area increased.

The US current account deficit was financed by means of larger net portfolio purchases by foreign investors (particularly foreign official purchases of securities) and a repatriation of liquidity on the part of resident investors. Inward direct investment weakened, instead, and there was the first drawdown since 2009 in the funds held by foreign investors with US banks and financial companies. Against a total of $385 billion of investment from abroad, in 2012 US residents reduced the outflows for the purchase of financial assets abroad to practically nil and repatriated larger amounts of bank capital than in the past.

The strengthening of inward portfolio investment in the US (amounting to about $550 billion, in line with the average figure for the last five years) involved both equity and debt securities.

The oil-exporting countries' overall current account surplus fell to $605 billion, equal to 8.6 per cent of GDP (compared with 9.4 per cent in 2011; Table 3.1). Most of the reduction came from the decline in the surpluses of Iran and Venezuela, partially offset by the increase in those of Saudi Arabia and Libya.

The slowdown in world trade dented the surpluses of the Asian exporters of manufactures. Japan's surplus shrank from $120 billion to $59 billion (about 1 per cent of GDP), owing mainly to the collapse of exports in the final part of the year.

China's current account surplus, barely larger in nominal terms than that of 2011, fell to 2.6 per cent in relation to GDP, a new post-2008 low. The trade surplus grew from $243 billion in 2011 to $323 billion, or 3.9 per cent of GDP (nevertheless still just half the pre-crisis level); both exports and imports of goods, especially raw materials, slowed sharply from the previous year.

Table 3.1

Current account of the balance of payments and foreign exchange reserve flows
(billion dollars and per cent)

	Current account balance (1)						Reserves		
	2010		2011		2012		2010	2011	2012
	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	Amount	Amount
United States	**-442.0**	**-3.0**	**-465.9**	**-3.1**	**-475.0**	**-3.0**	**1.7**	**15.5**	**2.2**
Euro area (2)	**-2.0**	**..**	**16.1**	**0.1**	**156.7**	**1.3**	**17.4**	**16.5**	**15.8**
Japan	**204.0**	**3.7**	**119.3**	**2.0**	**59.0**	**1.0**	**39.3**	**196.7**	**-31.0**
United Kingdom	**-57.6**	**-2.5**	**-32.8**	**-1.3**	**-85.5**	**-3.5**	**12.6**	**10.9**	**9.3**
Canada	**-58.4**	**-3.6**	**-52.8**	**-3.0**	**-67.0**	**-3.7**	**2.8**	**8.7**	**2.7**
Latin America	**-60.7**	**-1.2**	**-75.5**	**-1.3**	**-99.5**	**-1.7**	**85.5**	**105.6**	**57.8**
Brazil	-47.3	-2.2	-52.5	-2.1	-54.2	-2.3	49.7	63.3	19.2
Asia	**380.5**	**3.5**	**330.9**	**2.6**	**275.8**	**2.0**	**653.7**	**430.0**	**238.2**
Newly-industrialized Asian economies	143.7	7.5	145.5	6.9	150.2	6.9	106.2	45.0	90.1
Hong Kong	*12.4*	*5.4*	*12.9*	*5.2*	*6.1*	*2.3*	*12.9*	*16.6*	*32.0*
Singapore	*62.0*	*26.8*	*65.3*	*24.6*	*51.4*	*18.6*	*37.9*	*12.0*	*21.6*
South Korea	*29.4*	*2.9*	*26.1*	*2.3*	*43.1*	*3.7*	*21.6*	*12.8*	*19.0*
Taiwan	*39.9*	*9.3*	*41.2*	*8.9*	*49.6*	*10.5*	*33.8*	*3.5*	*17.6*
ASEAN-4	51.4	3.5	46.4	2.7	5.1	0.3	87.4	52.3	20.4
Indonesia	*5.1*	*0.7*	*1.7*	*0.2*	*-24.2*	*-2.8*	*29.3*	*13.6*	*2.3*
Malaysia	*27.3*	*11.1*	*31.7*	*11.0*	*19.4*	*6.4*	*9.5*	*26.9*	*6.0*
Philippines	*8.9*	*4.5*	*7.1*	*3.2*	*7.2*	*2.9*	*16.6*	*11.9*	*6.2*
Thailand	*10.0*	*3.1*	*5.9*	*1.7*	*2.7*	*0.7*	*32.0*	*-0.1*	*5.9*
China	237.6	4.0	201.7	2.8	213.7	2.6	450.0	336.7	128.3
India	-52.2	-3.2	-62.8	-3.4	-93.3	-5.1	10.1	-4.0	-0.7
Central and Eastern Europe	**-82.9**	**-4.7**	**-119.5**	**-6.3**	**-79.3**	**-4.3**	**22.0**	**7.3**	**30.9**
Oil-exporting countries	**351.9**	**6.3**	**618.1**	**9.4**	**605.1**	**8.6**	**113.4**	**161.1**	**234.0**
OPEC (3)	233.7	8.9	466.2	15.6	461.9	13.8	61.9	130.4	182.5
Algeria	*12.1*	*7.5*	*19.8*	*10.0*	*12.3*	*5.9*	*13.6*	*20.2*	*8.5*
Angola	*6.7*	*8.1*	*13.1*	*12.6*	*11.3*	*9.6*	*6.1*	*6.7*	*4.5*
Ecuador	*-1.6*	*-2.6*	*-0.1*	*-0.2*	*-0.4*	*-0.5*	*-1.4*	*0.2*	*-0.6*
Iran	*27.3*	*6.5*	*59.4*	*12.0*	*26.8*	*4.9*	*..*	*0.2*	*-0.1*
Iraq	*4.1*	*3.0*	*22.5*	*12.5*	*14.9*	*7.0*	*6.2*	*10.4*	*2.2*
Kuwait	*38.3*	*31.9*	*70.8*	*44.0*	*78.1*	*45.0*	*1.0*	*4.6*	*3.1*
Libya	*14.6*	*19.5*	*3.2*	*9.1*	*29.4*	*35.9*	*0.9*	*5.2*	*11.8*
Nigeria	*13.4*	*5.9*	*8.8*	*3.6*	*17.7*	*6.6*	*-9.8*	*0.3*	*11.2*
Qatar	*34.1*	*26.8*	*52.6*	*30.4*	*54.2*	*29.5*	*12.3*	*-14.4*	*16.3*
Saudi Arabia	*66.8*	*12.7*	*158.5*	*23.7*	*177.2*	*24.4*	*35.0*	*96.0*	*115.8*
United Arab Emirates	*9.1*	*3.2*	*33.3*	*9.7*	*29.4*	*8.2*	*6.7*	*4.5*	*9.8*
Venezuela	*8.8*	*2.2*	*24.4*	*7.7*	*11.0*	*2.9*	*-8.6*	*-3.2*	*..*
Mexico	-1.9	-0.2	-9.7	-0.8	-9.2	-0.8	20.7	23.7	16.4
Norway	50.2	11.9	62.7	12.8	71.2	14.2	3.9	-3.4	2.5
Russia	70.0	4.6	98.8	5.2	81.3	4.0	26.9	10.4	32.6

Sources: IMF and national statistics.
(1) Due to errors, omissions and differences in international statistics, the world current account balance is not nil but positive (according to IMF estimates, by $326 billion in 2010, $409.5 billion in 2011 and $336.3 billion in 2012). – (2) The aggregate for the euro area relates to 17 member countries. – (3) The flows of reserves for Iraq and Libya in 2012 are through November 2012, the latest figure available. The flows for Iran include gold.

The global build-up of foreign exchange reserves slackened in 2012 compared with the previous three years: the stocks of reserves (which also reflect the effects of exchange-rate variations for the components in currencies other than the dollar) grew overall by about $560 billion, compared with an expansion of about $1 trillion in 2011. The slowdown was almost entirely attributable to Asia: in Japan, after the exceptional increase recorded in 2011, the stock of reserves fell by about $30 billion, while in China, the leading holder of world reserves with over $3.3 trillion (equal to 40 per cent of GDP), the reserves grew by about $128 billion, considerably less than in the previous three years.

The foreign exchange reserves held by the main oil-exporting countries (totalling more than $1.8 trillion) grew at a slightly faster pace than in 2011. The build-up was greatest in Saudi Arabia, Qatar and Russia.

4. INTERNATIONAL ECONOMIC COOPERATION

In 2012 the international community continued its efforts to limit the effects of the global recession and achieve strong, sustainable and balanced growth. The IMF approved new programmes of financial assistance for member countries, some of which in collaboration with the European authorities. Its financial resources were boosted with new bilateral loans from some members.

The G20 undertook to complete the economic policy coordination exercise (part of the Framework for Strong, Sustainable and Balanced Growth) and continued to direct the financial regulatory reform assigned to the Financial Stability Board.

Regarding its development agenda, the G20 decided to give priority to investment in infrastructure, food security and environmental sustainability. As in previous years, official aid was affected by the economic difficulties and climate of austerity in donor countries. The international community is drawing up a new common framework for poverty reduction that will replace the Millennium Development Goals after the 2015 deadline. The World Bank aims to eliminate extreme poverty by the end of 2030.

IMF support for member countries and ongoing reforms

IMF resources and loans to member countries. – In 2012 and the first few months of 2013 the IMF approved seven new financial assistance programmes, for a total of SDR 27.2 billion, almost entirely relating to the support programme for Greece. Another SDR 73 billion was committed for precautionary programmes, in particular a Precautionary and Liquidity Line to Morocco amounting to SDR 4 billion, the renewal of the Flexible Credit Line for Mexico to the tune of SDR 47 billion and, in January this year, that for Poland (SDR 22 billion). The renewals extend the duration of each arrangement by two years.

In mid-May of this year the IMF and the European authorities agreed to lend Cyprus a total of €10 billion (around $13 billion). About €1 billion (SDR 891 million, equal to 5.6 times the country's quota) was provided by the IMF in the form of a three-year Extended Fund Facility .

At the end of April the stock of IMF credit to its member countries stood at around SDR 90 billion, almost unchanged from 2011. On the same date, the stock of financial resources committed by the IMF for loans to member countries, including amounts not yet disbursed, came to almost SDR 200 billion, 40 per cent of it in favour of euro-area countries.

The IMF's financial resources normally come from the quota subscriptions of member countries, whose total amount and individual size are periodically reviewed. However, the Fund can also call on additional, temporary sources of funding. In April 2013 the New Arrangements to Borrow were re-activated for a total of about SDR 370 billion ($560 billion). These funds contribute to the IMF's Forward Commitment Capacity (FCC), i.e. its effective capacity to disburse new loans over the following twelve months, which in April amounted to SDR 264 billion ($400 billion). Moreover, given the deterioration in the economic and financial situation in the euro area, several member countries decided last year to build up the Fund's resources through new bilateral loans for a total of SDR 300 billion ($456 billion), SDR 260 billion of which has already been made available. These resources represent a second line of defence as they will only be deployed if the FCC falls below SDR 100 billion.

IMF quotas and governance. – In 2010, on the occasion of the 14th General Review of Quotas, the Executive Board approved an ambitious package of reforms that included a doubling of the quotas and some major changes to the governance structure. None of the reforms has yet come into force because of the failure to obtain the majority required. Specifically, the measures have not yet been ratified by the United States whose quota (17.69 per cent) is large enough to give it de facto veto power.

In the same year, the IMF Board of Governors asked the Executive Board to review, by the end of January 2013, the quota formula and also called for the 15th General Review of Quotas to be brought forward to January 2014. In January this year it was decided to postpone discussions on the new formula until the 15th Quota Review.

IMF oversight of member countries. – Following the results of the traditional triennial review of the IMF's macroeconomic and financial surveillance, in July 2012 the Executive Board approved a new decision in matters of oversight designed to integrate more closely the bilateral and multilateral dimensions of surveillance. The decision, which came into force in January this year, establishes the framework for the roles and responsibilities of member countries and of the IMF in this area with the aim of preserving the economic and financial stability of the single countries and of the global community. The main innovation is the possibility to extend consultations (in accordance with Article 4 of the Statute) to include discussion of the potential repercussions of national policies on global as well as internal stability.

In 2012 the IMF produced several important documents concerning multilateral surveillance. In July it published a detailed analysis of the external positions and the misalignments of exchange rates, where appropriate, of the 28 largest countries in terms of GDP. For the second consecutive year it also published the spillover reports for the five countries and economic areas of systemic importance (euro area, China, Japan, United Kingdom and United States). The first evaluation report on the overall situation of the European Union was published as part of the Financial Sector Assessment Program. Finally, in November 2012 the IMF stated its institutional view on the liberalization and management of capital flows and in March this year published guidelines designed to ensure closer conformity of bilateral and multilateral recommendations.

G20 initiatives

Framework for Strong, Sustainable and Balanced Growth. – The G20's ambitious project for the coordination and reciprocal evaluation of national economic policies, launched in 2009, lost impetus last year as a result of major differences of opinion concerning the possibility of setting specific quantitative objectives for the consolidation of public finances in the years to come.

Meanwhile, work continued on the monitoring exercise to assess progress in meeting the economic policy commitments of the various countries under the Accountability Assessment Framework announced in Cannes in 2011 and launched in June 2012 at the Los Cabos summit.

Reform of the financial sector oversight and surveillance mechanisms. – In 2012 work continued to implement the far-reaching and complex programme to reform the financial sector oversight and surveillance mechanisms. Considerable progress was made with the reform of the over-the-counter derivatives markets and in respect of the new capital and liquidity requirements for banks (Basel III) already adopted by half of the G20 countries. In addition, the IMF is pursuing its commitment to make the key attributes of effective resolution regimes for financial institutions operative.

Policies for development and poverty reduction

The G20's development agenda. – The G20 countries continued work on the development agenda last year, in accordance with the guidelines drawn up by the Seoul Development Consensus for Shared Growth and specified in the action plan approved in 2011. The Mexican presidency emphasized that strong, inclusive and environmentally sustainable economic growth is essential in order to reduce poverty; accordingly, priority has been given to promoting investment in infrastructure, food security and inclusive green growth.

Two further lines of action included in the G20's development agenda are facilitating international transfers of migrants' remittances and improving access to financial services on the part of the most disadvantaged (financial inclusion). Regarding remittances, in 2012 total flows reached an unprecedented $514 billion, almost four times the amount recorded in 2000. The World Bank estimates that the global average cost of transferring remittances to the developing countries has decreased only slightly (from 10 per cent in 2008 to 9 per cent in the first quarter of 2013) compared with the target of 5-point reduction set by the G8 summit at L'Aquila in July 2009.

As regards financial inclusion, the Mexican presidency gave particular support to the improvement of financial education and consumer protection. A project to share best practices in financial inclusion (the Peer Learning Program) was launched to encourage the adoption of national strategies in non-G20 members as well. For 2013, the Russian presidency is promoting the introduction of a new technical assistance service provided by the World Bank to support countries planning to increase the financial inclusion of their citizens.

The Millennium Development Goals. – It has recently been estimated that, with two years to go before the 2015 deadline, globally only four of the twenty-one points that make up the eight Millennium Development Goals have been achieved. These are: to halve with respect to 1990 the proportion of people below the extreme poverty threshold (to which rapid growth in China and India has made a decisive contribution) and of those who do not have access to sources of drinking water; to improve living conditions for slum dwellers; and to reduce gender inequality in access to primary education. Progress on all the other fronts, particularly those related to improving health and education services, has been unsatisfactory.

Financing by the main multilateral development banks. – In 2012 the World Bank, including the International Development Association (IDA), approved new loans worth $35.3 billion, significantly more than the average for the pre-recession years but considerably less than in 2011 ($43 billion) and the 2010 peak ($58.7 billion) when extremely large loans were approved to counter the effects of the global recession. The sectors receiving most funds were general government, energy, transport and healthcare.

In 2012 new financing operations approved by the Asian Development Bank amounted to $21.6 billion, a figure very much in line with those of the previous years and much higher than in the period before the financial crisis. The Inter-American Development Bank approved new loans amounting to $11.4 billion, continuing a sharp upward trend. The average amount of new loans has almost doubled in recent years, rising from $6.9 billion in 2003-07 to $12.3 billion in 2008-12.

Bilateral assistance. – The OECD estimates that net flows of official development assistance, measured at constant prices and exchange rates, declined by 4 per cent in 2012 and were 6 per cent below the peak figure recorded in 2010. This represents the largest reduction since 1997, excluding 2007 that is, when some exceptional debt cancellations took place. Contributory factors were the fiscal adjustment measures taken by many donor countries in response to the financial crisis and the efforts to reduce sovereign debt in the euro area.

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

5. MACROECONOMIC DEVELOPMENTS

The euro area's GDP diminished in 2012 after a two-year upswing, in response to the decline in investment and household consumption. Factors in the contraction of the main national demand components were the worsening of credit conditions for households and firms and the process of public and private debt reduction, which was particularly intense in some countries. Net foreign demand made a positive contribution despite a slowdown in export growth. In the course of the year the slackening of activity extended also to the countries least exposed to the sovereign debt crisis. The cyclical difficulties were reflected in a deterioration in labour market conditions, especially for people younger than 25.

The decline in GDP became more pronounced in the fourth quarter, when the persistent weakness of domestic demand was compounded by a contraction in sales abroad. In the first quarter of 2013 economic activity continued to contract, albeit less sharply (by 0.2 per cent compared with the previous quarter, according to the flash estimate).

The adjustment of the current account imbalances of the euro-area countries continued last year, reflecting both the performance of the economy and gains in competitiveness, which were larger in some countries. The reduction was particularly sharp for the deficits that had been largest in the previous years.

Consumer inflation came down slightly to an average annual rate of 2.5 per cent. Net of fiscal factors, it was barely over 2 per cent. The moderation of world raw material prices was counteracted by increases in indirect taxes in some countries as part of fiscal adjustment packages. Prices slowed further in 2013, to a twelve-month rate of 1.2 per cent in April. Forecasters expect inflation to average 1.5 per cent for the year. Over longer horizons, inflation expectations are in line with the Eurosystem's definition of price stability.

The euro area

Euro-area GDP contracted by 0.6 per cent in 2012 after expanding by a total of 3.5 per cent in 2010 and 2011 (Table 5.1). Output increased by 0.7 per cent in Germany, stagnated in France and declined by 1.4 per cent in Spain and 2.4 per cent in Italy. Among the countries subjected to macroeconomic adjustment programmes, GDP again fell steeply in Greece (6.4 per cent) and Portugal (3.2 per cent); economic activity slowed in Cyprus as well, for the first time since 2009 (down by 2.4 per cent). GDP also diminished in Belgium, Finland, the Netherlands and Slovenia.

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)

	2010	2011	2012	2012			
	Year	Year	Year	Q1	Q2	Q3	Q4
				GDP			
France	1.7	2.0	..	..	-0.2	0.1	-0.2
Germany (2)	4.2	3.0	0.7	0.6	0.2	0.2	-0.7
Italy (2)	1.7	0.4	-2.4	-1.0	-0.6	-0.2	-0.9
Spain (2) (3)	-0.3	0.4	-1.4	-0.4	-0.4	-0.3	-0.8
Euro area (2) (4)	2.0	1.4	-0.6	-0.1	-0.2	-0.1	-0.6
				Imports			
France	8.9	5.1	-1.1	0.9	0.2	0.1	-1.3
Germany	11.1	7.4	1.8	-0.7	2.3	0.6	-0.6
Italy	12.6	0.5	-7.7	-3.6	-0.6	-1.7	-0.9
Spain (3)	9.2	-0.9	-5.0	-2.0	-1.3	2.7	-4.8
Euro area (4)	9.6	4.2	-0.9	-0.4	0.6	0.1	-0.9
				Exports			
France	9.5	5.4	2.4	0.1	0.9	0.5	-0.7
Germany	13.7	7.8	3.7	0.7	3.3	1.5	-2.0
Italy	11.4	5.9	2.3	-0.6	1.0	1.2	0.3
Spain (3)	11.3	7.6	3.1	-2.6	1.8	5.1	-0.9
Euro area (4)	11.2	6.3	2.7	0.5	1.7	0.9	-0.8
				Household consumption (5)			
France	1.6	0.6	-0.3	0.3	-0.4	..	..
Germany	0.9	1.7	0.6	0.1	0.2	..	0.1
Italy	1.5	0.1	-4.2	-1.5	-1.1	-1.1	-0.6
Spain (3)	0.7	-1.0	-2.1	0.5	-1.1	-0.5	-2.0
Euro area (4)	1.0	0.1	-1.3	-0.2	-0.5	-0.2	-0.5
				Government consumption			
France	1.8	0.4	1.4	0.6	0.5	0.3	0.3
Germany	1.7	1.0	1.4	0.6	-0.3	0.7	0.4
Italy	-0.4	-1.2	-2.9	-1.8	-0.6	-0.2	0.1
Spain (3)	1.5	-0.5	-3.7	-1.1	-0.3	-2.5	-0.3
Euro area (4)	0.8	-0.2	-0.4	-0.1	-0.3	-0.1	0.1
				Gross fixed investment			
France	1.4	2.9	-1.2	-1.4	-0.2	-0.7	-0.8
Germany	5.9	6.2	-2.5	-1.0	-1.9	-0.4	-0.7
Italy	0.6	-1.8	-8.0	-3.7	-1.8	-1.2	-1.2
Spain (3)	-6.2	-5.3	-9.1	-2.5	-3.1	-1.3	-3.9
Euro area (4)	-0.4	1.5	-4.1	-1.4	-1.6	-0.8	-1.2
				National demand (6)			
France	1.7	2.0	-0.9	0.2	-0.3	..	-0.3
Germany	2.7	2.6	-0.4	-0.2	-0.4	-0.3	0.2
Italy	2.1	-1.0	-5.3	-1.9	-1.2	-1.0	-1.3
Spain (3)	-0.7	-1.9	-3.9	-0.3	-1.3	-1.1	-2.0
Euro area (4)	1.3	0.5	-2.2	-0.5	-0.6	-0.5	-0.6

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) The aggregate for the euro area relates to 17 countries. – (5) Consumption of resident households and non-profit institutions serving households. – (6) Includes changes in stocks and valuables.

Foreign demand helped to sustain economic activity. Despite a recovery in price competitiveness, due largely to the depreciation of the euro in nominal effective terms, the growth of exports of goods and services decelerated for the second year running, to 2.7 per cent from 11.2 per cent in 2010 and 6.3 per cent in 2011; this was due in part to the sharp slowdown in world trade growth from 6.0 to 2.5 per cent. At current prices and exchange rates the world market share of the leading euro-area countries decreased marginally. As in the previous two years, in 2012 export growth was relatively strong in Germany (3.7 per cent), while in Italy and France it was slightly less than the area-wide average. The area's imports decreased by 0.9 per cent, owing to the weakness of domestic demand. As a result foreign trade made a substantial positive contribution of 1.6 percentage points to GDP growth, the largest ever recorded since these statistics have been available.

In the euro area as a whole domestic demand declined by 2.2 per cent, more than cancelling out the recovery of the previous two years. After stagnating in 2011, household spending fell significantly (by 1.3 per cent). Of the larger countries, Germany alone recorded an increase in consumption, and a much smaller one than in the previous year (0.6 as against 1.7 per cent).

Households' propensity to save diminished again, although not as markedly as in the previous two years. In 2012 the saving rate was 12.8 per cent, 2.5 points lower than in 2009. The rate fell sharply in Spain last year (from 11.0 to 8.2 per cent) while holding broadly stable in the other three major economies.

Government consumption, which had decreased slightly already in 2011, contracted by 0.4 per cent at constant prices, reflecting the strict budgetary measures taken in a number of countries.

Investment fell significantly. In 2012 gross fixed capital formation in the euro area declined by 4.1 per cent. Investment in machinery and equipment, which fell by 3.6 per cent, was curtailed by lower capacity utilization, which was nearly 7 percentage points below the level recorded prior to the global crisis, by the uncertain outlook for demand and by persistently tight credit terms.

Construction activity, already weak, deteriorated further. Building investment declined by 4.5 per cent overall and residential investment, which accounts for just over 50 per cent of the total, by 3.5 per cent. The cumulative investment loss since 2007 came to 20 per cent.

Destocking gathered pace in the second half, subtracting half a percentage point from GDP growth. According to the surveys coordinated by the European Commission, in the closing months of the year manufacturing firms reported that their inventories were relatively low by past standards.

The contraction of economic activity was most marked in the fourth quarter, GDP declining by 0.6 per cent compared with the third quarter, as for the first time in four years exports no longer helped to sustain output but declined by 0.8 per cent. The cyclical slackening involved nearly all the euro-area countries, including those that had still been expanding. GDP decreased during the quarter by 0.7 per

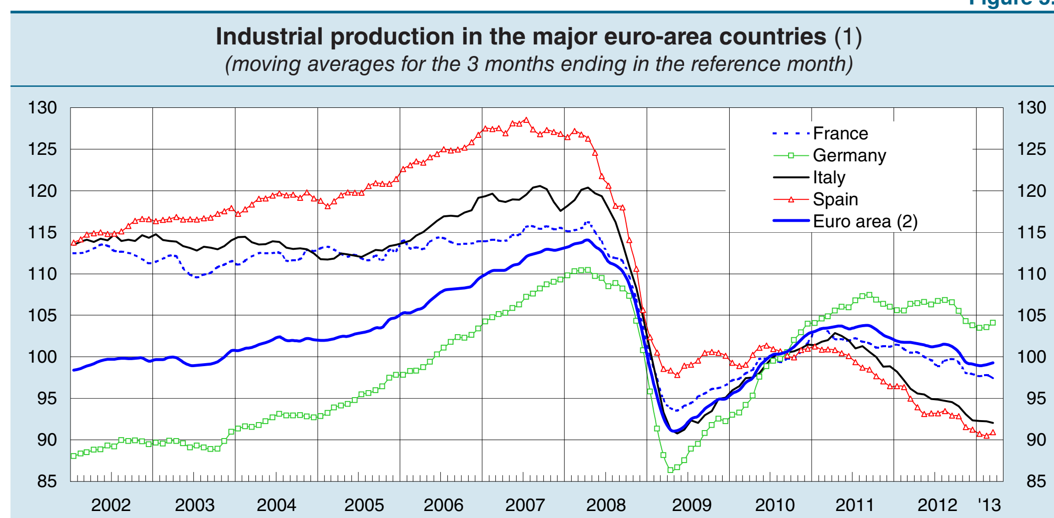
cent in Germany, 0.5 per cent in Finland, 0.4 per cent in the Netherlands, 0.2 per cent in France and 0.1 per cent in Austria.

The recession eased in the first quarter of 2013. According to the flash estimate, area-wide GDP declined by 0.2 per cent during the quarter, with developments in the main economies still uneven: a slight increase (0.1 per cent) in Germany against further declines of 0.2 per cent in France and 0.5 per cent in Italy. Area-wide industrial production stagnated on average for the quarter (Figure 5.1).

Figure 5.1

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

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



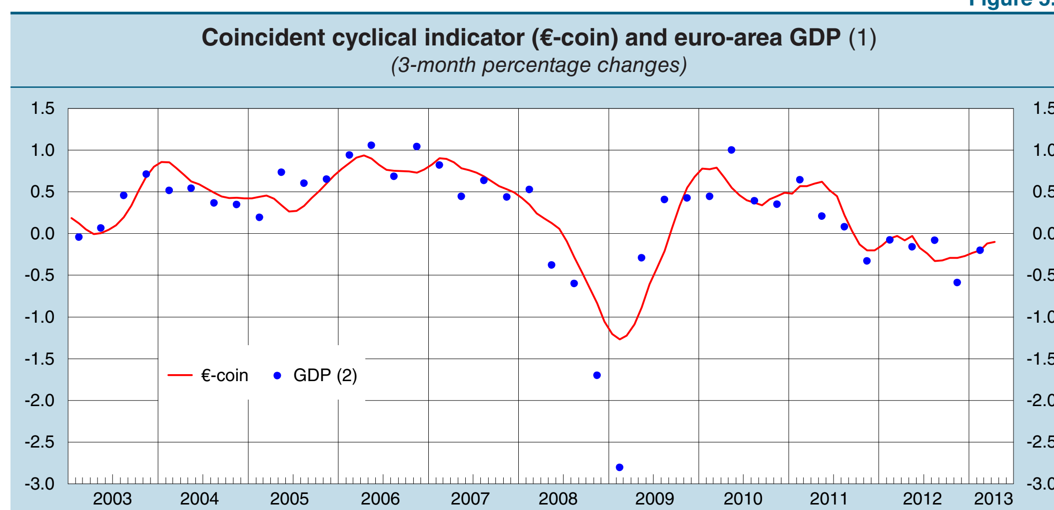
Sources: Based on Istat and Eurostat data.
(1) Indices, 2010=100; seasonally adjusted data. – (2) The aggregate for the euro area relates to 17 countries.

The Bank of Italy's monthly €-coin indicator, which estimates contemporaneous GDP growth in the euro area shorn of short-term volatility, showed a decrease in economic activity throughout 2012; it registered its low for the year in August and rose slowly thereafter. In the last few months the indicator has continued to improve, though remaining slightly negative; in March and April it registered -0.1 per cent (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

Average annual consumer price inflation in the euro area eased from 2.7 to 2.5 per cent (Table 5.2). The decrease was due mainly to the slowdown in energy price growth (from 11.9 to 7.6 per cent).

Table 5.2

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

	France			Germany			Italy			Spain			Euro area		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Consumer prices (1)															
Overall index	1.7	2.3	2.2	1.2	2.5	2.1	1.6	2.9	3.3	2.1	3.1	2.4	1.6	2.7	2.5
Index excluding food and energy products	1.0	1.1	1.5	0.6	1.2	1.3	1.7	2.0	2.0	0.8	1.2	1.3	1.0	1.4	1.5
of which: goods	*0.2*	*0.5*	*1.3*	*0.5*	*1.0*	*1.3*	*1.2*	*1.4*	*1.8*	*0.3*	*0.5*	*1.0*	*0.5*	*0.8*	*1.2*
services	*1.5*	*1.6*	*1.6*	*0.7*	*1.4*	*1.3*	*1.9*	*2.5*	*2.2*	*1.1*	*1.6*	*1.5*	*1.4*	*1.8*	*1.8*
Food products	1.3	2.3	3.3	1.5	2.5	3.2	0.5	2.7	3.1	1.1	2.8	2.6	1.1	2.7	3.1
of which: processed	*0.7*	*2.9*	*3.1*	*0.8*	*3.0*	*2.6*	*0.9*	*2.9*	*3.6*	*1.4*	*4.2*	*3.5*	*0.9*	*3.3*	*3.1*
unprocessed	*2.1*	*1.4*	*3.7*	*3.0*	*1.4*	*4.5*	..	*2.5*	*2.4*	*0.7*	*1.3*	*1.6*	*1.3*	*1.8*	*3.0*
Energy products	9.7	12.0	5.2	3.9	10.0	5.6	4.2	11.2	13.9	12.5	15.7	8.8	7.4	11.9	7.6
Producer prices (2)	**2.7**	**5.4**	**2.7**	**1.5**	**5.6**	**2.1**	**3.1**	**5.1**	**4.1**	**3.7**	**6.9**	**3.8**	**2.7**	**5.8**	**2.9**
GDP deflator (3)	**1.0**	**1.3**	**1.5**	**0.9**	**0.8**	**1.3**	**0.4**	**1.3**	**1.6**	**0.4**	**1.0**	**0.3**	**0.8**	**1.2**	**1.2**

Source: Based on Eurostat data.
(1) Harmonized index of consumer prices. – (2) Producer price index for industrial products sold in the domestic market. – (3) For Spain, the annual percentage change is calculated on the basis of raw quarterly data.

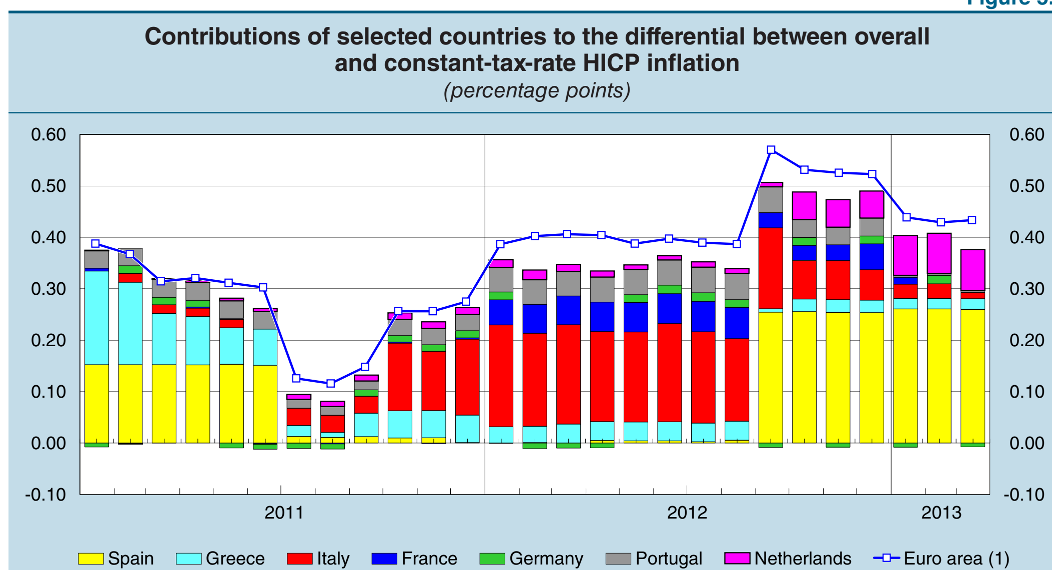
Core inflation net of the most volatile components came to 1.5 per cent, about the same as in 2011. Among the main components, service prices again rose by 1.8 per cent while the prices of non-food, non-energy goods accelerated slightly to just over 1 per cent, owing in part to indirect tax increases. The rate of inflation was affected fairly strongly by these increases, which were concentrated in a few countries. The difference between the rise in the Harmonized Index of Consumer Prices and the HICP at constant tax rates (which Eurostat calculates by subtracting from sales prices the amounts due to changes in indirect taxes, on the assumption that these are passed through to prices immediately and in full) widened from 0.3 percentage points in 2011 to nearly half a point in 2012. The gap reflected primarily the budgetary packages passed in Italy in the second half of 2011 and in Spain in 2012 (Figure 5.3).

The average increase in the HICP came to just over 2 per cent in 2012 in France and Germany. The rise was more pronounced in Italy (3.3 per cent), largely because of indirect tax increases. In connection with the further easing of the pressure from energy prices, in early 2013 area-wide inflation continued the downward trend that had begun in the closing months of 2012, falling to 1.2 per cent in April.

Producer prices and costs. – Producer price increases for goods sold on the domestic market slowed significantly last year, from 5.8 to 2.9 per cent year on year. The slowdown involved all components and was sharpest for intermediate, energy and food products, which were most directly affected by the fall in world commodity prices. The reduction in producer price inflation continued in early 2013, to a twelve-month rate of 0.7 per cent in March. Business surveys indicate a further abatement of input cost pressures for euro-area firms.

Figure 5.3

Contributions of selected countries to the differential between overall and constant-tax-rate HICP inflation
(percentage points)



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

Unit labour costs for the entire economy rose by 1.6 per cent year on year (Table 5.3). Given virtually unchanged hourly earnings growth of just over 2 per cent, the acceleration in unit labour costs (in 2011 the rise had been only half as large) was due to the cyclical slowdown in hourly productivity growth, from 1.4 to 0.8 per cent.

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			
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
	Industry excluding construction (3)									
France	4.8	2.4	2.4	-0.4	1.3	-1.1	-1.0	-0.7	2.4	2.7
Germany	2.5	4.2	3.1	-0.2	6.2	-0.7	3.0	-0.5	-0.7	4.5
Italy	2.3	2.9	0.8	-0.6	1.2	-3.5	0.3	-2.8	1.4	3.6
Spain	-0.9	2.0	2.8	2.3	2.7	-2.9	-0.1	-5.1	-3.7	-0.3
Euro area	2.4	3.7	2.5	0.8	3.3	-1.4	0.8	-2.2	-0.1	2.9
	Services (4)									
France	2.2	2.3	1.2	0.5	2.4	0.5	1.1	..	0.9	1.7
Germany	2.9	2.8	0.8	0.9	1.8	1.5	1.0	0.6	2.1	1.9
Italy	0.3	0.3	-0.1	-1.1	0.7	-1.2	0.8	-0.2	0.5	1.4
Spain	-0.5	-1.6	0.6	2.0	1.4	-0.4	0.8	-2.3	-1.1	-3.5
Euro area	1.7	1.7	0.6	0.6	1.3	0.1	0.7	-0.5	1.1	1.2
	Total economy									
France	2.6	2.2	1.5	0.3	2.2	0.1	0.7	-0.1	1.1	2.0
Germany	2.9	3.1	1.6	0.3	3.0	0.7	1.4	0.4	1.3	2.8
Italy	1.0	1.2	0.2	-0.6	0.5	-2.0	0.3	-1.4	0.8	1.8
Spain	-0.1	-0.6	1.9	2.7	1.0	-1.5	-0.9	-4.2	-2.0	-3.2
Euro area	2.1	2.4	1.4	0.8	1.6	-0.5	0.2	-1.2	0.7	1.6

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) Value added at base prices, chain-linked volumes, reference year 2005. – (3) Manufacturing, mining and quarrying, and electricity generation and distribution. – (4) Wholesale and retail trade, transport and telecommunications; financial and real-estate services; and other services.

The rise in overall unit labour costs was especially large in Germany (2.8 per cent), where hourly earnings rose by 3.1 per cent while productivity stagnated (a gain of just 0.3 per cent). It was smaller in France (2.0 per cent) and Italy (1.8 per cent), thanks to greater wage moderation. Unit labour costs actually fell by 3.2 per cent in Spain, reflecting the significant contraction in employment, which was especially sharp in the construction industry.

Inflation expectations. – The expectations for average consumer price inflation in the euro area in 2012 of the professional forecasters surveyed by Consensus Economics held steady at about 2.5 per cent from the spring onwards. Their expectations for 2013, which remained at slightly less than 2 per cent throughout 2012, fell to 1.6 per cent in May 2013 (Table 5.4). Longer-term expectations and those that can be inferred from the financial markets have been regularly consistent with the Eurosystem's price-stability objective.

Table 5.4

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

	2013	2014
France	1.2	1.6
Germany	1.6	1.9
Italy	1.7	1.6
Spain	1.8	1.5
Euro area	1.6	1.6

Source: Consensus Economics.
(1) May 2013.

Employment

The slackening of economic activity affected labour market conditions. According to national accounts data, the number of persons employed in the euro area contracted by 0.6 per cent on average in 2012; differences between countries were significant. In Germany, where GDP continued to grow through the third quarter, employment increased by 1.1 per cent for the year as a whole; in France it remained unchanged. The number of persons in work declined by 0.3 per cent in Italy and much more sharply (4.2 per cent) in Spain.

The unemployment rate rose further to an average of 11.4 per cent in 2012, more than a percentage point higher than in 2011. In March 2013 it was 12.1 per cent, the highest level in thirty years. The deterioration was worst for persons under 25, whose unemployment rate rose to 24.0 per cent (in 2007, before the onset of the global crisis, it had been 15.5 per cent). The rate rose in all the main economies except Germany, where it stood at 5.4 per cent in February 2013. In March the unemployment rate was 11.5 per cent in Italy, 11.0 per cent in France and 26.7 per cent in Spain, where it was over 55 per cent for persons younger than 25.

The balance of payments

The area's balance of payments. – The current account of the euro area's balance of payments registered a surplus of €116.0 billion in 2012, or 1.2 per cent of GDP (Table 5.5), compared with the modest surplus of €14.9 billion or 0.2 per cent in 2011. The improvement was due almost entirely to the increase in the trade surplus from €6.8 billion to €100.6 billion. At current prices, merchandise exports increased by 7.2 per cent, while the growth of imports slowed sharply from 14.2 to 2.0 per cent, reflecting the weakness of domestic demand and the deceleration in import prices.

Table 5.5

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

	2008	2009	2010	2011	2012
Current account	**-141.1**	**-13.5**	**3.5**	**14.9**	**116.0**
Goods	-21.9	30.7	17.2	6.8	100.6
Services	43.4	44.9	56.5	73.2	90.9
Income	-65.3	8.8	39.0	42.1	32.2
Transfers	-97.3	-97.8	-109.2	-107.2	-107.8
Capital account	**10.0**	**8.3**	**5.7**	**11.2**	**15.1**
Financial account	**122.5**	**15.0**	**9.1**	**-42.7**	**-133.2**
Direct investment	-218.8	-67.0	-88.8	-118.7	-44.8
Portfolio investment	241.1	246.8	119.5	252.5	52.3
Financial derivatives	-84.6	19.0	18.4	-5.3	5.6
Other investment	188.2	-188.4	-29.5	-161.0	-132.1
of which: monetary financial institutions (2)	*-132.1*	*67.6*	*-18.8*	*-339.5*	*-103.1*
Change in official reserves (3)	-3.4	4.6	-10.5	-10.2	-14.2
Errors and omissions	**8.6**	**-9.8**	**-18.3**	**16.6**	**2.1**

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.

Net financial outflows increased from €42.7 billion to €133.2 billion. Among these, however, the deficit on foreign direct investment narrowed from €118.7 billion to €44.8 billion. Net inward portfolio investment fell from €252.5 billion to €52.3 billion, owing to the resumption of investment abroad by residents. On the liability side, foreign purchases of shares issued by area residents increased while those of debt securities remained unchanged. Other investment (loans, deposits and trade credits) recorded net outflows of €132.1 billion owing to a decrease in foreign financing to resident monetary financial institutions, which generated massive liability-side outflows.

The very sharp increase in the current account surplus helped reduce the area's net international investment debtor position from 13.9 per cent at the end of 2011 to 12.0 per cent of GDP at the end of 2012.

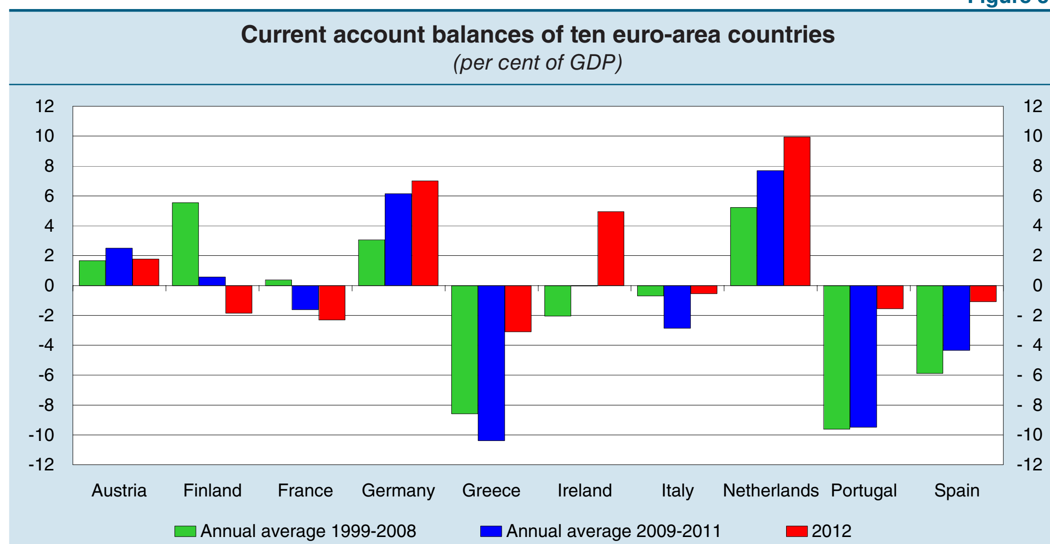
Single countries' payment balances. – The external imbalances of most of the countries that had accumulated growing current account deficits in the period prior to the crisis were reduced, but not the massive German and Dutch surpluses.

Last year, for the first time in five years, there were simultaneous, sizeable reductions in the current account deficit in Greece (from €20.6 billion to €6.0 billion), Italy (from €48.3 billion to €8.4 billion), Portugal (from €12.0 billion to €2.6 billion) and Spain

(from €39.8 billion to €11.3 billion). Furthermore Ireland, which had returned to a positive balance in 2010, widened its surplus from €1.8 billion to €8.1 billion. On the other hand, the French deficit increased from €38.9 billion to €46.7 billion. Germany's enormous surplus widened further, from €161.2 billion to €185.4 billion, or 7.0 per cent of GDP, and that of the Netherlands was practically unchanged, edging down from €61.0 billion to €59.7 billion or 9.9 per cent of GDP (Figure 5.4).

Figure 5.4

Current account balances of ten euro-area countries
(per cent of GDP)



Sources: Based on Bank of Italy and Eurostat data.

In the deficit countries, the key factor in the adjustment was the fall in imports in connection with the decline in national demand and the deceleration in import prices; imports grew only in Ireland. In Greece, Portugal and Spain the improvement in the current account balance also benefited from the reduction in the deficit on the income account, due mainly to decreased outflows of interest on debt securities.

The total outflow from the four countries that had been affected by large-scale portfolio disinvestment by non-residents in 2011 (Greece, Italy, Portugal and Spain) diminished from €192.5 billion to €155.0 billion. The improvement was accounted for entirely by Italy and Spain, where net sales of securities by non-residents in the early months of 2012 were largely offset by the resumption of net purchases beginning during the summer, following the stabilization of the financial markets achieved in part through the ECB's unconventional monetary policy measures. In Ireland, net foreign purchases of portfolio securities more than doubled, owing above all to increased purchases of Irish investment fund units.

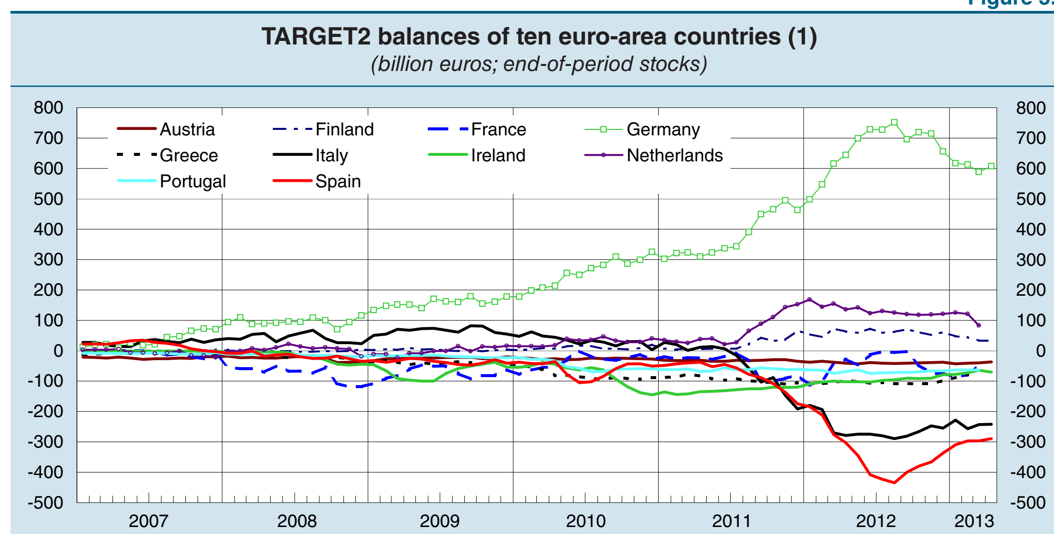
The change in loans, deposits and other investment shows that again in 2012 non-residents made net disposals of the instruments of banks of Greece, Italy, Portugal and Spain, for a total of €240 billion, nearly €170 billion from Spain alone. These outflows were only partly offset by Italian and Spanish residents' disposals of foreign assets. The countries that had requested financial assistance also received funds from the European Financial Stability Facility and the European Stability Mechanism.

TARGET2 balances. – The TARGET2 payment system balances of the central banks of the countries worst hit by the sovereign debt crisis mirror developments in the imbalances in cross-border movements of private capital. Up to the middle of the year the

balances had worsened, especially for Spain and Italy (Figure 5.5), reflecting the increased segmentation of intra-area capital markets and non-residents' disposals of government securities and withdrawals of bank deposits. Symmetrically, the creditor position of the German central bank was greatly amplified, as the liquidity inflow due to the current account surplus was not reinvested abroad and the banking system's outstanding external credits were reduced. In August the overall debtor position of Greece, Ireland, Italy, Portugal and Spain vis-à-vis the ECB peaked at about €1 trillion, while the creditor position of Finland, Germany and the Netherlands reached €940 billion.

Figure 5.5

TARGET2 balances of ten euro-area countries (1)
(billion euros; end-of-period stocks)



Sources: Bank of Italy and Institute of Empirical Economic Research, Osnabrück University (Euro Crisis Monitor).
(1) For some countries the data may differ slightly from the balances recorded in TARGET2 owing to amounts in connection with other assets or liabilities vis-à-vis the Eurosystem.

Beginning in the final months of the year, the easing of the strains within the euro area and the resumption of capital flows to the countries affected by the sovereign debt crisis translated into a significant reduction in the TARGET2 imbalances. Both debtor and creditor positions diminished appreciably, in particular those of the German and Finnish central banks. The improvement continued into 2013; the Bundesbank's creditor balance came down from its peak of €751.4 billion last August to €607.9 billion in April.

6. BUDGETARY POLICIES

After contracting substantially in 2011, the euro area's net borrowing declined further last year, from 4.2 to 3.7 per cent of GDP, and the European Commission forecasts that the reduction will continue this year and in 2014 as well.

The efforts of national governments and the European institutions to improve the EU's economic governance continued in 2012. The launch of the European Stability Mechanism strengthens the array of tools available for financial crisis management; the fiscal compact aims to reinforce budget discipline; and the so-called two-pack is designed to step up economic surveillance especially of the countries in difficulty.

The European institutions have put forward proposals for closer integration in the field of finance and in budgetary and economic policy and at the same time for strengthening the democratic legitimacy of the common decision-making process. Alongside the debate on the future of the Economic and Monetary Union, at international level a discussion has developed on the most appropriate means and timetable for coupling fiscal adjustment with policies for economic growth.

Budgetary policies and performance in 2012. – After decreasing by more than 2 percentage points of GDP in 2011, general government net borrowing in the euro area was reduced by a further 0.4 percentage points last year (Table 6.1). Given the unfavourable macroeconomic context (GDP fell by 0.6 per cent, whereas in 2011 it had expanded by 1.4 per cent), the improvement in the structural deficit (i.e. adjusted for the effects of the economic cycle and for temporary measures) was considerably greater (1.4 percentage points).

Net borrowing increased in eight member countries, most notably in Portugal, Estonia, Spain and Finland. The largest deficit reductions were recorded in Ireland, Slovenia, Germany and Italy.

At the end of 2012 only five area countries – Estonia, Finland, Germany, Luxembourg and Malta – were not subject to excessive deficit procedures. Of these, only Malta had net borrowing above the threshold of 3 per cent of GDP that year. Of the countries subject to procedures, by contrast, only Austria and Italy had deficits not exceeding the threshold.

In a worse-than-expected economic context, on average the budget outturns improved less than governments had planned last spring. The targets implied that area-wide net borrowing would come down by just over 1 percentage point of GDP. The largest favourable divergences from the targets came in Estonia, Ireland and Germany; unfavourable, in Spain, Cyprus and Greece.

Table 6.1

General government net borrowing and debt: outturns and forecasts
(per cent of GDP)

	Net borrowing				Debt (1)			
	2011	2012	2013	2014	2011	2012	2013	2014
Austria	2.5	2.5	2.2	1.8	72.5	73.4	73.8	73.7
Belgium	3.7	3.9	2.9	3.1	97.8	99.6	101.4	102.1
Cyprus	6.3	6.3	6.5	8.4	71.1	85.8	109.5	124.0
Estonia	-1.2	0.3	0.3	-0.2	6.2	10.1	10.2	9.6
Finland	0.8	1.9	1.8	1.5	49.0	53.0	56.2	57.7
France	5.3	4.8	3.9	4.2	85.8	90.2	94.0	96.2
Germany	0.8	-0.2	0.2	0.0	80.4	81.9	81.1	78.6
Greece	9.5	10.0	3.8	2.6	170.3	156.9	175.2	175.0
Ireland	13.4	7.6	7.5	4.3	106.4	117.6	123.3	119.5
Italy	3.8	3.0	2.9	2.5	120.8	127.0	131.4	132.2
Luxembourg	0.2	0.8	0.2	0.4	18.3	20.8	23.4	25.2
Malta	2.8	3.3	3.7	3.6	70.3	72.1	73.9	74.9
Netherlands	4.5	4.1	3.6	3.6	65.5	71.2	74.6	75.8
Portugal	4.4	6.4	5.5	4.0	108.3	123.6	123.0	124.3
Slovakia	5.1	4.3	3.0	3.1	43.3	52.1	54.6	56.7
Slovenia	6.4	4.0	5.3	4.9	46.9	54.1	61.0	66.5
Spain	9.4	10.6	6.5	7.0	69.3	84.2	91.3	96.8
Euro area	**4.2**	**3.7**	**2.9**	**2.8**	**88.0**	**92.7**	**95.5**	**96.0**

Source: European Commission, Spring Forecast, May 2013.
(1) The debt of each country includes its share of loans granted by the EFSF, bilateral loans to other EU countries and its share in the capital of the ESM.

After a reduction of more than 2 percentage points in 2011, the primary deficit fell by a further half-point in 2012, to 0.6 per cent of GDP. Germany and Italy were the only two countries to run a significant primary surplus (of about 2.5 per cent). The average deficit of the other area members came to 3.1 per cent. By comparison with 2011, the ratio of primary expenditure to GDP rose by 0.4 points to 46.8 per cent and that of revenue by 0.9 points to 46.2 per cent. Interest payments remained broadly unchanged at around 3 per cent of GDP.

The ratio of public debt to GDP rose by 4.7 points in the euro area overall, to 92.7 per cent; consolidating the assistance loans to EMU countries in difficulty, the ratio was 90.6 per cent, compared with 87.3 per cent in 2011. In some countries the debt ratio rose particularly sharply: in Portugal, Cyprus and Spain it went up by around 15 percentage points. In these countries the increase depended in significant measure on the gap between nominal GDP growth and the average cost of the debt; in Spain and Cyprus it also depended on several actions in support of the financial system. The debt ratio diminished only in Greece, owing in particular to the debt restructuring carried out during the spring with the involvement of private sector creditors (see the box "Private sector involvement in resolving the Greek crisis," *Economic Bulletin,* April 2012).

Financial support to countries in difficulty. – The support programmes for Greece, Ireland and Portugal continued last year, financed through the European Financial

Stability Facility, the European Financial Stabilisation Mechanism and, for Ireland, bilateral loans. The programme for Spain was approved and its financing assigned to the ESM, which became operational in October. In the spring of 2013 an assistance plan for Cyprus was drawn up. Under various support programmes, European countries and institutions and the IMF disbursed loans totalling some €198 billion in 2012 and another €23 billion in the first few months of 2013, bringing total outlays since 2010 to about €362 billion (Table 6.2).

Table 6.2

Financial support to countries in difficulty: detail (1)
(billion euros)

	2010	2011	2012	2013 (Jan. - May) (2)	Total to May 2013	Total support programme
IRELAND						
Bilateral loans	0.0	0.5	2.5	0.5	3.4	4.8
EFSF	0.0	7.6	4.4	0.8	12.8	17.7
EFSM	0.0	13.9	7.8	0.0	21.7	22.5
IMF	0.0	12.8	6.4	1.0	20.2	22.5
Total	**0.0**	**34.7**	**21.1**	**2.2**	**58.1**	**67.5** (3)
PORTUGAL						
EFSF	–	6.9	11.3	0.8	19.0	26.0
EFSM	–	14.1	8.0	0.0	22.1	26.0
IMF	–	13.0	8.2	0.8	22.0	26.0
Total	–	**34.0**	**27.5**	**1.6**	**63.1**	**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** (4)
Second support programme						
EFSF	–	–	108.2	11.8	120.0	144.6 (5)
IMF	–	–	1.7	3.2	4.9	28.0
Total	–	–	**109.8**	**15.0**	**124.9**	**172.6**
SPAIN						
ESM	–	–	39.5	1.9	41.3	100.0
Total	–	–	**39.5**	**1.9**	**41.3**	**100.0**
CYPRUS						
ESM	–	–	–	2.0	2.0	9.0
IMF	–	–	–	0.1	0.1	1.0
Total	–	–	–	**2.1**	**2.1**	**10.0**

Sources: For bilateral loans to Ireland, National Treasury Management Agency; for loans granted by the EFSF, EFSF website; for loans granted by the EFSM, European Commission Investor presentation, 19 April 2013; for IMF loans not included in the first support programme for Greece, IMF press releases issued with each disbursement; for the first support programme for Greece, European Commission, The second economic adjustment programme for Greece, March 2012; for ESM loans, ESM press releases.
(1) Rounding may cause discrepancies in totals. – (2) Based on data available at 23 May. – (3) Does not include the €17.5 billion contribution of Ireland using the funds of the Irish Treasury and the National Pensions Reserve Fund. – (4) 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 through the end of 2011. The remaining sum was incorporated in the second support programme. – (5) Does not include €35 billion of securities issued by the EFSF to activate the buy-back scheme underpinning the quality of securities issued or fully guaranteed by Greece.

Last year Greece received €110 billion in loans as part of the second support programme (set out in March 2012), which took the place of that subscribed in May

2010. Under the two programmes, through the early months of 2013 Greece received about €198 billion in loans (slightly more than its GDP in 2012); almost 90 per cent of these funds came from other euro-area countries in bilateral loans or through the EFSF, the rest from the IMF.

In view of the worsening economic outlook and the problems in activating the second support programme, in November 2012 the Eurogroup agreed on a set of measures to make the conditions for financial support to Greece less onerous: the interest rate on bilateral loans was reduced by 100 basis points; the maturity of all the loans was lengthened by fifteen years and interest payments on the EFSF loans deferred for ten years; it was decided that Greece would receive an amount equal to the national central banks' profits on the bonds held in the Securities Markets Programme portfolio; and some fees on EFSF loans were reduced. After the debt restructuring in the spring on 2012, in December Greece completed a debt buy-back, which was officially estimated to have reduced the public debt by about ten percentage points of GDP (see the box "The recent agreements on the second economic adjustment programme for Greece," *Economic Bulletin,* January 2013).

Under the support programme set in 2010, Ireland received €21.1 billion in 2012 and another €2.2 billion in the first few months of this year. The total granted to Ireland since the start of the programme amounts to €58 billion (36 per cent of the country's 2012 GDP); €21.7 billion came from the European Commission through the EFSM, €20 billion from the IMF, €12.8 billion from the EFSF and nearly €3.5 billion from bilateral loans from the United Kingdom, Sweden and Denmark.

The programme for Portugal, finalized in May 2011, also continued, with loans of €27.5 billion in 2012 and €1.6 billion in the early months of 2013. These resources brought the total financial support to Portugal to €63 billion, or 38 per cent of the 2012 GDP. The funds were provided by the EFSM and the IMF in almost equal portions and by the EFSF for a slightly smaller amount.

Altogether, in 2012 and the first few months of 2013 the EFSF lent more than €137 billion to Greece, Ireland and Portugal, against securities issues of around €200 billion. Last year the EFSM issued securities worth €16 billion to finance loans to Ireland and Portugal.

In July 2012, following a request from the Spanish Government, the Eurogroup decided to grant financial assistance through the ESM for a maximum of €100 billion. The resources, granted to the government and earmarked for the recapitalization of some banks, are subject to specific conditions concerning the situation of the individual banks, the implementation of structural reforms in the banking sector generally and compliance with the European rules on state aid. A contingent facility of €30 billion that had been formed at the EFSF to cope with emergencies in the Spanish banking system was liquidated following the ESM's disbursement of its first tranche of assistance.

In March and April 2013 the Government of Cyprus, the European institutions and the IMF worked out an agreement on an assistance package for about €10 billion (56 per cent of the country's GDP in 2012). At the end of April the ESM approved a preliminary plan for loans of up to €9 billion. On 15 May the IMF approved a loan for the other €1 billion, with the immediate disbursement of the first €86 million. The agreements provide for the restructuring of the banking system, with the involvement of shareholders, bondholders and depositors (except those with less than €100,000).

In addition, a programme of structural reforms, privatizations and fiscal adjustment is planned.

Overall, from the start of operations through the first part of 2013 the ESM granted loans for €43.3 billion. In detail, €41.3 billion was allocated to Spain (about 4 per cent of its GDP in 2012), of which about €39.5 billion was paid in December and about €1.9 billion in February 2013, while the first tranche (€2 billion) of the loan to Cyprus was paid on 13 May; a second instalment of about €1 billion is scheduled for the end of June.

The outlook. – The European Commission forecasts that euro-area general government net borrowing will diminish in 2013 by a further 0.8 percentage points to 2.9 per cent of GDP (Table 6.1).

The largest deficit reductions are expected in Greece and Spain, the sharpest deterioration in Slovenia. Of the five countries subjected to excessive deficit procedures for which the Council of the EU has set 2013 as the deadline for correction (Austria, France, the Netherlands, Slovakia and Slovenia), only Austria and Slovakia are expected to run deficits of less than 3 per cent.

For 2014, in the absence of measures beyond those already decided, the Commission estimates that the area-wide budget deficit will come down marginally by comparison with this year, to 2.8 per cent of GDP. The public debt ratio is projected to reach 96.0 per cent.

From 2008 to 2010 the overall fiscal stance in the euro area – measured as the change in the cyclically adjusted primary balance – was expansive (with a maximum of nearly 2 percentage points in 2009). It was restrictive in 2011 (by nearly 2 points) and again in 2012. In these last two years primary expenditure fell by 4.5 per cent in real terms (deflated using the HICP). Investment spending declined also in nominal terms (by some 14 per cent). According to the Commission's forecasts, the stance will remain restrictive this year and be broadly neutral in 2014. The cyclically adjusted primary surplus, which was 0.9 per cent of GDP in 2007, will be 1.7 per cent this year.

The debate on fiscal consolidation. – The protraction of the recession and the persistence of poor prospects have fueled a hot debate on the proper strategy for fiscal consolidation. In a number of quarters it has been suggested that fiscal consolidation should be postponed or effected more gradually in order to prevent the negative effects from weighing too heavily on an already less than robust economic situation.

Many theoretical and empirical works have demonstrated that the negative effects of fiscal adjustment tend to prevail, and that their impact is greater in cyclical downturns like the present one, characterized by monetary policy rates close to zero, credit restrictions, and stringent liquidity constraints on households and firms. The downward impulse, moreover, appears to be more pronounced in the case of simultaneous budget corrections in countries that are major trading partners.

Such effects are potentially substantial in a highly integrated economy like that of the euro area. However, their size with regard to single countries is limited. For example, it is estimated that, other conditions equal, a 1-point increase in growth in Germany will produce an increase in Italian exports the same year of less than 0.1 per cent of GDP.

Further, owing among other things to the diversity of methodological approaches, there is no consensus on the magnitude of the budget multipliers, i.e. the indicators that provide an estimate of the impact of budgetary measures on macroeconomic variables. According to some evaluations, where the budget multipliers, the level of the debt and the elasticity of the budget balance to GDP are sufficiently high, the repercussions of budgetary measures can be strong enough to actually increase the public debt ratio in the short term. European Commission estimates based on 2011 budget data put the multiplier threshold above which fiscal adjustment becomes self-defeating in a range from 0.5 in Greece to 2.8 in Estonia. For Italy it is 0.6. These thresholds are generally higher than the consensus estimates of the multipliers under normal conditions.

Countries with high levels of public or private debt, fragile banking or financial systems, or significant external account deficits are particularly exposed to the risk of a crisis of confidence. Timely corrective measures are accordingly needed in order to signal their determination to pursue sustainable levels of deficit and debt in the medium term; this applies especially to countries with a history of institutional shortcomings and fiscal laxness.

In addition, it must be considered that the impact of fiscal adjustment policies depends not only on their credibility and sufficient duration but also on their composition. In the short term, cuts in spending on goods and services and investment tend to be more depressive (unless the reduction involves prices rather than volumes) than reductions in transfer payments or increases in taxation. The difference in the economic impact is greater when tax increases are concentrated on higher income groups not subject to liquidity constraints. In the medium and long run, however, tax increases generate resource allocation distortions that reduce the economy's growth potential (for a discussion of the macroeconomic impact of the restrictive measures enacted in Italy, see the section "Budgetary policy for 2012: objectives and results" in Chapter 13).

The reform of European governance

The sweeping reform of European economic governance initiated in March 2010 in response to the emergence of financial tensions was intensified in late 2011 and early 2012 as the sovereign debt crisis in a number of euro-area countries deepened (see the section "The reform of European governance" in the Annual Report for 2011, Chapter 6). In 2012 the European institutions announced and in some cases approved a series of measures with the objective not only of restoring investor confidence in the short term but also of strengthening the entire constitution of the Union.

In March 2012 all the EU member countries except the United Kingdom and the Czech Republic signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The part of the Treaty known as the fiscal compact is intended to strengthen budgetary discipline. Specifically, the signatories undertook to include in their national legal order, preferably at constitutional level, rules providing for the achievement and maintenance of a general government budgetary position that is in balance or in surplus in structural terms and an automatic mechanism for the correction of deviations. The Treaty went into effect on 1 January 2013 for all the countries of the euro area except Belgium, Malta and the Netherlands, which have not

yet ratified it, and Luxembourg, where it goes into effect on 1 June. Italy honoured its fiscal compact undertaking with the passage of a constitutional amendment in April 2012 and implementing legislation in December.

The Commission's proposals for regulations, known as the two-pack (see the section "The reform of European governance" in the Annual Report for 2011, Chapter 6) were approved with amendments by the European Parliament in March 2013 and by the Council of the EU on 13 May. The rules apply in particular to countries in a situation of excessive deficit, in grave financial difficulties or requiring precautionary financial assistance.

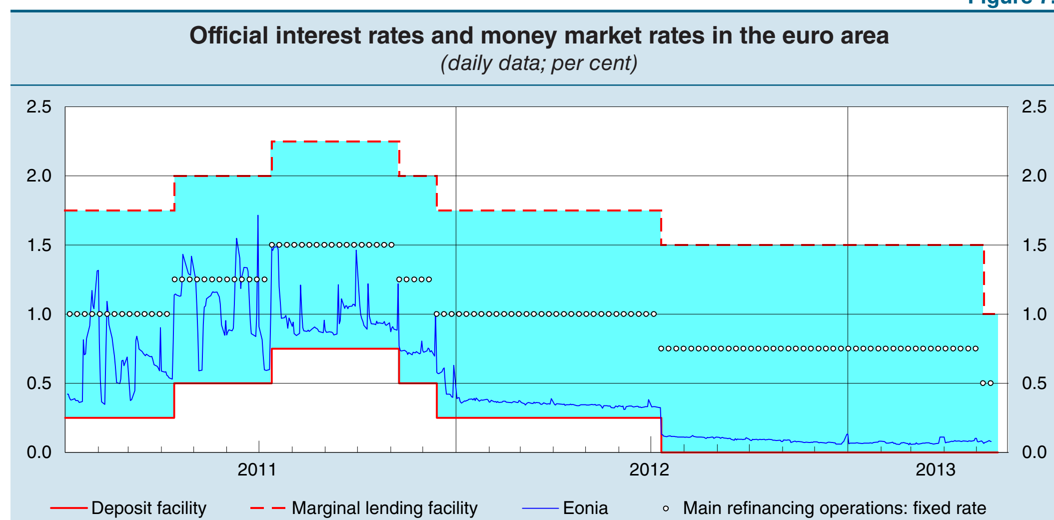
In 2012 the main European institutions made proposals to enhance the ability of the Economic and Monetary Union to cope with the present crisis and possible future shocks. A first report by the President of the European Council, in cooperation with the presidents of the Commission, the Eurogroup and the ECB, was presented in June. It called for closer integration in the field of finance and of budgetary and economic policies and for strengthening the democratic legitimacy of the European decision-making process. The definitive version of the report "Towards a genuine economic and monetary union", presented in December, specifies the actions needed to attain these objectives. In November the Commission presented its "Blueprint for a deep and genuine economic and monetary union," offering concrete proposals to reinforce the EMU, with a timetable for implementation.

7. THE SINGLE MONETARY POLICY

Faced with the weakness of economic activity, the steady decline in both actual and expected inflation and the severe dysfunctions that continued to affect the financial markets, in 2012 the Governing Council of the European Central Bank eased monetary conditions further by reducing official interest rates and adopting new unconventional measures to preserve the uniformity of monetary policy transmission in the euro area (Figure 7.1). Official rates were lowered again at the beginning of this May.

Figure 7.1

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



Sources: ECB and Thomson Reuters Datastream.

The acute tensions that had begun to afflict the money and capital markets of Italy and other countries of the area in the second half of 2011 gradually subsided in the early months of last year, thanks in part to the Eurosystem's two longer-term refinancing operations (LTROs) with three-year maturity. Conditions on the financial markets nevertheless turned worse again in the spring, reflecting mounting concern about the growth prospects of the countries most exposed to the crisis, political uncertainty in the wake of the Greek elections in May and the troubles of the Spanish banking system.

In June the ECB Governing Council announced that it would continue to supply liquidity through full allotment tenders at least until mid-January 2013 and expanded the range of assets eligible as collateral in monetary policy operations. At the beginning of July it cut official interest rates by 25 basis points, taking the rate on main refinancing operations to 0.75 per cent and that on the deposit facility to zero.

The strains on the financial markets nevertheless grew more severe in the second half of July. Added to the uncertainty about the area's economic prospects was the perceived lack of cohesion among the member countries in the process of European governance reform and in strengthening the crisis-management framework. Fears of monetary union reversibility – so-called redenomination risk – aggravated the distortions in the sovereign debt markets, amplifying the deviation of the yields on the government securities of the countries hit hardest by the tensions from the levels consistent with underlying economic and fiscal conditions. For Italy, we estimate that this divergence exceeded 3 percentage points.

In order to counter the effects of these tensions on the functioning and uniformity of the monetary policy transmission mechanism, in August the Governing Council announced a new measure, Outright Monetary Transactions (OMTs) on the secondary market for government securities, whose technical features were specified in September. OMTs provide a means of counteracting the serious distortions in sovereign debt markets produced by redenomination risk; they can apply to the securities of countries that request a European financial assistance programme and comply with its conditions.

The announcement of OMTs sparked an improvement in bond and stock market conditions in the countries affected by the tensions and fostered a resumption of capital flows to them. Factors in this progress were the credibility gained by the action of national governments and the decisions taken at European level in the second half of 2012, including the agreements on the creation of a single system of banking supervision, on financial assistance to the Spanish banking system and on the renewal of financial aid to Greece.

In the first few months of 2013 the crisis in Cyprus and political uncertainty in the wake of the election in Italy had only a fleeting impact on the easing of financial market strains. Still, both the growth and the cost of credit to firms and households continue to differ widely across euro-area countries. This reflects not only the state of credit demand, connected with differences in countries' cyclical positions, but also the conditions of supply. The latter are influenced by the differing ability of national banking systems to access wholesale funding markets and by the creditworthiness of bank customers, in turn a function of cyclical performance.

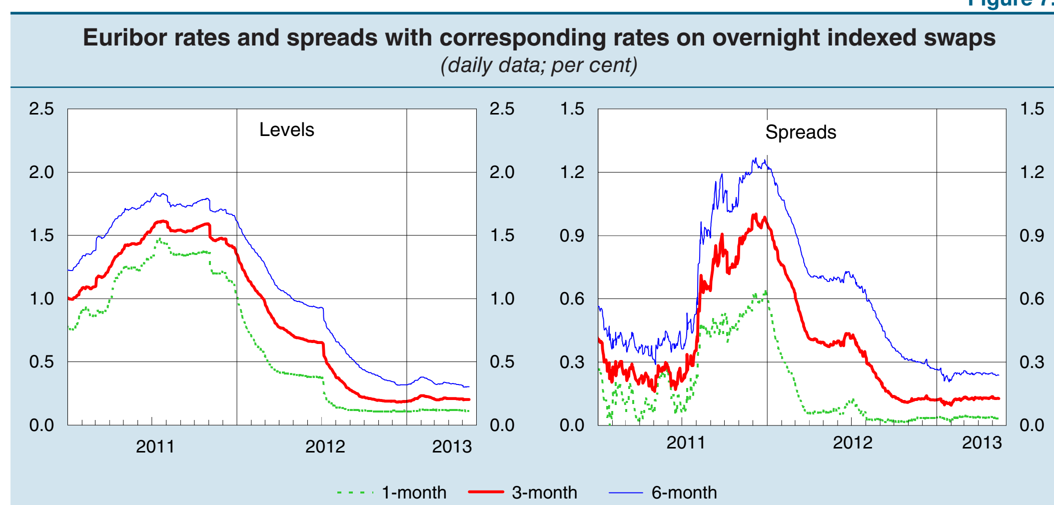
In late 2012 and the first few months of 2013 the slowdown in economic activity began to affect even the most solid member countries; medium-term inflation expectations declined to just above 1.5 per cent. Against this background, in May the Governing Council reduced the rate on main refinancing operations by another 25 basis points, to 0.5 per cent, and the marginal lending rate by 50 basis points, to 1.0 per cent, holding the rate on the deposit facility at zero. The Governing Council also announced that refinancing operations would continue to be carried out by means of tenders with full allotment as long as necessary and at least until the beginning of July 2014; announced that it had initiated consultations with other European institutions on measures to promote a functioning market for asset-backed securities collateralized by loans to non-financial corporations; and reiterated that it stood ready to take further action based on its assessment of incoming information.

Interest rates and the exchange rate of the euro

Short-term interest rates. – During 2012 short-term interest rates declined further from levels that were already historically very low at the beginning of the year. This was the consequence of the measures taken by the Governing Council in the last part of 2011 – particularly the two three-year LTROs and their mitigating effects on the strains in the interbank market – and of the 25-basis-point cut in official rates decided in July 2012. In December the interest rate on unsecured interbank loans (Euribor) with three months' maturity reached the record low of 0.18 per cent, compared with 1.4 per cent a year earlier (Figure 7.2). The spread vis-à-vis three-month overnight indexed swaps, a gauge of interbank market risk premiums, was equal to approximately 10 basis points, some 90 basis points less than a year earlier. The spreads between overnight rates on the national markets and Eonia, which in some countries at the end of 2011 had reached aberrant levels of more than one percentage point, fell to nil.

Figure 7.2

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



Source: Thomson Reuters Datastream.

Real short-term interest rates were negative throughout 2012; calculated as the difference between three-month Euribor and inflation expectations for the subsequent quarter according to the survey conducted by Consensus Economics, the real rate fell to -2.0 per cent in September and then rose slightly in the final part of 2012 and early 2013 as inflation expectations diminished.

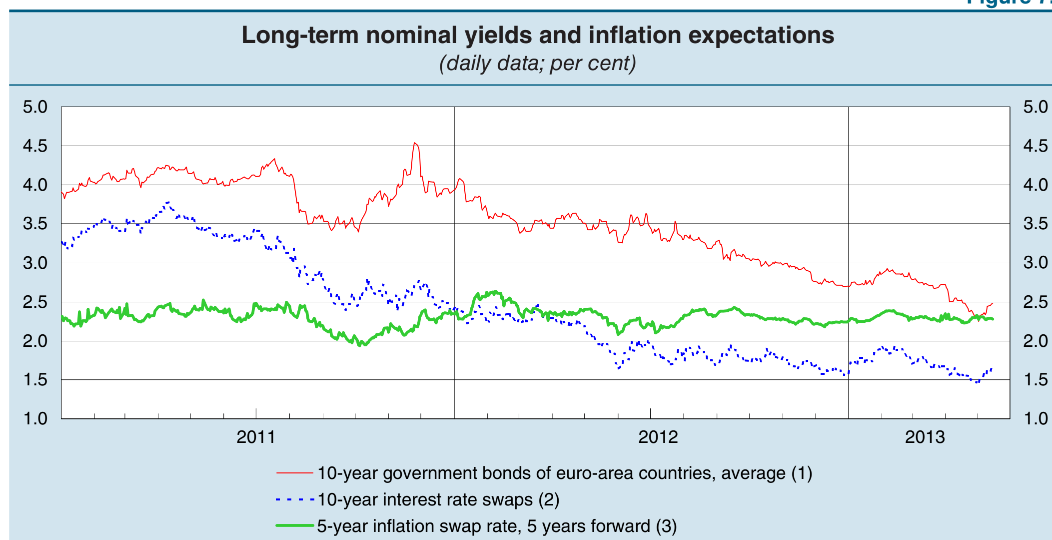
Long-term interest rates. – Long-term interest rates in euros, measured on the basis of ten-year swap contracts, came down gradually in the spring owing to the weakness of economic activity; they remained very low for the rest of the year and in early 2013. At the beginning of May they stood at 1.5 per cent, the lowest level since the launch of the third phase of monetary union, as against 2.4 per cent at the end of 2011 (Figure 7.3).

Yields on government securities declined during 2012 in the euro area as a whole, though they displayed high volatility in some countries. In the early months of the year they decreased across the board following the measures taken by the

Governing Council to support liquidity and the actions decided at European level and by the individual member countries to combat the crisis. Nevertheless tensions flared up again in the spring as the economic situation darkened and fears of euro reversibility revived. In the second half of July the yield spread between ten-year Italian and German government securities rose to 540 basis points (from an average of 310 in March), just below the November 2011 peak; for Spanish government bonds the spread widened to around 640 basis points (from 330).

Figure 7.3

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



Sources: Thomson Reuters Datastream and calculations 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 by GDP at constant 2011 prices. – (2) Fixed-rate yield of 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.

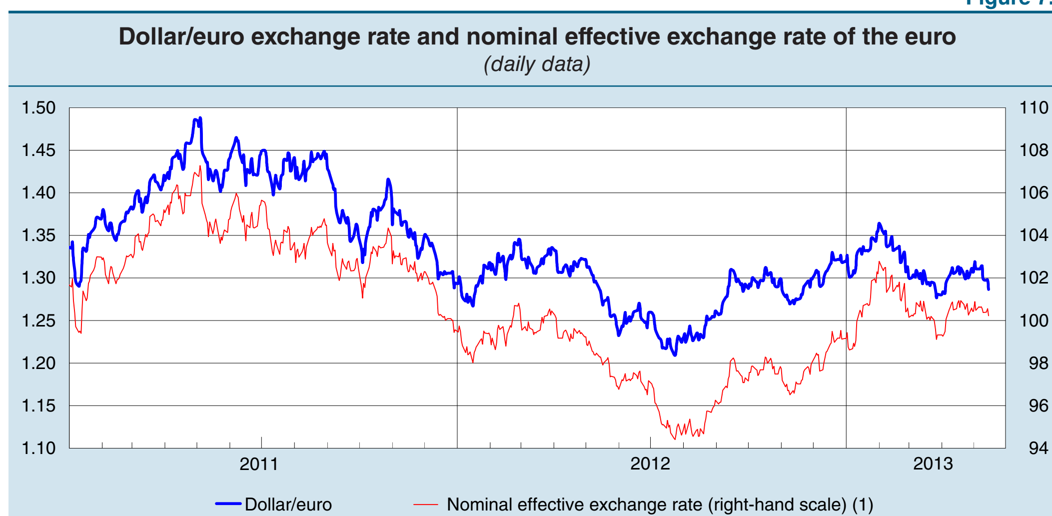
The announcement of OMTs and the advances in European governance in the second half of the year helped to reduce redenomination risk. In the first few months of 2013 the markets were affected only transiently and to a limited extent by the political uncertainty in Italy and the crisis in Cyprus; in mid-May the yield spreads of Italian and Spanish over German government securities were equal to about 260 and 300 basis points respectively.

Long-term inflation expectations remained consistent with the objective of price stability during 2012. The yields of swap contracts on the euro-area inflation rate five to ten years ahead, which include a risk premium, fluctuated modestly around 2.3 per cent. Similar indications emerge from the surveys conducted by Consensus Economics and the ECB's survey of professional forecasters.

The exchange rate of the euro. – In the first part of 2012 the intensification of redenomination risk was accompanied by a gradual weakening of the euro against the main international currencies; from the start of the year through the end of July it depreciated by about 5 per cent against the dollar in nominal effective terms (Figure 7.4).

This trend subsequently reversed as a consequence of the measures taken in the area to combat the crisis and the further easing of monetary conditions in the United States and Japan. In mid-May of this year the euro's exchange rate against the dollar and its nominal effective rate were both back close to their levels of early 2012.

Figure 7.4



Source: ECB.
(1) Index: 1999 Q1=100. A rise in the index corresponds to an appreciation.

Money and credit

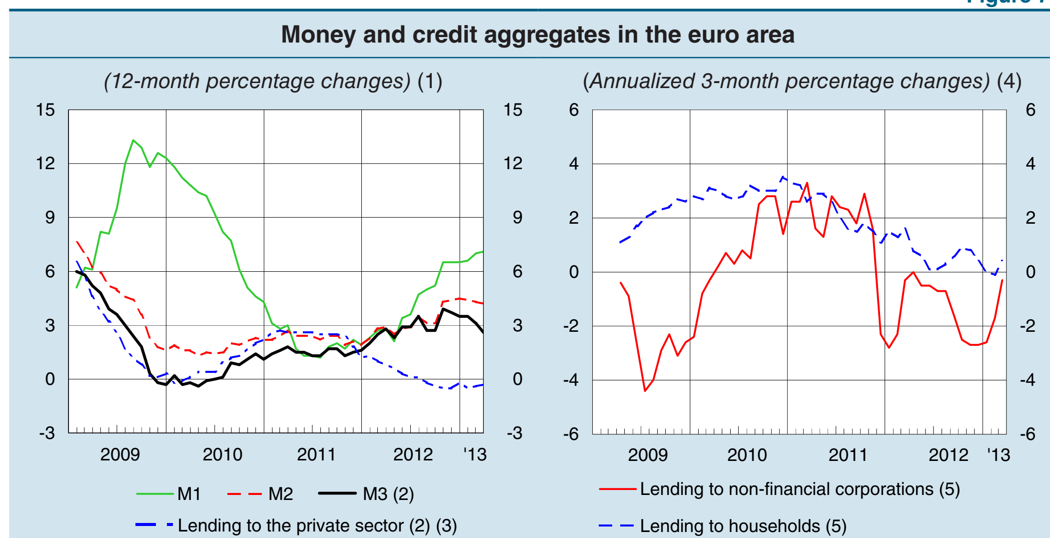
Money. – The behaviour of the broad monetary aggregate M3 and of its components during 2012 was affected by the weakness of economic activity and by portfolio shifts in response to the decline in yields. M3's rate of expansion rose, though remaining moderate (3.5 per cent in December, as against 1.6 per cent at the end of 2011; Figure 7.5). The acceleration chiefly involved very-short-term deposits, whose growth was sustained by a strong preference for liquidity on the part of all money-holding sectors in a setting of low interest rates and acute uncertainty on the financial markets. In the first few months of 2013 the growth of M3 slowed slightly, to 2.6 per cent in March. The disparity of national contributions to the growth of euro-area M3 diminished markedly in the final part of 2012, thanks to the gradual recovery in the money supply in the countries most exposed to the crisis, where it had contracted sharply in the preceding months.

Credit. – The twelve-month rate of growth in bank loans to the private sector slackened during 2012, turning negative in August and ending the year at -0.2 per cent (compared with 1.2 per cent at the end of 2011). This reflected the contraction of lending to non-financial corporations (-1.3 per cent in December, compared with growth of 1.4 per cent in December 2011) and the moderation of growth in lending to households (0.7 per cent, compared with 2.0 per cent in 2011). Quarter-on-quarter growth in lending to firms remained negative throughout 2012, ending the year at -2.7 per cent on a seasonally adjusted annual basis, while that in lending to households continued on the downward path it had taken in 2011. The contraction in lending to firms abated in the first few months of 2013.

The average interest rate on new loans to firms and that on new mortgage loans to households fell during 2012 by about 80 and 60 basis points respectively. Both rates continued to decline in the first few months of 2013; in March they were equal to 2.6 and 3.1 per cent.

Figure 7.5

Money and credit aggregates in the euro area



Source: ECB.
(1) Changes calculated on end-of-month data adjusted for calendar effects. – (2) From June 2010 onwards the data are based on the definitions of M3 and of lending to the private sector adopted by the ECB in September 2012, which exclude repos with central counterparties from those aggregates. – (3) 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-profit institutions serving households, non-profit institutions serving households, non-financial corporations, insurance companies and pension funds, non-money-market investment funds and other financial institutions. – (4) Changes calculated on the basis of end-of-month data, adjusted for seasonal and calendar effects. – (5) Loans in euros and other currencies granted by monetary financial institutions, adjusted for the accounting effects of securitizations; data available since January 2009.

Disparities from country to country in the trends in lending growth and the cost of loans diminished during 2012 and the first part of 2013, though they remained pronounced. They reflect not only the countries' different cyclical positions but also the fragmentation of the financial markets along national lines in connection with the sovereign debt crisis. After increasing sharply in the previous two years, the dispersion across countries of the growth rates in lending to households gradually lessened in 2012; that of lending to firms stabilized, thanks to the revival of credit in some of the countries worst affected by the crisis (Figure 7.6). In the second half of the year, after the announcement of OMTs, the dispersion of interest rates on new loans to households also decreased, while that of interest rates on new loans to firms stopped increasing.

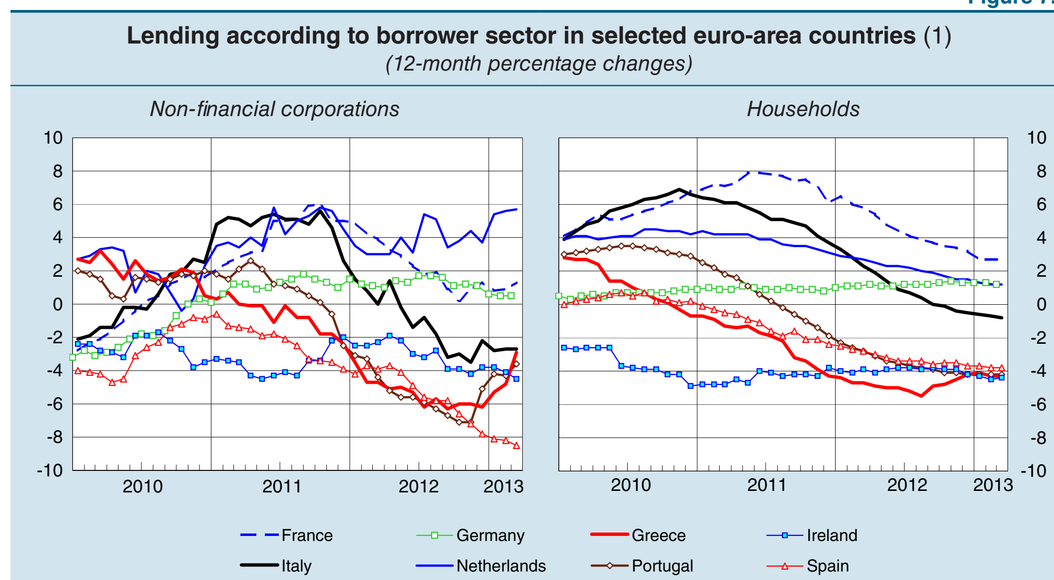
Banks' responses to the quarterly euro-area bank lending survey indicate that non-financial corporations' demand for credit remained slack throughout 2012, mainly reflecting scant demand for loans to finance investment and, in the countries less affected by the sovereign debt tensions, greater use of alternative sources of financing. The tightening of supply conditions gradually abated in the second half of the year as banks' funding costs and balance-sheet constraints exerted a less negative impact following the three-year LTROs and the announcement of OMTs. However, the poor macroeconomic situation and mounting credit risk continued to have adverse effects on supply conditions, especially as regards the cost of riskier loans.

While the tightening of bank credit affected firms of every type, its repercussions were greatest for smaller enterprises, whose riskiness is more cyclically sensitive and whose ability to tap alternative sources of finance is limited. After surging in the most acute phase of the sovereign debt crisis, the interest rate differential between new short-term loans of up to €1 million to euro-area firms and loans of larger amounts fluctuated last year barely above 150 basis points, some 70 basis higher than its average for the

period 2003 to 2009. The greater difficulty of smaller firms in accessing credit in 2012 is also shown by the results of the ECB's half-yearly survey on the access to finance of small and medium-sized enterprises in the euro area.

Figure 7.6

Lending according to borrower sector in selected euro-area countries (1)
(12-month percentage changes)



Source: ECB.
(1) Loans in euros and other currencies granted by monetary financial institutions, adjusted for the accounting effects of securitizations.

Monetary policy operations

Money market conditions remained relaxed during 2012 and the early months of 2013 thanks to abundant excess liquidity in the banking system and the ECB's announcements that Eurosystem refinancing operations would continue to be conducted with full allotment as long as necessary.

The liquidity supplied by the Eurosystem grew considerably following the two three-year LTROs, settled on 22 December 2011 and 1 March 2012 (Table 7.1 and Figure 7.7). These two operations provided the euro-area banking system with financing amounting to about €1 trillion (more than €500 billion net of the decrease in recourse to other operations); the Bank of Italy supplied its counterparties with just over €250 billion (about €140 billion net). At the same time banks significantly reduced their recourse to main refinancing operations, three-month LTROs and special-term refinancing operations with a maturity equal to one maintenance period.

The abundance of excess liquidity necessarily led to an increase in banks' funds with the Eurosystem. Initially this happened through large-scale use of the deposit facility, which at the beginning of March reached a historic high of just under €830 billion. From July, when the Governing Council reduced official rates, cutting that on the deposit facility to zero, banks held part of the excess liquidity in current accounts with the Eurosystem in the form of non-interest-bearing reserves. Excess liquidity, though continuing to be ample, diminished slightly in the final part of the year and more markedly in the first few months of 2013 as a consequence of the early repayment of about a quarter of the funds obtained in the two three-year LTROs (Italian banks

have exercised this option for very limited amounts to date). During 2012 and the early part of this year, highly accommodative liquidity conditions kept Eonia steadily about 65 basis points below the rate on main refinancing operations (Table 7.1).

Table 7.1

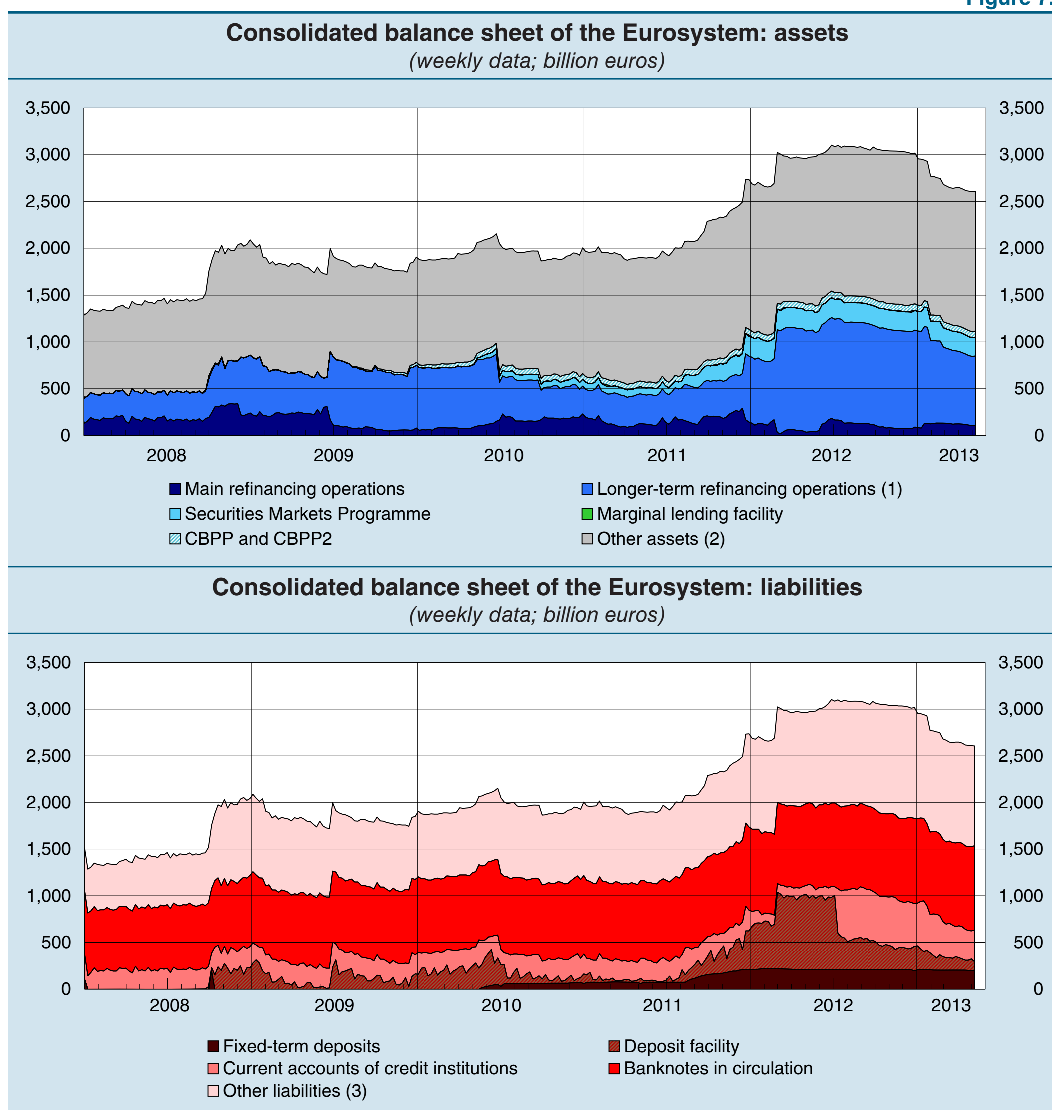
Monetary policy operations and money market interest rates
(daily averages for the period shown)

	8 Dec. 2010 14 June 2011	15 June 2011 13 Dec. 2011	14 Dec. 2011 12 June 2012	13 June 2012 11 Dec. 2012	12 Dec. 2012 7 May 2013
Main refinancing operations (MROs)					
Volume (1)					
Euro area	139.7	180.6	91.9	118.1	113.0
Italy	8.5	36.1	23.2	6.6	7.2
Italy's share (2)	6.1	20.0	25.3	5.6	6.3
Number of participants per tender					
Euro area	203	181	111	89	75
Italy	26	34	25	17	15
Longer-term refinancing operations					
Volume (3)					
Euro area	321.5	364.8	904.0	1065.2	882.3
Italy	29.7	54.5	214.7	270.6	265.2
Italy's share (2)	9.2	14.9	23.7	25.4	30.1
Number of participants per tender					
Euro area	131	110	126	35	32
Italy	24	25	22	16	17
Standing facilities (4)					
Marginal lending facility					
Euro area	1.5	1.6	2.8	1.2	1.4
Italy	0.0	0.0	0.1	0.0	0.1
Deposit facility					
Euro area	34.2	142.9	633.7	366.4	166.5
Italy	0.5	1.3	13.9	3.0	2.6
Excess reserves (5)					
Euro area	1.51	3.05	4.72	355.69	303.90
Italy	0.04	0.10	0.15	13.39	19.43
Money market rates					
Eonia	0.79	0.94	0.37	0.13	0.07
Eonia – MRO spread (6)	-29.1	-47.2	-62.9	-65.6	-67.7
Volatility of Eonia – MRO spread (7)	24.3	19.9	5.8	1.6	1.3

Sources: Bank of Italy and ECB.
(1) Daily average stock of funds disbursed to monetary financial institutions through main refinancing operations; billion 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 special-term refinancing operations with a maturity equal to one maintenance period; billion euros. – (4) Billion euros. – (5) Difference between the funds held by counterparties on current accounts with national central banks and required reserves; billion euros. – (6) 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.

In the course of the summer fears for the solidity of the monetary union exacerbated the tensions on government securities markets. To counter the distortions in yields due to redenomination risk and their repercussions on the effectiveness and uniformity of monetary policy transmission, in August the Governing Council announced a new measure, Outright Monetary Transactions (OMTs), whose technical features were specified in September (see the box "The European Central Bank's Outright Monetary Transactions", *Economic Bulletin*, October 2012).

Figure 7.7



Source: ECB.
(1) Special-term operations with a maturity of one reserve maintenance period and longer-term refinancing operations with a maturity of 3, 6, 12 and 36 months. – (2) First and second Covered Bond Purchase Programmes. – (3) Gold, foreign currency assets and other minor items. – (4) Revaluation accounts, foreign currency liabilities, capital, reserves, other minor items.

OMTs consist in secondary market purchases of government securities with a residual maturity of between one and three years for which the Eurosystem will not have preferred creditor status. They may be carried out only for the securities of countries that request an EFSF or ESM financial assistance programme, provided that it envisages possible purchases of government securities on the primary market by the above-named entities. The implementation of OMTs requires subsequent compliance with the conditions fixed by the programme. The Governing Council retains full discretion over recourse to OMTs, which will be used if deemed necessary from a monetary policy perspective and are fully within the ECB's mandate in that they serve to pursue price stability within the euro area. As with the Securities Markets Programme, which was terminated at the time the technical features of OMTs were announced, the liquidity so created will be sterilized.

The measures taken by the ECB were decisive in alleviating the tensions in the bond and equity markets of the countries most exposed to the crisis, fostering a resumption of capital flows to those economies. This is confirmed by the reduction in the imbalances of the euro-area central banks' positions in the TARGET2 payment system, which provide a gauge of the financial markets' segmentation along national lines.

During 2012 the Governing Council further widened the range of assets that can be pledged as collateral with the Eurosystem, in order to preserve the availability of eligible assets, improve the banking sector's access to refinancing operations and assist the supply of credit to households and firms. In particular, it suspended the minimum rating threshold for securities issued or guaranteed by the governments of countries under a European Union or IMF programme; reinstated the eligibility of debt instruments denominated in US dollars, British pounds or Japanese yen issued and held in the euro area; and reduced the minimum rating threshold for some types of asset-backed security, which will be subject, however, to larger haircuts in relation to their lower credit rating. The Bank of Italy, availing itself of the possibility offered by the decisions taken by the Governing Council in December 2011, began in February 2012 to accept as collateral performing bank loans with features different from those normally required by the Eurosystem – so-called additional credit claims (ACCs). In line with the decisions of other Eurosystem national central banks, in November the Bank of Italy lowered the minimum acceptable amount of ordinary bank loans from €500,000 to €100,000, so as to permit loans of the size typically granted to smaller firms to be used; in February of this year the same decision was extended to additional credit claims.

THE ITALIAN ECONOMY

8. DEMAND, SUPPLY AND PRICES

Italy's GDP declined by 2.4 per cent in 2012. The recession, which had begun in the second half of 2011, put an end to the brief upswing of the two previous years.

Last year's economic contraction, which involved both industry and the service sector, was largely due to the repercussions of the sovereign debt crisis. The strains in the credit market and the budget adjustment affected all the components of national demand. Business investment was deterred by financial constraints, ample unutilized capacity and poor demand prospects. Household consumption was held back by a decline in disposable income due both to higher taxes and to the persistent weakness of the labour market. Household and business confidence indicators were at very low levels.

Exports sustained demand, but their growth slowed despite improved price competitiveness, above all because of flagging sales to euro-area countries. As a result of sharply decreased imports, foreign trade nevertheless made a significant positive contribution of around 3 percentage points to GDP growth. The current account balance improved appreciably, returning to surplus in the fourth quarter for the first time since the summer of 2005. The correction of the external imbalance was accompanied by decreased public sector dissaving; however, the private saving rate fell slightly, registering an all-time low.

The decline in GDP, while moderating, continued in the early part of this year as well. According to our survey of industrial and service firms, the larger companies are planning to resume investment in the course of the year. For the economy as a whole, investment plans are still being curtailed, but much less markedly so than last year. Looking ahead, domestic demand could be stimulated by the rapid implementation of the measures for the payment of a substantial portion of general government trade debts.

Average annual consumer price inflation increased slightly to 3.0 per cent, owing to higher indirect taxes, which pushed the rate of inflation up by nearly a full percentage point, while the inflationary pressures from imports abated. Inflation subsided rapidly from the autumn on, as the effects of the fiscal measures ran their course, bringing the Italian rate back into line with the euro-area average. In April the twelve-month rise in the consumer price index for the entire resident population (CPI) was 1.1 per cent, and forecasters expect inflation to remain moderate in the months to come.

The causes of the recession

The contraction of economic activity in Italy in 2012 can be ascribed almost entirely to the repercussions of the sovereign debt crisis, which were transmitted to the economy through a variety of channels. The increase in the yield spread between Italian and German government securities, which only slowly retreated part of the way from its November 2011 peak, was transmitted to the cost of credit to the private sector. Italian banks' difficulty in raising funds on the international market limited firms' access to credit. The fiscal adjustment measures, though most probably serving to avert a potential financial collapse, impacted on domestic demand. The slowdown of the global economy,

and the European economy in particular, curbed the growth of exports. And the decline in confidence among businesses and households further dampened spending.

The effect of these factors on the main macroeconomic variables can be quantified by comparing actual developments during 2012 with what would have happened, according to the Bank of Italy's quarterly macroeconomic model, in a non-crisis scenario (see *Economic Bulletin*, January 2013). This scenario was based on assumptions consistent with the forecasts made by the main international organizations in the spring of 2011 before the deepening of the sovereign debt crisis.

In this scenario, it is estimated that in the absence of the factors mentioned Italian GDP could have grown last year by about 1 per cent, 3.4 percentage points better than the actual outturn. The worsening of the terms of credit for households and firms – both the increase in interest rates and the tightening of access – subtracted one percentage point from GDP growth in 2012. A slightly larger impact can be ascribed to the fiscal adjustment packages enacted starting in the second half of 2011, which, while essential to prevent a deepening of the sovereign debt crisis with incalculable consequences, nevertheless had adverse effects on aggregate demand. The slowdown in world trade growth – in large part owing to the decline in activity in the countries of the euro area, Italy's largest trading partners – is estimated to have shaved 0.6 percentage points off GDP growth. Finally, a negative effect of 0.7 points can be attributed to the greater pessimism and heightened uncertainty of households and firms as gauged by indicators of confidence; it cannot be precluded that this deterioration was itself due in part to the budget measures and to the worsening of credit conditions.

Household consumption

After stagnating on average for three years, household spending shrank by 4.3 per cent in 2012 (Table 8.1). Per capita spending fell back to about the amount recorded in 1998. According to our estimates, more than half the contraction can be traced to the impact on disposable income of the budget adjustment measures and the unfavourable trend in employment, and to the deterioration in the assessment of the economic situation.

All the main expenditure components decreased; durable goods purchases fell particularly sharply (by 12.7 per cent), especially spending on furniture and transport equipment. New car registrations declined for the fifth straight year, falling 20 per cent to 1.4 million, a thirty-year low. Purchases of semi-durable goods, mainly clothing and footwear, also fell sharply (by 9.4 per cent), after stagnating in 2011. Consumption of non-durables – which serve needs that are hard to defer – declined by 4.5 per cent (and spending on food alone by 3.0 per cent). Purchases of services diminished more modestly, by 1.4 per cent, after expanding 1.6 per cent in 2011, as spending on housing and healthcare held up relatively well.

The magnitude of the contraction in consumer spending in 2012 was roughly on a par with the 4.8 per cent decline in consumer households' real disposable income (Figure 8.1 and Table 8.2). In years past, despite unfavourable economic developments, households had acted to prop up consumption standards by limiting saving. When adjusted for the lesser monetary erosion of the value of financial assets due to lower inflation, the decline in disposable income last year becomes somewhat less pronounced (about 4 per cent).

Table 8.1

Sources and uses of income

	Per cent of GDP in 2012 (volumes at previous-year prices)	2011			2012		
		Percentage changes		Contribution to GDP growth (chain-linked volumes)	Percentage changes		Contribution to GDP growth (chain-linked volumes)
		Chain-linked volumes	Deflators		Chain-linked volumes	Deflators	
Sources							
GDP	–	0.4	1.3	–	-2.4	1.6	–
Imports of goods *fob* and services (1)	28.6	0.5	7.6	-0.1	-7.7	3.1	2.3
of which: goods	*23.4*	*1.0*	*8.7*	*-0.2*	*-8.3*	*2.8*	*2.1*
Uses							
National demand	98.4	-1.0	2.3	-1.1	-5.3	2.0	-5.4
Consumption of resident households	60.0	0.1	2.9	0.1	-4.3	2.8	-2.6
Consumption of general government and non-profit institutions serving households	20.7	-1.2	-0.1	-0.3	-2.9	0.4	-0.6
Gross fixed investment	18.3	-1.8	3.3	-0.4	-8.0	1.3	-1.5
machinery, equipment and transport equipment	*7.4*	*-1.1*	*2.5*	*-0.1*	*-11.1*	*0.4*	*-0.9*
intangible assets	*1.1*	*-0.6*	*2.3*	*..*	*-2.0*	*0.7*	*..*
construction	*9.8*	*-2.6*	*4.2*	*-0.3*	*-6.2*	*2.2*	*-0.6*
Change in stocks and valuables (2)	–	–	–	-0.5	–	–	-0.6
Exports of goods *fob* and services (3)	30.2	5.9	4.1	1.6	2.3	1.9	0.7
of which: goods	*24.9*	*6.8*	*4.4*	*1.5*	*1.9*	*1.7*	*0.5*
Net exports	–	–	–	1.4	–	–	3.0

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

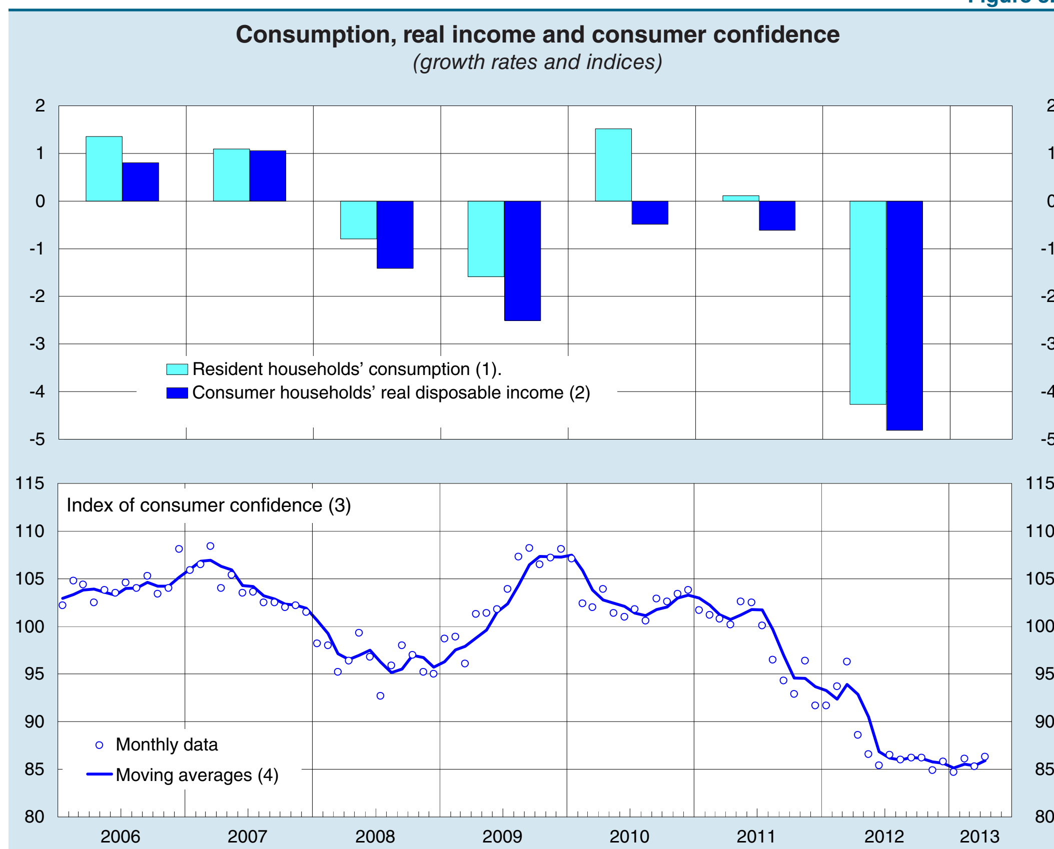
In nominal terms, the income of consumer households diminished considerably less sharply (2.2 per cent). The fall was largely due to the drop in self-employment income net of social contributions (down 8.2 per cent), itself due above all to the 6.1 per cent decrease in income per standard self-employed labour unit.

Total gross wages and salaries remained essentially unchanged last year. The decline in payroll employment (down by 1.2 per cent in terms of full-time equivalent workers) was practically offset by the rise in nominal per capita wages, though this was less than the rate of inflation.

Net property income, which had been sharply curtailed by the crisis of 2008-09, fell by 0.9 per cent last year, mainly as a consequence of the decrease in dividends and other distributed profits.

Social benefits continued to rise, while the increase in taxation as part of the budget adjustment measures subtracted one percentage point from disposable income. The overall effect of the action of general government was moderately negative (0.3 percentage points).

The only previous downward correction of consumption consistent with a fall in income came during the recession of the early 1990s. Last year the consumer household saving rate diminished very slightly but reached a historic low of 7.9 per



Source: Based on Istat data.
(1) Chain-linked volumes; percentage changes on previous year. – (2) Deflated using the resident households' consumption deflator. – (3) Indices, 2005=100; seasonally adjusted data. – (4) For the three months ending in the reference month.

cent of disposable income (compared with 12.3 per cent in 2007). Spending decisions were also presumably influenced by mounting uncertainty about the economic outlook in general and the state of the labour market in particular (Figure 8.1).

Gross national saving (comprising firms and the public sector as well as households) rose to 17.4 per cent of disposable income, largely recouping the decline of the previous four years. Private-sector saving was broadly stable, while the net dissaving of general government decreased from 1.5 to 0.4 per cent of national income. The improvement in the public sector's current budget deficit was due in part to the curbing of collective consumption in nominal terms. The deficit on foreign transactions was practically eliminated.

Investment

Gross fixed investment fell by 8.0 per cent (Table 8.3). Investment has fallen every year since 2008 except for 2010, with a cumulative decline of about 20 per cent. The drop in 2012 was especially steep for machinery, equipment, transport equipment and intangibles (down by 9.9 per cent), while construction investment decreased by 6.2 per cent. The fall in investment reflected the unfavourable conditions of finance, ample unutilized capacity and uncertain demand prospects. The investment rate declined to 18.3 per cent of GDP, even lower than the minimum recorded in 1994.

Table 8.2

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

	Per cent of households gross disposable income in 2012	2010	2011	2012
		Percentage changes		
Earnings net of social contributions charged to workers	43.9	1.7	2.1	-0.1
Income from salaried employment per standard labour unit	–	*3.0*	*1.3*	*1.1*
Total social contributions (1)	–	*0.3*	*0.3*	..
Standard employee labour units	–	*-1.5*	*0.5*	*-1.2*
Income from self-employment net of social contributions (2)	18.4	-0.1	1.7	-8.2
Income from self-employment per standard labour unit	–	..	*2.6*	*-6.1*
Total social contributions (1)	–	*-0.3*	*-0.2*	*-1.4*
Standard self-employed labour units	–	*0.1*	*-0.7*	*-0.9*
Net property income (3)	24.8	..	2.3	-0.9
Social benefits and other net transfers	32.1	2.5	1.2	2.2
of which: net social benefits	–	*2.6*	*2.2*	*2.0*
Current taxes on income and wealth (–)	19.2	2.7	0.1	5.5
Consumer households' gross disposable income	**100**	**1.0**	**2.2**	**-2.2**
in real terms (4)	–	-0.5	-0.6	-4.8
in real terms, adjusted for expected inflation (4) (5)	–	-1.6	-1.7	-4.4
in real terms, adjusted for past inflation (4) (6)	–	-2.5	-2.0	-3.8
Private sector gross disposable income	–	**1.7**	**2.3**	**-1.8**
in real terms (4)	–	0.2	-0.5	-4.5
in real terms, adjusted for expected inflation (4) (5)	–	-1.3	-2.0	-4.1
in real terms, adjusted for past inflation (4) (6)	–	-2.3	-2.3	-3.2
		Per cent		
Consumer households' average propensity to save (7)	–	**9.1**	**8.4**	**7.9**
calculated on income adjusted for expected inflation	–	7.1	5.4	5.2
calculated on income adjusted for past inflation	–	7.1	5.1	5.6
Private sector average propensity to save (7)	–	**23.0**	**22.5**	**22.3**
calculated on income adjusted for expected inflation	–	23.6	23.4	23.1
calculated on income adjusted for past inflation	–	23.6	23.5	23.0

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 (primarily rental income), 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 fund reserves) to the gross disposable income of the sector.

Net of depreciation and amortization, investment spending was virtually nil in 2012, falling to 0.2 per cent of GDP, more than five percentage points lower than the average for the five years preceding the 2008-09 recession.

The contraction in construction investment in 2012 was of about the same magnitude in residential and non-residential building (6.8 and 6.4 per cent respectively), and in both segments the decline eased in the second half. The building slump, which began before the global crisis, has subtracted an annual average of half a percentage point from GDP growth for the past five years.

Table 8.3

Fixed investment
(chain-linked volumes, unless otherwise indicated)

	Percentage composition in 2012 (1) (volumes at previous-year prices)	Percentage change			Per cent of GDP (1) (volumes at previous-year prices)	
		2010	2011	2012	2000	2012
Construction	53.4	-4.5	-2.6	-6.2	9.5	9.8
residential	*25.1*	*-0.1*	*-4.0*	*-6.8*	*4.2*	*4.6*
other	*23.6*	*-9.4*	*-1.1*	*-6.4*	*4.5*	*4.3*
property transfer costs	*4.7*	*-2.4*	*-1.6*	*-2.3*	*0.8*	*0.9*
Machinery and equipment	32.5	10.3	-1.5	-10.6	7.4	5.9
Transport equipment	8.3	-0.1	0.7	-12.2	2.2	1.5
Intangible assets	5.8	-2.4	-0.6	-2.0	1.2	1.1
Total gross fixed investment	**100.0**	**0.6**	**-1.8**	**-8.0**	**20.3**	**18.3**
Total excluding residential buildings	–	0.9	-1.1	-8.4	16.1	13.7
Total excluding construction	–	6.8	-1.0	-9.9	10.7	8.5
Total net fixed investment (2)	**–**	**-1.7**	**-21.6**	**-87.4**	**5.8**	**0.2**

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

The number of house sales plummeted by 25.8 per cent last year. House prices decreased by 2.7 per cent; in real terms the decline was 5.5 per cent, bringing the total downward correction from the 2007 peak to 11.0 per cent.

Non-residential construction investment continued to be affected by the decrease in public works spending as part of the budget adjustment. According to the Bank of Italy's survey of a sample of 474 construction firms in the early months of 2013, the volume of new public works diminished by 8.8 per cent in 2012, continuing the downtrend under way since 2007. Expectations were for a further decline, though a smaller one, in 2013.

The Bank's early-2013 survey of 4,214 firms with at least 20 workers in industry excluding construction and private non-financial services confirmed the sharp fall in gross fixed investment in 2012. For the entire sample the decline was slightly more moderate than the planned retrenchment as reported in the previous year's survey (Table 8.4). The decline was sharper for manufacturing firms, especially small ones. It was especially steep among non-exporter firms and those in traditional sectors, which suffered more severely from the pronounced contraction in domestic demand.

Investment plans for 2013 indicate a further but shallower cutback, scarcely half that of 2012. In both manufacturing and services the firms with over 500 workers plan a resumption of investment growth this year, while those with fewer than 200 workers foresee no upturn. The expectations of firms producing mainly for the domestic market remain more unfavourable.

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 2012 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 2012	*-11.3*	*-16.1*	*-12.5*	*-11.2*	*-6.7*	*-6.8*	*-14.0*	*-5.5*	*-19.1*
realization rate (4)	*98.3*	*108.9*	*103.5*	*99.5*	*89.1*	*98.1*	*91.0*	*100.9*	*94.1*
plans for 2013	*-2.6*	*-8.3*	*-5.2*	*-8.1*	*5.8*	*-3.0*	*3.3*	*0.5*	*-7.6*
Realized investment in 2012	-10.0	-14.9	-11.5	-8.7	-7.1	-7.8	-9.4	-6.2	-17.3
Realization rate (4)	98.2	108.0	102.1	99.0	92.7	97.7	94.9	99.6	95.0
Plans for 2013	-3.7	-9.6	-5.1	-4.2	-0.2	-3.2	-1.3	-2.3	-7.1
Services (5)									
Realized investment in 2012	-7.5	-4.2	-9.2	-9.6	-8.4	....	....	-7.5	-7.4
Realization rate (4)	97.9	107.1	108.7	95.8	90.2	....	....	96.8	100.4
Plans for 2013	-6.3	-17.1	-18.4	-3.7	4.8	....	....	-5.9	-7.0
Total									
Realized investment in 2012	-8.7	-8.5	-10.3	-9.1	-7.8	....	....	-6.9	-12.2
Plans for 2013	-5.0	-13.8	-11.5	-4.0	2.3	....	....	-4.0	-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 2012. – (3) With reference only to industrial firms with 50 employees or more. – (4) Realized investment during the year as a percentage of investment planned (according to the previous year's survey), both at current prices. – (5) Private sector non-financial services.

Exports and imports

Exports. – Unlike the other demand components, exports continued to sustain economic activity in 2012, although their growth in volume terms slowed from 5.9 to 2.3 per cent (Table 8.1). The slowdown reflected the easing of world trade growth from 6.0 to 2.5 per cent. Italy's world market share slipped to 2.7 per cent at current prices and exchange rates.

Exports of goods, which account for more than 80 per cent of Italy's total, gained 1.9 per cent in 2012, compared with 6.8 per cent in 2011, a bit less than the 2.4 per cent growth in world merchandise trade (Table 8.5). The main factor in the slowdown was the drop in sales to euro-area countries (which account for 40.5 per cent of the total), where demand declined. On the positive side, exports benefited fully from the recovery in international trade outside the euro area, where Italy's sales growth outpaced potential demand in the three years 2010-12.

Table 8.5

Italian merchandise export volumes, foreign demand and world trade
(percentage changes on previous year)

	Italian merchandise exports	of which: euro area	of which: non-euro area	Foreign demand (1)	World trade
2010	12.4	*9.8*	*14.6*	10.8	14.0
2011	6.8	*3.2*	*9.6*	4.7	6.3
2012	1.9	*-1.6*	*4.5*	1.0	2.4

Sources: Based on IMF and Istat data.
(1) Foreign demand is calculated as the weighted average of imports by volume of Italy's trading partners, weighted by their shares of Italian exports by value.

Italian exporters' price competitiveness, gauged by producer prices of manufactures, improved by more than two percentage points in 2012 thanks above all to the nominal depreciation of the euro.

Imports. – After stagnating in 2011, imports slumped by 7.7 per cent last year in volume terms, largely owing to the contraction of investment and the slowdown in exports, which are the demand components with the most substantial input of imports.

Supply

Value added in industry excluding construction declined by 3.5 per cent in 2012, accounting for just over half a percentage point of the contraction in GDP. Between the first quarter of 2008 and the fourth quarter of 2012, the loss came to 17.1 per cent. The decrease was sharpest last year in the textiles and furniture industries, while output in the food products and pharmaceuticals sectors was broadly stable.

In construction, value added fell for the fifth straight year, declining by 6.3 per cent and bringing the cumulative decrease with respect to the fourth quarter of 2007 to 21.9 per cent at the end of the year.

In the service sector, value added contracted by 1.2 per cent, accounting for 0.8 percentage points of the decline in GDP. The most pronounced decreases were in retail and wholesale trade, transport, communications, and public services.

GDP continued to fall in the first quarter of 2013 (by 0.5 per cent according to Istat's preliminary estimate), although less steeply than in the fourth quarter. The recent legislative measures to accelerate the payment of general government trade debts and tax refunds for a total of €40 billion this year and next should improve firms' financial situation and may help to revive aggregate demand.

Prices and costs

Average consumer price inflation as measured by the index for the entire resident population (CPI) increased slightly in 2012, from 2.8 to 3.0 per cent (Table 8.6), owing

entirely to higher indirect taxes. Istat releases data on the impact of fiscal measures on the harmonized index (HICP), which rose by 3.3 per cent last year compared with 2.9 per cent in 2011. In this case the indirect tax measures accounted for 0.8 percentage points of increase during the year, compared with 0.3 points in 2011.

Table 8.6

Consumer prices

	Percentage changes on previous year		Percentage weights
	2011	2012	2012
Index of consumer prices for the entire resident population	**2.8**	**3.0**	**100.0**
Unregulated goods and services	**2.7**	**2.8**	**86.8**
Unprocessed food	2.5	2.2	6.5
Processed food	2.4	2.7	10.4
Energy products	14.6	14.3	5.2
Non-food and non-energy products	1.4	1.7	25.8
Services	2.2	1.9	36.7
Tobacco	4.1	6.8	2.2
Regulated goods and services	**3.3**	**4.8**	**13.2**
Overall index excluding food, energy and tobacco	**1.9**	**1.7**	**73.0**
Harmonized index of consumer prices	**2.9**	**3.3**	**100.0**

Source: Based on Istat data.

Domestic inflation, measured by the GDP deflator, picked up slightly from 1.3 to 1.6 per cent, while the import deflator decelerated from 7.6 to 3.1 per cent. The acceleration in unit labour costs, which was due almost entirely to the cyclical fall in productivity, was countered by the compression of profit margins.

Energy goods registered the largest price increases, averaging 13.9 per cent for the year compared with 11.3 per cent in 2011. The acceleration was due entirely to the increases in indirect taxes on fuels enacted in 2011. Core inflation, measured by the CPI net of food and energy products, eased from 1.9 to 1.7 per cent despite the raising of the ordinary VAT rate from 20 to 21 per cent in September 2011. By our estimates, if the rate had not been raised the decline in core inflation would have been about half a percentage point greater.

Consumer price inflation came down progressively in the course of 2012. The twelve-month rate was 3.3 per cent in the first quarter, 2.5 per cent in the fourth. The price moderation induced by the persistent slackness of economic activity was accompanied by the deceleration of energy price inflation (from over 15 per cent in the first quarter to 11.5 per cent in the fourth) because of the decline in world oil prices and, in the fourth quarter, the exhaustion of the effects of the September 2011 increase in VAT. In the fourth quarter core inflation fell below 1.5 per cent for the first time since 2009.

Disinflation continued in the first few months of 2013 as well. The twelve-month rise in the CPI came down to 1.1 per cent in April, mainly as a result of falling energy prices.

Consumer price inflation as measured by the HICP averaged 0.8 percentage points higher in Italy than in the euro area in 2012. However, the gap narrowed progressively beginning in the autumn as the tax effects wore off, and by April 2013 it was nearly closed.

Producer prices and costs. – In 2012 the producer price index for the domestic market rose by 4.1 per cent on average, down from 5.1 per cent in 2011. Producer price inflation slowed rapidly in the course of the year, falling to less than 1 per cent at the beginning of 2013 and nil in March. The decrease was due in part to the pronounced deceleration in energy prices, but also to the weakness of domestic demand.

The average producer prices of non-energy goods exports rose by 1.2 per cent on average in 2012, in line with the corresponding indicator of domestic market prices and also with the increases decided by French and German firms.

Unit labour costs for the entire economy increased by 1.8 per cent, compared with 0.8 per cent in 2011. Given stable hourly earnings growth of about 1 per cent, the acceleration was due to the cyclical fall in productivity, which declined by 0.6 per cent in 2012 after rising by 0.2 per cent in 2011. In industry, where the productivity loss was most pronounced, unit labour costs rose by nearly 4 per cent. Firms countered the cyclical change in unit labour costs by compressing profit margins (as is normal in the case of short-term fluctuations), which were narrowed by 3.2 per cent compared with 2011.

Inflation expectations. – The inflation forecasts of the economists surveyed by Consensus Economics for 2012 rose gradually in the early part of the year as the effects of the indirect tax increase were factored in and stood at about 3 per cent starting in the second quarter. Expectations for 2013 as a whole, however, were revised downward repeatedly starting in the autumn. This reflected above all the easing of the pressures in world commodities markets and the fall in actual inflation. In May the Consensus Economics forecast for Italy in 2013 was 1.7 per cent, just barely above that for the euro area as a whole.

9. THE LABOUR MARKET

The decline in employment that had begun in the second half of 2011 continued through 2012. Requests for more wage supplementation hours and greater use of part-time work led to a decrease in per capita hours worked, which helped to limit the drop in the number of persons in work. The decline in total hours worked was less than that in output: hourly labour productivity fell by 0.6 per cent.

Payroll employment contracted largely as a result of fewer hirings, while the number of terminations remained basically unchanged. In the second half of the year, in line with the objectives of the labour market reform that came into force last July, there were signs of a shift in firms' demand towards standard payroll jobs and away from atypical and quasi-employee contracts.

The number of economically active persons – either employed or seeking work – rose. The increase was the largest in over thirty years and concerned all age groups; it reflects the extended working life of older people and more energetic job seeking by the younger generations faced with increasingly poor employment prospects. The growth in the workforce at a time of slack labour demand drove up the unemployment rate, which in March this year rose to 11.5 per cent on a seasonally adjusted basis, compared with 12.1 per cent for the euro-area as a whole.

In 2012, as the gap between labour supply and demand widened, wage growth slowed below the rate of consumer price increase. Despite this moderation, unit labour costs rose, partly owing to the decline in labour productivity.

Employment and labour demand

As the recession that had begun in the middle of 2011 continued, it led to a drop of 1.4 per cent on average in actual hours worked, compared with an increase of 0.3 per cent in 2011. The accompanying drop in the number of persons in employment (0.3 per cent) was not as large, however, and was below the figure recorded during the 2008-09 recession (Table 9.1 and Figure 9.1).

The contraction in average hours worked (-1.1 per cent), which measures manpower utilization, was sharp in construction and manufacturing, less so in services; it affected both payroll employment (-1.1 per cent) and self-employment (-0.9 per cent). In the case of payroll employment, over half the decrease was due to greater use of short-time working, which coincided, especially in the largest firms, with a rise in wage supplementation hours and a reduction in overtime.

Table 9.1

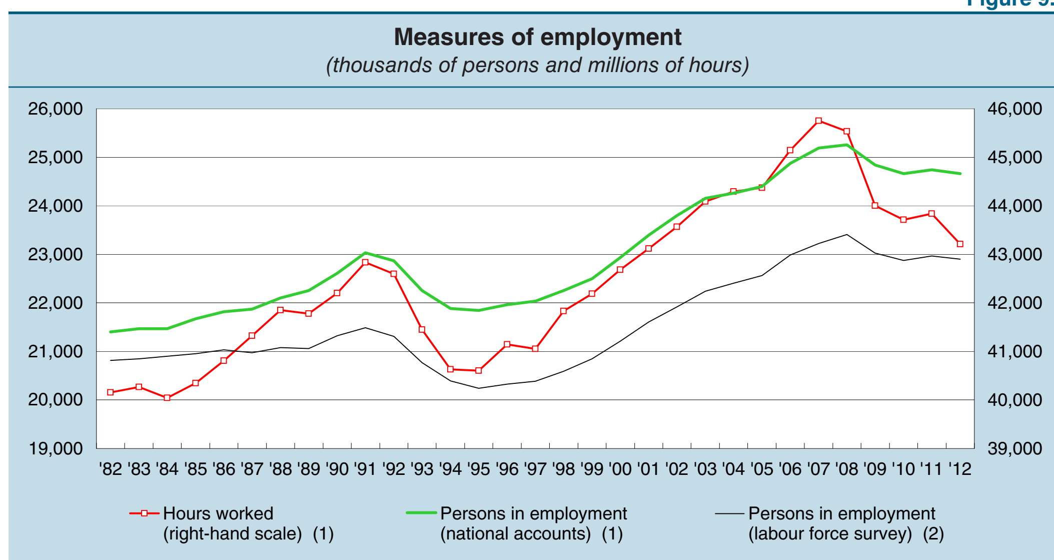
Labour input in the Italian economy by sector (1)
(percentage shares and percentage changes)

	Persons in employment		Standard labour units		Total hours worked		Jobs	
	Share	% change	Share	% change	Share	% change	Share	% change
	2012	2011/ 2012	2012	2011/ 2012	2012	2011/ 2012	2012	2011/ 2012
Agriculture, forestry, fisheries	**3.8**	**-2.7**	**5.0**	**-3.5**	**5.0**	**-5.8**	**5.9**	**-3.6**
Industry excl. construction	**19.0**	**-1.6**	**18.1**	**-1.9**	**17.7**	**-2.8**	**16.4**	**-1.6**
Mining and quarrying	0.1	-4.8	0.1	-6.0	0.1	-7.2	0.1	-4.7
Manufacturing	17.7	-1.7	16.8	-2.0	16.5	-3.0	15.3	-1.7
Energy, gas and water supply; sewerage network and waste management	1.1	0.4	1.1	0.1	1.0	0.6	1.0	0.4
Construction	**7.2**	**-5.2**	**7.5**	**-5.4**	**7.4**	**-6.4**	**6.9**	**-4.8**
Services	**70.1**	**0.7**	**69.4**	**-0.2**	**69.9**	**-0.2**	**70.8**	**0.2**
Wholesale and retail trade, repair of motor vehicles and motorcycles	14.6	-0.1	14.4	-0.7	15.8	-1.1	13.2	-0.3
Accommodation and food services	5.5	3.7	6.4	0.7	7.0	0.8	7.8	-0.2
Transport, storage and communications	6.8	-1.1	8.4	-1.2	7.9	-1.8	9.4	-0.6
Financial and insurance services	2.6	0.4	2.7	0.3	2.4	0.2	2.3	0.8
Sundry business and household services (1)	12.0	1.5	11.7	0.9	12.3	1.0	11.6	1.3
General government (2)	5.3	-1.8	5.4	-1.9	4.5	-1.9	4.5	-1.8
Education	5.8	-1.8	5.8	-2.4	4.1	-1.7	5.0	-1.8
Healthcare	6.9	1.4	6.7	0.8	6.1	1.0	6.1	1.6
Other public, social and personal services (3)	3.9	1.6	3.8	0.7	3.8	1.2	3.5	1.5
Activities of households and residential institutions	6.7	4.2	4.1	2.4	6.0	1.3	7.4	1.6
Total	**100.0**	**-0.3**	**100.0**	**-1.1**	**100.0**	**-1.4**	**100.0**	**-0.7**
of whitch: unreported	*10.5*	*0.8*	*12.1*	*-0.9*	*....*	*....*	*17.0*	*-1.2*

Source: Istat, national accounts.
(1) Rounding may cause discrepancies in totals. – (2) Real-estate, professional, scientific and technical, administrative and support services. – (3) Includes defence and compulsory social insurance.

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).

The number of part-time payroll employees rose by 10.0 per cent in 2012 (Table 9.2). While it is still mainly women who work part-time, in the last four years contracts of this type have increased significantly among male employees as well, accounting for almost 7 per cent of the total last year. This upturn was limited to what is termed "involuntary" part-time: the share of male workers settling for a part-time job because they could not find a full-time position doubled from 2008 to 2012.

Table 9.2

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

	Centre and North		South and Islands		Italy	
	Thousands of persons	Percentage change 2011-12	Thousands of persons	Percentage change 2011-12	Thousands of persons	Percentage change 2011-12
Employees	**12,696**	**..**	**4,518**	**-0.6**	**17,214**	**-0.2**
Permanent	11,118	-0.5	3,721	-1.1	14,839	-0.7
full-time	9,237	-1.9	3,170	-3.8	12,407	-2.4
part-time	1,881	6.8	551	17.6	2,432	9.1
Fixed-term and temporary	1,578	3.9	797	1.7	2,375	3.1
full-time	1,135	0.5	565	-2.4	1,700	-0.4
part-time	443	13.4	232	13.2	675	13.3
Self-employed	**4,022**	**-0.9**	**1,663**	**-0.4**	**5,685**	**-0.7**
Entrepreneurs, professionals and own-account workers	3,415	-1.0	1,460	0.3	4,875	-0.6
Family workers	249	-6.7	83	-12.0	332	-8.1
Cooperative members	31	-1.9	14	17.2	45	3.2
Collaborators	240	4.8	80	-0.1	320	3.5
Occasional workers	87	9.9	26	-5.6	113	5.9
Full-time	3,427	-2.6	1,459	-1.7	4,886	-2.3
Part-time	596	10.0	203	10.3	799	10.1
Total employment	**16,718**	**-0.2**	**6,180**	**-0.6**	**22,899**	**-0.3**

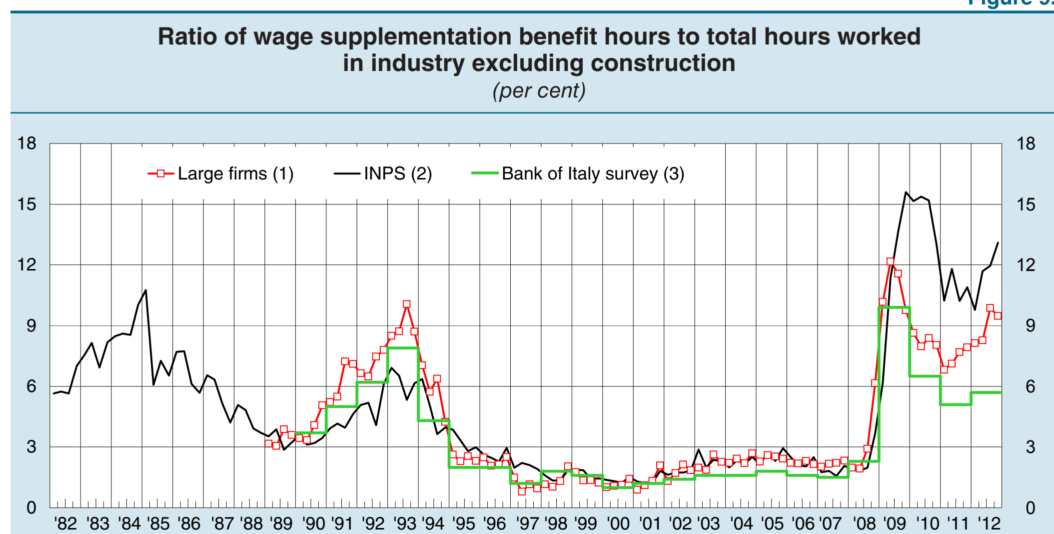
Source: Based on Istat's labour force survey.
(1) Rounding may cause discrepancies in totals.

There was a renewed increase in the number of wage supplementation hours authorized in 2012, up by 12.1 per cent over the year (compared with a drop of 18.8 per cent in 2011) to 3.6 per cent of average total hours worked by payroll employees and to almost 12 per cent in industry excluding construction (Figure 9.2). The trend gained pace during the year and concerned both the ordinary component of wage supplementation and the component under waiver; the extraordinary component fell by 5.5 per cent on average during the year, but began to rise again in the closing months. According to INPS estimates, firms used less than half of the total hours authorized, as in 2011.

The decrease in the number of payroll employees was largely due to the drop in the number of new contracts as the number of terminations remained basically unchanged.

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.

The tendency of firms in recent years to favour flexible forms of employment in the face of uncertainty about the timing and strength of the recovery seems to have eased somewhat in 2012. In the second half of the year, alongside the decline in the number of employees on permanent contracts, there was a drop in quasi-employee and atypical contracts as well; this resulted in greater use of fixed-term payroll contracts. According to the national accounts, the number of unreported jobs, i.e. without a contract or in violation of tax laws, fell by 1.2 per cent, i.e. more than the number of regular ones (-0.6 per cent).

The 0.7 per cent decline in self-employment concerned almost exclusively own-account workers without employees in the industrial sector, notably those with lower educational qualifications. By contrast the number of freelance professionals, mainly graduates, increased.

On a sectoral level, the trends observed at the beginning of the recession persisted. The decline in employment occurred mainly in construction (-5.2 per cent) and the rest of industry (-1.7 per cent). In the service sector, employment grew at a slower pace (0.7 per cent) than in 2011 owing to the further large reduction in general government employment; in private services employment growth was strongest in accommodation and food services (3.7 per cent) and in personal services (4.2 per cent).

The geographical variations in employment trends reflected the sectoral differences. The contraction in the North-West was due to the predominance of industry and the one in the South to the weight of general government.

Employment continued to contract in the first quarter of 2013, falling by 1.8 per cent with respect to the year-earlier period. Business surveys indicate that this trend will persist, albeit at a slower pace, for the rest of the year. According to the quarterly survey of inflation and growth expectations conducted by the Bank of Italy and *Il Sole 24 Ore* in March, 22.9 per cent of firms expected to reduce their staff in the following three months, compared with 30.7 per cent in December. On the other hand, there

was an increase in the percentage of firms expecting a rise in manpower utilization, particularly in manufacturing.

The composition of employment of the resident population

According to Istat's labour force survey, the number of residents in employment declined by 69,000 or 0.3 per cent on average in 2012 (Table 9.3). The employment rate for the population aged 15-64 was 56.8 per cent, against 56.9 per cent in 2011.

Table 9.3

Labour supply in 2012
(thousand persons and per cent)

	Centre and North		South and Islands		Italy	
	Thousands of persons (1)	Percentage change 2011-12 (2)	Thousands of persons (1)	Percentage change 2011-12 (2)	Thousands of persons (1)	Percentage change 2011-12 (2)
Labour force	**18,181**	**1.7**	**7,461**	**3.7**	**25,642**	**2.3**
Women	7,952	2.9	2,781	6.5	10,733	3.8
Men	10,229	0.8	4,680	2.1	14,909	1.2
Italians	15,829	1.2	7,096	3.4	22,926	1.8
Foreigners	2,352	5.4	365	10.8	2,717	6.1
Total employment	**16,718**	**-0.2**	**6,180**	**-0.6**	**22,899**	**-0.3**
Women	7,214	0.8	2,244	2.5	9,458	1.2
Men	9,504	-0.9	3,937	-2.2	13,441	-1.3
Italians	14,697	-0.7	5,868	-0.9	20,565	-0.7
Foreigners	2,021	3.2	313	6.6	2,334	3.7
Job seekers	**1,463**	**29.5**	**1,281**	**31.0**	**2,744**	**30.2**
Women	738	29.0	537	27.4	1,275	28.3
Men	725	29.9	744	33.7	1,469	31.8
Italians	1,132	32.3	1,229	30.4	2,361	31.3
Foreigners	330	20.6	52	44.8	383	23.4
Participation rate (ages 15-64)	**69,5**	**1.1**	**53,0**	**2.0**	**63,7**	**1.4**
Women	61,3	1.7	39,3	2.5	53,5	2.0
Men	77,7	0.5	67,0	1.5	73,9	0.9
Italians	69,2	1.3	52,5	2.0	62,9	1.6
Foreigners	71,6	-0.5	64,6	0.9	70,6	-0.4
Employment rate (ages 15-64)	**63,8**	**-0.2**	**43,8**	**-0.2**	**56,8**	**-0.2**
Women	55,5	0.4	31,6	0.8	47,1	0.6
Men	72,0	-0.8	56,2	-1.2	66,5	-0.9
Italians	64,1	..	43,3	-0.2	56,4	-0.1
Foreigners	61,5	-1.7	55,3	-1.4	60,6	-1.7
Unemployment rate	**8,0**	**1.7**	**17,2**	**3.6**	**10,7**	**2.3**
Women	9,3	1.9	19,3	3.2	11,9	2.3
Men	7,1	1.6	15,9	3.8	9,9	2.3
Italians	7,2	1.7	17,3	3.6	10,3	2.3
Foreigners	14,1	1.8	14,3	3.4	14,1	2.0
Youth unemployment rate (ages 16-24)	**28,9**	**5.5**	**46,9**	**6.6**	**35,3**	**6.2**
Women	31,2	5.3	49,9	5.2	37,5	5.5
Men	27,2	5.7	45,1	7.4	33,7	6.6
Italians	28,0	5.4	47,5	6.2	35,5	6.0
Foreigners	33,1	6.4	35,8	14.4	33,5	7.3

Source: Based on Istat's 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.

Employment among Italian nationals fell by 0.7 per cent (-0.4 per cent in 2011). The gender gap narrowed further, with the difference between the employment rate of men (66.0 per cent) and that of women (46.7 per cent) diminishing by 1.3 percentage points compared with 2011 and by 4.7 points compared with 2005. The trend was common to all age groups, but it was particularly marked among the central categories. The difficulty of finding work for young people and the extension of working life (partly due to the raising of the retirement age under the 2011 reform) affected both sexes equally. In the 34-54 age group, however, the growth in women's employment (0.2 per cent) following the increase in women's labour supply contrasted with the 1.4 per cent decline in the employment of men.

The growth in the number of foreigners in employment slowed to 3.7 per cent, from 8.2 per cent in 2011. The trend mainly concerned men, most of whom are employed in the construction industry; their number rose by just 0.5 percentage points after increasing by an annual average of 10 per cent between 2004 and 2011. The 8.4 per cent increase in the number of foreign women in employment benefited from the expansion of the personal services sector. As the growth in the employment of foreigners slackened, immigration diminished: the rate of increase in the foreign population aged over 15 slowed from 9.5 per cent in 2011 to 6.6 per cent in 2012. The employment rate for foreigners aged 15-64 fell to 60.6 per cent (71.5 per cent for men and 50.8 per cent for women).

The decline in employment of all residents was not evenly distributed among the different educational levels. The rate fell by 0.4 percentage points for graduates and lower-secondary school diploma-holders (to 76.6 and 43.7 per cent respectively) and by 1 percentage point among workers with only an upper-secondary school diploma (to 64.2 per cent).

Labour supply and unemployment

The number of persons active in the labour market rose by more than half a million (2.3 per cent), the largest increase since the data first were first collected in 1977. Given the small decrease in the number of people of working age, the participation rate rose from 62.2 to 63.7 per cent; all the main age groups were affected, albeit to different degrees.

At the start of the recession, unemployed persons, discouraged by the lack of jobs, preferred to exit the workforce, presumably putting off the search for work; adjusted for regional differences, higher unemployment rates were accompanied by lower participation rates. In the last two years, with the continuing recession, people of working age instead react to poorer job prospects by stepping up their search efforts: the labour supply is now growing fastest in the regions where unemployment is greatest.

The growth in labour supply and the weakness of demand drove up the average unemployment rate from 8.4 to 10.7 per cent in 2012, equal to 2,700,000 persons. The increase was again particularly sharp among those aged 15-24 (35.5 per cent, against 29.1 per cent in 2011), although it was also above 1 percentage point among persons aged over 44.

The increase, among the ranks of the unemployed, in the number of adults with previous work experience raises the problem of relocating them to other occupations and sectors, particularly in the case of construction workers, who have greater difficulty finding different work. These problems are heightened by the still unequal and limited access to active employment policies offering vocational training and re-training.

The growth in the labour supply came to a halt in the early months of this year. In March the seasonally adjusted activity rate was 63.7 per cent, compared with 64.1 per cent in the last quarter of 2012. However, the drop in employment pushed the number of unemployed almost up to the 3 million mark.

Regulation of the labour market

Law 92/2012 (the Fornero reform) provides for a structural reorganization of the main labour market regulations to achieve a more balanced distribution of job safeguards and of access to unemployment buffers and active policies for the various categories of workers, while preserving the requisite margins of flexibility in the use of labour.

Several measures rely on regulatory and economic leverage to restore the relative advantages of the different types of work contract. The use of particularly flexible forms of employment (temporary, "on-call" and casual work contracts) is limited to cases in which they effectively respond to the employer's organizational or productive requirements. In the category of quasi-employment, the use of collaboration contracts is restricted to highly skilled functions or tasks, a number of criteria defining the subordinate nature of the work are introduced by law, and the social security contributions and pay rates are gradually brought into line with those of payroll positions. In the area of fixed-term contracts, the reform abolishes the requirement to state the reason for the limited duration of the first contract, which had led to numerous disputes in the past, while increasing the mandatory interval between the stipulation of contracts with the same worker in order to discourage their recurrent use. The possibility for firms to make use of the different forms of apprenticeship has been extended, provided that a given proportion of apprentices have been taken on permanently in the preceding three years.

The introduction of tighter restrictions and higher costs for the use of flexible contracts has been accompanied by a reform of the rules governing individual dismissal to reduce the economic cost to the firm should the worker decide to appeal against the measure. Reinstatement is now only possible in specific cases and the fines for late payment of social security contributions have been abolished; alternatively, the judge can order payment of compensation up to a specified amount. The reform also seeks to reduce the costs associated with lengthy court proceedings by making it compulsory to attempt reconciliation before resorting to legal action and introducing a special procedure for disputes relating to individual dismissals.

The reform of employment contracts has been accompanied by a review of the system of unemployment buffers. When it comes fully into force, the new system of unemployment insurance (Assicurazione Sociale per l'Impiego, ASpI) will replace the previous ordinary unemployment benefits for the non-farm and construction sectors, the reduced requirement benefits and the mobility benefits, and extend the range of eligible beneficiaries. The unemployment benefit for quasi-employees introduced

under Law 191/2009, which is differently structured from the ASpI, has been made permanent.

Under the reform, a higher contribution to the ASpI is due on fixed-term contracts because they are more likely to give rise to applications for benefits. This distinction, and the introduction of a contribution in respect of dismissals of permanent employees and apprentices, means that the mechanism for funding the ASpI is now based on an experience-rating system designed to limit inappropriate use and encourage socially more efficient management of workforce turnover.

The reform reorganizes the system of extraordinary wage supplementation, which firms can still use in the event of financial difficulties, restructuring or reorganization, but which is unavailable to firms undergoing bankruptcy proceedings. Firms with 15 or more employees in the sectors outside the system are required to set up bilateral solidarity funds or to join a residual fund managed in the same way and set up under the umbrella of INPS.

Earnings, labour costs and industrial relations

The growth in actual earnings per full-time equivalent employee slowed for the second year running, from 1.3 to 1.0 per cent in nominal terms for the entire economy, the lowest rate since 1993 (Table 9.4). With consumer prices accelerating, real wages contracted more sharply than in 2011 (-1.9 per cent against -1.5 per cent); we estimate that they will remain stationary over the next two years.

In public employment, where negotiations were halted and wage increases frozen, nominal earnings were virtually unchanged in 2012 and are expected to remain so in 2013. Slower earnings growth in the private sector (down from 2.0 to 1.6 per cent) affected all branches except financial, real-estate, professional, scientific and technical occupations and was mainly due to the performance of earnings determined by national contracts, which rose by 1.5 per cent (1.8 per cent in 2011). Wage increases under industry-wide contracts signed in the course of 2012 – the most important being for the credit, food, chemicals and engineering sectors – were generally in line, adjusted for the recouping of inflation during previous contracts, with the rise in the price index. For firms in financial difficulty or to encourage new business starts-ups, some contracts allow employers, with the agreement of the trade unions, to defer the payment of single tranches of the pay rises.

In order to encourage company-level bargaining, Law 228/2012 (the 2013 Stability Law) extends to 2013-2015 the more favourable tax treatment for sums paid out in the form of productivity bonuses under collective company bargaining or local-level agreements. As of last year, such sums are also permanently eligible for reduced social security contributions (Law 92/2012).

Unit labour costs in the entire economy accelerated from growth of 0.9 per cent in 2011 to 2.0 per cent last year. Given the slowdown in nominal earnings per full-time equivalent worker, the performance of unit labour costs can be ascribed entirely to the 1.0 percentage point drop in labour productivity, against an increase of 0.4 per cent in 2011 (Table 9.4). The acceleration in unit labour costs was sharpest in industry excluding construction (from 1.5 to 3.6 per cent), where productivity turned downwards after the increases of the previous two years.

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)	Compensa-tion 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	-1.4	-2.5	1.1	3.6	3.5	2.3	67.0	1.8	1.7
2009	-15.1	-9.5	-6.2	2.9	2.7	9.5	70.1	-1.4	2.1
2010	6.0	-3.2	9.5	4.6	4.2	-4.8	68.2	6.5	3.0
2011	1.2	0.4	0.8	2.6	2.3	1.5	70.0	3.5	-0.2
2012	-3.5	-1.9	-1.6	2.1	2.0	3.6	72.3	1.6	-0.9
				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	3.3	3.4	6.0	70.4	0.1	1.4
2009	-8.4	-1.4	-7.1	4.0	3.7	11.6	73.2	-1.2	3.2
2010	-3.1	-2.3	-0.8	2.9	2.6	3.4	76.1	3.1	1.3
2011	-3.4	-2.2	-1.2	2.9	2.4	3.7	74.8	-3.0	0.1
2012	-6.3	-5.4	-1.0	2.1	1.7	2.7	73.9	-2.2	-0.9
				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	2.5	2.5	2.5	53.4	0.9	0.6
2009	-3.9	-1.5	-2.4	0.9	0.7	3.1	54.0	-1.1	0.1
2010	1.6	-0.5	2.0	2.9	2.9	0.8	54.4	2.8	1.4
2011	0.8	1.2	-0.4	1.4	1.3	1.8	54.4	-0.4	-1.4
2012	-1.2	-0.1	-1.1	1.1	1.0	2.2	54.7	-0.4	-1.8
				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	2.7	0.2
2006-2010	-0.4	-0.6	0.2	2.9	2.8	2.7	60.2	1.2	1.0
2009	-7.0	-3.7	-3.5	1.9	1.6	5.2	61.5	-0.8	1.1
2010	2.2	-1.3	3.5	3.4	3.2	-0.3	61.6	3.8	1.8
2011	0.5	0.3	0.2	2.0	1.9	1.6	61.8	0.4	-0.8
2012	-2.2	-1.3	-0.9	1.6	1.5	2.4	62.3	..	-1.4
				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	-0.4	0.1	2.7	2.7	2.5	65.0	0.9	0.8
2009	-5.6	-2.9	-2.8	1.8	1.7	4.7	66.1	-0.5	1.1
2010	1.7	-1.1	2.8	2.8	2.8	-0.1	66.2	2.9	1.2
2011	0.5	0.1	0.4	1.3	1.3	0.9	66.1	0.2	-1.5
2012	-2.0	-1.1	-1.0	1.0	1.0	2.0	66.5	-0.3	-1.9

Source: Based on Istat, national accounts.
(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.

10. THE PRODUCTIVE ECONOMY AND STRUCTURAL POLICIES

In 2012 value added diminished in almost all sectors. A comparison with the main European countries, where economic activity declined less, confirms the fragility of the Italian productive system, which has still not overcome the obstacles that were already slowing down growth in the decade before the Great Recession.

The small size of Italian firms affects the level and growth of productivity, making it more difficult for businesses to bear the costs and risks of innovation and expansion into international markets. The institutional context is not very favourable for business activity. A broad programme of structural reform has been launched to stimulate growth in the medium term. Its completion and the full implementation of the measures planned are essential to guarantee its effectiveness.

Sectoral dynamics

Value added diminished by 2 per cent in real terms in 2012, reversing the weak recovery recorded in 2010-11. The decline, common to all the main sectors, was more marked in manufacturing (-3.9 per cent) – with only food products and pharmaceuticals showing a slight improvement (0.8 and 0.2 per cent respectively) – and, in particular, in construction, which suffered its worst contraction since the start of the crisis (-6.3 per cent; Table 10.1).

Value added in services declined by 1.2 per cent, in particular as a result of difficulties in the sectors most closely linked to manufacturing, such as transport and storage (-4.7 per cent).

Since 2007, value added has contracted by 6.5 per cent. The sectors most affected are construction (down by more than 20 per cent) and manufacturing (down by 15.9 per cent). All the main segments except pharmaceuticals contributed to the decline in manufacturing. In the traditional sectors (textiles and footwear, wood and furniture), value added fell by nearly a quarter. The contraction was even more marked in refining and transport equipment (-31.9 and -26.3 per cent respectively).

In 2012 services came to 73.8 per cent of total value added, up from 70.8 per cent in 2007. Growth was buoyant in particular in financial, household and entertainment services (up by 8.8, 7.2 and 5.4 per cent respectively since 2007). Conversely the value added in agriculture fell by 5.5 per cent and its contribution came to 2 per cent of the total in 2012.

Table 10.1

Value added and labour productivity by sector of economic activity
(average annual percentage shares and changes)

	Share of total value added (1)		Value added (2)				Productivity (3)			
	2007	2012	2001-2007	2008-2012	2011	2012	2001-2007	2008-2012	2011	2012
AGRICULTURE	**2.1**	**2.0**	**-0.5**	**-1.1**	**0.2**	**-4.4**	**1.2**	**0.9**	**3.1**	**-1.0**
INDUSTRY	**27.2**	**24.2**	**1.1**	**-3.5**	**0.1**	**-4.2**	**0.3**	**-0.6**	**0.5**	**-1.2**
Industry excluding construction	20.8	18.3	0.8	-3.1	1.2	-3.5	0.8	0.1	0.8	-1.6
Mining and quarrying	0.4	0.3	-1.2	-3.8	1.1	-0.6	-1.0	-0.4	1.4	5.7
Manufacturing	18.3	15.5	0.8	-3.4	1.0	-3.9	0.8	0.0	0.7	-1.9
Food products	1.8	1.8	-0.6	-0.8	1.7	0.8	-0.9	0.3	0.1	2.1
Textiles, clothing and leather	1.9	1.4	-2.0	-4.9	-5.3	-7.5	0.8	-0.4	-5.4	-6.6
Wood, paper, and publishing	1.2	0.9	-0.3	-4.7	-1.5	-7.8	0.7	-0.6	1.8	-2.2
Coke and refined petroleum products	0.4	0.1	-4.0	-7.4	7.0	-5.9	-4.2	-5.6	8.3	-1.1
Chemical products	0.7	0.6	-0.9	-3.3	-5.0	-3.5	-0.6	-1.6	-5.2	-3.0
Pharmaceutical products	0.4	0.4	2.7	0.4	-0.6	0.2	2.8	3.0	0.5	1.8
Rubber, plastic and non-metallic mineral products	1.8	1.4	0.9	-4.3	1.6	-6.7	1.4	0.8	4.4	-1.5
Basic metals and metal products	3.3	2.7	2.7	-3.4	4.5	-3.5	1.0	0.6	3.0	-0.7
Computers, electronic and optical products	0.7	0.8	1.2	-2.2	1.5	-0.3	0.8	0.3	-0.6	-0.4
Electrical equipment	0.8	0.8	2.4	-1.8	-1.3	-3.4	1.8	1.6	-0.4	-0.7
Machinery and equipment	2.3	2.2	2.5	-2.1	6.3	-2.6	1.0	-0.5	2.2	-2.8
Transport equipment	1.1	0.8	0.5	-5.9	-2.5	-3.3	0.8	-1.2	-3.7	-2.4
Furniture, other industries, repairs and installation	1.8	1.6	1.0	-5.4	0.4	-6.4	0.2	-2.0	1.4	-5.4
Electricity, gas, steam and air conditioning	1.5	1.5	1.8	-0.3	6.9	-0.4	4.3	0.5	6.6	-0.6
Water, sewerage, waste	0.7	0.9	0.0	-1.3	-5.6	-0.2	-2.5	-2.2	-6.6	-0.3
Construction	6.3	5.9	2.5	-4.8	-3.4	-6.3	-0.4	-2.6	-1.2	-1.0
SERVICES	**70.8**	**73.8**	**1.4**	**-0.5**	**0.7**	**-1.2**	**0.1**	**-0.3**	**0.1**	**-1.0**
of which:										
Trade and repairs	*11.0*	*10.9*	*0.5*	*-1.9*	*1.2*	*-1.6*	*-0.2*	*-1.2*	*0.8*	*-0.9*
Transportation and storage	*5.5*	*5.6*	*1.4*	*-2.5*	*-0.3*	*-4.7*	*0.3*	*-1.8*	*-0.8*	*-3.0*
Hotels and restaurants	*4.1*	*4.2*	*0.4*	*0.4*	*2.5*	*0.4*	*-1.5*	*0.4*	*0.3*	*-0.2*
Information and communication	*4.5*	*4.1*	*4.4*	*-0.1*	*-1.8*	*-1.9*	*2.9*	*0.2*	*-1.4*	*-1.9*
Financial activities	*5.3*	*5.3*	*3.2*	*1.7*	*0.5*	*0.3*	*1.6*	*2.1*	*1.1*	*0.0*
Real estate activities	*12.6*	*14.1*	*1.0*	*-0.2*	*1.1*	*-0.1*	*-1.5*	*0.2*	*0.1*	*4.3*
Professional, administrative and support service activities	*8.4*	*9.0*	*1.4*	*-1.5*	*1.3*	*-1.7*	*-1.6*	*-2.4*	*-1.6*	*-2.8*
TOTAL	**100.0**	**100.0**	**1.3**	**-1.3**	**0.5**	**-2.0**	**0.3**	**-0.3**	**0.4**	**-1.0**

Source: Istat's, 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; chain-linked volumes.

Industry has been more severely affected in Italy than in the other main European countries by the prolonged crisis of the last five years: the contraction of value added in industry excluding construction has been more than twice as sharp as in the rest of the euro area, and its contribution to total value added fell to 18.3 per cent in 2012, 2.5 percentage points less than in 2007, against a fall of 0.8 percentage points in the preceding five-year period. However, within the euro area, the importance of Italy's industrial sector is second only to that of Germany.

The capacity of Italy's productive economy to increase sales and create value added has been undermined both by long-standing institutional factors that hamper start-ups and entrepreneurial activity and, more recently, by extremely sluggish domestic demand and firms' growing difficulties in obtaining credit.

Besides these external factors, business performance reflects the different strategies adopted. According to the Bank of Italy's survey of industrial and non-financial service firms with 20 or more workers, between 2010 and 2012 the firms that were more active on international markets and more innovative recorded greater growth in turnover.

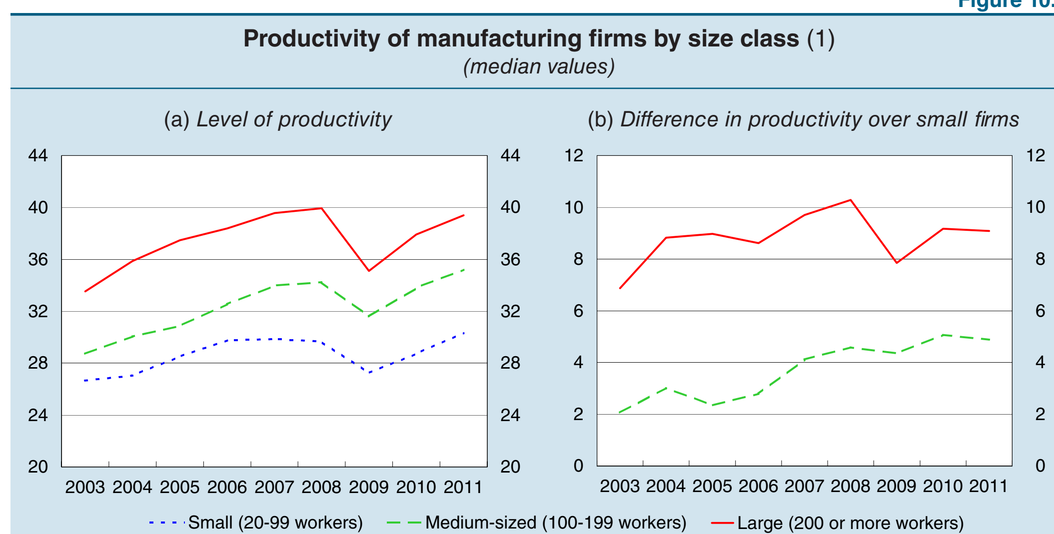
By international standards, in terms of size, there is a preponderance of small and very small firms in Italy, which adversely affects the level and growth of aggregate productivity and limits the spread of strategies promoting internationalization and innovation within the productive system.

Eurostat data for 2010 indicate that Italian manufacturing firms have a lower average number of workers than firms in the other main European countries (an average of 9.4 workers, which was 12 per cent lower than in Spain, scarcely half as many as in France and not even a third as many as in Germany). Businesses with fewer than 20 workers make up almost 93 per cent of the total, those with 250 or more just 0.3 per cent. Even within the largest size class, Italian companies are smaller than in the other European countries except Spain.

In manufacturing industry, on average in the period 2003-11, the median hourly productivity of the largest firms (200 or more workers) was 16 per cent higher than that of firms with 100-199 workers and 30 per cent higher than that of smaller firms (20-99 workers). In the last decade, the efficiency gap affecting small firms has widened (Figure 10.1).

Figure 10.1

Productivity of manufacturing firms by size class (1)
(median values)



Sources: Based on data from the Bank of Italy's *Survey of Industrial and Service Firms* and Cerved Group.
(1) Value added per hour worked, at constant prices..

The legislative and regulatory framework for business

The indicators of the quality of the institutional context for business activity – both those of the objective characteristics of regulation and its enforcement and those of the subjective perceptions of entrepreneurs – place Italy far down in the rankings, in some cases even below the emerging economies (Table 10.2).

Table 10.2

Ranking on the main institutional environment indicators

	Corruption (1)	Government effectiveness (2)	*Doing Business* (3)	
			Civil justice	Construction permits
Italy	72	72	160	103
G7 (excluding Italy)	16	20	19	33
Euro area (excluding Italy)	29	27	36	102
Southern Europe (4)	48	53	60	58
Emerging economies (4)	75	84	129	177
Number of countries	176	212	185	
Type of indicator	Perception	Perception	Characteristics of the regulations	

Sources: Based on World Bank and Transparency International data.
(1) Transparency International, Corruption Perception Index 2012. – (2) World Bank, Worldwide governance indicators 2011. – (3) World Bank, *Doing Business*, 2013. – (4) Southern Europe: Spain, Portugal and Greece; emerging economies: Brazil, Chile, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The position of the group is based on the average of individual countries' rankings.

In the last two years a vast programme of reform has been launched to create a more growth-friendly environment. At the same time, the central government and local authorities have continued, albeit with some delays, to finalize the implementing provisions on which the effectiveness of the entire programme depends.

The measures have tackled some of the main issues underlying the problem of growth in the Italian economy, such as the burden of bureaucracy on firms, the extreme slowness of civil justice, business regulations that do not encourage efficient resource allocation, and insufficient infrastructure. A more coherent set of measures would have helped operators to understand them better, thus increasing their effectiveness. The reforms also suffer from the inefficiency of general government.

Administrative simplification. – The efforts to ease the burden of bureaucracy on firms continued. The implementation of Decree Law 5/2012 (the "Simplify Italy" decree), converted into Law 35/2012, has nevertheless been delayed owing to the complexity of the reorganization process required and the highly fragmented nature of the administrative functions.

Civil justice. – In order to increase their efficiency, judicial districts across Italy have been reorganized by merging smaller offices and progress has been made in computerization. The so-called "business courts" began work in September 2012. The interventions, which aim at a higher level of specialization and at shortening work time and reducing the costs of providing the service, are in keeping with the guidelines of the international institutions.

To reduce the caseload, it was decided to filter appeals to the Court of Cassation and revise the procedure for recognizing damages caused by the excessive length of the

proceedings (the Pinto law). To ensure that these measures are effective, the problem of the backlog needs to be addressed, possibly with extraordinary provisions.

In December 2012 the Constitutional Court declared that the mandatory attempt at conciliation introduced in 2010 was unconstitutional on grounds of excessive delegation of power. Re-introducing this instrument, with suitable adjustments to avoid some of the problems of the repealed legislation, could help reduce the caseload.

Bankruptcy law. – The rules governing compositions with creditors were changed to make it easier to start proceedings, provide for an advance of the related benefits and facilitate access to credit for businesses that invoke bankruptcy protection. Making it simpler to initiate the composition process could bring company crises to light more promptly, thus increasing the chances of success of the debt restructuring and improving the recovery rate even if the composition were to fail. At the same time, however, the new rules could be used opportunistically. Empirical evidence, while showing substantial recourse to the new procedure, does not yet allow the detection of abuses. Careful monitoring of the working of the new rules and a quantitative analysis of the effects would permit the identification and resolution of problems.

Two new instruments were introduced, namely debt restructuring agreements and the liquidation of assets, in order to resolve over-indebtedness of consumers and entrepreneurs not subject to the traditional bankruptcy procedures. These interventions bring Italian law into line with that of the main EU countries. The legislation represents a sort of insurance for the debtor against the adverse effects of persistent severe indebtedness and a means of coordinating the enforcement actions undertaken by creditors. The new procedures provide safeguards to prevent opportunistic behaviour on the part of the debtor. Nevertheless the possibility of obtaining a cancellation of residual debts and the less than complete elimination of the risk of abuse could determine a reduction in the recovery rate and a tightening of the credit supply conditions offered by the banks.

Company law. – It is now possible to set up limited liability companies with share capital of just one euro: a simplified company for people under 35 years of age (Decree Law 1/2012, converted into Law 27/2012) and a reduced capital company with no age limits (Decree Law 83/2012). The measures aim to reduce the cost of starting a business, allowing interested parties to benefit from limited liability even if they have virtually no risk capital.

Under Decree Law 221/2012, a specific set of rules was created to encourage the constitution and growth of innovative firms during the start-up phase. For these businesses, some of the rules under company law can be waived during the first four years of the firm's life.

The new rules have brought about the hoped-for modernization of the law, albeit at the cost of serious fragmentation of the corpus of company law.

Prevention of corruption. – Law 190/2012 contains preventive and repressive measures, attributing to the independent authority for the evaluation, transparency and integrity of general government entities (CiVIT) the function of national anti-corruption authority. It also introduces protection for public employees who report suspected wrongdoing at their place of work (also referred to as whistleblowing). This

is the first comprehensive intervention against corruption and responds to numerous requests from international organizations. The effectiveness of the preventive measures will depend in particular on the capacity of government bodies to exploit the actions required in order to revamp their organization and culture. The law does not address some problems in the field of sanctions in relation to the statute of limitations.

Infrastructure. – The process of reform to promote the creation of infrastructure in Italy continued last year, implementing some of the measures enacted in 2011 and introducing further provisions for procedural simplification and information transparency. Some important problems persist, however, especially as regards the selection of private contractors and the excessive fragmentation of public procurement.

Specific measures were introduced to incentivate public-private partnerships, in particular tax breaks and the rationalization of the project approval procedure. The problems related to the preparation of contracts and project financing, crucial to reducing the high failure rate of initiatives, still need to be addressed.

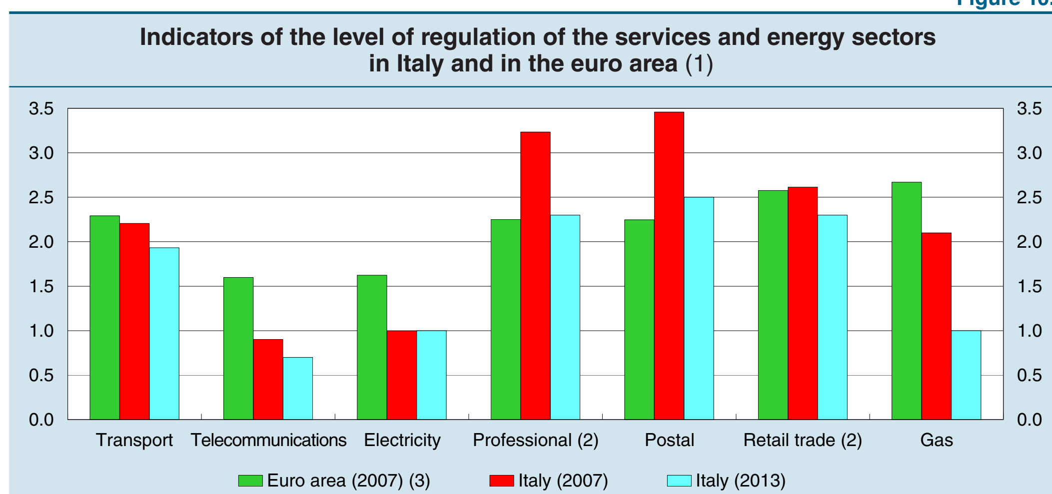
Regulation and competition in services and energy

The reforms enacted in 2012 have affected many sectors, increasing the level of competition in the markets and improving the regulatory framework. For the reforms to work their effects in full, the secondary legislation must be finalized.

The OECD indicators on the regulation of services and energy showed that in 2007 (the most recent data available) Italy had a relatively restrictive regulatory framework compared with the rest of the euro area, above all as regards postal and professional services. An assessment of what these indicators would read today, in particular following the recent reforms, appears to show an improvement, especially in the sectors where Italy had been lagging behind and in the gas sector (Figure 10.2). The macroeconomic impact of the recent liberalizations, proxied by the variation in these

Figure 10.2

Indicators of the level of regulation of the services and energy sectors in Italy and in the euro area (1)



Sources: Based on Ministry for the Economy and Finance and OECD data.
(1) The indicators range from 0 (least restrictive) to 6 (most restrictive). – (2) The latest data available for the sectors of retail trade and professional services refer to 2008. – (3) The average value for the euro area excludes, besides Italy, Cyprus and Malta, two countries for which no data are available.

indicators, can be simulated with a dynamic general equilibrium model. The estimates suggest that once the reforms are fully phased in, the level of GDP should increase by 3.5 per cent, mainly owing to an improvement in total factor productivity.

Work began last year on defining the implementing provisions for the liberalization measures introduced, in particular with Decree Law 1/2012. In some sectors, such as professional services and gas, the main regulations required were adopted. In others, such as transport and insurance, the new laws are not yet fully operative. In the same way, the process of implementing the measures to eliminate unjustified regulatory restrictions on business and to simplify the relevant bureaucratic procedures has not yet been completed.

In the second half of 2012 a judgment of the Constitutional Court and the reform of the legal profession changed the regulations governing, respectively, local public services and the legal profession, slowing the process of opening up competition.

11. INNOVATION

Innovative activity, a crucial component of economic growth, is less intense in Italy than in the leading advanced economies, above all in the private sector. R&D spending, an important measure of the resources deployed for innovation, is also lower, far from the objective of 3 per cent of GDP set by the European Commission in its Europe 2020 growth strategy. The gap in the propensity to patent is even wider.

There are several factors in this lag. Innovation is impeded, even more than by their specialization in traditional products, by firms' small size and largely family-based management model. Share capital, preferable to bank loans for financing businesses with uncertain results and pronounced information asymmetries, is less common than in other countries. The allocation of resources to the most innovative enterprises is held back by the institutional and regulatory framework.

Some 40 per cent of R&D spending is public. The scientific output of public research compares fairly well with that of other countries, even though Italian universities do not rank particularly high internationally. Despite some recent progress, public-private partnerships remain underused. Government incentives for R&D and business innovation have delivered modest results. Their effectiveness has been impaired by the piecemeal nature of interventions, regulatory instability, and uncertainty over disbursement timeframes.

Italy's innovation gap

The proportion of GDP spent on R&D is lower in Italy than in the leading European countries: in 2011 it came to 1.3 per cent, against an average of 1.9 per cent in the EU and 2.8 per cent in Germany. Private-sector spending is particularly low by international standards (0.7 per cent, compared with 1.2 and 1.9 per cent respectively), while the public-sector gap is narrower (0.5, as against 0.7 and 0.9 per cent).

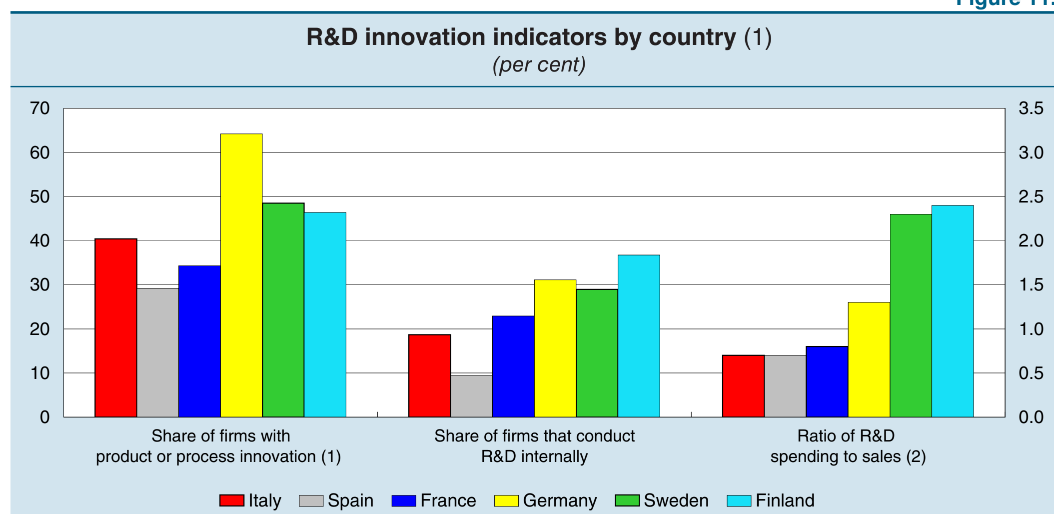
Turning to the private sector, Italy's backwardness stems both from less frequent engagement in R&D by firms and from lower spending on it. According to Eurostat's Community Innovation Survey (CIS) for the three-year period 2008-10, the share of firms that invest in R&D is 18.7 per cent, as against 22.9 per cent in France and some 30 per cent in Germany and Scandinavia (Figure 11.1). As a proportion of sales, R&D expenditure amounted to 0.7 per cent in Italy, around half as much as in Germany and less than a third as much as in Finland and Sweden.

The data on R&D expenditure may underestimate the true extent of innovation efforts, especially where small firms that frequently innovate without officially recording any outlay are predominant. In all countries, the share of firms that allocate resources to

new products and processes exceeds the share of those that invest in R&D: in Italy this reaches 40 per cent, at least on a par with the other leading countries except Germany. However, firms that realize innovations but do not conduct formal R&D activity have significantly lower patenting capacity than those that do, a smaller share of turnover from innovative products, and lower productivity. The contribution of innovative activity to firms' growth potential is accordingly diminished.

Figure 11.1

R&D innovation indicators by country (1)
(per cent)



Source: Eurostat, Community Innovation Survey, 2008-2010.
(1) Includes firms that are currently innovating or have abandoned or suspended innovation. – (2) Right-hand scale. For Germany, 2006-08 data.

In 2010, there were 7.4 applications filed with the European Patent Office for every 100,000 inhabitants in Italy, far less than in France (13.5), Germany (26.7) or Sweden (30.8). For brands – and industrial designs in particular – the gap is smaller. Overall, unlike the other main advanced countries Italy is a net importer of technology not incorporated in physical goods.

The factors responsible for Italy's innovation lag reside in several features of the private productive and financial system and in the difficulty the public sector has in creating a propitious institutional and regulatory climate for innovation and in directly supporting innovative activity.

The characteristics of the productive and financial system

Specialization. – The propensity for R&D and innovation is markedly uneven among sectors: it is strongest in technologically advanced manufacturing and lowest in the sectors where unskilled labour and low-value-added products feature more heavily.

Italy's sectoral bias towards traditional and low-tech products goes only part of the way to explaining the innovation lag in this country: if Italy had the same sectoral composition as Germany, say, the gap between the two countries in terms of the share of manufacturing firms that engage in R&D would narrow by around 10 per cent.

The level of innovation in Italy is lower in all sectors, but it varies widely among firms. According to our analyses, even within the same manufacturing sector, the firms

that are most exposed to competitors in countries where production costs are lower have done most to innovate.

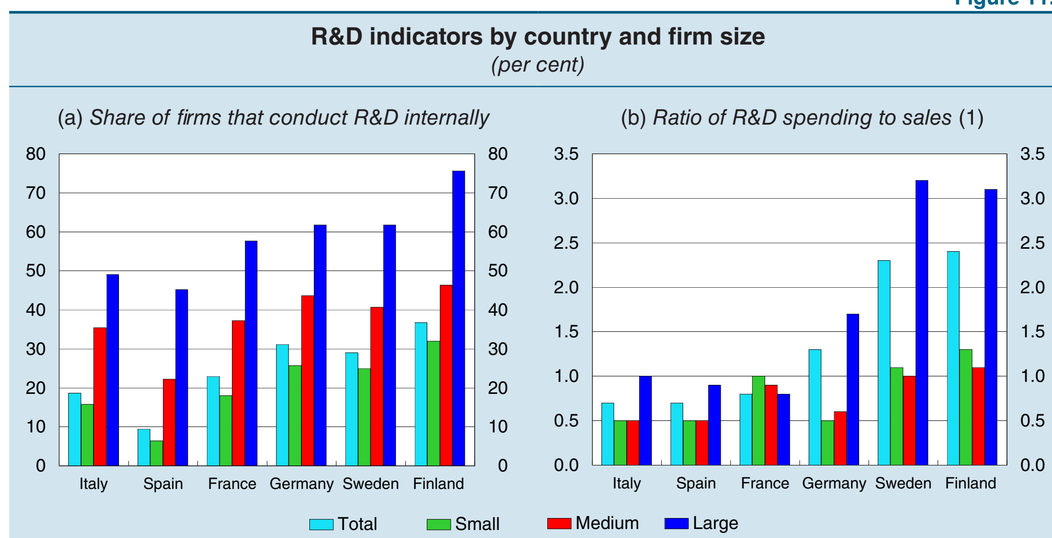
Firm size. – According to the CIS, in all the leading European countries the proportion of firms that conduct internal R&D increases with size: in Italy it is 15.8 per cent for firms with 10-49 employees, 35.4 per cent for those with 50-249 employees, and 49.1 per cent for the largest firms (Figure 11.2). As size increases, so does the share of firms having launched innovative projects, R&D spending in proportion to sales, and the capacity to reach agreements for cooperation on innovative activities with other firms and above all with universities and the public sector.

The smaller the firm, the harder it is to sustain the high fixed costs associated with starting innovative projects. The lower propensity of small and medium-sized enterprises to export further reduces the incentive to invest in innovation that stems from the possibility of spreading these costs over a larger volume of sales. It is estimated that the expansion of foreign demand has a positive effect on the patenting ability of Italian manufacturing firms, in particular the largest and most productive.

The small size of firms, a distinctive feature of the Italian manufacturing system by comparison with other countries, is a more important factor than sectoral specialization in limiting innovative activity. Almost 30 per cent of the difference between Italy and Germany in the share of manufacturing firms with R&D is attributable to the different size structure of firms.

Figure 11.2

R&D indicators by country and firm size
(per cent)



Source: Eurostat, Community Innovation Survey, 2008-2010.
(1) For Germany, 2006-08 data.

Ownership and managerial structures. – Family-run firms play a greater role in the Italian economy than in the other main European countries. Based on a survey conducted by the EFIGE research project (European Firms in a Global Economy), wholly family-owned and managed firms make up 59 per cent of the total in Italy, as against 18 per cent in France and 22 per cent in Germany. These firms have a lower-than-average propensity to engage in R&D. The essential coincidence of the firm's

capital with that of the proprietor family can lower the willingness to undertake risky projects.

A relatively old entrepreneurial class also acts as a brake on innovation: according to EFIGE the share of business owners aged over 64 is 22 per cent in Italy, as against 9 per cent in Germany and 5 per cent in France.

The financial system. – The high degree of risk and the information asymmetries associated with innovative activity mean that firms' internal resources are the primary source of financing of R&D. When firms require external financial resources, recourse to debt capital is limited by the amount of assets eligible as collateral, which is lower among innovative firms, and by moral hazard problems, stemming from the borrower's economic interest in using the funds for riskier investments than those envisaged by the lender. For banks, a firm's reputation can make up for insufficient information on its investment plans, as the importance of long-term relationships with firms shows: it is estimated that an increase in the duration of relationships from three to six years is associated with a better than 10 per cent increase in the likelihood of conducting R&D.

Share capital, by contrast, does not require guarantees and enables investors to benefit in full from the returns on successful innovative projects. The problem of information asymmetries is often resolved by the active presence in firms of venture capital intermediaries – investors that provide early-stage financing as well as consulting for firms in high growth potential sectors – or "business angels", private investors operating on a smaller scale with respect to venture capital funds. A good many empirical studies show how recourse to equity capital considerably increases the innovative activity of firms; for Italy, the issue of shares is found to increase the probability of R&D being conducted by around one third.

According to EFIGE, in all the major European countries over 80 per cent of R&D spending by firms is internally funded. In Italy and in France the second biggest source of financing is bank debt (slightly less than 10 per cent of R&D spending), whereas in Germany and the United Kingdom, this proportion is much lower (around 3 and 1 per cent respectively) and share capital plays a more important role.

New firms, which are often those that introduce the most radical innovations, cannot rely on long-term relationships with banking intermediaries and have greater need of external venture capital. Accordingly they suffer from the underdevelopment of the venture capital sector in Italy: the share of R&D spending financed with venture capital is 0.1 per cent, as against 0.3 per cent in France and Germany and 0.4 per cent in the United Kingdom. The business angels sector has experienced rapid growth in Italy in recent years, but an OECD study finds that the number of business angel networks is still low by international standards.

Demand and supply factors have slowed the spread of venture capital. In order to favour recourse to equity capital, since 2011 firms have been able to deduct from their income an amount equal to the return on their new share capital, currently set at 3 per cent (Decree Law 201/2011, ratified by Law 214/2011). In 2011 and 2012 tax incentives were introduced for investors in venture capital funds and in the risk capital of innovative start-ups, aligning Italian law more closely to that of the other European countries.

The role of the public sector

Regulation. – The OECD estimates that the most innovative firms tend to grow less in countries where the regulation of the business services sector is more restrictive, the legal system is more inefficient, and bankruptcy laws carry heavier penalties for firms. It is plausible that all these factors diminish innovation in Italy.

Overly restrictive regulation of the labour market can curb innovation both by hampering the redistribution of resources and by discouraging increases in production by firms that intend to undertake innovative projects, with potentially high but uncertain returns. On the other hand, stable employment relationships can strengthen incentives to build up human capital, both for firms and workers.

In Italy there is a negative correlation between the share of temporary workers in a firm's workforce, on the one hand, and the probability of taking out patents and the number of patents per firm, on the other. It is also estimated that following the adoption of Law 30/2003, (the Biagi Law), which facilitated apprenticeship contracts – longer-term than other fixed-term arrangements, with vocational training objectives, aimed primarily at young people – the number of apprentices has increased in firms in the more patent-intensive sectors, to the benefit of the number of patents and R&D spending.

Human capital supply. – In Italy the share of university graduates in the workforce is considerably lower than in the other main European countries. This may reflect a shortage of highly-educated workers, or demand that continues to favour less skilled work. Estimating a structural econometric model on data taken from sample surveys of firms and households, it can be shown that human capital supply factors outweighed demand, holding sectoral composition constant. This is confirmed by the high percentage of firms for which the shortage of skilled workers constitutes one of the main obstacles to innovation – 40 per cent according to the Bank of Italy's Survey of Industrial and Service Firms with 20 or more employees.

Public research and technology transfers. – A little over 40 per cent of R&D spending is made by the public sector (universities and public research centres). According to the available indicators, the scientific output of the Italian public research system is close to that of other major European countries, both in quantity and quality.

The institutional structure governing the public research system reflects the preponderant role of the State in policymaking and funding. However, the possibility for the numerous public research entities to undertake projects independently and the lack of any stringent coordination poses the risk of duplication and dispersion. The effectiveness of the public research system is also impaired by the limited use of results-based criteria for allocating financial resources among projects and actors (public research bodies and universities). According to the Ministry for Education, Universities and Research, in 2012 the results-based portion of the ordinary fund for research bodies and institutions was 7 per cent; for universities, the performance-based share of the ordinary fund was 13 per cent.

Public research provides only limited support to innovation in the private productive system. The CIS shows that the share of innovative firms that have cooperated

with public institutions (universities or other public entities) to conduct innovative activity is 7.6 per cent in Italy, less than in France (22.9 per cent), Germany (19.7 per cent) and Spain (16.5 per cent). The gap persists even among the largest firms. Our analyses indicate that proximity to universities of excellence favours cooperation with the university system, in particular for small and medium-sized enterprises.

Public demand for innovation. – In the Europe 2020 strategy, the public procurement of innovative products and R&D services has become a pillar of European policies for innovation. For the provision of R&D services, the pre-commercial procedure for public tenders is activated when the contracting authority's requirements are so technologically complex that they cannot be met through the acquisition of existing goods and services. One of the underlying reasons for the pre-commercial procedure is the distribution of risk and potential benefits among the contracting authority and participating firms. Acquisition policies geared towards innovation can also facilitate the identification of appropriate solutions for the provision of public services and innovative infrastructures, an area where Italy lags behind other countries.

According to Eurostat data public sector expenditure on supplies in 2010 amounted to 16.2 per cent of GDP in Italy. Decree Law 179/2012 promotes the pre-commercial procedure for public tenders as one of the instruments available to the Ministry for Education, Universities and Research for furthering industrial research. The decree law envisages its use as part of a plan to promote major research and innovation projects in connection with the realization of the Digital Agenda; it also establishes that Italy's dedicated Digital Agency shall conduct an annual review of general government to identify problems of special social or environmental relevance that the products, services and technologies already on the market cannot resolve. Some pilot projects have been launched in Lombardy, Puglia and Valle d'Aosta.

Policies to support R&D and innovation in the private sector. – Most of the advanced economies have public policies to support R&D and innovation by private firms: tax breaks or subsidies that directly lower the costs of investment in innovation and other measures to favour the birth of innovative firms and the development of technology clusters in selected geographical areas.

The public resources that Italy allocates to the promotion of innovative activity by firms are less than in the other main European countries. According to the European Commission's State Aid Scoreboard, resources for R&D and innovation in Italy amounted to 0.03 per cent of GDP in 2011, compared with 0.05 in the United Kingdom, an average of 0.08 in the EU, 0.09 in Spain, 0.10 in France and 0.12 in Germany. In Italy these resources are distributed among a relatively high number of beneficiary firms, categories of intervention and national and regional decision-making centres.

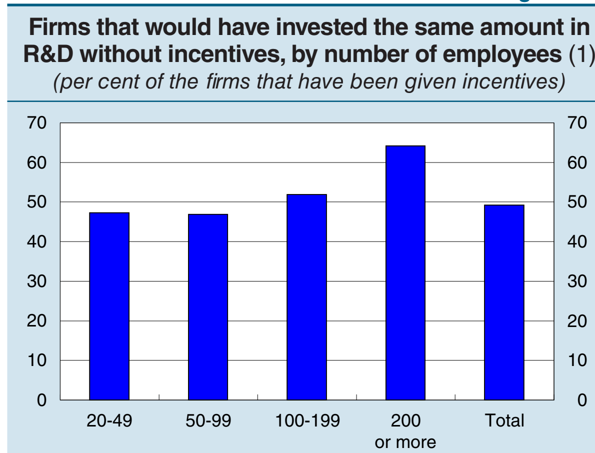
In 2012 work began to reorder, rationalize and rethink national programmes of incentives to firms, not only for research and innovation. The measures included the abrogation of some rules, the simplification of procedures and the reformulation of previous legislation.

Apart from the administrative and operational costs, incentives, if not properly designed, may fail to trigger the desired additional investment and can produce

distortions in the allocation of resources. According to the Survey of Industrial and Service Firms, around half of the industrial firms that received public aid for R&D in the three years from 2009-11 declared that they would have spent at least the same amount even without assistance (Figure 11.3). The rare empirical assessments of the effects of State aid on R&D and innovation in Italy suggest that the programmes are only moderately effective overall and appear to have been more useful in sustaining innovative activity among smaller-sized firms, those that are likely to encounter greater difficulties in accessing external financing.

Figure 11.3

Firms that would have invested the same amount in R&D without incentives, by number of employees (1)
(per cent of the firms that have been given incentives)



Source: Banca d'Italia, *Survey of Industrial and Service Firms*.
(1) Industrial firms excluding construction; data for 2009-11.

Business incubators, which in Italy are primarily public, can help to create and develop innovative start-ups. Decree Law 179/2012 provides explicit support for such incubators. In the last twenty years various measures have been taken in Italy to strengthen innovative activity through the creation and development of technology clusters, inspired in part by the experiences of voluntary agglomerations of high-tech firms. The interventions, which have benefited from public funding, aim to activate synergies among research centres, universities and private enterprises in certain geographical areas; they include policies for technology districts and science and technology parks. Analyses of the main balance-sheet items and the propensity to patent show how, overall, the "best" firms are the ones that opt to locate in a district or park; however, the competitive advantages of these firms with respect to similar ones located elsewhere do not seem to increase significantly following their entry into the cluster.

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

In 2012 the deficit on the current account of Italy's balance of payments narrowed from 3.1 to 0.5 per cent of GDP, the lowest level since 2004. The large adjustment, which was achieved despite the slight deterioration in the energy balance, reflected the resilience of exports and the reduction in imports due to weak domestic demand. The result for the current account plus the capital account was virtually in balance.

Following substantial disposals of Italian government securities by foreign investors in the first quarter of last year, the financial account showed a resumption of net inflows thanks to the easing of sovereign debt tensions. The Bank of Italy's deficit in TARGET2 increased in the first half of the year but improved significantly from September on.

Italy's net external debtor position was again modest in relation to GDP. The slight deterioration with respect to the previous year was due almost entirely to the increase in the market prices of Italian government securities, which entailed a revaluation of the public sector's foreign liabilities.

The current and capital accounts

The current account. – Italy's external current account, which had deteriorated continuously since the beginning of the millennium, improved significantly in 2012, the deficit declining to €8.4 billion (0.5 per cent of GDP) from €48.3 billion the previous year (Table 12.1). A current account adjustment of 2.6 percentage points of GDP in the space of just one year is without precedent in recent years and is only comparable to the 3.2 point improvement recorded in 1993, after the devaluation of the lira.

Merchandise trade. – The *fob-fob* merchandise trade balance returned to a surplus (1.1 per cent of GDP, from a deficit of the same magnitude in 2011). The improvement was attributable to the non-energy component, the surplus on which almost doubled to 5.1 per cent of GDP, the highest level since the introduction of the euro. By contrast, the increase in the euro prices of oil caused a further slight deterioration in the energy deficit, which reached 3.9 per cent of GDP, the highest level since the beginning of the 1990s.

The growth in Italian merchandise exports in value terms slowed from 11.4 to 3.7 per cent, reflecting the performance of world trade. Exports, which also benefited from improved price competitiveness, were boosted by demand from countries outside the European Union, while intra-EU exports diminished, reflecting the weakness of demand in the euro area.

Table 12.1

Balance of payments (1)
(billion euros)

	2008	2009	2010	2011	2012
Current account	**-44.9**	**-30.2**	**-54.5**	**-48.3**	**-8.4**
Goods	-2.1	0.8	-20.9	-17.4	17.8
Non-energy products (2)	55.3	41.5	29.5	42.4	79.4
Energy products (2)	-57.5	-40.7	-50.4	-59.7	-61.6
Services	-8.6	-8.4	-9.2	-5.7	-0.7
Income	-19.4	-10.4	-8.3	-9.4	-10.1
Transfers	-14.8	-12.2	-16.1	-15.8	-15.5
of which: EU institutions	*-9.9*	*-7.0*	*-10.1*	*-10.4*	*-9.6*
Capital account	**-0.2**	**-0.1**	**-0.6**	**0.6**	**3.8**
Intangible assets	-1.0	-0.6	-0.7	-0.4	1.7
Transfers	0.9	0.5	0.2	1.1	2.1
of which: EU institutions	*2.2*	*1.6*	*1.5*	*2.7*	*3.2*
Financial account	**31.4**	**37.3**	**86.7**	**72.8**	**7.7**
Direct investment	-53.1	-0.9	-17.7	-13.9	-10.7
Outward	-45.7	-15.3	-24.7	-38.6	-23.2
Inward	-7.4	14.5	6.9	24.7	12.5
Portfolio investment	75.2	28.1	38.5	-34.4	29.2
Equity and investment funds	61.9	2.6	-37.9	8.9	0.8
Debt securities	13.3	25.5	76.4	-43.3	28.4
Financial derivatives	1.9	4.3	-4.7	7.5	-0.4
Other investment	13.0	5.7	71.8	114.5	-9.0
of which: monetary financial institutions (3)	*-18.5*	*-2.4*	*8.3*	*-73.2*	*-58.7*
Change in reserve assets (4)	-5.6	0.1	-1.0	-0.9	-1.5
Errors and omissions	**13.7**	**-7.1**	**-31.7**	**-25.2**	**-3.1**

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

The performance of exports differed across product sectors. Fairly strong growth was recorded for metals (which account for almost 13 per cent of total exports and were driven by trade in gold), pharmaceuticals and refined oil products. There was also a significant rise in exports of food and leather products (notably handbags, leather goods and luggage), continuing the favourable trend of recent years. In the majority of the other traditional sectors and in machinery and equipment the rate of growth was below average, while in some sectors (textiles, transport equipment, household appliances and other electrical goods, and electronics) exports actually decreased.

In value terms Italian merchandise exports accounted for 2.7 per cent of world trade in 2012, down from 2.9 per cent in each of the two previous years. At constant prices and exchange rates, the share has remained unchanged in the last three years at 3.1 per cent.

Imports *fob* decreased in value by 5.4 per cent (1.2 percentage points of GDP), reflecting the persistent weakness of economic activity and especially the sharp contraction in investment and household consumption. According to foreign trade data, the decline affected mainly imports of capital goods and intermediate inputs.

Purchases of motor vehicles returned to 1993 levels as a share of GDP; the 0.4 point decline recorded in 2012 was part of a downward trend under way for the past five years not only in Italy but also in the other leading euro-area countries, although it has been less marked in Germany and France. Among intermediate inputs, imports of photovoltaic cells, which had benefited greatly from tax incentives for two years, decreased by 0.3 percentage points of GDP.

The improvement in the trade balance was the result of surpluses both with the other EU countries (€10.4 billion compared with a deficit of €2.7 billion in 2011) and with non-EU countries (€7.5 billion against -€14.7 billion). The deficit with Germany was halved owing to the drop in imports of motor vehicles, photovoltaic cells and machinery and equipment. Regarding the non-EU countries, the increase in the trade surplus with the United States was fostered by the euro's depreciation against the dollar and the growth in US domestic demand. The trade balance with China, with which Italy has its widest bilateral deficit, also improved.

Services. – After narrowing again sharply with respect to the peak recorded in 2010, the deficit on services was almost wiped out in 2012, falling from €5.7 billion to €0.7 billion.

The surplus on travel increased further, to €11.5 billion, benefiting as in the previous year from increased receipts and substantially stationary outlays. The annual growth in receipts at current prices declined from 5.6 to 3.8 per cent, owing to the slowdown in tourist flows from Germany and France and the decrease in those from Spain and the other countries hardest hit by the recession. Tourist receipts from countries outside the EU accelerated thanks to the contribution of US and Russian visitors.

Italian travellers' spending abroad fell by 0.3 per cent last year, compared with an increase of 0.8 per cent in 2011. The decrease in spending on vacations (-12.4 per cent), tied to the drop in household consumption, was almost entirely offset by the growth in spending on business travel and on trips for *other personal reasons*, which include study trips and *visits to friends and relatives*.

The deficit on transport services decreased to €8.1 billion as a consequence of the decline in merchandise imports. With freight rates stable on average, the contraction in the volume of purchases helped to bring down spending on transport services.

The deficit on services other than transport and travel decreased from €7.3 billion in 2011 to €4.2 billion, continuing the previous year's improvement. As in 2011 imports stagnated, while exports were boosted by royalties and licences, financial and insurance services and above all *other business services*. Within the latter item, architectural, engineering and other technical services, research and development, and services between affiliated firms performed fairly well.

Income. – The deficit on the income account was basically unchanged in 2012 at €10.1 billion, against €9.4 billion in 2011. For portfolio investment, which accounted for almost all of the deficit on investment income, there was a reduction in both inflows and outflows, reflecting the decrease in foreign assets and liabilities in the last two years. Direct investment income also declined owing to the contraction in firms' profits. By contrast, the surplus on labour income increased by €1.1 billion thanks to the larger receipts of cross-border workers and a reduction in outflows to non-resident workers.

Transfers. – The deficit recorded under current transfers was virtually stationary with respect to 2011 at €15.5 billion. Workers' remittances abroad, which almost doubled between 2005 and 2011 with the large rise in the number of foreigners, fell to €6.8 billion, compared with €7.4 billion in the previous year. Contributory factors were the decline in the employment rate among foreign workers and the recession in Italy.

Capital account. – The surplus on capital account rose to €3.8 billion (from €0.6 billion in 2011), mainly owing to the improvement in the balance on intangible assets, which benefited from the export of carbon emission rights. The surplus on capital account vis-à-vis the EU institutions amounted to €3.2 billion.

The financial account

In 2012 the financial account recorded net inflows worth €7.7 billion, which financed the deficit in current and capital account to the tune of €4.6 billion; the residual item *errors and omissions* amounted to -€3.1 billion, which is extremely low by historical standards.

Direct investment. – After picking up in the previous two years, Italian direct investment abroad declined to €23.2 billion, compared with €38.6 billion in 2011. The contraction was sharpest in the category of non-bank intra-group loans, which had recorded particularly large outflows the year before. Equity investment, instead, was unchanged with respect to 2011: slack M&A activity abroad was offset by sizeable capital increases for foreign subsidiaries, particularly in the energy sector. Inward direct investment also decreased, from €24.7 billion to €12.5 billion, reflecting market uncertainty; signs of a recovery only appeared towards the end of the year. Overall, the balance of direct investment recorded net outflows of €10.7 billion in 2012.

Portfolio investment. – In 2012 the balance of portfolio investment returned to register net inflows (€29.2 billion). Large disposals of foreign securities by Italian residents (€61.5 billion) more than offset those of Italian securities by international investors (€32.3 billion).

Continuing the trend that began in 2011 with the worsening of the sovereign debt crisis, residents – notably households, banks and insurance companies – greatly scaled back their exposure in foreign debt instruments, reflecting the shift of portfolio composition towards Italian securities and, in the case of households, the reduction in holdings of debt securities. Disposals, for the most part consisting in the non-renewal of securities maturing during the year, were mainly of bonds issued by banks and other financial intermediaries and of government securities of the leading euro-area countries. There was an increase in purchases of equities and investment fund units, partly due to households' growing preference for foreign funds over Italian ones.

The large disposals of Italian government securities by non-residents that had begun in the middle of 2011 continued through the first quarter of 2012. Purchases of government securities picked up from the summer onwards, including for medium- and long-term maturities, as financial market conditions slowly improved in response to the measures taken by the Eurosystem and to the narrowing of interest rate spreads

on Italian government securities. Foreign investors showed renewed interest also in equities and corporate bonds. Over the year as a whole, net investments in equities amounted to €16.1 billion; net disposals of debt instruments totalled €48.4 billion but, excluding the first quarter of the year, there were net purchases for €12.3 billion. At the beginning of this year non-residents continued to increase their exposure in Italian portfolio securities (€17.9 billion in the first quarter).

Table 12.2

Net international investment position
(billion euros)

	Stocks at end-2010 (1)	January-December 2012					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	1,180.7	25.4	55.4	-3.2	58.6	80.8	1,261.6
Direct investment	333.3	21.3	5.9	-0.2	6.1	27.2	360.5
Portfolio investment	642.5	-28.5	50.3	-2.0	52.3	21.7	664.3
of which: equity and investment funds	*305.4*	*18.3*	*32.0*	*-1.5*	*33.5*	*50.3*	*355.7*
Other investment	181.6	32.8	-1.0	-1.0	..	31.7	213.4
Derivatives	23.3	-0.1	0.2	..	0.2	0.2	23.4
Liabilities	1,290.9	5.2	89.9	-1.6	91.5	95.1	1,386.0
Direct investment	242.3	9.9	3.2	-0.1	3.2	13.1	255.4
Portfolio investment	900.4	-25.2	86.9	-0.9	87.8	61.7	962.0
of which: equity and investment funds	*97.9*	*9.6*	*11.3*	*..*	*11.3*	*20.9*	*118.8*
Other investment	121.2	19.9	..	-0.6	0.6	19.9	141.1
Derivatives	27.0	0.5	-0.1	..	-0.1	0.4	27.4
Net position	**-110.2**	**20.3**	**-34.5**	**-1.6**	**-32.9**	**-14.2**	**-124.4**
				Resident banks			
Assets	492.6	-18.1	14.7	-0.5	15.1	-3.5	489.1
Liabilities	728.5	-60.3	41.9	-0.4	42.3	-18.4	710.1
Net position	**-235.9**	**42.2**	**-27.3**	**-0.1**	**-27.2**	**14.9**	**-221.0**
				Central bank			
Assets	214.0	-8.1	7.9	-1.2	9.1	-0.2	213.8
Liabilities	194.1	62.0	..	..	..	62.0	256.1
Net position	**19.9**	**-70.1**	**7.9**	**-1.2**	**9.1**	**-62.2**	**-42.3**
				All sectors			
Total assets	1,887.3	-0.8	78.0	-4.8	82.8	77.2	1,964.5
Total liabilities	2,213.5	6.9	131.9	-1.9	133.8	138.7	2,352.2
Total net position	**-326.2**	**-7.7**	**-53.9**	**-2.9**	**-51.0**	**-61.6**	**-387.8**

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

Other investment. – The balance on *other investment* relating to the banking sector saw a net outflow of €58.7 billion, largely due to the decrease in foreign liabilities. Contributory factors were the funding difficulties on the international interbank market and the reduction in intra-group loans to Italian branches of foreign banks in connection with the policies enacted to balance assets and liabilities on a national basis. Under *other investment*, attributable to the Bank of Italy, there was a net inflow of €62.6 billion (compared with €194.8 billion in 2011) in relation to the TARGET2 balance. After deteriorating sharply in the first quarter, the Bank of Italy's debit balance in the system stabilized before improving significantly from September on. At the end of April 2013 the deficit was €242 billion, €47 billion less than the peak figure recorded in August 2011.

The net international investment position

At the end of 2012, Italy's net external debtor position amounted to €387.8 billion, or 24.8 per cent of GDP, compared with €326.2 billion in 2011 (Table 12.2). The increase, only a small part of which was attributable to the modest inflows in the financial account (€7.7 billion), reflects above all the negative contribution of valuation adjustments (€53.9 billion). The latter stemmed largely from the decline in the yields on Italian government securities, which caused an increase in the market value of the public sector's foreign liabilities.

Italy's net debtor position is slightly worse than that of France (15.9 per cent of GDP) but smaller than that of the United Kingdom (35.3 per cent) and especially compared with Greece, Ireland, Portugal and Spain, whose net foreign liabilities represent between 90 and 120 per cent of GDP.

13. THE PUBLIC FINANCES

General government net borrowing decreased in 2012 for the third successive year, reaching 3.0 per cent of GDP and thus permitting the closure of the excessive deficit procedure against Italy. Excluding interest payments, there was a surplus of 2.5 per cent, a level close to that of Germany. In the other euro-area countries the deficit was equal to 3.1 per cent on average. The improvement in the Italian accounts reflects the corrective measures introduced in the three years 2010-12, which brought a large increase in revenue in relation to GDP and, for the third successive year, a decrease in primary expenditure in nominal terms.

For 2013, despite the protraction of the recession and the temporary effects on the deficit of the measures adopted to accelerate the payment of general government commercial debts, the Economy and Finance Document (EFD) forecasts a small decrease in net borrowing to 2.9 per cent of GDP, a figure confirmed by the recent estimates of the European Commission. The primary surplus is expected to stay at its 2012 level. Tax revenue and social security contributions are forecast to rise to 44.4 per cent of GDP, a new high, and primary expenditure to start rising again, albeit at a modest pace. On a structural basis the budget will be in balance, in line with the undertaking entered into at European level. The ratio of debt to GDP will continue to rise, driven up by the modest growth in nominal GDP, the disbursements to support euro-area countries in difficulty, and the outlays for the payment of commercial debts. The results for the first four months of this year show that the public finances will need to be monitored carefully in the coming months.

It is expected that the structural budget balance will continue to improve in 2014; subsequently, in the absence of adjustment measures, there would be a gradual deterioration owing to the acceleration of expenditure. Compliance with the balanced budget rule will require adjustment measures from 2015 onwards that the EFD estimates at 0.2 per cent of GDP per year for three years. The ratio of debt to GDP is expected to come down from 2014 onwards, thanks in part to privatization receipts equal to about 1 percentage point of GDP per year. The European Commission's scenario for the public finances is less favourable: the structural deficit is expected to grow slightly in 2014.

The implementing provisions of the constitutional law enacting the balanced structural budget rule will enter into force on 1 January 2014. Priority must continue to be given to revising expenditure and reinforcing the fight against tax evasion, to permit a lasting reduction in today's high rates of taxation.

THE PUBLIC FINANCES IN 2012

Budgetary policy for 2012: objectives and results

The objective for net borrowing in 2012 that was set in September 2009 and confirmed in April 2011 was 2.7 per cent of GDP (Table 13.1), in line with the commitments entered into at European level following the start of the excessive deficit procedure against Italy at the end of 2009. In the second half of 2011, with sovereign debt market tensions increasing and macroeconomic conditions deteriorating, more ambitious objectives were established and three sets of exceptionally large adjustment measures adopted.

Table 13.1

Public finance objectives, estimates and outturn for the year 2012
(billion euros and per cent of GDP)

	General government				*Memorandum items*		
	Net borrowing	Primary surplus	Interest payments	Debt (1)	Real GDP growth rate (%)	Nominal GDP	Net borrowing 2011
Objectives							
Economy and Finance Document for 2011 (EFD 2011) (April 2011) (2)	44.9	39.2	84.0	….	1.3	1,642.4	61.9
per cent of GDP	*2.7*	*2.4*	*5.1*	*119.4*			*3.9*
EFD 2011 Update (September 2011)	25.3	60.5	85.8	….	0.6	1,622.4	61.7
per cent of GDP	*1.6*	*3.7*	*5.3*	*119.5*			*3.9*
Report to Parliament 2011 (December 2011) (3)	….	….	….	….	-0.4	1,612.3	60.9
per cent of GDP	*1.2*	*4.6*	*5.8*	*120.1*			*3.8*
Estimates released in 2012							
EFD 2012 (April 2012) (2)	27.2	57.0	84.2	1,959.6	-1.2	1,588.7	62.4
per cent of GDP	*1.7*	*3.6*	*5.3*	*123.4*			*3.9*
EFD 2012 Update (September 2012)	41.2	44.9	86.1	….	-2.4	1,564.4	62.4
per cent of GDP	*2.6*	*2.9*	*5.5*	*126.4*			*3.9*
Outturn (4)	**47.6**	**39.1**	**86.7**	**1,988.7**	**-2.4**	**1,565.9**	**60.0**
per cent of GDP	*3.0*	*2.5*	*5.5*	*127.0*			*3.8*

(1) The estimates and objectives given in the official documents are not fully consistent, as the treatment of the effects of financial support to EMU countries in difficulty and Italy's contribution to the European Stability Mechanism is not uniform. – (2) The EFD includes the Stability Programme. – (3) Data underlying the Report to Parliament 2011. These data, except for GDP, were published in EFD 2012. – (4) Sources: Istat and, for the debt, Bank of Italy.

In September 2011 the EFD 2011 Update, which included the effects of the first two adjustments referred to above, lowered the estimate of net borrowing in 2012 to

1.6 per cent of GDP. The Report to Parliament 2011, published in December, took account of the third adjustment as well and indicated a deficit of 1.2 per cent of GDP.

In total it was officially estimated that the measures enacted in the second half of 2011 would reduce net borrowing in 2012 by 3.1 percentage points of GDP. More than three quarters of the overall adjustment came from revenue measures, which mainly concerned indirect taxes, especially VAT, property taxes, excise duties and the stamp duty on financial instruments. The adjustments can be estimated to have reduced the growth in GDP by 1 percentage point in 2012.

The EFD published in April 2012 increased projected net borrowing to 1.7 per cent of GDP, primarily owing to the larger contraction in GDP than had been forecast in December (1.2 per cent, as against 0.4 per cent). The Government also launched a review of expenditure and in July issued a spending review decree law identifying some possible savings that would permit reductions in revenue with no change in the balance.

The unfavourable trend of macroeconomic prospects entailed a further worsening of the public finance estimates: in September 2012 the EFD Update raised net borrowing to 2.6 per cent of GDP and lowered the primary surplus to 2.9 per cent.

The outturn for net borrowing in 2012 was 3.0 per cent of GDP, a decrease of 0.8 percentage points on the figure for 2011 (Table 13.2); the time limit set at European level for eliminating Italy's excessive deficit was thus respected. The gap of 0.4 points with respect to the estimate made in September was due to the lower-than-expected level of revenue. The primary surplus grew by 1.3 points to 2.5 per cent of GDP, since revenue increased in relation to GDP, while primary expenditure remained basically stable (Figure 13.1).

Table 13.2

Main indicators of the general government finances (1)
(per cent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Revenue	44.7	44.3	43.9	45.5	46.5	46.5	47.0	46.6	46.6	48.1
Expenditure (2)	48.4	47.8	48.3	49.0	48.2	49.2	52.5	51.1	50.4	51.2
of which: interest payments	*5.1*	*4.7*	*4.6*	*4.6*	*5.0*	*5.2*	*4.7*	*4.6*	*5.0*	*5.5*
Primary surplus	1.5	1.2	0.2	1.2	3.4	2.5	-0.8	0.1	1.2	2.5
Net borrowing	3.6	3.5	4.4	3.4	1.6	2.7	5.5	4.5	3.8	3.0
Total borrowing requirement	3.0	3.6	5.0	3.9	1.7	3.2	5.7	4.5	4.0	4.2
Borrowing requirement net of privatization receipts	4.3	4.2	5.3	3.9	1.9	3.2	5.8	4.5	4.1	4.7
Debt	104.1	103.7	105.7	106.3	103.3	106.1	116.4	119.3	120.8	127.0
Debt net of the financial support given to EMU countries (3)	104.1	103.7	105.7	106.3	103.3	106.1	116.4	119.0	120.0	124.3

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. – (3) Net of direct loans to Greece, Italy's share of loans granted via the European Financial Stability Facility and its contribution to the capital of the European Stability Mechanism.

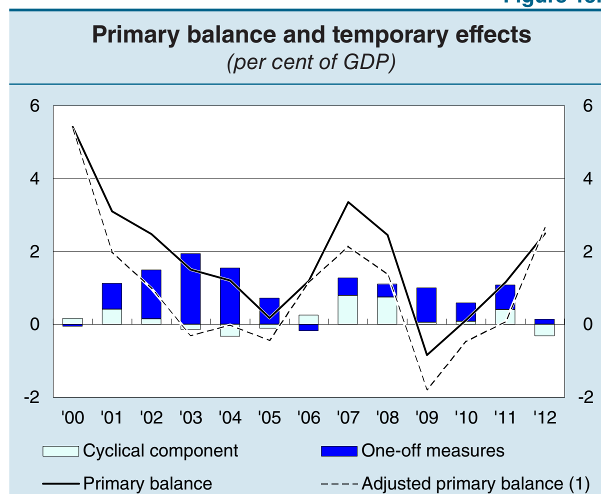
General government revenue and expenditure

Revenue. – General government revenue increased by 2.4 per cent or €17.4 billion in 2012, buoyed by the effects of the 2011 and 2012 budgets. Not counting the

additional revenue attributable to these measures (about €31 billion), revenue diminished by about 2 per cent, whereas nominal GDP contracted by 0.8 per cent.

Figure 13.1

Primary balance and temporary effects
(per cent of GDP)



(1) Adjusted for the effects of the economic cycle and one-off measures; per cent of trend GDP.

The measures introduced in 2011 and 2012 were officially estimated to increase revenue between 2011 and 2012 by about €34 billion, of which nearly one third was to come from the early entry into force of the new municipal property tax (IMU) and about €11 billion from the broadening of the property tax base. The effect of the municipal property tax measures was about €2 billion more than originally estimated, primarily owing to the discretionary rate increases that were made by municipalities but had not been included in the original estimates. By contrast, the revenue produced by the stamp duty measures was about €2.5 billion less than expected (considering both the stamp duty on financial assets reported under the foreign asset disclosure scheme and that connected with financial intermediaries' periodic notifications to customers). Lastly, the loss of revenue connected with the possibility for firms, subject to some conditions, to convert a part of their accrued tax assets into tax credits was larger than originally expected (more than €2.5 billion, compared with an original estimate of next to nothing).

Tax revenue and social security contributions rose from 42.6 to 44.0 per cent of GDP (Table 13.3), almost 3 percentage points more than the average of the other euro-area countries.

Table 13.3

General government revenue (1)
per cent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Direct taxes	13.3	13.3	13.2	14.3	15.0	15.2	14.6	14.6	14.3	15.1
Indirect taxes	13.9	14.0	14.1	14.8	14.6	13.7	13.6	14.0	14.1	14.9
Capital taxes	1.3	0.6	0.1	0.0	0.0	0.0	0.8	0.2	0.4	0.1
Tax revenue	**28.6**	**27.8**	**27.5**	**29.1**	**29.6**	**28.9**	**29.0**	**28.8**	**28.8**	**30.2**
Social security contributions	12.5	12.6	12.6	12.6	13.1	13.7	14.0	13.8	13.7	13.8
Tax revenue and social security contributions	**41.0**	**40.4**	**40.1**	**41.7**	**42.7**	**42.6**	**43.0**	**42.6**	**42.6**	**44.0**
Other current revenue	3.4	3.6	3.5	3.6	3.5	3.6	3.8	3.8	3.8	3.8
Other capital revenue	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.3	0.3
Total revenue	**44.7**	**44.3**	**43.9**	**45.5**	**46.5**	**46.5**	**47.0**	**46.6**	**46.6**	**48.1**

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

Receipts of social security contributions remained basically stable, while tax revenue rose by 5.1 per cent or €22.8 billion, with direct and indirect tax receipts growing at much the same pace. Capital tax receipts fell from €7.0 to €1.4 billion owing to the lapsing of the one-off revenue from the substitute tax on real-estate leasing (€1.3 billion in 2011) and the near-elimination of the revenue from the substitute tax on the alignment of fiscal and book values, which fell from €5.1 billion to €0.6 billion.

The increase of €11.3 billion in direct taxes came primarily from the growth in personal income tax, the increases in the regional personal income surtax introduced by the December 2011 adjustment measures, and the reform of the taxation of income from financial assets enacted in the summer of the same year.

The increase of €11.5 billion in indirect taxes was mainly due to IMU, which brought in a total of €23.7 billion, of which €22.6 billion was included under indirect taxes and the rest among direct taxes. The increase in revenue compared with that produced in 2011 by the old municipal property tax (ICI) was equal to €13.9 billion, of which the indirect tax component was €13.4 billion.

Expenditure. – In 2012 general government expenditure increased in nominal terms by 0.6 per cent, rising from 50.4 to 51.2 per cent of GDP (Table 13.4). The increase was due to the further rapid growth in interest payments, while primary expenditure declined for the third successive year (falling by 0.5 per cent to a level 1.8 per cent below that recorded in 2009).

Table 13.4

General government expenditure (1)
(per cent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Compensation of employees	10.8	10.7	10.9	10.9	10.6	10.8	11.3	11.1	10.7	10.6
Intermediate consumption	5.2	5.3	5.4	5.1	5.1	5.4	5.9	5.8	5.8	5.7
Market purchases of social benefits in kind	2.6	2.7	2.8	2.8	2.7	2.7	2.9	2.9	2.8	2.8
Social benefits in cash	16.7	16.8	16.9	16.9	17.0	17.6	19.2	19.2	19.3	19.9
Interest payments	5.1	4.7	4.6	4.6	5.0	5.2	4.7	4.6	5.0	5.5
Other current expenditure	3.6	3.6	3.7	3.6	3.7	3.8	4.2	4.1	3.8	3.7
Total current expenditure	**44.0**	**43.9**	**44.2**	**44.0**	**44.1**	**45.4**	**48.1**	**47.8**	**47.4**	**48.1**
of which: current expenditure net of interest payments	*38.9*	*39.1*	*39.6*	*39.3*	*39.1*	*40.3*	*43.5*	*43.2*	*42.4*	*42.6*
Gross fixed investment (2)	2.5	2.4	2.4	2.4	2.3	2.2	2.5	2.1	2.0	1.9
Other capital expenditure	1.9	1.5	1.7	2.7	1.7	1.5	1.9	1.2	1.1	1.2
Total capital expenditure (2)	**4.3**	**3.9**	**4.1**	**5.0**	**4.0**	**3.8**	**4.4**	**3.3**	**3.0**	**3.1**
Total expenditure (2)	**48.4**	**47.8**	**48.3**	**49.0**	**48.2**	**49.2**	**52.5**	**51.1**	**50.4**	**51.2**
of which: expenditure net of interest payments (2)	*43.2*	*43.1*	*43.7*	*44.3*	*43.2*	*44.0*	*47.9*	*46.5*	*45.5*	*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.

Primary current expenditure decreased by 0.5 per cent, despite the increase of 2.4 per cent in social benefits in cash, which account for nearly half of the aggregate. Among the latter outlays, pensions and the non-pension component grew at much the same pace.

The increase in pension expenditure was due to the adjustment for inflation (3.0 per cent, of which 0.4 points was a previous-year balancing item); in 2012, as provided for by the December 2011 package, the adjustment was not applied to pensions more than three times the minimum benefit (about €1,450 per month). On the basis of the data currently available the number of pensions appears to have decreased slightly. The reform of the pension system enacted in December 2011 did not affect the number of new pensions paid because, owing to the retirement interval mechanism, the workers who retired in 2012 had qualified in the previous year and were therefore not subject to the more stringent requirements introduced in December 2011.

Employee compensation decreased by 2.3 per cent as a result of the further significant fall in staff numbers. After rising to a peak in 2006, the number of general government employees has fallen without interruption, by a total of nearly 8 per cent or 280,000 workers, as a result of increasingly tight restrictions on turnover. The contraction was most pronounced for central government, with a fall of 9.4 per cent or 190,000 workers.

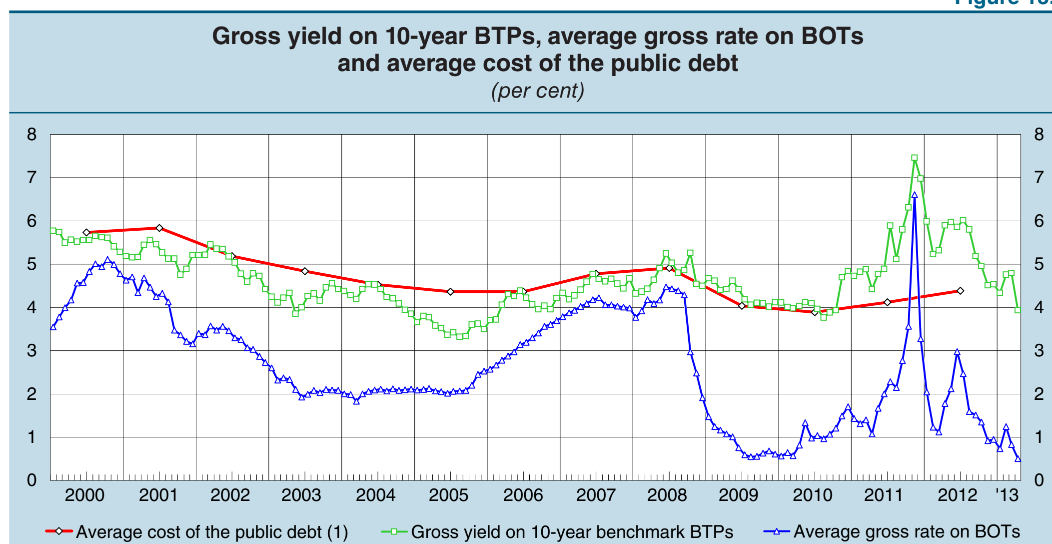
Expenditure on social benefits in kind, 90 per cent of which consists of healthcare outlays, diminished for the second successive year, contracting by 3.2 per cent. Intermediate consumption decreased by 2.4 per cent after rising by 1.2 per cent in 2011. Both items were affected by the savings imposed by the July 2012 spending review decree law.

After growing slightly in 2011, capital expenditure – excluding receipts entered in the accounts as a reduction: sales of electromagnetic spectrum frequencies (€3.8 billion in 2011) and property (€1.1 billion in 2011 and €1.2 billion in 2012) – contracted by 7.6 per cent. The investment component also contracted, by 5.9 per cent compared with 2011 and by 23.3 per cent over the last three years.

Interest payments increased by 10.7 per cent (€8.4 billion), primarily owing to the increase in the average cost of the debt from 4.1 to 4.4 per cent (Figure 13.2).

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 grew from €63.6 billion in 2011 to €65.7 billion, or from 4.0 to 4.2 per cent of GDP (Table 13.5). Excluding the main financial transactions (privatizations and the more stringent treasury arrangements for many public entities, which reduced the borrowing requirement, and the financial support provided to some EMU countries, which increased it), the general government borrowing requirement was €3 billion less than in 2011.

Table 13.5

General government balances and debt (1)
(million euros)

	2008	2009	2010	2011	2012
Net borrowing	42,700	83,603	69,267	60,016	47,633
Total borrowing requirement	50,533	86,905	69,851	63,638	65,683
Privatization receipts (2)	19	798	8	1,560	7,874
Borrowing requirement net of privatization receipts (2)	50,552	87,703	69,859	65,198	73,557
Debt	1,671,001	1,769,254	1,851,252	1,907,392	1,988,629
Memorandum items:					
Treasury deposits with the Bank of Italy (3)	20,333	31,731	43,249	24,255	34,394
Other deposits	32,810	35,466	35,688	35,385	27,187
Financial support to EMU countries (4)	–	–	3,909	13,118	42,665
of which: bilateral loans	–	–	*3,909*	*10,007*	*10,007*
EFSF	–	–	–	*3,110*	*26,925*
ESM	–	–	–	–	*5,732*
Average residual maturity of the debt (in years)	7.5	7.7	7.8	7.5	7.1

Source: For net borrowing, Istat.
(1) Rounding may cause discrepancies. – (2) The privatization receipts are those of central government. – (3) Treasury deposits with the Bank of Italy and liquid balances deposited with the banking system. – (4) Loans granted to EMU countries both bilaterally and via the European Financial Stability Facility (EFSF) and Italy's contribution to the capital of the European Stability Mechanism.

The disparity between the borrowing requirement and net borrowing. – The general government borrowing requirement, net of privatization receipts, exceeded net borrowing by 1.7 percentage points of GDP in 2012, compared with an average of 0.5 points from 2003 through 2011 (Table 13.6). This result was mainly due to the net accumulation of financial assets (1.8 per cent of GDP).

The debt. – The ratio of general government debt to GDP rose from 120.8 to 127.0 per cent. The increase, which reflected that in the central government debt (Table 13.7), was mainly due to the wide gap of 6.5 percentage points between the average cost of the debt and the expansion of nominal GDP and to the financial support provided to EMU countries, only partly offset by the primary surplus of 2.5 percentage points.

With relatively favourable conditions at the short end of the yield curve, the proportion of short-term securities in the total increased by 1 percentage point to 9.2 per cent in 2012; by contrast, the proportion of variable rate securities decreased from 8.9 to 7.3 per cent. The proportion of inflation-linked securities rose by 1.5 points to 9.2 per cent, partly as a result of the introduction in March 2012 of BTP Italia bonds. The average residual maturity of the debt shortened from 7.5 to 7.1 years.

Table 13.6

Reconciliation between net borrowing and change in the debt
(per cent of GDP)

		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
(a)	**Net borrowing (Istat)**	**3.6**	**3.5**	**4.4**	**3.4**	**1.6**	**2.7**	**5.5**	**4.5**	**3.8**	**3.0**
(b)	Balance of financial items (1)	0.3	1.0	1.3	0.6	0.5	0.2	0.6	0.5	0.9	1.8
	of which: support to EMU countries (2)	–	–	–	–	–	–	–	*0.3*	*0.6*	*1.9*
(c)	Cash basis minus accrual basis	0.5	-0.4	-0.6	0.0	-0.1	0.4	-0.3	-0.6	-0.5	-0.1
	primary balance	*0.8*	*-0.3*	*-0.4*	*-0.2*	*0.2*	*0.2*	*-0.5*	*-0.6*	*-0.4*	*0.1*
	interest payments	*-0.2*	*-0.2*	*-0.1*	*0.3*	*-0.2*	*0.2*	*0.2*	*0.0*	*0.0*	*-0.2*
(d)=(a)+(b)+(c)	**Public sector borrowing requirement (MEF) and including EFSF loans** (3)	**4.4**	**4.1**	**5.2**	**4.0**	**2.1**	**3.2**	**5.8**	**4.4**	**4.2**	**4.7**
(e)=(f)-(d)	Difference between the general government and public sector borrowing requirements	-0.1	0.1	0.1	-0.1	-0.1	0.0	-0.1	0.1	-0.1	0.0
(f)	**General government net borrowing requirement (BI)** (3)	**4.3**	**4.2**	**5.3**	**3.9**	**1.9**	**3.2**	**5.8**	**4.5**	**4.1**	**4.7**
(g)	Privatization receipts (-)	-1.3	-0.6	-0.3	0.0	-0.2	0.0	-0.1	0.0	-0.1	-0.5
(h)=(f)+(g)	**Total borrowing requirement (BI)**	**3.0**	**3.6**	**5.0**	**3.9**	**1.7**	**3.2**	**5.7**	**4.5**	**4.0**	**4.2**
(i)	Change in the Treasury's deposits at the Bank of Italy (4)	-0.6	0.2	-0.1	0.6	-0.8	0.7	0.8	0.7	-1.2	0.6
(l)	Issue discounts	-0.3	0.0	-0.2	0.2	0.3	0.3	0.0	0.0	0.7	0.4
(m)	Change in the euro value of foreign exchange liabilities	-0.2	-0.1	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
(n)=(h)+(i)+(l)+(m)	**Change in the debt (BI)**	**1.9**	**3.7**	**4.8**	**4.6**	**1.1**	**4.2**	**6.5**	**5.3**	**3.6**	**5.2**
(o)=(a)-(n)	Difference between net borrowing and change in the debt	1.7	-0.2	-0.4	-1.2	0.5	-1.5	-1.0	-0.8	0.2	-2.1
(p)=(a)-(f)	*Difference between general government net borrowing and the general government borrowing requirement*	*-0.7*	*-0.7*	*-0.8*	*-0.5*	*-0.3*	*-0.5*	*-0.3*	*0.0*	*-0.3*	*-1.7*
(q)=(f)-(n)	*Difference between the general government borrowing requirement and the change in debt*	*2.3*	*0.5*	*0.5*	*-0.7*	*0.8*	*-1.0*	*-0.7*	*-0.8*	*0.6*	*-0.5*

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 European Financial Stability Facility (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. – (2) Loans granted to EMU countries both bilaterally and via the European Financial Stability Facility (EFSF) and Italy's contribution to the capital of the European Stability Mechanism.– (3) Net of privatization receipts. – (4) Treasury deposits with the Bank of Italy and liquid balances deposited with the banking system.

The share of securities held by non-residents decreased for the second successive year, falling from 38.3 per cent at the end of 2011 to 35.0 per cent at the end of 2012. Excluding the securities purchased under the Securities Markets Programme and those held on behalf of Italian investors in managed portfolios and investment funds based abroad, the share at the end of 2012 was close to 25 per cent.

Local authorities' use of derivatives. – There was a further reduction in local authorities' use of financial derivatives, mainly as a consequence of the early closing of some transactions and the ban on new contracts imposed in June 2008 (see the subsection "Local authorities' use of derivatives", Chapter 13, *Annual Report,* 2008).

Table 13.7

Composition of the public debt by issuer (1)
(per cent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
General government	**104.1**	**103.7**	**105.7**	**106.3**	**103.3**	**106.1**	**116.4**	**119.3**	**120.8**	**127.0**
Central government	*98.7*	*98.2*	*99.6*	*99.2*	*96.1*	*99.1*	*108.8*	*111.8*	*113.4*	*119.6*
Local government	*5.2*	*5.4*	*6.2*	*7.2*	*7.2*	*7.0*	*7.6*	*7.5*	*7.5*	*7.4*
Social security institutions	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*

(1) Rounding may cause discrepancies.

On the basis of supervisory reports and Central Credit Register data, which cover only contracts concluded with intermediaries operating in Italy, at the end of 2012 the notional value of the outstanding contracts was €10.4 billion, compared with €12.6 billion at the end of 2011 and €26.1 billion at the end of 2008. According to the Central Credit Register (which collects data on authorities with a total exposure, including derivative contracts' negative market value, of more than €30,000), at the end of 2012 the number of authorities with derivative contracts had fallen to 176 (of which 12 regions, 24 provinces and 128 municipalities) from 232 at the end of 2011 and 473 at the end of 2008.

Despite the fall in the notional value of the outstanding contracts, the negative market value of transactions with resident intermediaries, the amount authorities would have to pay them if the transactions were closed early, has grown in the last few years from €1.1 billion in December 2008 to €1.4 billion at the end of 2012. This increase, which occurred while short-term interest rates were falling sharply, suggests that a significant portion of the outstanding contracts had been taken out to hedge against a rise in interest rates (see the box "Local authorities' derivative transactions", *Financial Stability Report*, No. 5, April 2013).

General government commercial debts. – On the basis of supervisory reports and sample surveys conducted on firms by the Bank of Italy, total general government commercial debts in 2012 can be estimated at just over €90 billion, basically the same as in 2011.

The figure given above is a rough estimate of the size of the phenomenon and a second-best solution in terms of the coverage of the survey and the accuracy and homogeneousness of the data, compared with information gathered directly on each public entity's commercial debts. The exercise covers both the commercial debts found in firms' annual accounts and those assigned without recourse to financial intermediaries. Under a decision adopted by Eurostat on 31 July 2012, the latter, which amounted to €10.5 billion in December 2012 and €10.9 billion in December 2011, are included in the public debt.

Estimates of European countries' commercial debts were released by Eurostat in April 2013. The figure given for Italy, with reference exclusively to current expenditure, was 4 per cent of GDP, which was higher than for the other countries that submitted data (e.g. 2.1 per cent in France and less than 1 per cent in Spain, including investment; only for Austria and Germany were data not available).

The estimates made by Istat (based on methodologies and sources largely different from those used by the Bank of Italy) and transmitted to Eurostat only considered

current expenditure, insofar as capital expenditure (which should also be accounted for on an accrual basis) is approximated by referring to the data on a cash basis and therefore does not give rise to discrepancies between payments and the registration of disbursements in the public accounts.

In 2012 the average time to payment of claims on general government increased by one week to more than 190 days, of which firms attribute about 90 days to contractual terms.

At the beginning of 2012 the Government appropriated €5.7 billion to extinguish part of central government's liabilities. During the year, to facilitate the discounting of supplier firms' claims with financial intermediaries, the procedures for obtaining the certification of claims by individual government entities were standardized, including with recourse to an information technology platform.

Decree Law 1/2012 (converted into Law 27/2012) provided for the settlement of the debts in cash or, at the request of the creditor, by means of the assignment of government securities. Only about €2.8 billion has been disbursed, of which €15 million in the form of government securities. Additional resources for the payment of debts (€1.7 billion) were found using part of the proceeds from the transfer of the shareholdings in Fintecna, SACE and SIMEST to Cassa Depositi e Prestiti. Firms were also allowed to offset tax liabilities against government commercial debts and it was made easier to access the guarantee fund for small and medium-sized enterprises.

In April 2013 the Government decided to disburse a total of €40 billion in the two years 2013-14 for the payment of general government debts, mostly commercial.

As of 2013, with the entry into force of Directive 2011/7/EU on combating late payment in commercial transactions, commercial supplies must be paid within thirty days, apart from some exceptions mainly concerning health services, which may be paid within 60 days. When the payment period comes to an end, arrears interest is charged (using the rate fixed by the ECB for main refinancing operations plus 8 percentage points).

Local government

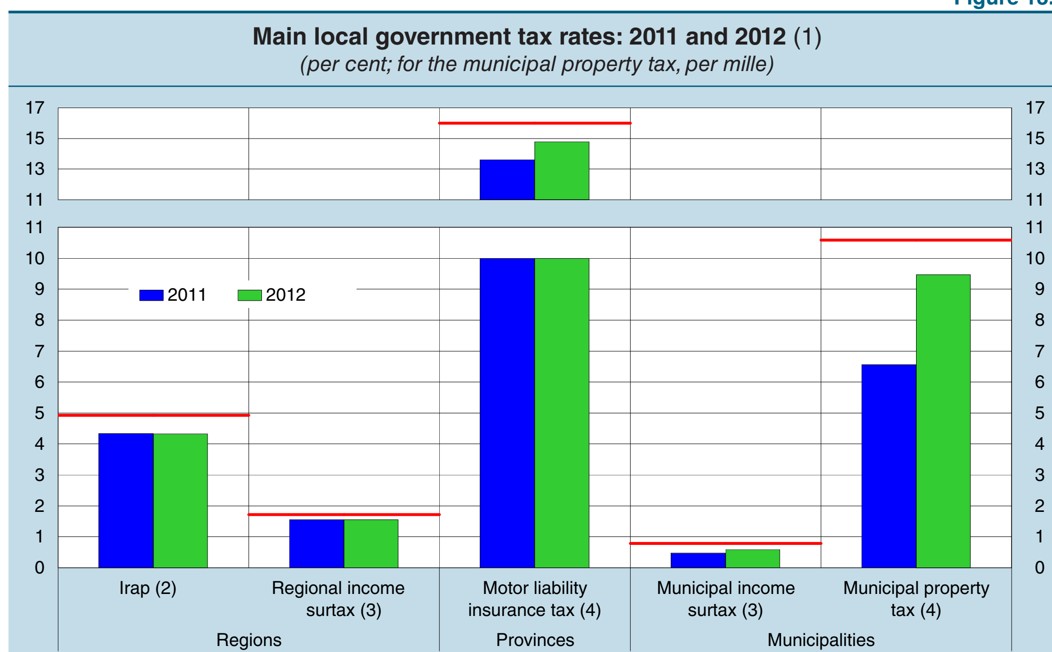
In 2012, for the first time since 1995, the local government consolidated accounts showed a small surplus. After falling in 2010 and 2011, revenue rose, albeit modestly. The average rates on the main regional taxes remained basically unchanged, while those applied by municipalities and provinces increased (Figure 13.3). The contraction in expenditure continued.

Local government revenue increased by 0.7 per cent to €240.0 billion. Transfers from other government entities decreased for the third successive year, falling by 7.1 per cent. This was more than offset by the growth in the tax component, buoyed primarily by municipalities' share of the revenue raised by IMU, the new municipal property tax (€15.6 billion or about €5.8 billion more than the 2011 yield of ICI, the old municipal property tax).

The introduction of IMU has brought the Italian legal system back into line with international practice and the indications of economic literature, which assign a key role

Figure 13.3

Main local government tax rates: 2011 and 2012 (1)
(per cent; for the municipal property tax, 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 healthcare deficits. – (2) 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 average obtained by weighting the rate set by each local government according to the tax base derived from income tax returns. – (4) Average of rates set by each municipality weighted according to proceeds.

to the taxation of residential property in local tax systems. Taxpayers can in fact easily link property taxes with specific services (in accordance with the benefit principle), thereby encouraging the financial responsibility of the bodies that impose the taxes. A revision of the Italian property register appears urgent, to eliminate unjustified differences in the values assigned to properties.

Local government expenditure, excluding transfers to other public bodies, decreased by 2.5 per cent to €234.7 billion. The current component decreased by 1.7 per cent to €206.7 billion as a consequence of the contraction in employee compensation and social benefits in kind, by 2.4 and 3.3 per cent respectively to €69.2 billion and €42.1 billion. Intermediate consumption, though again decelerating, rose by 0.9 per cent to €65.2 billion.

Healthcare expenditure, which is a very large share of the regions' current expenditure, declined by 0.7 per cent, after falling by 0.8 per cent in 2011, to stand at 7.1 per cent of GDP. The fall reflected the reduction of 1.5 per cent in employee compensation and that of 2.0 per cent in social benefits in kind, mainly as a result of the measures to curb spending on pharmaceuticals under the spending review decree law. By contrast, spending on intermediate consumption increased, rising by 2.4 per cent, as against 3.8 per cent in 2011. The slowdown in the growth of healthcare expenditure achieved in the last few years has benefited not only from the measures adopted at national level but also from those established by the deficit-reduction plans of the eight regions with the largest healthcare expenditure overshoots (Abruzzo, Calabria, Campania, Lazio, Molise, Piedmont, Puglia and Sicily).

Capital expenditure, excluding transfers to other public bodies and property disposals, decreased by 8.4 per cent to €28.8 billion, above all owing to the further

contraction in investment, by 7.1 per cent to €21.9 billion. Disbursements to firms in the form of investment grants and transfer payments contracted in total by 15.7 per cent to €5.6 billion.

BUDGETARY POLICY FOR 2013 AND THE MEDIUM TERM

Budgetary policy and the budget adjustment for 2013-15

The three budgetary adjustment packages approved in the second half of 2011 provided for an additional correction to the public finances – compared with what had been established for the previous year – equal to about 1.5 percentage points of GDP, taking the official estimate of the total correction to more than 4.5 points. According to the estimates made at the time the last two packages were adopted, they were expected to permit budgetary balance to be achieved in 2013 (see Chapter 13, "The public finances", *Annual Report*, 2011). Net borrowing for 2013 was nonetheless expected to rise to 0.5 per cent of GDP in the Economy and Finance Document published in April 2012 and then to 1.8 per cent in the September EFD 2012 Update (Table 13.8). The revisions took account of the progressive deterioration in economic conditions and the September forecasts also gave consideration to the Stability Law that the Government was about to submit to Parliament and which was expected to increase the deficit slightly.

Table 13.8

Public finance objectives and estimates for the year 2013
(billion euros and per cent of GDP)

	General government					*Memorandum items*			
	Net borrowing	Primary surplus	Additional impact of commercial debt measures	Interest payments	Debt (1)	Real GDP growth rate (%)	Nominal GDP	Net borrowing 2012	Debt 2012
Objectives									
EFD 2011 Update (September 2011	1.7	89.1	–	90.8	….	0.9	1,665.0	25.3	….
per cent of GDP	*0.1*	*5.4*		*5.5*	*116.4*			*1.6*	*119.5*
EFD 2012 (April 2012) (2)	8.6	79.9	–	88.5	1,977.1	0.5	1,626.9	27.2	1,959.6
per cent of GDP	*0.5*	*4.9*		*5.4*	*121.5*			*1.7*	*123.4*
EFD 2012 Update (September 2012)	….	….	–	….	….	-0.2	1,582.4	41.2	….
per cent of GDP	*1.8*	*3.8*		*5.6*	*126.1*			*2.6*	*126.4*
Estimates									
Report to Parliament 2013 (March 2013)	38.3	45.6	7.9	83.9	….	-1.3	1,573.2	47.4	….
per cent of GDP	*2.4*	*2.9*	*0.5*	*5.3*	….			*3.0*	….
EFD 2013 (April 2013) (2)	45.4	38.5	–	83.9	2,051.4	-1.3	1,573.2	47.6	1,988.7
per cent of GDP	*2.9*	*2.4*		*5.3*	*130.4*			*3.0*	*127.0*

(1) The estimates and objectives given in the official documents are not fully consistent, as the treatment of the effects of financial support to EMU countries in difficulty and Italy's contribution to the European Stability Mechanism is not uniform. – (2) The EFD (the Economy and Finance Document) includes the Stability Programme.

All told, the interventions approved in 2012 (the spending review and the budgetary package) did not alter the balances since they reduced both revenue and expenditure by about half a percentage point of GDP in each of the three years 2013-15 (Table 13.9). The net reduction in expenditure mainly concerned the disbursements of local authorities and the healthcare system. In addition, a stamp duty was introduced on financial transactions and some excise duties were increased. The interventions made it possible in 2012 to avoid implementing the VAT rate increases of the 2011 budgetary packages (Figure 13.4) and to revise them in the following years; some tax reliefs also became possible.

Table 13.9

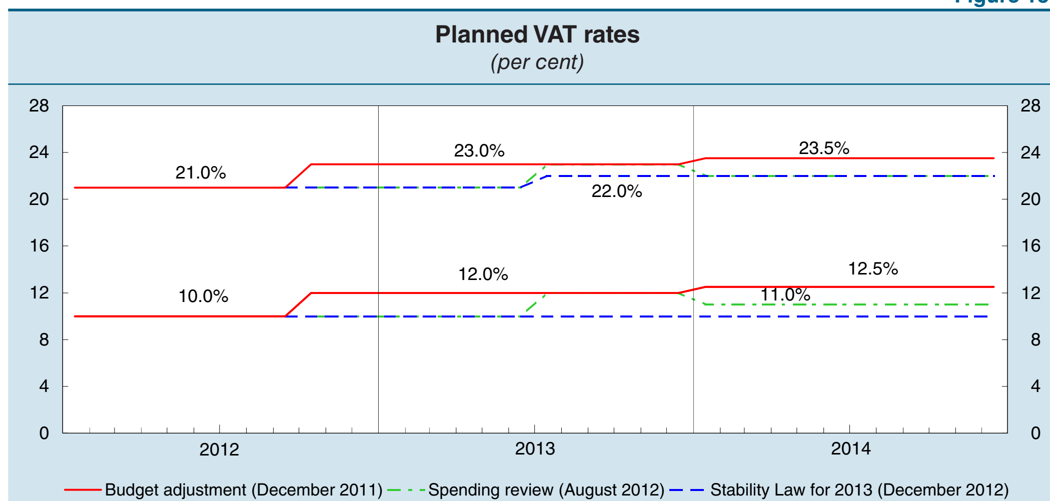
Effects of the 2012 public finance measures on the general government consolidated accounts
(million euros)

	2012	2013	2014	2015
PROCUREMENT OF RESOURCES	**4,568**	**21,129**	**22,539**	**22,620**
Measures that increase revenue (A)	–	**4,577**	**5,425**	**4,955**
Stamp duty on financial transactions (2)	–	1,004	1,215	1,202
Excise duties on fuels (2)	–	1,107	1,107	1,107
Payments on account on insurance companies' technical provisions (2)	–	623	374	374
Reduction in relief for purchase of company cars (2)	–	412	549	532
Non-deferral of substitute taxes (2)	–	200	846	423
Other measures (1) (2)	–	1,231	1,335	1,317
Measures that reduce expenditure (B)	**4,568**	**16,552**	**17,114**	**17,665**
Central government (1) (2)	–	1,544	1,574	1,649
Local government (1) (2)	2,300	7,400	7,700	7,975
Healthcare expenditure (1) (2)	900	2,400	3,000	3,100
Purchases of goods and services (1)	141	615	615	615
Public employment (1)	107	319	665	730
Transfers to public entities and research organizations (1)	153	410	410	410
Local public transport (2)	–	1,135	1,157	1,093
Capital transfers (1)	500	500	400	400
Other measures (1) (2)	467	2,228	1,593	1,693
USE OF RESOURCES	**3,966**	**23,432**	**22,374**	**21,614**
Measures that reduce revenue (C)	**3,392**	**13,234**	**16,538**	**15,538**
Revision of VAT rates (1) (2)	3,280	11,002	12,164	12,164
Extension of labour productivity tax relief (2)	–	950	1,000	200
Increase in tax credits for dependent children (2)	–	939	1,341	1,206
Revision of the Irap tax base (2)	–	–	1,050	1,266
Other measures (1) (2)	112	343	983	702
Measures that increase expenditure (D)	**574**	**10,198**	**5,836**	**6,076**
Local public transport (2)	–	1,600	1,600	1,600
Support for areas hit by earthquakes (1)	–	1,000	1,000	450
Peace missions (1)	–	1,000	–	–
Local government (2)	–	600	–	–
Contingency fund (1)	–	658	–	–
Property rental fund (2)	–	249	847	590
Road haulage (1) (2)	–	559	212	212
Pensions (workers under pension reform safeguards) (1)	–	–	190	590
Infrastructure investment (2) (3)	–	515	740	1,103
Multilateral funds (development and environment) (2)	–	295	295	295
Other measures (1) (2)	574	3,722	952	1,236
Net change in revenue (E=A-C)	**-3,392**	**-8,657**	**-11,113**	**-10,583**
Net change in expenditure (F=D-B)	**-3,994**	**-6,354**	**-11,278**	**-11,589**
Change in net borrowing (G=F-E)	**-602**	**2,303**	**-165**	**-1,006**
of which: Decree Law 95/2012	*-602*	*-16*	*-27*	*-627*
Stability Law for 2013	–	*2,319*	*-138*	*-379*
per cent of GDP				
Net change in revenue (E=A-C)	**-0.2**	**-0.6**	**-0.7**	**-0.6**
Net change in expenditure (F=D-B)	**-0.3**	**-0.4**	**-0.7**	**-0.7**
Change in net borrowing (G=F-E)	**0.0**	**0.1**	**0.0**	**-0.1**

Source: Based on official data published in the Economy and Finance Document for 2013.
(1) Decree Law 95/2012, converted into Law 135/2012. – (2) Stability Law for 2013 (Law 228/2012). – (3) Includes railway infrastructure (including the Turin-Lyons line), road infrastructure and the MOSE project in Venice.

Figure 13.4

Planned VAT rates
(per cent)



The latest estimates for 2013

The EFD published on 10 April 2013 updated the net borrowing forecast for 2013 to 2.9 per cent of GDP, 1.1 percentage points more than forecast in September 2012. Of this increase 0.4 points came from the higher-than-expected outturn for the 2012 deficit, about 0.5 points from the larger contraction in GDP and 0.5 points from the measures aimed at accelerating the payment of commercial debts, approved a few days earlier by the Government. By contrast, interest payments were revised downwards by 0.3 percentage points of GDP, thanks to the favourable trend of government securities yields.

Decree Law 35/2013 sets out to accelerate the payment of general government debts. Disbursements amounting to €20 billion are planned in both 2013 and 2014; of these amounts the settlement of commercial debts will account for respectively €16.9 billion and €17.25 billion (of which €1.25 billion by firms offsetting tax liabilities). Larger tax refunds are planned amounting to €2.5 billion in 2013 and €2.75 billion in 2014 (excluding the offsets referred to above). Lastly, provision is made for an increase in the co-financing of European programmes of €0.6 billion in 2013 (an increase in disbursements of €0.8 billion, of which €0.2 billion financed by transfers from the EU). The impact of the decree on net borrowing amounts to €7.5 billion (0.5 per cent of GDP) and is concentrated in 2013. It derives exclusively from the payments on capital account since Istat's estimate of this item for the preparation of the general government accounts is based on the disbursements recorded on a cash basis. By contrast the payments in respect of current expenditure do not affect net borrowing because the related costs have already been recorded in earlier years on an accrual basis.

The primary surplus is expected to remain at its 2012 level. Tax revenue and social security contributions are projected to rise by 0.4 percentage points of GDP to 44.4 per cent. After slowing for three years, the increase of 1.7 per cent in primary expenditure will reflect the payment of commercial debts on capital account and, on current account, the growth of 2.7 per cent in social benefits in cash, owing to the 2.2 per cent increase in pensions and the substantial increase of 4.5 per cent in other benefits. When the above disbursements are excluded, capital expenditure contracts slightly by 0.1 per cent and primary current expenditure falls by 1.0 per cent.

Despite the recession continuing, the plans for the consolidation of the public finances are not being abandoned. According to the Government's estimates, the structural budget outcome will improve by 1.2 percentage points and move into balance, in line with the commitment to achieve this result in 2013.

The ratio of debt to GDP will continue to increase, rising from 127.0 to 130.4 per cent. This will reflect the impact, equal to 4.7 percentage points of GDP, of the difference between the average cost of the debt and the growth rate of nominal GDP (equal to respectively 4.2 per cent and 0.5 per cent), partially offset by the primary surplus of 2.4 percentage points. The other factors, which together would push up the debt ratio by a total of 1.1 points, include the disbursements to support euro-area countries in difficulty (0.8 points), the effects of the measure to accelerate the payment of commercial debts (0.8 points over and above the forecast impact on net borrowing) and the planned privatization receipts (-1.0 points).

The European Commission's recent forecasts converge on the figure for net borrowing of 2.9 per cent of GDP in 2013. The primary surplus of 2.4 per cent of GDP would be the highest in the EU; only Germany would come close (2.3 per cent). The structural deficit will decrease less than indicated in the EFD, by 0.9 percentage points of GDP, to 0.5 per cent.

On 17 May 2013 the Council of Ministers temporarily suspended payment of the first instalment of the municipal property tax on first homes and announced a revision of property taxes; the reform must be approved by the end of August and be consistent with achievement of the planning objectives indicated in the EFD, as specified in a safeguard clause. On the same occasion the resources available for the Wage Supplementation Fund were increased.

It is estimated that in the first four months of the year the general government borrowing requirement, net of privatization receipts, amounted to about €48 billion, an increase of some €2 billion on the corresponding period in 2012 that was entirely due to extraordinary financial transactions. In the same period State budget tax revenue, excluding lotto and lotteries, was up by 1.2 per cent or €1.3 billion compared with the corresponding period in 2012.

In the remaining part of the year the public finances may benefit from an improvement in economic conditions, but will be adversely affected by the measure on the payment of commercial debts (offset only in part by the increase in VAT); achievement of the objectives for 2013 will therefore require careful monitoring of the accounts.

Programmes and prospects for 2014-17

According to the estimates on a current legislation basis published in the EFD, the improvement in the public finances will continue over the next four years thanks to the recovery in economic growth, set to be nearly 1.5 per cent per year on average. Net borrowing is forecast to fall to 1.8 per cent of GDP in 2014 and then to decline gradually over the three following years to reach 1.0 per cent at the end of the forecasting horizon.

The primary surplus is expected to increase by 1.4 points in 2014 to 3.8 per cent of GDP, mainly as a consequence of the lapsing of the effects of the measure to accelerate the payment of commercial debts and the contraction of primary current expenditure in relation to GDP. In the three following years the primary surplus is expected to grow by nearly 0.5 percentage points of GDP per year on average, to stand at 5 per cent in 2017.

The structural budget outturn is expected to improve further in 2014, moving from the balance forecast for 2013 to a small surplus of 0.4 per cent of GDP. In the absence of adjustment measures, a steady deterioration will then ensue as expenditure accelerates: there would be a small deficit of 0.2 per cent of GDP as early as 2015, which would increase to 0.6 per cent in 2017. The estimates published in the EFD therefore indicate that compliance with the balanced budget principle enshrined in the Constitution and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (which includes the fiscal compact) will require corrective measures in the order of 0.2 percentage points of GDP per year from 2015 onwards.

Including the effects of the measures designed to keep the structural budget in balance, net borrowing would fall from 1.8 per cent of GDP in 2014 to 1.5 per cent in 2015 and 0.4 per cent in 2017. As provided for by the accounting and public finances law, the EFD also contains a scenario on an unchanged policies basis. To this end the EFD gives an indicative quantification of the extra resources that might be needed to confirm (by means of legislation) the practices, commitments and economic policy and budgetary interventions adopted in earlier years for the main expenditure sectors. The EFD estimates these resources at 0.1, 0.3 and 0.4 percentage points of GDP in respectively 2015, 2016 and 2017. If it was decided to maintain a balanced structural budget while refinancing all the various expenditure programmes and confirming the consolidated practices, the cumulative adjustment over the three years would have to be in the order of 1 percentage point instead of the 0.6 points estimated on a current legislation basis.

The ratio of debt to GDP will begin to come down in 2014 (falling from 130.4 to 129.0 per cent; excluding the support provided to EMU countries, the debt would fall by 1.7 points), benefiting from the acceleration in GDP, the smaller amount of financial support provided to euro-area countries in difficulty and the reduction in the deficit. The EFD forecasts also take into account privatization receipts equal to about 1 percentage point of GDP in each year in the period 2013-17. In the planning framework, which includes the effects of the additional measures needed to maintain structural budget balance, the debt falls to 117.3 per cent of GDP in 2017.

The European Commission's forecasts are less favourable for the public finances in 2014. Net borrowing is expected to be 2.5 per cent of GDP, a decrease of only 0.4 points, as against the EFD's 1.8 points. In structural terms the Commission's forecasts indicate a deterioration in the balance of 0.2 percentage points of GDP, to 0.7 per cent.

The balanced budget amendment to the Constitution

In December 2012 an absolute majority of the two houses of Parliament approved Law 243/2012 implementing the constitutional reform that introduced the balanced

budget principle into the Italian legal system (Constitutional Law 1/2012). The new rules will enter into force in 2014, except for those governing local authorities and the State budget law, which will come into effect in 2016.

In particular, provision is made for the suppression in 2016 of the Stability Law, whose contents will be transferred to the budget law, which is to be divided into two sections, one devoted to the fiscal developments on a current legislation basis and the other to the financial effects of the new legislative measures.

The reform makes a profound change to the legal framework for the public finances. General government is required to meet the medium-term objective established at European level and currently corresponding to a structurally balanced budget. The reform also lays down that divergences from the objective established for the structural budget balance may be authorized by Parliament (with the favourable vote of the absolute majority of each house) at the request of the Government, but only if there are exceptional events and an adjustment plan has been prepared; in the absence of exceptional circumstances, the Government must indicate measures able to bring the structural budget balance back into line with the objective in the financial year following that in which the overshoot was found.

The definition of budgetary targets in structural terms allows full use to be made of built-in stabilizers by permitting deficits to the extent that they are due to the effects of the economic cycle. Law 243/2012 also transposes the new European rules on debt and expenditure dynamics.

The rules on the aggregate planning of the public finances are set out for the budgets of the individual entities (central government, local authorities and non-territorial bodies). For the State, in particular, budgetary targets corresponds to a deficit or a surplus (specified in advance in the budget law and as an outturn in the State general accounts) that is consistent with the planning objectives for general government as a whole.

The budget constraints for local authorities. – Law 243/2012 modifies the budget constraints for local authorities and the rules on their recourse to debt.

The new provisions, which will enter into force in 2016, impose a single set of rules for all local authorities, thus innovating with respect to the present distinction between regions on the one hand and provinces and municipalities on the other. The rules should make it possible in the future to abandon the Domestic Stability Pact. The budget of each entity will be considered to be balanced if it meets both the following conditions: (a) there is a non-negative balance between final revenue and final expenditure (excluding the taking out and repayment of loans); and (b) there is a non-negative balance between current revenue and current expenditure, including principal repayments in respect of loans. These rules must be complied with by the budget forecast and the budget outturn (on both a cash and an accrual basis).

Any budget surpluses are to be used to repay debt or to finance investment expenditure. Where there is a deficit, the local authority must adopt measures to restore a balanced budget within the three following years.

To prevent local authorities' budget constraints leading to procyclical policies at local level, in adverse cyclical conditions and when exceptional events occur, central

government will make an additional transfer to local authorities; by contrast, in favourable circumstances the latter will contribute to the sinking fund for the redemption of government securities. The amount of these transfers will be determined taking into account the share of the authorities' own revenue influenced by the economic cycle.

The new rules confirm that local authorities may borrow only to finance investment expenditure. They lay down, however, that borrowing must be on the basis of agreements at regional level guaranteeing, for the year in question, that final revenue and final expenditure are in balance for all the local authorities in the region, including the region itself. At all events, provision is made for each local authority to be able to borrow up to the amount of loan repayments included in its budget forecast.

If the budget outturn shows that balance on a cash basis has not been achieved at regional level, the next year the deficit contributes to determining the balance between final revenue and final expenditure and is divided among the authorities that did not achieve their objectives. Incentives and rules will have to be established for the allocation of surpluses and deficits among the local authorities of each region and it will be necessary to specify the role of regions as coordinating entities on the one hand and borrowers themselves on the other.

The proposed mechanism guarantees margins of flexibility for the financing of investment, which, especially for small authorities, can fluctuate widely. The constraint is consistent with the substantial stabilization of local authorities' debt. The application of the Domestic Stability Pact has already achieved this result for all the authorities taken together: at the end of 2012 their total debt amounted to €115.3 billion, a level analogous to that obtaining at the end of 2009.

According to the budget outturns published by Istat, in 2010 Italy's local authorities (regions, provinces and municipalities) complied with the constraint on their final budgetary balances on a cash basis: final revenue exceeded final expenditure by 2.2 per cent. On an accrual basis there was a deficit of about 3 per cent, with significant variations between the different subsectors (Table 13.10).The difference between the balances referred to above was almost entirely due to the excess of commitments over payments for capital expenditure. The budget outturns in the two years 2011-12 may be better since the rules of the Domestic Stability Pact were made more stringent from 2011 onwards.

Table 13.10

Local government budget balances in 2010
(per cent of expenditure)

Balances		Level of government			
		Municipalities	Provinces	Regions	**Total**
On a cash basis	Balance of final revenue and expenditure (1)	0.3	-0.3	3.1	**2.2**
	Balance on current account (2)	0.0	3.6	11.8	**8.5**
On an accrual basis	Balance of final revenue and expenditure (1)	-0.5	-2.2	-4.4	**-3.2**
	Balance on current account (2)	0.4	2.4	5.7	**4.2**

Source: Based on Istat data (*I bilanci consuntivi delle Regioni e Province autonome, I bilanci consuntivi delle amministrazioni provinciali, I bilanci consuntivi delle amministrazioni comunali).*
(1) Difference between final revenue (tax revenue, revenue from transfers, non-tax revenue and capital revenue) and final expenditure (current expenditure and capital expenditure). – (2) Difference between current revenue and current expenditure, including the principal amounts of loan repayment instalments.

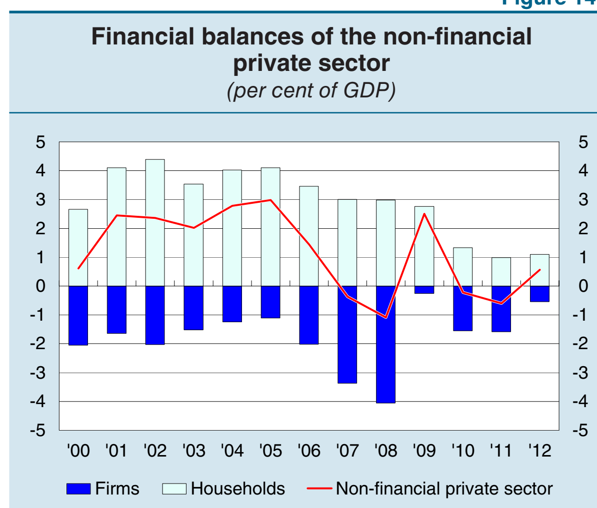
The Parliamentary Budget Office. – As part of the constitutional reform, the Parliamentary Budget Office has been set up to analyse and verify the performance of the public finances, produce independent forecasts, assess compliance with the budgetary rules and set corrective mechanisms in motion in the event of divergence from the objectives. The Office will be completely autonomous in making its assessments. In line with what European rules provide, if the Office's assessments differ significantly from those of the Government, at the request of at least one third of the members of one of the competent parliamentary committees, the latter must explain why it believes it can confirm its assessments or bring them into line with those of the Office (the so-called comply-or-explain principle).

An independent body can make an important contribution to the conduct of budgetary policy. In addition to monitoring the consistency between objectives and policies, it can increase the transparency of the information available on the public finances, thereby permitting citizens to exercise greater control over policies and reducing the costs deriving from uncertainty.

14. THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

Figure 14.1

Financial balances of the non-financial private sector
(per cent of GDP)



Source: ISTAT.

Households' total net assets grew in 2012 by a modest 1.3 per cent, but in real terms they diminished by 1.9 per cent. While household wealth was boosted by rising securities prices, its growth was curbed by the decline in house prices and, for the third year running, by the very low level of financial saving (Figure 14.1). New bank loans for house purchase declined by a half as demand sagged along with disposable income and supply conditions remained tight, particularly for riskier borrowers; the margins on new loans at both variable and fixed rates increased. Credit quality worsened slightly, especially for consumer credit and for loans other than those for house purchase; more stringent screening by banks in granting mortgage loans limited the extent of the deterioration.

Two recessions within the span of a few years caused a sharp deterioration in firms' economic and financial situation. Firms' shrinking volume of business, their diminished ability to repay debts and banks' more selective lending policies led to more difficult conditions in the credit market. Lending to firms contracted during 2012 and the first quarter of this year; the interest rate spread on new loans compared with the euro-area average remained around 90 basis points. The percentage of businesses reporting they had failed to get all or some of the credit they had applied for stood at historically high levels. Although Italian firms have a modest debt burden in proportion to GDP, their fragility compared with their peers abroad is accentuated by their weaker capitalization. In order to contain the effects of the recession, the Government and trade associations expanded the measures to support access to credit, liquidity and the rebalancing of firms' financial structure.

HOUSEHOLDS

Financial saving and wealth

The saving rate of consumer and producer households continued to diminish in 2012, falling to 11.4 per cent of disposable income (7.9 per cent for consumer households

alone). The decline was reflected in households' acquisitions of financial assets, but thanks to the fall in financial liabilities the sector's financial surplus rose to 1.1 per cent of GDP. This was still well below the levels recorded up to 2009 (Figure 14.1).

The value of financial assets rose slightly, thanks mainly to the rally of securities prices late in the year. After slumping in 2011, net financial wealth grew by 2.9 per cent in real terms, less than the euro-area average of 3.6 per cent and short of the gains registered in the United Kingdom and the United States (5.5 and 7.8 per cent respectively). The real-estate component of Italian household wealth shrank, instead, by 4.1 per cent in real terms as a result of the fall in house prices. Total net wealth remained equal to eight times disposable income, mainly owing to the fall in the latter.

Investment in financial assets. — Net purchases of financial assets fell from €36 billion in 2011 to €16 billion last year (Table 14.1), the smallest volume since 1995, the year from which continuous time series are available. The largest flow of investment went to term deposits (€51 billion), which benefited from a reduction in the relevant tax rate on interest. Among disposals, large net sales were recorded for both short- and longer-term Italian government securities (€28 billion) and foreign bonds (€25 billion). The latter were almost completely offset by purchases of foreign investment funds; the overall share of assets issued by non-residents in Italian households' financial portfolios remained stable at 9 per cent.

There were further net disposals of Italian investment funds units amounting to €6 billion, less than in 2011. By contrast, households made €7 billion of net purchases of equities issued by residents. Thanks to the positive performance of securities prices, the portion of total financial assets consisting of riskier assets (equities and investment funds) rose to 28 per cent, compared with 29 per cent for instruments issued by banks and 19 per cent for insurance and pension fund reserves.

Debt

Italian consumer and producer households' debt contracted in 2012 for the first time in fifteen years, although the decline was modest (0.7 per cent compared with the stock at the end of 2011). Nevertheless, the ratio of financial debt to disposable income rose to 66 per cent owing to the sharp decrease of income; the ratio remains low by international standards.

Bank debt was down by 0.5 per cent in December 2012 from a year earlier and continued to contract in the first quarter of this year, with the decline reaching 0.8 per cent. In the euro area, the average rate of growth in bank lending slowed from 2.0 per cent in 2011 to 0.7 per cent last December, with marked differences between the main countries (Figure 14.2).

Loans for house purchase. – Loans to consumer households for house purchase remained stable between 2011 and 2012; in March of this year they contracted by an annualized 0.3 per cent (Table 14.1). New loans for house purchase amounted to €26 billion in 2012, roughly half the previous year's amount, reflecting, among other things, the diminished volume of mortgage surrogation or replacement.

Table 14.1

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

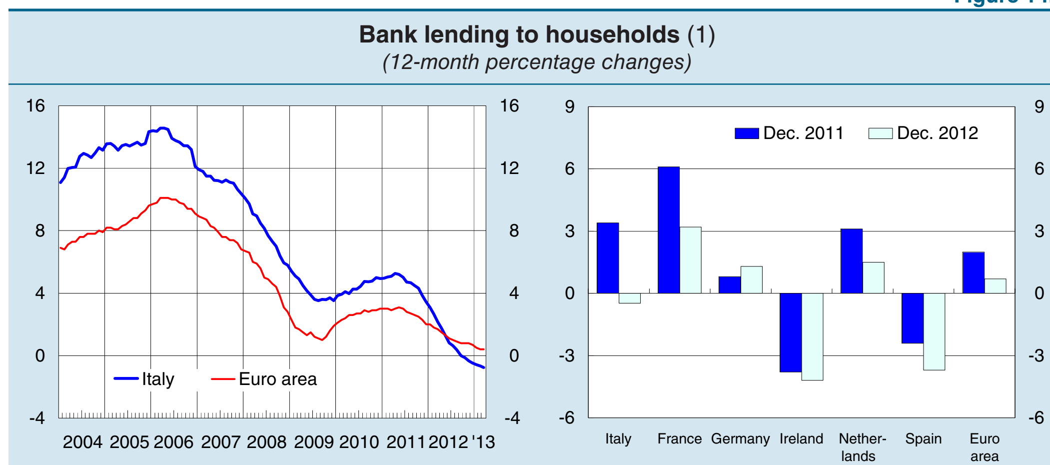
	End-of period stocks			Flows	
	2012	Percentage composition		2011	2012
		2011	2012		
ASSETS (2)					
Cash	120,149	3.3	3.2	6,967	1,964
Instruments issued by banks	1,059,587	28.6	28.5	7,520	37,194
of which: sight deposits	*489,543*	*14.0*	*13.2*	*-17,996*	*-8,407*
other deposits	*194,579*	*4.0*	*5.2*	*10,312*	*50,958*
medium- and long-term securities	*375,465*	*10.6*	*10.1*	*15,204*	*-5,357*
Postal deposits and other postal savings (3)	344,281	9.3	9.3	4,218	14,740
Government securities	188,475	5.3	5.1	61,551	-27,684
of which: short-term	*13,817*	*0.7*	*0.4*	*14,206*	*-11,280*
medium- and long-term	*174,658*	*4.6*	*4.7*	*47,345*	*-16,405*
Medium- and long-term corporate securities	1,129	0.1	0.0	-16,234	-5,872
Investment fund units	267,437	6.6	7.2	-18,843	16,667
of which: Italian	*144,692*	*4.1*	*3.9*	*-22,783*	*-5,853*
foreign	*122,745*	*2.5*	*3.3*	*3,940*	*22,520*
Shares and other equity	763,984	19.4	20.6	4,609	5,663
of which: Italian	*726,313*	*18.3*	*19.5*	*2,597*	*7,381*
foreign	*37,671*	*1.1*	*1.0*	*2,012*	*-1,718*
Other external assets	160,780	5.0	4.3	-14,476	-23,902
of which: deposits	*29,841*	*0.8*	*0.8*	*736*	*863*
short-term securities	*517*	*0.0*	*0.0*	*43*	*137*
medium- and long-term securities	*130,422*	*4.1*	*3.5*	*-15,256*	*-24,901*
Insurance, pension fund reserves and severance pay entitlements	693,509	19.1	18.7	2,210	-1,667
of which: life insurance	*427,268*	*11.7*	*11.5*	*-331*	*-5,226*
Other financial assets (4)	116,962	3.3	3.1	-1,126	-1,494
Total assets	**3,716,294**	**100.0**	**100.0**	**36,397**	**15,610**
LIABILITIES					
Short-term debt (5)	59,989	6.4	6.4	1,308	-151
of which: bank	*58,289*	*6.2*	*6.3*	*1,618*	*-103*
Medium- and long-term debt (6)	649,748	70.3	69.8	17,235	-6,738
of which: bank	*551,938*	*59.9*	*59.3*	*20,671*	*-6,076*
Other financial liabilities (7)	220,719	23.2	23.7	1,125	3,635
Total liabilities	**930,456**	**100.0**	**100.0**	**19,667**	**-3,253**
BALANCE	**2,785,838**			**16,730**	**18,863**

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.

Figure 14.2

Bank lending to households (1)

(12-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 securitizations, reclassifications, exchange-rate variations, value adjustments and other variations not due to transactions.

Several factors contributed to the drop in new mortgage loans. Demand was sapped by the slump of disposal income (down 4.8 per cent in real terms) and households' diminished ability to save. Banks' remained highly selective in screening consumers because of the worsening outlook for the economy and for the housing market in particular. Quantitative limits, very stringent in the first half, were eased in the second, when banks operated mainly through the margins applied to loans, especially in the case of riskier borrowers. Between 2006 and 2012 the share of new mortgage loans granted to younger borrowers (below the age of 35) diminished from 42 to 35 per cent and the share going to non-EU citizens fell from 10 to 4 per cent.

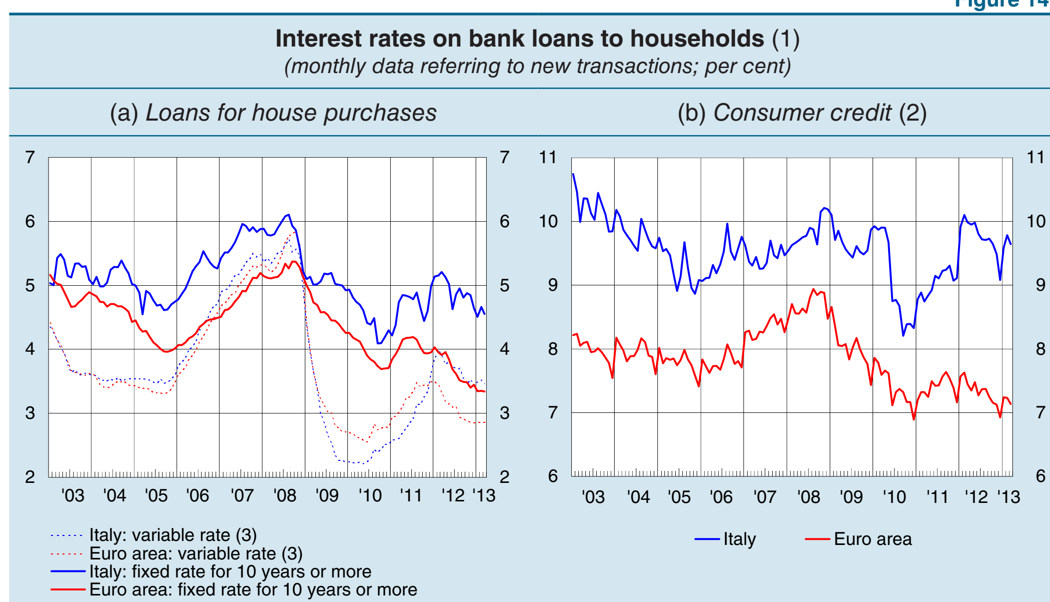
The terms and conditions of new mortgage loans generally remained unchanged or worsened slightly compared with the previous year. According to the regional bank lending survey conducted every six months by the Bank of Italy's branches, new mortgages with a loan-to-value ratio exceeding 80 per cent decreased from 6 to 5 per cent of disbursements; the average loan-to-value ratio declined from 60 to 59 per cent. The average maturity of new mortgages held steady at 22 years, while the share with a maturity of 30 years or longer increased from 25.0 to 26.3 per cent of disbursements.

Interest rates on mortgage loans. – After rising considerably in 2011, interest rates on new mortgage loans diminished last year but did not fall back to their end-2010 levels. The decline was larger for fixed-rate mortgages with a term of at least 10 years (from 5.0 per cent in December 2011 to 4.6 per cent) than for new variable-rate contracts (from 3.6 to 3.4 per cent). The reduction in interest rates in the euro area as a whole was more pronounced than in Italy for both types of mortgage, widening the gap (Figure 14.3.a).

In Italy, mortgage lending rates came down less than the reference rates (IRS and Euribor) as a result of a widening of spreads, particularly on new variable-rate mortgages. The increase in margins reflected a smaller decrease in the cost of bank funding than in the reference rates, banks' persistent difficulty in raising long-term funds and their perception of heightened customer risk.

Figure 14.3

Interest rates on bank loans to households (1)
(monthly data referring to new transactions; per cent)



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) Annual percentage rate of charge on new loans. The APRC includes ancillary expenses (administrative expenses, loan examination fees and insurance). From June 2010 interest rates on credit cards are no longer included. – (3) Variable rate or renegotiable within one year.

Consumer credit. – The volume of consumer credit outstanding fell in 2012 for banks and financial companies alike. The overall contraction came to 1.2 per cent in December; it eased to 0.7 per cent in the first three months of 2013 (Table 14.2). There was a further large decline in earmarked loans, in line with the negative trend in spending for durable goods, especially transport equipment. Non-earmarked loans granted by financial companies continued to expand, while those granted by banks shrank in the second half of the year owing mainly to the reduction in personal loans.

Table 14.2

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

	Twelve-month percentage changes					Stock March 2013 (2)
	December 2010	December 2011	June 2012	December 2012	March 2013	
			Loans for house purchases			
Banks	3.9	4.5	2.1	0.1	-0.3	346,064
			Consumer credit			
Banks	2.4	1.5	-0.3	-0.9	-1.3	56,881
Financial companies	0.5	1.9	-1.3	-1.5	-0.2	60,545
Total banks and financial companies	**1.4**	**1.7**	**-0.8**	**-1.2**	**-0.7**	**117,426**
			Other loans (3)			
Banks	9.5	2.7	-0.2	0.4	0.1	108,500
			Total loans			
Total banks and financial companies	**4.3**	**3.5**	**1.1**	**-0.1**	**-0.3**	**571,990**

Source: Supervisory reports.
(1) Loans include repos and bad debts. The data for March 2013 are provisional. – (2) Includes securitized loans. – (3) Other loans consist mainly of lines of credit and mortgage loans for purposes other than the purchase, construction or restructuring of residential property.

Interest rates on consumer credit. – The annual percentage rate of charge on new consumer credit granted by banks rose to 10.0 per cent in May 2012, subsequently falling back in December to the end-2011 level of 9.1 per cent. In the first few months of 2013 the cost of consumer credit began to rise again (Figure 14.3.b). The differential vis-à-vis the average for the euro area, where the rate on consumer credit edged down (from 7.2 to 6.9 per cent in the year to December), reached 2.5 percentage points in March 2013, remaining at historically high levels. Contributory factors were the greater frequency in Italy of short-term payment arrears, which affect credit recovery costs, and the inefficiency of the civil justice system, which affects litigation costs.

Household wealth and debt in Italy compared with the other euro-area countries

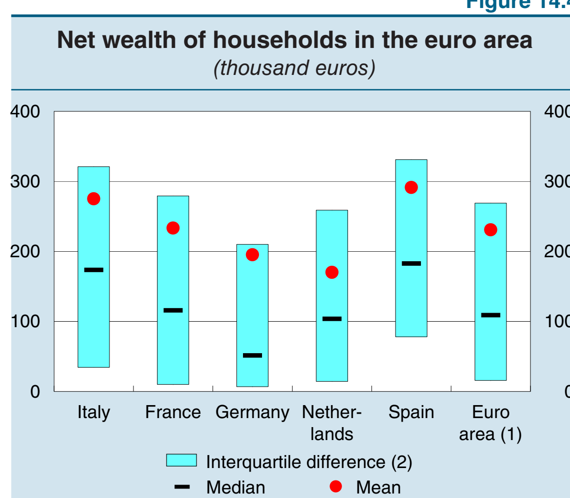
According to the first harmonized survey of euro-area household finance and consumption, in 2010 the average household in Italy had net wealth of €275,000, less than in Spain (€291,000) but more than in France (€233,000), Germany (€195,000) and the Netherlands (€170,000; Figure 14.4). The inequality of the distribution of net wealth is less pronounced in Italy than in France, Germany and the euro area as a whole, but greater than in Spain and the Netherlands.

Several factors affect these survey findings on net wealth. The high figure for Italy depends in part on the larger average size of Italian households. If examined in per capita terms, the gap narrows from 18 to 5 per cent with France and from 41 to 15 per cent with Germany, and disappears with Spain. The different composition of wealth also affects the disparities between countries: in Italy, financial assets made up 10 per cent of household gross wealth in 2010, lower than the euro-area average (17 per cent) and the figure in Germany (21 per cent). Under-reporting the value of financial assets, a common occurrence, can lead to an underestimation of total wealth, of a magnitude that will vary directly with the importance of the financial component of wealth. Another consideration is the risk associated with the illiquidity of investment in housing. Owing to the larger portion of total wealth consisting of real wealth, total assets are riskier in Italy, especially when the housing market is weak, as it is at present.

Despite the high percentage of owner-occupiers among Italian households and the high average value of houses, household debt is low by international standards, thanks both to the lower incidence of borrowing and to the lower amount of liabilities per household.

Figure 14.4

Net wealth of households in the euro area
(thousand euros)



Source: "The Eurosystem Household Finance and Consumption Survey", ECB, April 2013.
(1) Fifteen countries; Estonia and Ireland did not take part in the first survey. – (2) Indicates the distance between the 25th and 75th percentiles.

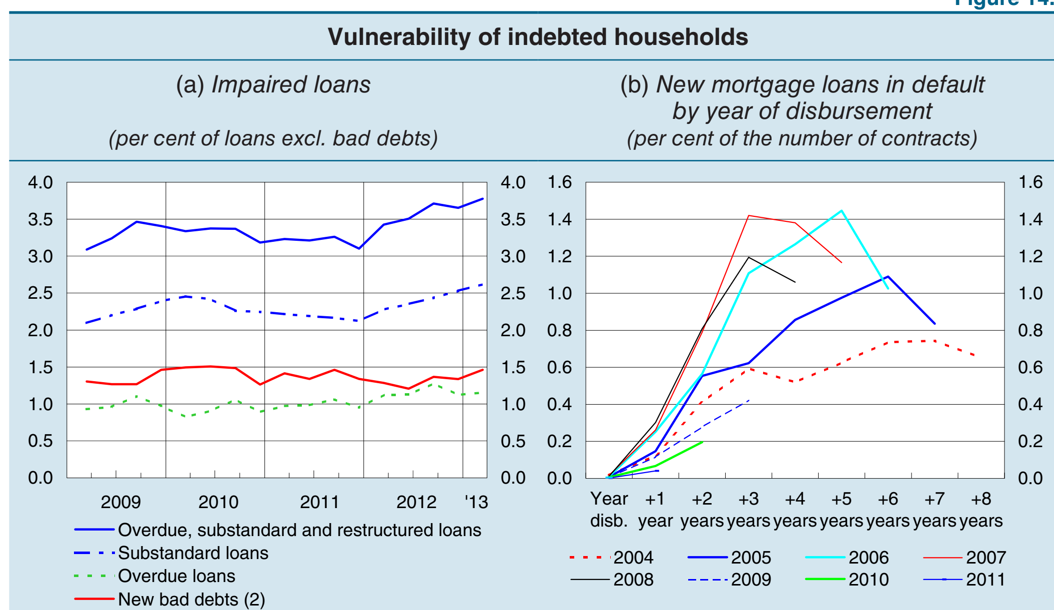
Indebted households' vulnerability

Households' debt servicing burden eased in 2012 as a consequence of the reduction in the stock of debt and the decline in interest rates (0.5 percentage points for the average rate on outstanding debts). Contributions also came from the spread of flexible loan contracts, which allow the amount of the instalment to be changed at no additional cost, and from more extensive use of the moratorium agreed between the Italian Banking Association and consumers' organizations. On the basis of the Bank of Italy's survey on household income and wealth, it is estimated that vulnerable households – those with an income below the median and with debt servicing costs exceeding 30 per cent of income – held just over 16 per cent of all household debt in 2012, comparable to their share in 2010.

The risk indicators of loans to households worsened slightly. Loans more than 90 days past due and substandard loans (for which banks report temporary repayment difficulties) rose to respectively 1.2 and 2.6 per cent of performing loans in the first quarter of 2013, from 0.9 and 2.1 per cent at the end of 2011 (Figure 14.5.a); the increase was sharper for consumer credit and for loans not for house purchase. The annual flow of adjusted new bad debts in relation to performing loans, which had declined in the first few months of 2012, subsequently grew, reaching 1.5 per cent in March 2013. Overall, the share of loans to households that moved into higher risk classes (net of improvements) showed only a modest increase (to 2.5 per cent in 2012 from 2.4 points in 2011). Banks' selectiveness in granting mortgage loans was reflected in a markedly lower default rate on mortgages granted in the years 2009-11 compared with those granted in the previous periods (Figure 14.5.b).

Figure 14.5

Vulnerability of indebted households



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) Consumer households. – (2) 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

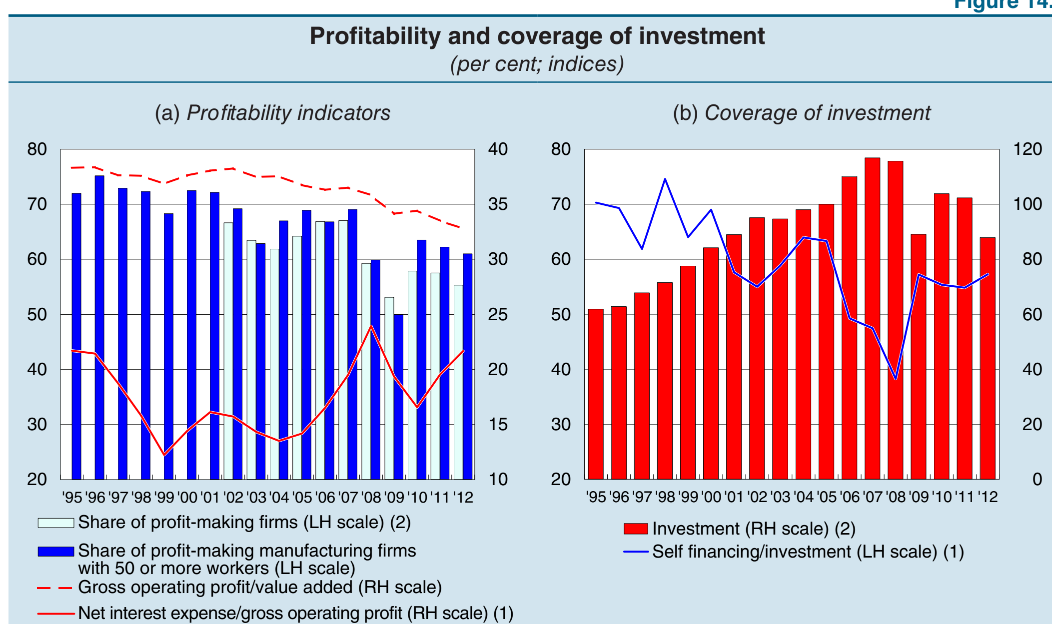
Profitability and financial balance

The recession that began in 2011 caused a sharp deterioration in firms' profitability. According to the national accounts, in 2012 the gross operating profit of non-financial corporations was down by 12 per cent compared with 2008, reaching a new low in relation to value added (Figure 14.6.a). Profitability was also eroded by higher net interest expense stemming from the increase in the cost of debt.

The slight improvement in firms' ability to cover investment with internal financial resources resulted from the drop in capital spending (Figure 14.6.b). The contribution of resources from other sectors diminished, with the sector's financial deficit falling to 0.5 per cent of GDP (Figure 14.1). A contribution to the contraction in the deficit came from the increase of about €13 billion in liquid assets, particularly bank deposits (Table 14.3). Acute uncertainty about the outlook for demand may have prompted firms, and especially larger corporations, to postpone their investments and to hold liquidity for use during a future expansion, if the constraints on accessing external financial sources were to persist.

Figure 14.6

Profitability and coverage of investment
(per cent; indices)



Sources: Banca d'Italia, Survey of Industrial and Service Firms, and calculations based on Istat data.
(1) Net interest expense and self-financing are estimated on the basis of the national economic accounts of the non-financial corporations sector, 1995-2012. – (2) Indices, 2005=100.

Debt and financial structure

Firms' financial debt fell by €9 billion in 2012; the decline was steeper for bank loans and medium- and long-term debt (Table 14.3). After rising sharply in the years before the crisis, the ratio of financial debt has stabilized at a level just under 190 per cent

Table 14.3

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

	End-of-period stocks			Flows	
	2012	Percentage composition		2011	2012
		2011	2012		
ASSETS					
Cash and sight deposits	234,708	14.2	15.2	-5,872	7,478
Other deposits	29,488	1.3	1.9	2,238	8,653
Short-term securities	633	0.1	0.0	430	-638
Medium- and long-term securities	59,471	3.8	3.9	-27,058	-10,036
of which: Italian government	*39,434*	*2.3*	*2.6*	*-7,516*	*-3,150*
Italian corporate	*2,276*	*0.1*	*0.1*	*-9,267*	*203*
foreign issuers	*12,957*	*1.0*	*0.8*	*-1,691*	*-4,337*
Shares and other equity	480,180	31.4	31.1	38,164	-16,414
of which: foreign	*261,451*	*14.8*	*17.0*	*18,234*	*20,691*
Investment fund units	7,494	0.4	0.5	-8	84
Accounts receivable	612,070	41.4	39.7	40,527	-48,040
Financial credits (2)	59,380	3.8	3.9	-9,234	-431
Other financial assets (3)	58,175	3.7	3.8	1,552	-797
Total assets	**1,541,599**	**100.0**	**100.0**	**40,737**	**-60,142**
of which: external	*423,262*	*24.9*	*27.5*	*17,611*	*19,977*
LIABILITIES					
Total financial debt	1,300,510	38.0	38.1	8,985	-8,702
of which: external	*148,184*	*3.8*	*4.3*	*-4,169*	*13,586*
Short-term debt (4)	399,575	11.8	11.7	6,859	-5,768
of which: to Italian banks	*331,087*	*9.9*	*9.7*	*11,512*	*-8,548*
Medium- and long-term debt (5)	783,294	23.6	23.0	2,295	-16,510
of which: to Italian banks	*533,583*	*16.3*	*15.6*	*11,488*	*-14,311*
Securities	117,641	2.6	3.4	-169	13,576
Shares and other equity	1,408,312	40.1	41.3	20,935	3,310
of which: held abroad	*256,564*	*6.8*	*7.5*	*22,076*	*11,421*
Accounts payable	528,478	16.8	15.5	32,726	-47,701
Other financial liabilities (6)	173,989	5.1	5.1	2,466	647
Total liabilities	**3,411,290**	**100.0**	**100.0**	**65,113**	**-52,445**
of which: external	*442,904*	*11.7*	*13.0*	*19,822*	*25,499*
BALANCE	**-1,869,691**			**-24,376**	**-7,696**

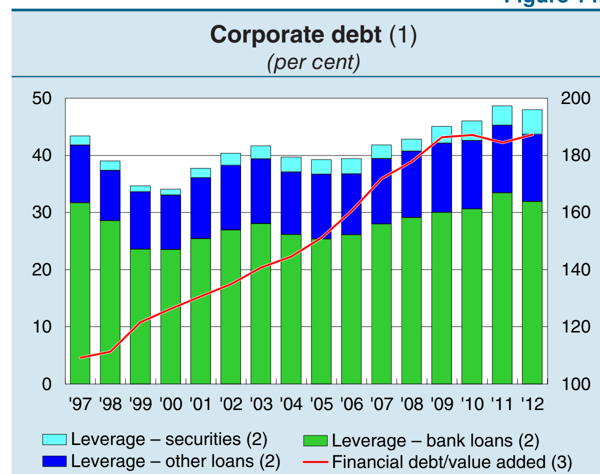
Source: Bank of Italy, financial accounts.
(1) The data refer to the non-financial corporations sector. Rounding may cause discrepancies in totals. – (2) Short-term foreign claims and intra-group claims. – (3) Insurance technical provisions, domestic derivatives and other minor items. – (4) Includes finance provided by factoring companies. – (5) Includes securitized loans, finance provided by leasing companies and intra-group liabilities. – (6) Postal current accounts, severance pay and pension provisions, domestic derivatives and other minor items.

(Figure 14.7). Leverage, defined as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices, decreased slightly to 48.0 per cent; this is still high compared with the past mainly owing to the fall in the market value of equity. Although Italian firms' debt in relation to GDP is low by international standards, their financial structure is made fragile by their lower capitalization. Overall, the differences with respect to other countries have remained fairly stable since the outbreak of the crisis.

The financial structure of Italian firms is characterized by a higher incidence of bank debt than the levels prevailing in the euro area and the Anglo-Saxon countries (66 per cent in 2012 as against approximately 50 and 30 per cent). During the crisis, dependence on bank credit, particularly high among small and medium-sized enterprises, has amplified the refinancing problems connected with the deterioration of banks' balance sheets and tighter lending policies.

Figure 14.7

Corporate debt (1)
(per cent)



Sources: Bank of Italy and Istat.
(1) The data refer 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.

Bonds. – Against the backdrop of worsening credit access conditions, there was a resurgence of corporate bond issuance in 2012. According to Dealogic data, gross domestic and international issues amounted to €33 billion, a historically high figure, although there was an accompanying tendency to shorten the maturity of issues. Nevertheless, bonds still make up less than 10 per cent of financial debt, a modest level by international standards.

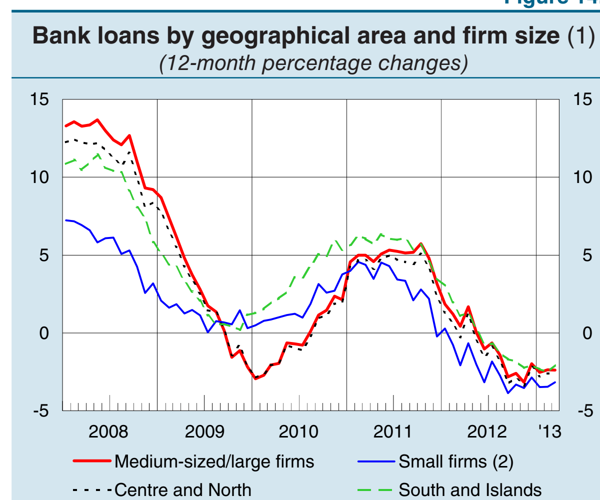
Bond issues represent an alternative source of financing to bank credit that is used by a limited number of large firms that have direct access to the capital market. Between 2007 and 2012 only 29 Italian industrial groups issued bonds; over the same period these corporations reduced their bank debt by about 40 per cent, while similar groups that did not issue increased their recourse to bank credit significantly.

Credit

Volumes and interest rates. – In 2012 lending to firms fell for the second time since the start of the financial crisis; the trend continued in the opening months of this year (Table 14.4). Bank loans, including repos and bad debts, declined by 2.5 per cent in the twelve months to March 2013. The contraction was greater for small firms (Figure 14.8) and in the manufacturing sector. In contrast with the past, firms with a sounder financial condition were also hit by the

Figure 14.8

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



Source: Supervisory reports.
(1) Loans include repos and bad debts. The percentage changes are calculated net of the effects of securitizations, reclassifications and other variations not due to transactions. – (2) Limited partnerships, general partnerships, informal partnerships, de facto companies and sole proprietorships with fewer than 20 workers.

Table 14.4

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

	12-month percentage changes					Percentage composition
	2009	2010	2011	2012	March 2013	March 2013
				Banks		
Branches of economic activity (2)						
Manufacturing	-5.5	-0.1	1.9	-7.4	-7.3	20.8
Construction	3.2	2.2	0.4	-2.7	-3.0	16.0
Services	-2.4	0.5	3.2	-4.8	-4.6	43.4
Other	4.4	8.9	9.5	0.2	-0.4	8.0
Technical forms						
Advances and current account loans	-15.7	1.3	2.8	-1.6	-2.4	25.5
Term loans	7.1	6.2	2.1	-2.6	-2.7	41.3
Other loans	3.6	-3.2	2.6	-7.7	-3.1	21.4
Total	**-1.7**	**2.5**	**2.5**	**-2.2**	**-2.5**	**88.2**
				Financial companies		
Leasing	-1.4	2.3	1.8	-2.6	-3.0	8.3
Factoring	-14.7	4.6	15.3	4.0	1.8	2.9
Other	-10.1	17.9	-9.6	-11.7	-11.0	0.6
Total	**-5.2**	**4.3**	**4.2**	**-1.5**	**-2.3**	**11.8**
				Banks and financial companies		
Total	**-2.1**	**2.7**	**2.7**	**-2.1**	**-2.5**	**100.0**

Sources: Supervisory reports and Central Credit Register.
(1) Data refer to the non-financial corporations and producer households sectors; data for March 2013 are provisional. Loans include repos and bad debts. – (2) Data taken from the Central Credit Register.

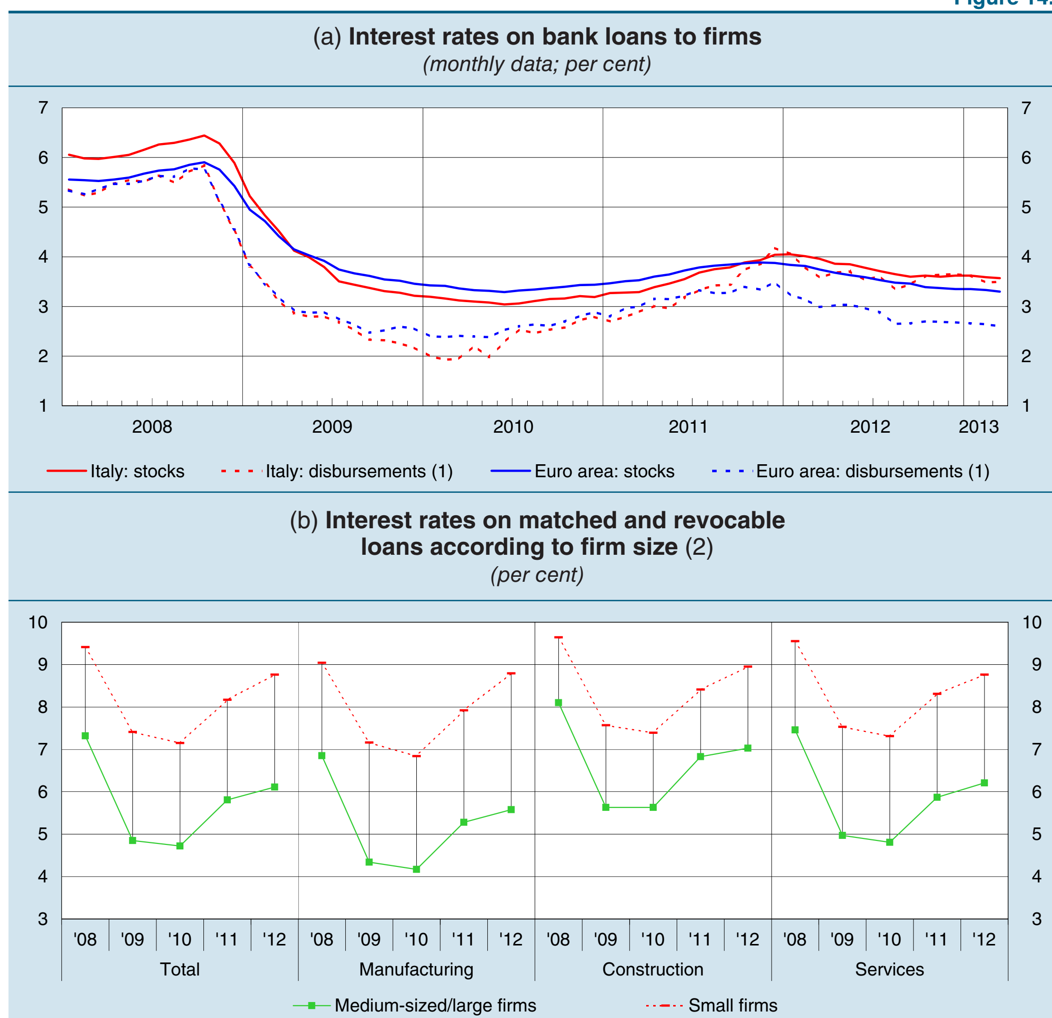
decline in credit, albeit to a lesser extent (see *Financial Stability Report* No. 5, April 2013).

Lending by financial companies showed a similar trend to bank credit, falling by 2.3 per cent in the twelve months to March 2013. Advances granted by factoring companies were an exception, growing by 1.8 per cent. This is mainly attributable to the lesser riskiness of this source of credit, which is used chiefly by large companies in managing their receivables.

Despite a slight decline, average bank lending rates were higher in 2012 than in the previous two years. The sovereign debt crisis was reflected in a considerable widening of the spread vis-à-vis the euro-area average: that on new business, which had been negative up to mid-2011, rose to 97 basis points in December 2012 and was equal to approximately 90 basis points in March (Figure 14.9.a).

In 2012 the increase in the average cost of short-term loans, inclusive of fees and commissions, was greater for firms with fewer than 20 workers. Compared with 2008, the differential vis-à-vis larger companies widened in all sectors of economic activity, notably manufacturing; it was smaller in construction, where large firms' borrowing costs are appreciably higher than in the other sectors (Figure 14.9.b).

Figure 14.9



Sources: ESCB harmonized statistics and Bank of Italy, Analytical survey of interest rates.
(1) New transactions other than current account loans. – (2) Rates are inclusive of fees and commissions. Matched loans include, among other items, advances on invoices and on bills and documents representing commercial credits. Revocable loans mainly consist of current account overdrafts. The total also includes loans to the agricultural, mining and quarrying, and water and energy supply sectors. For the definition of size classes, see Figure 14.8.

Credit demand and supply. – The contraction in bank lending in 2012 was due to factors on both the demand side, connected with the drop in investment, and the supply side, deriving from banks' adoption of restrictive lending policies. The Eurosystem's quarterly bank lending survey confirmed the persistence of highly selective lending policies, largely ascribable to the uncertain overall economic situation and the high riskiness of particular sectors and enterprises. In recent years banks' needs for greater coverage of credit risk have been reflected in an increase in the share of secured loans, which rose from 63.5 per cent in 2007 to 67.6 per cent last year according to Central Credit Register data. In the Bank of Italy's survey of industrial and service firms, the share of businesses reporting that in 2012 they had not obtained all or some of the credit they had requested exceeded 12 per cent, a ten-year high; they represented more than a third of all firms that actually applied for new loans. The difficulty of accessing credit was widespread all across sectors of activity, size classes and geographical areas. Firms reacted to the deterioration in borrowing conditions mainly by curbing their operating costs and, to a lesser extent, cutting back on planned investments.

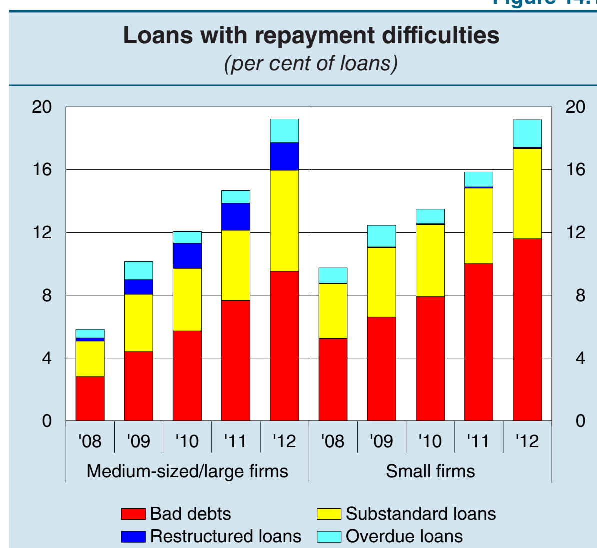
Financial fragility and debt repayment difficulties

Firms' financial condition has become more fragile. In 2012 the ratio of interest expense to gross operating profit, a commonly used gauge of firms' ability to repay debt, rose from 19.6 to 21.7 per cent, returning to historically high levels (see Figure 14.6). On the basis of recent forecasts of the main macroeconomic variables, the trend in bank debt and its cost, this ratio would tend to diminish in 2013.

Figure 14.10

Loans with repayment difficulties

(per cent of loans)



Source: Supervisory reports. For the definition of size classes, see Figure 14.8.

The worsening in financial condition was reflected in a large increase in bank loans with repayment difficulties, which amounted to 19.2 per cent of total lending at the end of 2012, three times the ratio in 2008; the increase was greater for medium-sized and large firms (Figure 14.10) and for construction companies. The deterioration continued in the first quarter of 2013, when the annualized flow of adjusted new bad debts reached 4.5 per cent of the start-of-period stock of performing loans, the highest level in recent years.

Repayment difficulties also increased slightly in business-to-business transactions. According to the Bank of Italy's survey of industrial and service firms, payment deferrals for domestic sales of goods not settled within 15 days of delivery rose to 84 days, from 82 in 2011; the share of claims which were paid later than the contractual deadline was 28 per cent and the average length of delays reached 43 days (compared with 27 per cent and 40 days in 2011).

Equity capital

The increase in corporate shareholders' equity amounted to €3 billion in 2012, compared with €21 billion in 2011 (see Table 14.3). New share issues by listed companies fell to a ten-year low of just over €400 million and there were only five initial public offerings, concentrated again on the stock market segments reserved to small and medium-sized enterprises.

According to data published by the Italian Private Equity and Venture Capital Association (AIFI), investment by companies of the sector amounted to just over €3.2 billion in 2012, down by 10 per cent compared with the previous year and again below the level recorded in the three years 2006-08. Transactions involving large firms, mainly leveraged buyouts, absorbed about 60 per cent of the resources. Early-stage investments grew to €135 million, more than in the past but still very

low by international standards: in relation to GDP, the amount was a third of that in France and Germany and just over a tenth of that in the United States. The underdevelopment of this segment of the financial market is a brake on the innovative activity of firms.

The main support measures

Measures to assist credit access and liquidity. – Alongside the measures adopted by the ECB to lessen banks' funding strains and prevent an even sharper contraction of lending to the economy, a number of initiatives have been undertaken in recent years to ease firms' access to credit and support their liquidity requirements. Existing measures have been renewed or strengthened and new ones introduced.

In the past few years the Central Guarantee Fund, operational for more than a decade, has been the chief instrument aimed at facilitating access to credit for small and medium-sized enterprises (SMEs). Between 2009 and 2012 it provided more than €16 billion in guarantees, activating nearly €31 billion of loans. The increase in its endowment, the widening of the range of potential beneficiaries and the provision of a government backstop guarantee, which relieves banks from capital charges for loans covered by the Fund, have contributed to the expansion of its operations.

In 2009 and 2012 the Italian Banking Association, the Government and corporate trade associations signed two memoranda of understanding that allowed SMEs with good economic prospects and without serious irregularities in debt repayment to suspend the repayment of principal on loans and leasing contracts. Through March 2013 more than 310,000 applications, referred to debts totalling more than €92 billion, had been accepted and just under €19 billion worth of debts rolled over. According to the survey conducted by the Bank of Italy's regional branches, considering the debtor positions benefiting from the moratorium between 2009 and 2012, 54 per cent of the loans with instalments in arrears at the start of the moratorium returned to a regular schedule of repayment.

Since 2009 Cassa Depositi e Prestiti (CDP) has been using resources deriving from postal savings to support SMEs by supplying earmarked funds at low interest rates to the banking system. After the exhaustion of the first €8 billion allocation, which benefited 53,000 firms, CDP made available a further €10 billion in 2012, of which just under €2 billion had been disbursed through April 2013.

Recent estimates indicate that the financial resources assigned to SMEs between 2009 and 2012 thanks to the loan moratoria and the interventions of CDP and the Central Guarantee Fund amount to at least 3 per cent of gross corporate loans, other than current account overdrafts, granted by banks in the same period.

Several measures were taken in 2012 to reduce general government debts to firms. The total volume of resources released to enterprises following these initiatives was modest. In April 2013 a new measure was approved for the payment of debts, mainly commercial, amounting to €40 billion in the two years 2013-14. The possible boost to growth is estimated at between 0.5 and 0.7 percentage points in the two years (see the box "The macroeconomic impact of the unfreezing of general government debts", *Economic Bulletin*, April 2013). Going forward, compliance with the time

frame established by the European directive on combating late payment in commercial transactions, in force since January of this year, could avert a further tightening of the financial constraints faced by firms.

According to a comparative study by the OECD on SME financing, in nearly all 25 countries included in the analysis, the expansion of government guarantee programmes was the tool of choice for mitigating the strains generated by the crisis.

Measures to boost capitalization. – Decree Law 201/2011, converted by Law 214/2011, introduced a deduction from taxable income of the notional return on new equity capital according to the allowance for corporate equity (ACE) model. The measure aims to reduce the disparity between the tax treatment of equity and debt financing and thus to stimulate the capital strengthening of firms.

Fondo Italiano di Investimento, promoted by the Ministry for the Economy and Finance together with leading Italian financial and entrepreneurial institutions, has been operational since November 2010. Its mission is to boost capitalization and consolidation among firms with a turnover of between €10 million and €250 million. With an endowment of €1.2 billion, through April 2013 the fund had approved direct investments amounting to €310 million for the acquisition of minority stakes and indirect investments in private equity funds totalling €350 million.

Fondo Strategico Italiano, a holding company whose controlling shareholder is CDP, was established in 2011 to acquire stakes – generally minority interests – in firms with good profitability and growth prospects, considered to be of major national interest.

This fund, which currently has an endowment of €4.4 billion, had subscribed commitments amounting to about €1.5 billion in five companies through April of this year.

15. THE MONEY AND FINANCIAL MARKETS AND THEIR INFRASTRUCTURE

After the serious tensions of 2011, conditions on the Italian financial markets eased in the early months of 2012, thanks also to the liquidity support measures adopted by the Governing Council of the ECB and the economic policy action initiated by the Government in the second half of 2011. The concern about the large volume of government securities maturing in that period gradually abated. From the end of March onwards, however, investors' fears for the solidity of the Spanish banking system, the political situation in Greece and the outlook for growth in Europe led to a deterioration on the euro-area markets that was especially pronounced in Italy. Fears of the reversibility of the euro spread among financial analysts and the press. Above all owing to these concerns, at the end of July the yield spread between ten-year Italian and German bonds widened almost to the high recorded in November 2011; bank share prices fell to their lowest level since 1999.

Conditions on the financial markets improved gradually from the summer onwards after the ECB had announced its Outright Monetary Transactions programme, which dispelled all doubt about the survival of the monetary union. In the following months the yields on Italian government securities came down significantly, thanks to the decrease in the risk premium; the liquidity of the secondary market improved; and purchases of government securities by non-residents, which had already begun to recover in the spring, accelerated.

Italian banks' issues of bonds to be placed on the market followed an irregular path in 2012 as a result of the tensions that affected euro-area sovereign markets; from September onwards the return to normal financial conditions permitted a revival in placement activity until February 2013, when there was a new halt. By contrast, issues by non-financial corporations increased, benefiting from the fall in interest rates in the second half of the year.

Share prices rose, albeit less than in the rest of the euro area. Bank shares remained unchanged overall: the sharp gains recorded from the end of July onwards only offset the large falls of the preceding period.

In February and March of this year the uncertainty about the outcome of the Italian general election and the way in which the Cyprus banking crisis was handled generated new tensions on Italy's financial markets, although they had only a limited and short-lived effect on Italian government securities. They had a greater impact on banks, whose share prices recorded large falls that were subsequently made good only in part, while their issues of bonds on the wholesale market thinned out considerably. From April onwards market conditions became significantly easier.

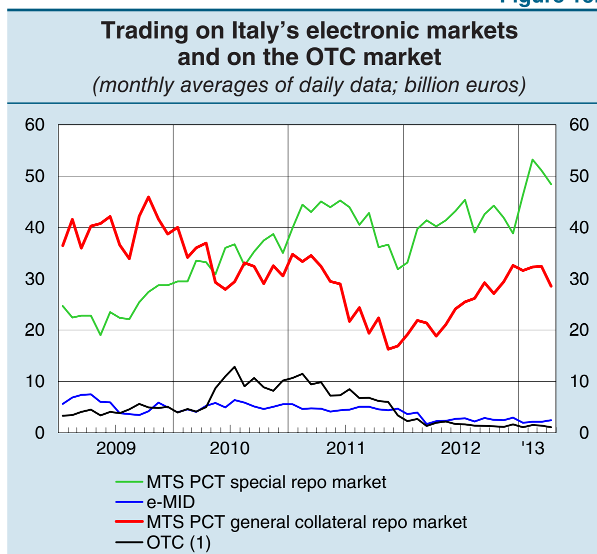
The money market

Trading in unsecured deposits on the e-MID market contracted in 2012 and in the first quarter of 2013 (Figure 15.1), partly as a consequence of the abundant liquidity available after the second three-year financing operation carried out by the ECB at the end of February 2012: from March of last year onwards the average daily turnover was constantly less than €3 billion, as against an average of €4.7 billion in 2011. The decline in trading in unsecured interbank deposits extended to OTC business, as estimated on the basis of data provided by the TARGET2-Banca d'Italia system. The preference for collateralized trading led to significant growth of the MTS general collateral repo market: in the first four months of 2013 the average daily volume was €31 billion, or more than in either of the two previous years. In the last few months there has also been a slight recovery in trading in the New MIC collateralized segment of the e-MID market.

Figure 15.1

Trading on Italy's electronic markets and on the OTC market

(monthly averages of daily data; billion euros)



Sources: Based on e-MID SIM S.p.A., MTS S.p.A. and TARGET2-Banca d'Italia data.
(1) Estimates based on TARGET2-Banca d'Italia data: uncollateralized trading on the money market between Italian banks belonging to different groups with maturities of up to one week.

Public sector securities

Supply and demand. – Net issues of Italian public-sector securities amounted to €46 billion in 2012, virtually unchanged on the previous year owing to the virtual stability of the general government borrowing requirement. At the end of 2012 the ratio of the stock of public-sector securities to GDP was 105.6 per cent (101.7 per cent at the end of 2011); the ratio of public debt to GDP was 127.0 per cent. As a consequence of the large volume of securities maturing, total gross issues in 2012 were very substantial (€481 billion, of which BOTs accounted for €241 billion, compared with €441 billion and €261 billion in 2011).

The fears that arose in the second half of 2011 about the volume of Italian government securities due to mature in the early months of 2012 gradually abated, partly as a result of the improvement in investor confidence and the suspension of the rule that had allowed public entities to hold their own resources with treasurer banks, which facilitated the Treasury's liquidity management and made its funding on the market more flexible. In 2012 the Treasury regularly succeeded in placing the new issues of government securities needed to cope with the massive volume of redemptions and finance the borrowing requirement, even when market tensions became acute again

in the spring. The cover ratio remained well over one throughout 2012 and was 1.4 for ten-year BTPs; it has remained high in the early part of this year as well.

The average residual maturity of government securities has remained long despite decreasing by five months, to six years and five months at the end of 2012. By contrast, the average duration has increased, rising by six months to five years, owing both to the large fall in interest rates and to the contraction in 2012 in the share of outstanding variable rate securities (CCTs). Net issues of BOTs increased to €19 billion from €2 billion in 2011, but the Treasury decreased its recourse to all the other types of securities: net placements of BTPs decreased from €70 billion to €63, while net redemptions of CCTs, CTZs and Republic of Italy bonds increased from respectively €14 billion, €7 billion and €4 billion to €22 billion, €9 billion and €5 billion.

In 2012 Italian banks made very substantial net purchases of government securities amounting to €100 billion, comprising mainly BTPs (€65 billion), BOTs (€18 billion) and CTZs (€11 billion). Insurance companies' net purchases declined but remained large, amounting to €17 billion, of which €14 billion were BTPs. Investment funds and other resident investors (mostly households) made net disposals of respectively €5 billion and €24 billion.

Past experience suggests that there are still ample margins for resident investors to increase their purchases of Italian government securities; despite the substantial investments they made in 2012; at the end of the year the ratio of their holdings of government securities to their total financial assets had risen only a little, to 8.5 per cent from 7.0 per cent in 2011 and was still about 25 per cent lower than the 11.6 per cent average for 1999, the first year of the euro. In particular, banks' holdings of government securities rose from 5.6 per cent of their total financial assets to 8.5 per cent, which was still well below the average for 1999 (13.0 per cent).

The proportion of Italian government securities held by foreign investors decreased very significantly: to 40 per cent at the end of 2012, down by 5 percentage points on a year earlier and by 11 points on June 2011. However, the contraction that began in the summer of 2011, with the spread to Italy of the tensions caused by the euro-area sovereign debt crisis, came to a halt in May, with the return of net foreign investment. In 2012 non-residents made net disposals of €50 billion, mostly between February and April; from May until the end of the year the balance of purchases and disposals turned positive by €8 billion.

In the first three months of 2013 foreign investors made very large net purchases of Italian government securities, amounting on the basis of preliminary data to €26 billion and consisting mainly of medium- and long-term paper.

Interest rates. – In 2012 rates on Italian government securities fluctuated widely, in line with the changes in investors' confidence in the solidity of some euro-area countries' public finances and the survival of the monetary union itself. Over the year the yields on Italian government securities recorded a substantial fall; for ten-year securities from 7.1 to 4.5 per cent and then to 3.9 per cent by the end of the second ten-day period in May of this year (Figure 15.2).

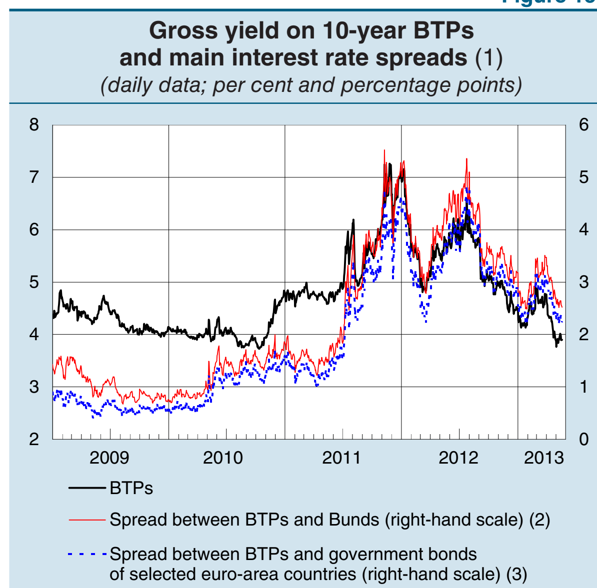
The wide fluctuations in yields were due to the movements in risk premiums, approximated by the yield spreads with respect to Germany. The spread between the benchmark ten-year BTP and the corresponding German Bund, which had peaked

in November 2011, narrowed in the early months of 2012, benefiting from the liquidity support measures adopted by the ECB and the rigorous measures taken beginning in the summer of 2011 to adjust the Italian public finances. In the spring, however, tensions reappeared, primarily as a result of the difficulties faced by Spanish banks. Fears of the reversibility of the euro spread among financial analysts and the press. Towards the end of July the ten-year spread between Italy and Germany rose to 5.4 percentage points, a value exceeded only by the November 2011 peak.

Figure 15.2

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

(daily data; per cent and percentage points)



Source: Based on Bloomberg data.
(1) Yields on benchmark bonds. – (2) Spread between the yield on 10-year BTPs and that on the corresponding Bunds. – (3) Spread between the yield on 10-year BTPs and the simple average of the yields on the corresponding government securities of the euro-area countries that were rated AAA by at least two of the main rating agencies at the end of 2011 (Austria, Finland, France, Germany and the Netherlands).

The levels reached by Italy's interest rate differentials with respect to Germany after the summer of 2011 were not justified by the difference, albeit significant, between the conditions of the two countries' public finances and economies. According to the analyses carried out by the Bank of Italy, confirmed moreover by those of numerous private and international institutions, the sovereign spread consistent with the performance of the two countries' public finance, macroeconomic and financial aggregates could be estimated using different models at about 200 basis points for the ten-year maturity, compared with a market value that had risen to 450 basis points; similar deviations also characterized the other maturities and the other euro-area countries hit by the financial market tensions. The level reached by sovereign spreads was much higher than would have been justified by countries' economic fundamentals even considering that, following the Greek public debt crisis, investors may have become more sensitive to individual euro-area countries' macroeconomic and budgetary conditions. The econometric analyses showed that yields were higher than expected for the weaker countries and lower than expected for the stronger ones.

The wide and persistent deviation from the spreads that would have been justified by national fundamentals may have been due to the emergence of a new systemic risk factor: fear of the reversibility of the euro. This hypothesis is confirmed by both qualitative and quantitative evidence (see the box "Sovereign spreads and euro reversibility risk", *Financial Stability Report*, November 2012). The qualitative indicators included surveys conducted among investors, news of banks' contingency plans for a country's exit from the monetary union and the large increase, from the summer of 2011 onwards, in Internet searches using keywords linked to the end of the euro. The quantitative indicators were derived from the prices of financial assets: from March 2012 onwards, for example, the interest rates on Belgian government securities, which had previously shadowed Italian and Spanish rates, moved towards French and German rates, giving rise to a grouping of countries along economic and geographic lines similar to that prevailing before the introduction of the euro.

To dispel the fears of euro reversibility, at the beginning of August the Governing Council of the ECB announced the introduction of Outright Monetary Transactions. Conditions on the financial markets gradually improved; at the end of 2012 the Italian ten-year yield spread was 3.2 percentage points, 2.1 points less than a year earlier.

The yield differential on Italian government securities continued to fall in the first few weeks of this year and bottomed out at 2.5 percentage points towards the end of January. Between February and March there were renewed tensions on the Italian financial markets – related to the uncertainty about the outcome of the Italian general election and the way in which the Cyprus banking crisis was handled – although their effect was limited and short-lived. According to many investors, in the weeks following the general election the impact of the greater political uncertainty in Italy was diminished by awareness of the progress made in the previous twelve months, especially the achievement of the public finance objectives and the large primary surplus.

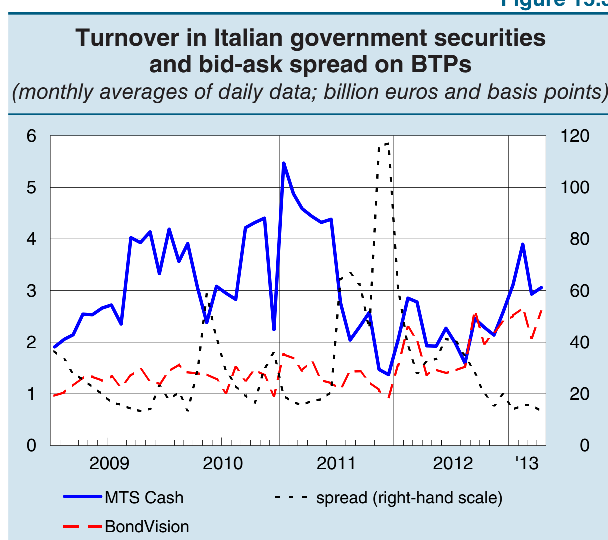
Subsequently, the abatement of the political uncertainty and the increasingly expansive stance of monetary policies, especially in Japan, which may have encouraged investors to look for higher yields, brought a new improvement in the conditions on financial markets that spread to the Italian market as well. At the end of the second ten-day period in May the Italian yield spread had returned to 2.5 percentage points.

The secondary market in government securities. – Liquidity conditions gradually improved on the MTS Cash secondary market in government securities, benefiting from the easing of tensions from the end of July 2012. The amounts of market makers' bids and offers returned to the levels recorded in the spring of 2011 (before the tensions spread to Italian sovereign debt) and trading volumes grew, with the average daily volume rising in the first four months of this year to close to its 2011 level (Figure 15.3). The improvement in confidence was also reflected in the bid-ask spread for BTPs, which fell by 47 basis points to 13 points between the beginning of 2012 and April 2013.

Figure 15.3

Turnover in Italian government securities and bid-ask spread on BTPs

(monthly averages of daily data; billion euros and basis points)



Source: Based on MTS S.p.A. data.

In 2012 trading on the MTS PCT special repo market remained stable at the high levels of the previous year with a daily average of €41 billion; trading subsequently increased to a historically high daily average of €53 billion in February 2013. One contributory factor was the application as of 1 November 2012 of the new European regulation on short selling, which imposed restrictions on uncovered short sales (see the box "The new European regulation on short selling", *Financial Stability Report*, April 2013), driving investors to obtain the securities they needed on the market. Special repo transactions continue to account for nearly two thirds of the repo segment of the market.

Trading volumes also remained high on BondVision, the market designed for institutional investors and smaller banks. Continuing the trend that began with the outbreak of the crisis, the gap in trading volumes with respect to the MTS Cash interdealer market narrowed considerably, disappearing completely for a time in the summer of 2012, when market tensions became pronounced again. For the year as a whole, average daily trading on the BondVision market grew by 37 per cent, to €1.9 billion; in the first four months of 2013 it grew further to €2.5 billion.

Corporate bonds and bank bonds

Issuance. – Italian companies made net issues worth €91 billion in 2012 (Table 15.1). Most of the issues were by banks (€83 billion, as against €66 billion in 2011), while other financial corporations continued to make net redemptions. Non-financial corporations returned to making net issues.

Table 15.1

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

	Net issues (2)			Stocks			*as a % of GDP*
	2010	2011	2012	2010	2011	2012	2012
Banks	-11,800	66,330	83,153	807,045	873,618	956,739	*61*
Other financial corporations	-36,458	-4,328	-6,132	243,398	239,125	233,022	*15*
Non-financial corporations	12,373	-100	13,576	89,874	90,018	103,615	*7*
Total	**-35,885**	**61,902**	**90,597**	**1,140,317**	**1,202,761**	**1,293,376**	***83***
Memorandum item:							
International market (3)	17,800	25,404	-43,663	621,619	647,674	603,978	*39*

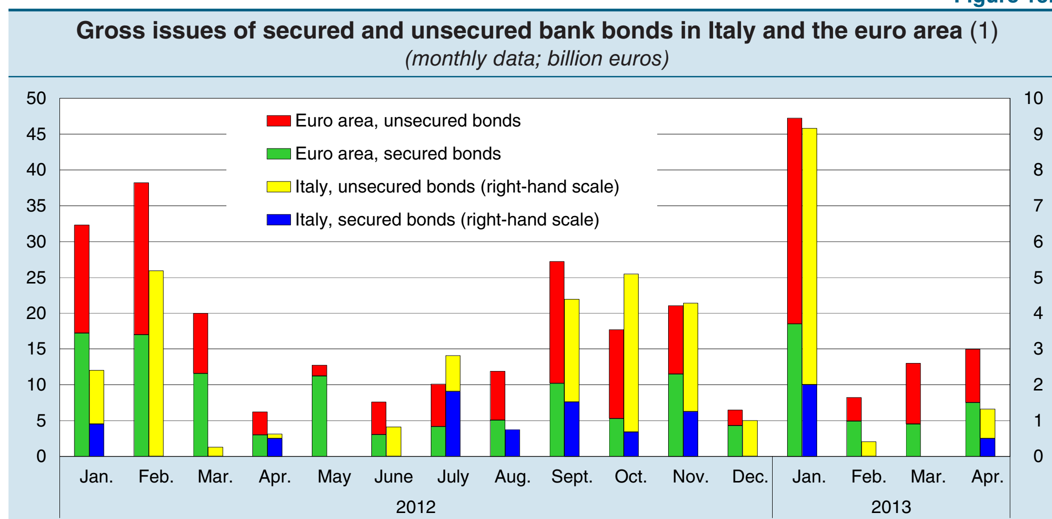
(1) The nationality and sector refer to the issuer and not to its parent company. Refers only to securities with a maturity at issue of more than one year. – (2) Difference between the face values of issues and redemptions. – (3) Based on BIS data. The international market consists of bonds issued in a market other than the local market of the country where the borrower resides. There is a break in the data compared with the past owing to a methodological change introduced by the BIS.

Banks' bond issuance varied significantly during the year, influenced by the tensions that developed on markets in the euro area (Figure 15.4). From September onwards the gradual return to normal of financial conditions reduced interest rates and encouraged a revival of issues. According to Dealogic data on the €76 billion of gross wholesale issues by companies belonging to Italian banking groups on Italian and international markets, 60 per cent of the new bonds were kept on banks' balance sheets to be used as collateral in Eurosystem refinancing operations. Nearly 70 per cent of the issues intended for sale to the market involved securities with no collateral or government guarantee.

In 2012 the gradual decrease in interest rates fostered a recovery in the net issues of Italian non-financial corporations to €14 billion, from nearly nil the previous year. According to Dealogic data, gross placements on the international market by issuers belonging to Italian non-financial groups increased from €19 billion to €29 billion; nearly 80 per cent of the new issues were accounted for by six large groups (Enel, Eni, Fiat, Snam, Telecom Italia and Terna), but the number of issuers increased to 14, from 6 in 2011. In the first four months of 2013 gross issues continued to run at a high level (€7 billion).

Figure 15.4

Gross issues of secured and unsecured bank bonds in Italy and the euro area (1)
(monthly data; billion euros)



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

Total Italian net issues of asset-backed securities (i.e. securities issued by special purpose vehicles and covered bonds) recorded a further large increase, from €34 billion to €49 billion, thanks above all to banks being able to use securitized instruments as collateral in Eurosystem refinancing operations. In particular, net covered bond issues increased from €38 billion to €56 billion.

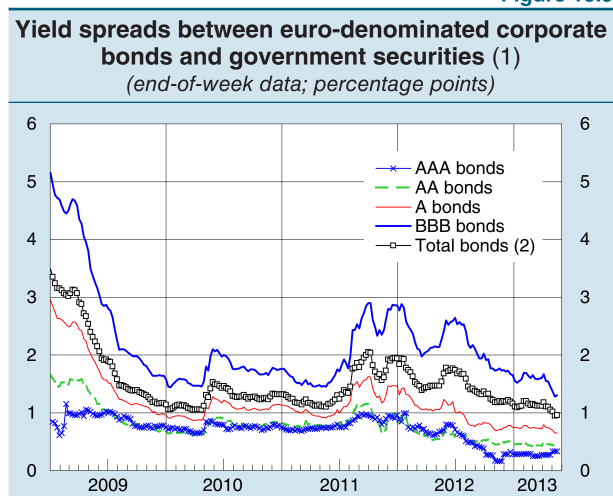
In 2012 gross issues of commercial paper and certificates of deposit by Italian companies contracted sharply from €130 billion to about €60 billion; banks' share of new placements rose from 53 to 60 per cent.

Yields. – The average yield on investment-grade bonds denominated in euros issued by non-financial corporations fell sharply in 2012 to a historical low of 1.8 per cent at the end of the year (from 3.2 per cent at the end of 2011). One contributory factor was the contraction in risk premiums (Figure 15.5). The returns on high-yield securities also fell very substantially, from 11.4 to 5.6 per cent.

The risk premiums on securities issued by non-financial corporations decreased more in Italy than the average for the other euro-area countries, benefiting from the significant reduction in the tensions affecting the Italian

Figure 15.5

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).

sovereign debt market in the second half of the year. For a sample of investment grade securities with a large free float the yield differential with respect to French and German government securities narrowed in 2012 by 1.8 percentage points for Italian firms and by 0.7 points for firms of other euro-area countries. The segmentation of the bond markets in the area nonetheless remains considerable: the risk premiums required by investors to hold securities of Italian firms are more than one point higher than the average for the rest of the euro area.

The easing of the tensions on the financial markets also benefited the yield spreads on the bonds of the main Italian banks, which narrowed on average by about 1.9 percentage points in 2012; the fall was in line with that recorded by the other euro-area countries. The average yield differential for Italian bank bonds was nonetheless 1.4 points higher than that of French banks and 2.4 points higher than that of German banks.

The equity market

Share prices. – The Italian stock exchange index gained 10 per cent in 2012, compared with an average gain of 15 per cent in the share prices of the main listed euro-area corporations (Figure 15.6.a). The pattern over the year parallelled the sovereign debt crisis. After rising in the early part of the year, share prices turned down in March and then rose again from the end of July onwards following the announcement by the President of the ECB that European authorities were determined to dispel every fear about the reversibility of the monetary union. In the first four months of 2013 the Italian stock exchange index gained 5 per cent, with wide fluctuations related to the political uncertainty in Italy and the Cyprus banking crisis.

In 2012 the volatility of the Italian stock exchange index was lower on average than in the previous year. It fell significantly from the end of July onwards and in December was at its lowest level since May 2011 (Figure 15.6.b).

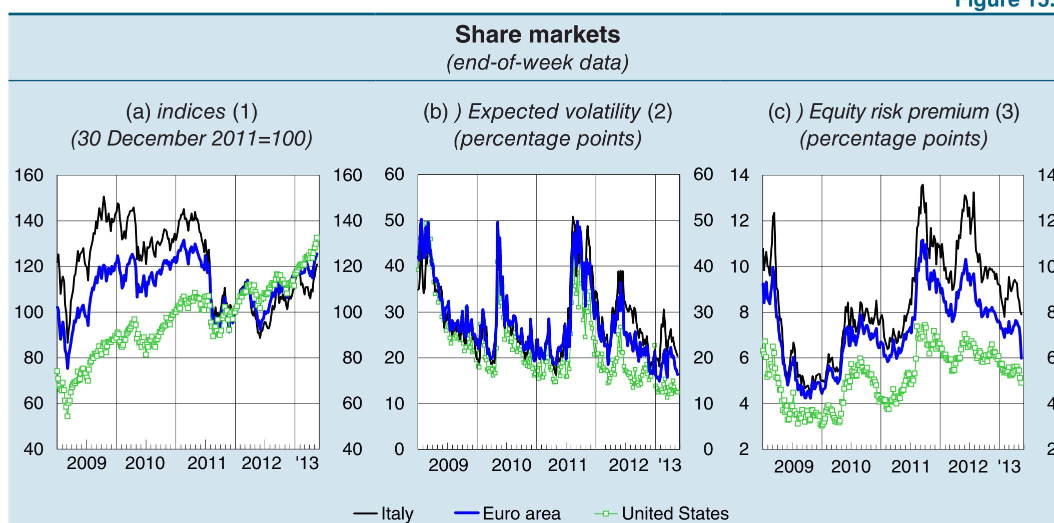
At the end of 2012, the current earnings-price ratio of Italian listed companies had fallen to 7 per cent (from 9 per cent a year earlier); this was nonetheless about 1 percentage point higher than the average since the mid-1980s. According to estimates that take short-term earnings expectations into account, at the end of the year the risk premium demanded by investors for holding Italian shares was 9.2 percentage points, compared with 7.6 points for the euro area as a whole (Figure 15.6.c).

Supply and demand. – There were six initial public offerings in 2012, two fewer than in 2011; five were in the segment for small and medium-sized firms (the AIM Italia-MAC alternative capital market). The volume of funds raised was very modest, falling to €184 million from €439 million in 2011.

The funds raised through capital increases by listed companies were slightly down on 2011, €10.1 billion, as against 11.9 billion (Table 15.2); one bank raised about three quarters of the total amount, insurance companies about one fifth and non-financial corporations the remainder.

Figure 15.6

Share markets
(end-of-week data)



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 expected earnings/price ratio for the subsequent 12 months and the nominal yield on 10-year government bonds (German Bunds are used for Italy and the euro area).

Table 15.2

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

	2008	2009	2010	2011	2012
Change in prices (1)	-48.7	20.7	-8.7	-24.0	10.2
Listed companies (number at end of year)	336	332	332	328	323
of which: Italian	*294*	*291*	*291*	*287*	*282*
in the STAR segment	*75*	*72*	*75*	*70*	*66*
Market capitalization of Italian companies (2)	374,702	457,126	425,099	332,374	365,466
per cent of GDP	*23.8*	*30.1*	*27.4*	*21.1*	*23.3*
Percentage composition:					
industrials	*33*	*37*	*41*	*45*	*47*
insurance	*11*	*9*	*7*	*7*	*8*
banking	*25*	*26*	*20*	*17*	*18*
financials	*3*	*2*	*3*	*3*	*2*
services	*28*	*26*	*28*	*29*	*25*
Total	**100**	**100**	**100**	**100**	**100**
Gross share issues by Italian companies (4)	7,700	18,541	6,855	11,862	10,120
of which: in the STAR segment	*238*	*97*	*50*	*311*	*116*
Market value of newly-listed companies (5)	464	561	8.060	12.743	802
of which: Italian	*464*	*510*	*8.060*	*12.743*	*802*
in the STAR segment	..	*226*	..	..	..
Dividends distributed by Italian companies (6)	39,072	21,309	16,036	17,009	13,207
Earnings/price ratio (7)	15.6	5.3	7.6	9.0	7.2
Dividend yield (7)	8.0	5.0	3.8	5.1	4.2
Turnover					
spot market (8)	*993,511*	*645,993*	*715,147*	*683,630*	*487,301*
FTSE MIB index futures (9)	*698,258*	*418,714*	*560,207*	*561,798*	*442,990*
FTSE MIB index options (9)	*268,264*	*140,345*	*174,918*	*162,684*	*107,232*
Turnover ratio of Italian companies (10)	179	155	162	181	140

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: up to 2009, World Federation of Exchanges data; from 2010 onwards, 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.

In 2012 the ratio of Italian companies' market capitalization to GDP rose from 21 to 23 per cent. In the other major advanced countries the ratio at the end of the year was much higher: 45 per cent in Germany, 63 per cent in France, 107 per cent in the United States and 156 per cent in the United Kingdom. The average daily turnover of shares on Borsa Italiana was significantly lower than in the previous year.

Market infrastructure

The average daily volume of transactions handled by the Express II securities settlement system operated by Monte Titoli fell in 2012 by 8 per cent in number and 10 per cent in value owing to the large contraction in trading on the Italian share market and the greater recourse made on the Italian bond market to central counterparty services supplied jointly by Italy's Cassa di Compensazione e Garanzia S.p.A. (CC&G) and France's LCH.Clearnet SA.

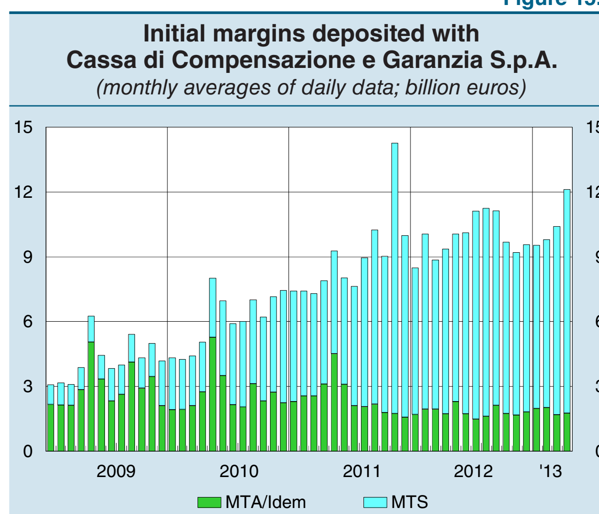
The percentage of fails (transactions not settled owing to non-delivery of the securities within the prescribed time limit) is an indicator of the efficiency of a settlement system as a whole (management company, intermediaries, operating procedures and technological infrastructure). In 2012 the proportion of fails in Express II remained almost unchanged compared with the previous year (on average 2.2 per cent of the daily value of transactions entered into the system).

In 2012 CC&G's business continued to grow on the bond market, especially that for government securities; by contrast it contracted on the cash and derivatives share markets.

The increased business on the government securities market influenced the margins CC&G required members to deposit. Initial margins (calculated on a daily basis against the theoretical settlement costs CC&G would incur in the event of a default by a member of the system) rose to a daily average of nearly €10 billion from €9 billion in 2011 (Figure 15.7). CC&G revised the amount of the bond market default fund several times during the year; in August it rose to a peak of €2.5 billion.

Figure 15.7

Initial margins deposited with Cassa di Compensazione e Garanzia S.p.A.
(monthly averages of daily data; billion euros)



Source: Based on Cassa di Compensazione e Garanzia S.p.A. data.

BANKS AND NON-BANK INTERMEDIARIES

16. THE FINANCIAL SYSTEM

Developments over the year

In 2012 the Italian financial system was affected by the persistent uncertainty on the international financial markets and above all by the contraction in economic activity.

The recession brought a pronounced worsening in the quality of banks' assets. The ratio of new bad debts to total outstanding loans increased significantly, especially for lending to non-financial firms. Faced with the progressive deterioration in loan quality, banks' credit supply policies remained restrictive; they were also influenced by the difficulty of raising long-term funds on international wholesale markets. This supply-side behaviour and the slowdown in the demand for credit led to a reduction of 0.2 per cent in lending, compared with an increase of 1.9 per cent in 2011. The reduction reflects the decrease of 1.3 per cent in lending by the five largest banking groups, which was offset only in part by the increase of 0.8 per cent in that of the other banks. In the early months of 2013 the decline in lending to the non-financial private sector continued, at a faster pace. The increase in banks' exposure to firms in temporary difficulty suggests that the flow of new bad debts could remain high this year.

The measures adopted by the ECB from the end of 2011 on helped to reduce banks' fund-raising problems, thus preventing a credit crunch. The more favourable conditions following the announcement in the summer of the Outright Monetary Transactions programme enabled the main Italian banks to issue bonds on the international markets again. Retail fund-raising growth continued apace. In view of the uncertainty that still hinders access to the wholesale markets, banks have not launched plans to repay three-year funds received from the ECB.

Net of the extraordinary items associated with impairments of goodwill, the profitability of the Italian banking system declined, primarily owing to the deterioration in loan quality; ROE came to 0.4 per cent in 2012. Provisions for loan losses, up by nearly 60 per cent on 2011, absorbed almost all of operating profit; the increase in loan loss provisions was also in part due to the recent supervisory action at a large number of banking groups aimed at verifying the adequacy of their non-performing-loan coverage ratios. Further measures were taken to continue the curbing of costs, which helped to support operating profitability notwithstanding the fall in net interest income.

Further progress was made in strengthening banks' capital position, with an increase in their highest quality capital and a contraction in their risk-weighted assets. Including the public support provided to Banca Monte dei Paschi di Siena (MPS), at the end of

2012 the core tier 1 ratio was 10.7 per cent for the banking system as a whole and 10.9 per cent for the five largest banking groups, respectively 1.4 and 2.0 percentage points up on the previous year. The support provided to MPS took the form of a loan, eligible for inclusion in regulatory capital, granted by the state at a high cost that increases with time. Even when this intervention is taken into consideration, the public support to Italian banks is very small by international standards. The capital strengthening measures adopted have gradually brought Italian banks into line with the Basel III requirements. Preliminary analyses conducted on the Italian banking system under the IMF's Financial Sector Assessment Program indicate that the capital strengthening achieved will enable the banking system as a whole to withstand adverse conditions.

In the specialized credit sector (leasing, factoring and consumer credit), the volume of business contracted, especially in leasing; loan quality deteriorated.

The asset management sector recorded a further net outflow of resources, although on a much smaller scale than in 2011. The inflow of resources was affected by the adverse economic conditions and, especially in the first half of the year, by the tensions on international financial markets. The net outflow of savings from Italian investment funds fell by more than half, while net inflows to foreign funds returned to growth, considerably increasing their share of the investment fund market. In the insurance sector there were net redemptions of life products and net subscriptions of with-profits policies. There was a net outflow of resources from individually managed portfolios, while the various types of supplementary pension scheme recorded a net inflow. Assets under management increased by 18 per cent, primarily as a result of the transfer of the Generali group's foreign operations to its Italian asset management company. At the end of the year institutional investors' assets were equal to 66 per cent of GDP; assets under management accounted for 24 per cent of households' financial assets. By international standards the portfolios of Italian institutional investors are marked by a small proportion of shares and corporate bonds and a large exposure to government securities, most of which are Italian.

The structure of the financial system

Banks and banking groups. – At the end of 2012 there were 706 banks operating in Italy, 34 fewer than a year earlier (Table 16.1). During the year seven new banks began to operate (two limited company banks, one mutual bank and four branches of foreign banks). Forty-one banks closed as a result of 35 mergers, takeovers and asset disposals (largely due to reorganizations within banking groups), five liquidations and the conversion of one bank into a financial company.

The number of banking groups fell by two, to 75. According to the list of financial conglomerates published in September 2012, six were operating in Italy at the end of 2011, of which three provided mainly banking and investment services (Azimut, Banca Carige and Intesa Sanpaolo).

In March of this year there were 67 foundations holding bank capital. Individually and jointly they owned more than 50 per cent in 16 banks, mostly of minor size. Stakes of between 20 and 50 per cent of the capital were held by individual foundations in two of the largest banking groups (MPS and Banca Carige).

Table 16.1

The structure of the Italian financial system

	31 December 2011				31 December 2012			
	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	–	–	–	77	–	–	–	75
Investment firm groups	–	–	–	20	–	–	–	19
Banks	189	–	551	740	169	–	537	706
of which: limited company banks	*162*	–	*52*	*214*	*141*	–	*56*	*197*
cooperative banks (banche popolari)	*18*	–	*19*	*37*	*18*	–	*19*	*37*
mutual banks (banche di credito cooperativo)	*8*	–	*403*	*411*	*9*	–	*385*	*394*
branches of foreign banks	*1*	–	*77*	*78*	*1*	–	*77*	*78*
Investment firms	8	23	71	102	9	24	68	101
Asset management companies and SICAVs	31	6	153	190	26	7	139	172
Financial companies entered in the special register under Article 107 of the Consolidated Law on Banking	65	–	123	188	58	–	128	186
Financial companies entered in the general register under Article 106 of the Consolidated Law on Banking	36	1	745	782	33	1	624	658
Electronic money institutions	–	–	3	3	–	–	3	3
Payment institutions	9	–	25	34	8	–	36	44
Other supervised intermediaries (2)	–	–	2	2	–	–	2	2

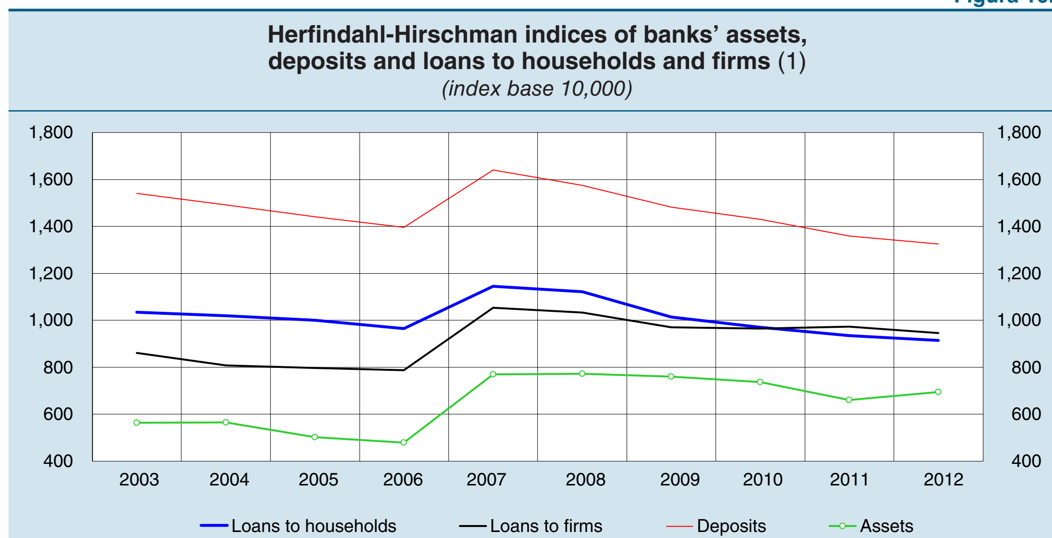
Sources: Supervisory registers and lists.
(1) Italian-owned groups or Italian sub-groups owned by foreign companies; includes parent undertakings (banks or investment firms). – (2) Bancoposta and Cassa Depositi e Prestiti.

The degree of concentration of the banking system. – The degree of concentration of the banking system, measured by the Herfindahl-Hirschman index calculated on the total consolidated assets of the units operating in Italy, was slightly higher last year than in 2003 (Figure 16.1).

The degree of concentration of the market for loans to firms is normally measured at regional level, while provincial indicators are used for loans to households and deposits. Between 2003 and 2012 the median Herfindahl-Hirschman indices for loans to households and deposits decreased, partly owing to the expansion of small banks outside their traditional geographical markets; in the same period the index for loans to firms rose slightly.

Figura 16.1

Herfindahl-Hirschman indices of banks' assets, deposits and loans to households and firms (1)
(index base 10,000)

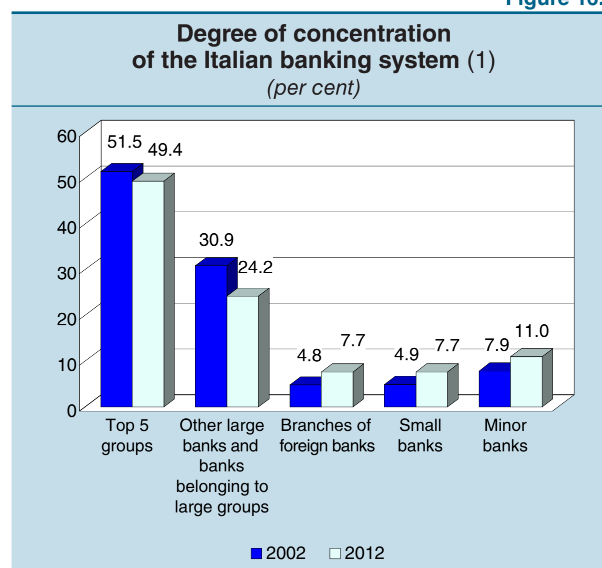


Source: Supervisory statistical reports.
(1) The asset index is calculated on a national basis, that for the market for loans to firms on a regional basis; the indices for the markets for deposits and loans to households (only consumer households) are calculated on a provincial basis. Median index for the deposit and loan markets.

Classifying banks according to size and group membership, at the end of 2012 the five largest groups (UniCredit, Intesa Sanpaolo, MPS, Banco Popolare and Unione di Banche Italiane) held 49.4 per cent of the assets of the banks and financial companies operating in Italy (Figure 16.2). Another 15 large groups and banks held 24.2 per cent. The 78 branches of foreign banks accounted for 7.7 per cent, as did the 31 small banks; the 482 minor banks held 11.0 per cent. In 2002 the five largest groups of the day held 51.5 per cent of system assets, over 2 percentage points more than at the end of 2012; there was an even larger contraction in the share of the other large groups and banks. The shares of the branches of foreign banks and of the small and minor banks increased significantly.

Figure 16.2

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. – At the end of 2012 Italian banks were operating abroad through 84 subsidiaries and 60 branches, a reduction of 4 units during the year. Italian banks' presence abroad remained substantial in the euro area (55 units, above all in Austria, Luxembourg and Germany), central and eastern Europe (56 units) and Switzerland (10 units).

At the end of 2012 there were 24 subsidiaries of foreign companies and banks operating in Italy, two of which figured among the top ten banking groups, with 8.4

per cent of total system assets. At the close of the year 37 foreign shareholders – mainly from EU countries – held equity interests of more than 5 per cent in 48 banks.

Non-bank intermediaries. – At the end of 2012 there were 172 asset management companies in operation, 18 fewer than a year earlier (Table 16.1). The deletions during the year were mainly due to companies exiting the market; only one asset management company was set up in 2012.

There were 101 Italian investment firms entered in the register at the end of 2012, one less than a year earlier; nine belonged to banking groups. The four firms entered in the register during the year were independently owned or bank-controlled and mainly provided advisory and portfolio management services. Nineteen groups of investment firms were entered in the relevant register; the firms belonging to these groups numbered 24.

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 two to 186. A total of 15 intermediaries, mostly engaged in consumer credit and the servicing of securitizations, exited the market, while 13 new operators were added to the register, mostly mutual loan-guarantee consortiums.

The payment institutions entered in the register referred to in Article 114-septies of the Consolidated Law on Banking (intermediaries authorized to provide payment services and grant short-term credit in connection with the services provided) numbered 44; eleven were added during the year.

At the end of 2012 the general register referred to in Article 106 of the Consolidated Law on Banking contained 658 financial intermediaries (which basically can engage in the same activities as the intermediaries entered in the special register but operate on a smaller scale); the decline of 124 units compared with the previous year was mainly due to deletions requested by the intermediaries themselves or ordered following action taken to put an end to irregularities. At the end of the year there were 707 entities entered in the other sections referred to in Article 155 of the Consolidated Law on Banking, of which 584 were minor mutual loan-guarantee consortiums and 123 were credit unions (*casse peota*).

17. THE ACTIVITY OF BANKS AND FINANCIAL INTERMEDIARIES

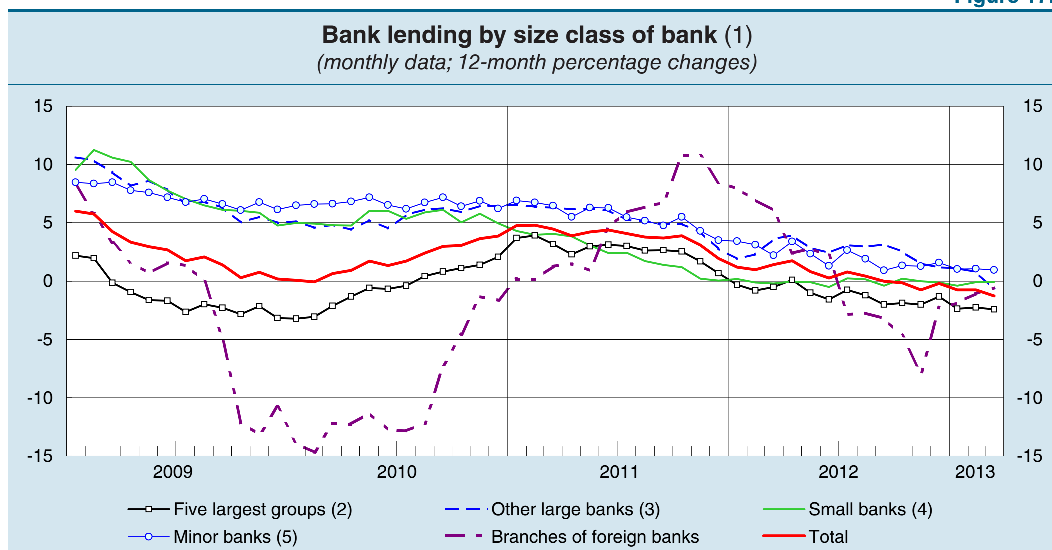
Assets

Credit contracted during 2012, reflecting both weaker demand for loans and the tightening of supply. The latter was in response to the deterioration of loan quality and, especially in the first part of the year, banks' fund-raising difficulties on wholesale markets. Banks increased their holdings of government securities, given abundant reserves of liquidity and relatively high yields.

Lending. – Including repos and bad debts, loans to residents from banks operating in Italy diminished by 0.2 per cent in 2012 after expanding by 1.9 per cent the previous year (Figure 17.1 and Table 17.1). The contraction became more pronounced in early 2013, with lending falling by 1.3 per cent in the twelve months to March.

Figure 17.1

Bank lending by size class of bank (1)
(monthly data; 12-month percentage changes)



Source: Supervisory reports.
(1) Data for March 2013 are provisional. Loans include repos and bad debts. Banks are classified according to the composition of banking groups at March 2013 and to unconsolidated total assets at December 2008. Percentage changes are calculated net of the effects of securitizations, reclassifications and other variations not due to transactions. – (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.

According to the Italian banks taking part in the euro-area bank lending survey, the decline in lending in Italy reflected not only weak demand but also restrictive supply

Table 17.1

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

	General govern-ment	Financial and insurance companies	Firms: total	Firms: medium-sized, large	Firms: small (2)	Firms: small (2): producer households (3)	Consumer households	Non-profit institutions serving households and units n.e.c.	Total
					Centre and North				
2010 – Dec.	4.3	8.4	2.0	1.5	3.9	6.4	4.6	15.7	3.7
2011 – Mar.	3.4	3.1	4.7	4.7	4.6	7.1	4.6	17.7	4.3
June	3.9	0.4	5.0	5.1	4.4	7.1	4.4	11.8	4.2
Sept.	1.5	-0.6	4.4	5.0	2.0	4.0	4.4	11.5	3.5
Dec.	-0.9	-2.4	2.3	3.0	-0.6	1.3	3.7	9.8	1.7
2012 – Mar.	2.6	4.8	-0.3	0.2	-2.4	-0.5	2.8	5.7	1.4
June	0.9	6.6	-1.6	-1.2	-3.5	-1.7	1.4	5.9	0.3
Sept.	5.7	8.9	-3.3	-3.1	-4.2	-2.6	0.7	3.7	0.2
Dec.	4.6	4.4	-2.2	-2.0	-2.9	-2.4	0.2	-1.6	0.0
2013 – Mar.	0.3	1.3	-2.6	-2.5	-3.2	-2.6	-0.2	-0.3	-1.2
					South				
2010 – Dec.	1.9	-3.9	5.3	6.2	3.1	3.2	5.3	0.9	4.9
2011 – Mar.	-0.3	-6.8	6.1	7.0	3.7	3.8	5.3	4.2	5.0
June	3.9	-10.3	6.1	6.8	4.0	4.1	5.0	3.4	5.2
Sept.	1.8	-12.7	5.4	6.5	2.4	2.6	4.9	2.5	4.6
Dec.	3.0	-10.4	3.5	4.4	1.0	1.2	3.9	3.2	3.4
2012 – Mar.	0.7	-9.0	1.1	1.9	-1.0	-1.0	2.5	-3.4	1.5
June	-2.3	-7.6	-0.7	-0.2	-2.0	-1.9	1.0	-3.0	-0.2
Sept.	-3.8	-8.5	-1.7	-1.3	-2.7	-2.9	0.4	-1.4	-1.1
Dec.	-1.7	-4.5	-2.1	-1.8	-2.9	-3.2	-0.4	-0.8	-1.4
2013 – Mar.	-2.5	-4.3	-2.1	-1.8	-2.9	-3.0	-0.8	2.0	-1.6
					Italy				
2010 – Dec.	4.1	8.1	2.5	2.1	3.8	5.6	4.8	13.8	3.8
2011 – Mar.	3.0	2.9	4.9	5.0	4.4	6.2	4.7	16.1	4.4
June	3.9	0.1	5.1	5.3	4.3	6.4	4.5	10.8	4.4
Sept.	1.5	-0.8	4.6	5.2	2.1	3.7	4.6	10.4	3.7
Dec.	-0.5	-2.6	2.5	3.2	-0.2	1.3	3.7	9.1	1.9
2012 – Mar.	2.4	4.5	-0.1	0.4	-2.1	-0.6	2.7	4.7	1.4
June	0.5	6.3	-1.4	-1.0	-3.2	-1.8	1.3	4.9	0.3
Sept.	4.7	8.5	-3.0	-2.8	-3.9	-2.7	0.6	3.2	0.0
Dec.	4.0	4.2	-2.2	-2.0	-2.9	-2.6	0.0	-1.5	-0.2
2013 – Mar.	0.0	1.2	-2.5	-2.4	-3.2	-2.7	-0.4	-0.1	-1.3

Source: Supervisory reports.
(1) Data for March 2013 are provisional. Loans include repos and bad debts. The allocation by geographical area is based on the customer's residence. The percentage changes are calculated net of the effect of securitizations, reclassifications and other variations not due to transactions. – (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.

policies, largely attributable to worsening expectations for economic activity and the prospects of specific firms or sectors. The tightening of lending standards chiefly took the form of higher rates on loans to riskier customers.

The growth rate of lending is negatively correlated with the default rate. Declining credit quality entails larger loan losses, which reduces profitability and consequently the profits that can be set aside to increase banks' capital. An increase in non-performing loans also reinforces banks' risk aversion, prompting them to adopt more prudent lending policies in order to limit further losses in the future.

The contraction in lending last year mostly involved loans to firms, which fell by 2.2 per cent to €962 billion, compared with an expansion of 2.5 per cent in 2011; the reduction was sharper (2.9 per cent) for loans to businesses with fewer than 20 workers. By contrast, lending to consumer households remained stable at €512 billion after growing by 3.7 per cent in 2011. At the end of 2012 loans to firms and households made up respectively 12.2 and 22.9 per cent of assets (equal to 32.7 and 61.4 per cent of GDP).

Lending growth slowed or was negative for banks of all sizes. Lending by the five largest banking groups (which account for about 45 per cent of total lending to the economy) contracted by 1.3 per cent, against an expansion of 0.7 per cent the previous year. Lending by small banks and by branches of foreign banks also diminished (by 0.1 and 2.2 per cent respectively), while the rate of expansion of lending by other large banks and by minor banks slowed respectively from 2.7 to 1.2 per cent and from 3.5 to 1.6 per cent. In March of this year the twelve-month change in lending was negative for all classes of bank except minor banks.

Securities and other assets. – Banks' proprietary holdings of debt securities, excluding those deriving from uncancelled securitized loans, accelerated sharply from 10.6 per cent growth in 2011 to expand by 39.3 per cent. The increase mainly involved government securities. In 2012 net purchases of Italian government securities amounted to around €100 billion, concentrated prevalently in the first quarter of the year, following the Eurosystem's longer-term refinancing operations. The increase involved banks belonging to all size classes except for branches and subsidiaries of foreign banks, which trimmed their holdings of Italian government securities by about €1 billion. Nearly half of the purchases were made by small and minor banks, which hold 30.8 per cent of the total stock, and about a third by the five largest groups, which hold 39.4 per cent of the stock and purchased mainly short-term securities.

In 2012 the share of government securities in banks' total assets rose by 2.6 percentage points, from 5.7 to 8.3 per cent, on the basis of unconsolidated data. In the same period the share of loans (net of repos with central counterparties) diminished by 3 percentage points, from 49.5 to 46.5 percent.

The improved liquidity and diminished risk of government securities contributed to the shift in the composition of assets. An additional factor was the persistence of a positive yield differential between government securities and several types of loan, such as those to households for house purchase. On average in 2012 the yield on the ten-year BTP was about one percentage point above the rate, inclusive of charges, on new

house-purchase loans to households. In France and Germany the corresponding spread was negative by 1.9 and 1.6 percentage points respectively.

The value of banks' holdings of debt securities issued by monetary financial institutions resident in Italy grew by 29.4 per cent in 2012, compared with 43.6 per cent in 2011. The increase was due mainly to issues and simultaneous repurchases of own bonds backed by a government guarantee (under Decree Law 201/2011, converted into Law 214/2011), used as eligible assets for Eurosystem refinancing. The government guarantee covered bank liabilities issued up to 30 June 2012.

Foreign assets declined by about €18 billion, or 4.8 per cent. Contributory factors were the fall in holdings of non-equity securities issued by residents both in other euro-area countries and in the rest of the world and the drop in deposits with euro-area monetary financial institutions.

Funding and liquidity management

The funding of banks operating in Italy, excluding liabilities towards other Italian banks, grew last year by 1.7 per cent, compared with 4.4 per cent in 2011 (Table 17.2 and Figure 17.2). The growth came from increases of 27.9 per cent in Eurosystem refinancing and of 3.9 per cent in retail funding, the latter driven by the deposits of resident households and firms (up by 6.6 and 7.5 per cent respectively). Net of Eurosystem refinancing, funding would have contracted by 0.8 per cent.

The average cost of funds (including funding from other banks resident in Italy) declined by 30 basis points in 2012 to 1.3 per cent, thanks both to the abatement of the tensions on sovereign debt markets and to greater recourse to Eurosystem refinancing and the growth in retail funding.

Wholesale funding. – In 2012 the portion of total funding consisting of wholesale funding (non-residents' deposits and repos and bonds not held by households) fell by 3.5 percentage points to 24.7 per cent; the portion deriving from Eurosystem refinancing grew by 2.3 points to 11.5 per cent. Italian banks did not initiate programmes to repay the three-year loans obtained from the Eurosystem.

Wholesale funding was affected by the decline of 12.7 per cent in non-residents' deposits and the drop of 14.8 per cent in bonds other than those held by households. The fall in both these components eased in the fourth quarter of 2012 and the first quarter of this year, after the ECB's announcement of Outright Monetary Transactions. In March 2013 wholesale funding, net of Eurosystem refinancing, was 6.3 per cent lower than twelve months earlier.

Conditions improved on the short-term funding markets following the Eurosystem's interventions, but tensions persisted on the markets for medium- and long-term funds. Spreads were still high on the issues of covered bonds, unsecured bonds and commercial paper made by the five largest banking groups in the second half of 2012, owing in part to the relatively long maturity of the securities issued and the subordinated status of some of them. From the end of February 2013, as a consequence of the uncertain political situation and new downgrades of Italian sovereign debt and

Table 17.2

Banks' main assets and liabilities (1)
(monthly data; 12-month percentage changes and million euros)

	Twelve-month flows				Twelve-month percentage change				Stocks at December 2012
	December 2010	December 2011	December 2012	March 2013	December 2010	December 2011	December 2012	March 2013	
				Assets					
Cash	-492	361	1,845	783	-4.2	3.2	16.0	8.0	13,360
Debt securities (2)	42,112	28,499	96,830	62,901	18.8	8.2	25.5	13.8	491,861
of which: government securities	*42,932*	*25,148*	*99,564*	*63,003*	*26.1*	*12.2*	*43.4*	*20.6*	*344,863*
Loans	80,272	39,193	-11,554	-33,122	4.5	2.1	-0.6	-1.7	1,927,847
Claims on central counterparties	-5,474	-17,040	41,342	29,951	-16.2	-44.6	195.0	97.2	62,542
Claims on the Eurosystem (d)	-11,716	10,485	-6,190	14,088	-33.4	44.8	-18.3	84.0	27,697
External assets	6,829	31,308	-17,561	-17,368	2.1	9.4	-4.8	-4.8	348,527
Claims on resident MFIs									
Loans	*-19,392*	*40,131*	*10,108*	*26,111*	*-4.4*	*11.5*	*2.8*	*7.7*	*333,338*
Securities	*-4,866*	*89,631*	*86,714*	*19,288*	*-2.3*	*43.6*	*29.4*	*5.5*	*381,992*
Shares and other equity	10,891	1,501	13,207	14,794	7.2	1.0	10.8	12.0	132,970
Other assets (3)	840	92,049	9,962	2,748	0.2	23.9	2.1	0.6	489,892
				Liabilities					
Deposits of residents in Italy (a)	-11,065	-6,519	67,753	78,071	-1.0	-0.6	5.9	6.7	1,216,214
Deposits of non-residents (b)	11,551	-42,105	-50,297	-28,843	2.7	-9.7	-12.7	-7.8	346,225
Bonds (4) (c)	-7,342	16,407	-42,527	-50,776	-1.2	2.7	-6.9	-8.3	576,332
Liabilities to central counterparties (3)	74,577	-47,292	48,412	44,236	197.0	-40.8	70.6	50.9	116,992
Liabilities to the Eurosystem (d)	22,898	163,959	60,165	-4,140	79.8	317.9	27.9	-1.5	275,708
Liabilities associated with sales of claims	-1,282	-2,140	-6,599	225	-12.5	-1.2	-4.2	0.1	152,549
Liabilities to resident MFIs									
Deposits	*-21,027*	*37,320*	*11,602*	*27,671*	*-4.6*	*10.6*	*3.2*	*8.0*	*338,663*
Bonds	*-4,866*	*89,631*	*86,714*	*19,288*	*-2.3*	*43.6*	*29.4*	*5.5*	*381,992*
Capital and reserves	13,154	26,875	-4,763	-6,635	5.0	6.4	4.8	4.3	372,703
Other liabilities	13,142	81,816	51,935	39,181	3.8	-9.4	9.3	1.0	432,647
Memorandum items:									
Net liabilities to central counter-parties (5) (e)	78,951	-30,252	7,070	14,285	::	-39.0	14.9	25.5	54,450
Total funding (f=a+b+c+d+e)	94,993	101,490	42,164	8,596	4.3	4.4	1.7	0.3	2,468,929

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 monetary financial institutions (MFIs). – (3) Money market fund units, movable and immovable assets, and other minor items. – (4) Excludes bonds held by MFIs resident in Italy. – (5) Growth rates are not reported because insignificant.

of several Italian banks, conditions worsened on the wholesale markets for funds with maturities longer than one year.

Retail funding. – Deposits from residents and bonds held by households rose to 66 per cent of total funding, up by 1.4 percentage points compared with 2011. This increase was accompanied by a change in the composition of retail funding, due to the harmonization of the tax treatment of financial investment income. Bonds held by households declined by 2.1 per cent – the tax rate on income from these instruments went up from 12.5 to 20 per cent with effect from January 2012. At the end of last year they made up 23.7 per cent of total retail funding, 1.4 percentage points less than in December 2011. Deposits of resident households and firms (whose yields benefited from a reduction in the tax rate from 27 to 20 per cent) expanded; the increase regarded both deposits with agreed maturity (55.3 per cent for firms and 101.2 per cent for households) and, to a lesser extent, those redeemable at notice. By contrast, repos and current account deposits diminished. In the early part of 2013 retail funding continued to expand, growing by 3.4 per cent in the twelve months to March.

At the end of 2012 the funding gap – the share of loans to resident customers not funded by deposits or bonds held by customers – was equal to 13.7 per cent, down by nearly four percentage points from December 2011. This decrease, due in part to the fall in lending, involved banks of all size classes, but it was most notable for subsidiaries of foreign banks (from 36.3 to 29.6 per cent), for small banks (from 3.8 to -3.1 per cent) and for the five largest groups (from 21.3 to 17.2 per cent). In December 2012 the funding gap was negative for small banks and for minor banks.

The liquidity position. – Italian banks' short-term liquidity improved. The Bank of Italy's weekly monitoring of 33 resident banking groups indicates that their net liquidity position, given by the difference between their expected cash flows and the liquidity available within a period of one month, practically doubled in 2012 to 8.9 per cent. The net liquidity position continued to improve in the opening months of this year. From February to April it was just above 10 per cent; excluding government-guaranteed bank securities, it would have been about two percentage points lower.

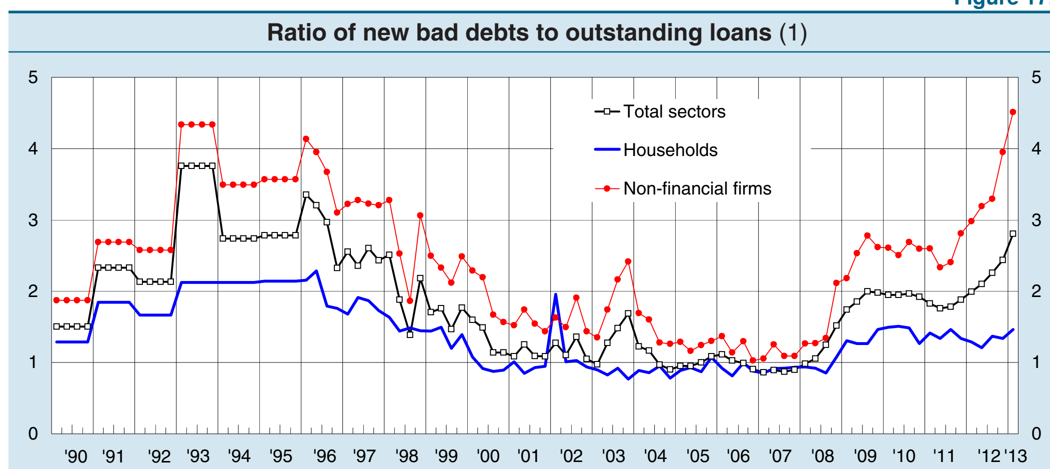
About €85 billion of wholesale bonds will have to be redeemed by the end of 2014. Italian banking groups will be able to meet these redemptions thanks in part to the availability of some €302 billion of assets that can be used as collateral for refinancing with the Eurosystem.

Credit risk and country risk

Loan quality. – Loan quality continued to deteriorate in 2012 as a consequence of the recession. The flow of new bad debts of banks and financial companies operating in Italy amounted to €39 billion, against €32 billion in 2011.

New bad debts grew progressively during the year. For the total economy, in the fourth quarter the flow rose on an annual, seasonally adjusted basis to 2.4 per cent of the stock of loans excluding adjusted bad debts at the end of the previous period, compared with 1.9 per cent in the fourth quarter of 2011 (Figure 17.2).

Figure 17.2



Sources: Supervisory reports and Central Credit Register.
(1) Annualized quarterly flow of adjusted bad debts in relation to the stock of loans excluding adjusted bad debts at the end of the previous quarter. Data seasonally adjusted where necessary.

Almost all the deterioration in credit quality was due to loans to firms, whose default rate reached 3.9 per cent in the fourth quarter, about one percentage point higher than in the same period of 2011. This is a historically high level, close to the peaks recorded during the recession of the early 1990s. The rise in the default rate was sharper for loans in the South (up 1.5 percentage points to 5.8 per cent) and to construction businesses (up 2.1 points to 6.7 per cent). It was more limited in the case of loans to households (up 0.2 points to 1.5 per cent).

The default rate on loans granted by small and minor banks continued to be slightly higher than that on loans granted by major and medium-sized/large banks.

For banking groups together with banks not belonging to groups, non-performing loans (bad debts, substandard loans, restructured loans and overdue exposures or breaches of overdraft ceilings) amounted to 13.5 per cent of total customer loans at the end of 2012, an increase of 2.3 percentage points from a year earlier (Table 17.3). For bad debts the ratio was 7.2 per cent; net of provisions the amount was equal to 29 per cent of regulatory capital (25 per cent in 2011).

Table 17.3

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

	Loans (2)	Share of total loans		Coverage ratio (3)		Share of total loans net of provisions	
	2012 (4)	2011	2012 (4)	2011	2012 (4)	2011	2012 (4)
				Banking system (5)			
Loans to customers	2,132,080	100.0	100.0	4.9	5.8	100.0	100.0
Performing	1,844,983	88.8	86.5	0.6	0.6	92.9	91.3
Non-performing	287,096	11.2	13.5	39.2	38.9	7.1	8.7
Bad debts	*152,590*	*6.2*	*7.2*	*55.7*	*55.0*	*2.9*	*3.4*
Substandard loans	*89,612*	*3.3*	*4.2*	*21.3*	*23.4*	*2.7*	*3.4*
Restructured loans	*21,020*	*1.0*	*1.0*	*17.4*	*22.4*	*0.8*	*0.8*
Loans overdue or breach of overdraft limits	*23,874*	*0.7*	*1.1*	*8.3*	*9.1*	*0.7*	*1.1*

Sources: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to groups.
(1) Rounding may cause discrepancies in totals. – (2) Loans are gross of provisions. – (3) Provisions in relation to the corresponding gross exposure. – (4) Provisional data. – (5) Includes groups and the subsidiaries of foreign banks.

In the first quarter of 2013 the default rate on an annual, seasonally adjusted basis was 2.8 per cent, 0.4 percentage points higher than in the previous quarter. The deterioration was particularly pronounced for firms (4.5 per cent).The growth in loans to customers in temporary difficulty (substandard and restructured positions) suggests that the flow of new bad debts could remain high this year as well.

The non-performing-loan coverage ratio. – For banking groups and banks not belonging to groups as a whole, the coverage ratio (loan loss provisions over gross non-performing exposures), after slipping from 39.2 per cent at end-2011 to 37.4 per cent in June, rose in the second part of the year to reach 38.9 per cent in December. This partly reflected the Bank of Italy's supervisory activity regarding the quality of bank assets, aimed at checking that coverage ratios were adequate.

The coverage ratio at the end of 2012 was about ten percentage points below the levels registered before the crisis. The drop is in part the consequence of the altered composition of non-performing loans, in which there is now a lower percentage of bad debts, which attract higher coverage ratios than other non-performing exposures. Another factor is the increase in the share of non-performing exposures backed by collateral, whose loss rates are significantly lower and coverage ratios consequently below those of uncollateralized loans. From 2007 to the end of 2012 the share of collateralized non-performing loans rose by ten percentage points to 45 per cent.

According to our estimates, if non-performing loans that are fully backed by collateral or by guarantees provided by public sector or financial sector entities are excluded from the bad debt aggregate, the coverage ratio would be more than 19 percentage points higher, at 58.1 per cent.

The non-performing-loan coverage ratio differs appreciably among the different size classes of bank. It was 41 per cent for the five largest groups, just under 38 per cent for large and small banks alike, and 27 per cent for minor banks.

Country risk. – The balance-sheet exposure of Italian banks and their foreign subsidiaries to non-residents diminished by 3.8 per cent in 2012. At the end of the year it amounted to €633 billion, or 23.7 per cent of the total exposure to residents and non-residents. The five largest groups' claims on non-residents accounted for 93.6 per cent of the total foreign exposure and were equal to 33.4 per cent of their total exposures.

The largest of these exposures were to borrowers resident in Germany (€178 billion), Austria (€77 billion), Poland (€36 billion) and the United Kingdom (€35 billion). Those to borrowers resident in Spain, Ireland, Portugal and Greece were modest (amounting to €27 billion, or about 1 per cent of the total exposures to euro-area residents); that to Cyprus was negligible.

The Italian banking system's balance-sheet exposure to the countries of central and eastern Europe, mostly ascribable to the largest groups, grew last year by 4.3 per cent to €171 billion (of which €42 billion vis-à-vis households and €76 billion vis-à-vis firms).

Profitability

The Italian banking system's ability to generate income remained weak in 2012; it was affected by a substantial increase in loan loss provisioning, which eroded the savings deriving from the reduction of operating costs. Net of the extraordinary items connected with goodwill impairments, ROE fell by 1.3 percentage points to 0.4 per cent (Table 17.4).

Table 17.4

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

	Banking system			Largest groups (2)		
	2011	2012 (3)	Percentage change	2011	2012 (3)	Percentage change
Net interest income (a)	54,008	51,673	-4.3	32,227	29,458	-8.6
Non-interest income (b)	37,884	43,110	13.8	23,757	25,384	6.9
of which: fees	*30,046*	*29,395*	*-2.2*	*18,034*	*17,406*	*-3.5*
Gross income (c=a+b)	91,892	94,782	3.1	55,984	54,842	-2.0
Operating expenses (d)	62,363	59,670	-4.3	38,033	34,914	-8.2
of which: staff costs	*33,742*	*32,886*	*-2.5*	*20,687*	*19,739*	*-4.6*
Operating profit (e=c-d)	29,530	35,112	18.9	17,951	19,929	11.0
Allocations to provisions and net value adjustments (f)	52,185	36,324	-30.4	43,476	21,705	-50.1
of which: for loan impairment	*19,261*	*30,356*	*57.6*	*12,775*	*18,105*	*41.7*
Ordinary profit (g=e-f)	-22,656	-1,213	94.6	-25,525	-1,776	93.0
Non-recurring profit (h)	-1,104	-381	65.5	-1,088	-583	46.4
Gross profit (i=g+h)	-23,761	-1,594	93.3	-26,613	-2,359	91.1
Taxes (l)	441	-337	-176.4	-997	-989	0.9
Profit from groups of assets undergoing disposal (after tax) (m)	63	-201	-417.3	37	-201	-637.8
Minority interest profit (n)	583	482	-17.4	425	384	-9.5
Parent company profit (o=i-l+m-n) (4)	-24,722	-1,939	92.2	-26,003	-1,955	92.5
Indicators *(per cent)*						
Ratio of non-interest income to gross income	41.2	45.5		42.4	46.3	
Cost/income ratio (5)	67.9	63.0		67.9	63.7	
Value adjustments in respect of loans/operating profit	65.2	86.5		71.2	90.8	
ROE	-9.3	-0.6		-15.9	-1.1	
ROE net of goodwill impairments	1.7	0.4		1.3	0.0	

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 2012. – (2) Five largest groups by total assets at December 2012. – (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 declined by 4.3 per cent or €2.3 billion, mainly owing to the smaller volume of lending. Gross income increased by 3.1 per cent, thanks in part to trading profits, which were buoyed by the market rallies in the first and fourth quarters, and to profits realized on sales or buybacks of financial liabilities.

The 4.3 per cent reduction in costs, compared with a 5.4 per cent increase in 2011, contributed to the growth of 18.9 per cent in operating profit. The ratio of operating costs to gross income was 63 per cent, down by nearly five percentage points from the previous year.

The deterioration in loan quality led to an increase of 57.6 per cent in loan loss provisions; the increase also reflected supervisory action to check that non-performing-loan coverage ratios were adequate. Loan write-downs amounted to 86 per cent of operating profit, as against 65 per cent in 2011.

Three of the five largest banking groups showed a profit for the year and distributed dividends equal to 55 per cent of profits, more than ten percentage points lower than the average payout ratio in the two years before the crisis (2006-07).

Capital

During 2012 Italian banks increased the highest-quality components of capital and reduced risk-weighted assets, improving their capital ratios.

The stress tests conducted under the IMF's Financial Sector Assessment Program indicate that the Italian banking system should be able to withstand adverse macroeconomic shocks, thanks to the capital strengthening carried out in recent years.

Capital and risk-weighted assets. – At the end of the year consolidated regulatory capital amounted to €235 billion, down by 1.3 per cent compared with the end of 2011 (Table 17.5). Tier 1 capital grew by €5 billion to €189 billion, mainly as a result of the capital increase carried out by one of the five largest groups. The contribution of new resources more than offset the losses incurred in 2012. Supplementary capital decreased by €8 billion to €51 billion, a decline of 13.4 per cent, owing to the non-renewal and buy-backs of hybrid instruments by the largest groups.

Table 17.5

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

	Banking system		Largest groups (2)	
	2011	2012	2011	2012
Allocations to regulatory capital	2,225	2,739	31	1,235
Regulatory capital	238,253	235,136	142,635	137,643
Core tier 1 capital ratio (%)	9.3	10.7	8.9	10.9
Tier 1 capital ratio (%)	10.0	11.1	10.0	11.6
Total capital ratio (%)	13.0	13.8	13.3	14.5
Financial leverage (3) (4)	17	18	19	19
Excess capital	91,388	99,135	56,888	61,677

Sources: 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. The data for December 2012 take account of the debt securities issued in February 2013 by the Monte dei Paschi di Siena group and subscribed by the Ministry for the Economy and Finance. – (2) Five largest groups by total assets at December 2012. – (3) Ratio of total balance-sheet assets to tier 1 capital. – (4) Provisional data.

Risk-weighted assets declined by more than 7 per cent. The reduction was due both to the introduction of internal models for calculating capital requirements by some large groups and the gradual extension of their perimeter (concluding a process under way for some time and assessed by the Bank of Italy) and to the shift in the composition of portfolios to assets attracting lower capital charges. The reduction of risk-weighted assets was especially pronounced for the five largest banking groups (11.3 per cent).

Capital ratios. – The strengthening of the core tier 1 capital ratio and the reduction of risk-weighted assets led to an improvement in banks' capital ratios. Taking account of the issue by Banca Monte dei Paschi di Siena of securities subscribed by the Ministry for the Economy and Finance, the core tier 1 ratio increased in 2012 by 1.4 percentage points to 10.7 per cent. Compared with the end of 2011 the tier 1 ratio rose by 1.1 percentage points, to 11.1 per cent, and the total capital ratio by 0.8 points, to 13.8 per cent.

The capital ratios of the two largest Italian groups are continuing to converge with those of a sample of eleven large European banks comparable in terms of business model (characterized, among other things, by significant international activity) and size (balance sheet assets greater than €600 billion). At the end of 2012 the two Italian groups' overall tier 1 ratio was 11.7 per cent, compared with the European sample's average of 13.3 per cent. Financial leverage, measured as the ratio of total balance-sheet assets (not weighted for risk) to tier 1 capital, was considerably lower for the two Italian groups than for their European peers (19, as against 28).

The outlook for capital strengthening. – In the first quarter of 2013 the capital ratios of the five largest groups remained broadly stable. According to the latest disclosures to the market, at the end of March the core tier 1 ratio was 10.8 per cent, the tier 1 ratio 11.5 per cent and the total capital ratio 14.4 per cent.

In 2012 Italian banks continued to adapt to the new capital adequacy requirements envisaged by the Basel III rules, though their progress was slower than in 2011.

The activity of non-bank intermediaries

The profitability of asset management companies and investment firms benefited during 2012 from the recovery of the financial markets, but the profits and business volumes of financial companies entered in the special register declined and the riskiness of their loan portfolios grew.

Asset management companies. – Asset management companies' net profit increased by 32.5 per cent to €510 million (Table 17.6). Gross operating profit grew as a combined result of the slight increase in fee income (connected with the good performance of the markets in the last quarter of the year) and the reduction in fee expense and operating costs, not least following corporate and group restructurings. The result on financial operations also improved, thanks to smaller losses on investments and larger trading profits.

Almost 20 per cent of asset management companies, mostly specialized in real-estate funds, made a loss for the year (compared with 34 per cent in 2011); of these, approximately one third left the market. The ratio of regulatory capital to the overall capital requirement fell with respect to the previous year (from 5.1 to 4.6).

Investment firms. – Italian investment firms' net profit (€125 million) increased by 40 per cent from 2011. Costs rose by a moderate 4 per cent, while profits were boosted by the positive results of trading on own account and by the increase in income from portfolio management and securities placement. The cost/income ratio declined from 76 to 68 per cent.

Table 17.6

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

	2011		2012		Percentage change
	Amount	Per cent (1)	Amount	Per cent (1)	
Fee and commission income	3,958	236.5	4,021	225.9	1.58
Fee and commission expense	2,284	136.5	2,241	125.9	-1.92
Gross operating profit (2)	**1,674**	**100.0**	**1,780**	**100.0**	**6.35**
Administrative expenses	1,141	68.2	1,083	60.9	-5.05
of which: staff costs	*612*	*36.6*	*589*	*33.1*	*-3.80*
Other operating expenses	20	1.2	42	2.4	108.72
Total operating costs (3)	**1,227**	**73.3**	**1,178**	**66.2**	**-3.97**
Other operating income	89	5.3	89	5.0	0.20
Net operating profit	**537**	**32.1**	**690**	**38.8**	**28.56**
Result on financial operations	74	4.4	103	5.8	39.86
Result on ordinary activities	**611**	**36.5**	**794**	**44.6**	**29.93**
Taxes	226	13.5	284	15.9	25.58
Net profit (loss) for the year	**385**	**23.0**	**510**	**28.7**	**32.48**

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.

Investment firms' regulatory capital, consisting almost entirely of tier 1 elements (capital and reserves), was 4 per cent higher at the end of 2012 than a year earlier. The increase in risks, particularly credit risk, entailed a slight rise in capital charges: the ratio of regulatory capital to the overall capital requirement was 4.8 at the end of 2012 (4.5 at the end of 2011).

Financial companies – Financial companies entered in the special register established by Article 107 of the Consolidated Law on Banking recorded a 1.3 per cent decline in the flow of loans granted. The contraction was greater in leasing than in consumer credit (26.7 against 7.4 per cent). By contrast, the factoring sector's turnover grew by 1.3 per cent.

The quality of financial companies' loans continued to worsen. Non-performing loans rose by nearly three percentage points as a share of total customer exposures, to 13.4 per cent. Among non-performing loans, a very substantial portion (50.4 per cent) consisted of bad debts.

Article 107 companies' profit for the year fell by 19.5 per cent compared with 2011, partly as a consequence of the decline of 5.4 per cent in fee income and the increase of 30.6 per cent in net losses on loans. The number of loss-making intermediaries, mainly leasing companies and mutual loan-guarantee consortiums, rose from 67 to 82. The ratio of regulatory capital to the overall capital requirement was equal to 1.5, broadly unchanged from 2011.

18. INSTITUTIONAL INVESTORS

In 2012 Italian institutional investors registered a net outflow of resources amounting to €18 billion, down sharply from €34 billion in 2011 (Table 18.1). Italian investment funds, life insurance products and individually managed portfolios registered net redemptions. Total assets increased by 18 per cent, to €1 trillion, chiefly as a result of the transfer of a leading insurance group's foreign portfolios to an Italian asset management company and, to a lesser extent, the positive returns on the assets under management. At the end of 2012 these were equal to 66 per cent of GDP and accounted for 24 per cent of households' financial assets.

Table 18.1

Italian institutional investors: net fund-raising and assets under management
(million euros and per cent)

	Net flows		End-of-period stocks			
	2011	2012 (1)	2011	2012 (1)	Percentage composition	
					2011	2012 (1)
Investment funds (2)	-29,681	-10,962	191,988	189,523	16.4	13.8
Insurance companies (3)	9,910	4,300	476,991	486,208	40.8	35.5
Pension funds (4)	5,250	4,953	60,038	68,989	5.2	5.0
Individually managed portfolios	-15,645	-11,473	438,884	625,182	37.6	45.6
Total	**-30,166**	**-13,182**	**1,167,901**	**1,369,902**	**100.0**	**100.0**
Consolidated total (5)	**-34,153**	**-17,968**	**882,114**	**1,037,902**	**–**	**–**
as a percentage of GDP	*-2.2*	*-1.1*	*55.9*	*66.3*	–	–

Sources: Based on Bank of Italy, Covip and Ivass data.
(1) Provisional. – (2) Italian investment funds and SICAVs. – (3) For end-of-period stocks, technical provisions net of reinsurance reserves. Excludes Italian branches of EU insurance companies and includes Italian branches of non-EU insurance companies. – (4) For end-of-period stocks, balance-sheet assets. – (5) Net of investments in Italian collective investment undertakings by the other categories of intermediary, investments of 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.

The negative economic outlook fuelled requests for early redemptions and kept household investment in financial assets at low levels. Asset management also suffered from the decline in the volume of products distributed through bank branches. Net fund-raising staged a recovery in the second part of the year, thanks to the improvement in conditions on the financial markets.

In the open-end funds sector the market share of Italian groups continued to decline. The shift in the composition of financial portfolios in favour of foreign investment funds continued and their share of the total assets of the funds distributed in

Italy rose from 63 to 67 per cent. Following the implementation of Directive 2009/65/EC on undertakings for collective investment in transferable securities ("UCITS IV"), which introduced a "European passport" for management companies, several Italian groups moved the management of foreign funds to Italy.

Of the various life insurance products, the net outflows were mainly from unit- and index-linked policies, while fund-raising was positive for with-profits policies offering a guaranteed minimum return. In the retirement saving sector, insurance-based products expanded again. The number of members and the flow of contributions of pension funds remained virtually unchanged, although the number of participants who suspended payments increased.

By international standards the portfolios of Italian institutional investors contain a large portion of (mostly domestic) government securities. The portions invested in equity securities and corporate bonds are relatively small, 4 and 24 per cent respectively for insurance companies and 15 and 10 per cent for pension funds (Table 18.2); investment in unlisted securities and in closed-end funds, including private equity and venture capital funds, is also modest.

Table 18.2

Institutional investors' main financial assets (1)
(percentage shares)

	2011				2012			
	Investmen funds (2)	Pension funds (3)	Insurance companies	Individually managed portfolios (4)	Investmen funds (2)	Pension funds (3)	Insurance companies	Individually managed portfolios (4)
Government securities	53	51	63	45	50	50	66	41
of which: Italian	*73*	*53*	*90*	*88*	*72*	*50*	*92*	*81*
Bonds	15	10	25	18	17	10	24	26
of which: Italian	*27*	*17*	*31*	*33*	*26*	*20*	*34*	*20*
Shares	22	13	4	11	21	15	4	7
of which: Italian	*12*	*5*	*62*	*48*	*13*	*6*	*66*	*38*
Investment fund units	6	13	6	23	6	14	5	22
Other financial assets	4	12	1	4	7	11	1	5
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
in millions of euros	*131,617*	*57,103*	*350,131*	*438,905*	*129,462*	*66,423*	*362,665*	*625,477*

Sources: Bank of Italy, Covip and Ivass.
(1) Balance-sheet values. Investments covering the technical provisions of the non-life sector and of traditional products of the life sector (class C) for insurance companies; assets under management for investment funds, individually managed portfolios and pension funds. – (2) Italian harmonized funds. – (3) Includes the Bank of Italy employees' pension fund. For 2012, provisional data. – (4) The differences between 2011 and 2012 are partly due to the reorganization of the Generali group, which transferred its foreign operations in this sector to its Italian asset management company.

Investment funds

Fund-raising and total assets. – In 2012 the net outflow from Italian open-end funds more than halved, from €34 billion in 2011 to €14 billion (Table 18.3). Net fund-raising by foreign funds distributed in Italy returned to growth, increasing from €1 billion to €15 billion. The increase involved both foreign funds promoted by Italian management companies and those controlled by foreign groups. The total assets of the funds distributed in Italy grew by around 10 per cent, to €457 billion, mainly as a result of revaluation gains.

Table 18.3

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

	Number of funds (2)		Net assets		Net fund-raising (3)	
	2011	2012	2011	2012	2011	2012
Harmonized open-end funds	609	555	131,572	129,462	-29,700	-11,631
Equity	165	129	19,145	17,943	-1,905	-2,748
Balanced	50	36	10,127	8,079	-1,915	-1,971
Bond	195	196	60,116	71,566	-13,920	52
Money market	27	20	25,621	13,899	-8,082	-4,076
Flexible	172	174	16,564	17,975	-3,877	-2,889
Non-harmonized open-end funds	202	188	22,093	20,331	-4,795	-2,844
Hedge funds (4)	120	99	8,051	6,225	-1,676	-1,805
of which: funds of funds	*98*	*80*	*6,558*	*5,079*	*-1,333*	*-1,439*
Other	82	89	14,042	14,106	-3,119	-1,039
of which: funds of funds	*50*	*48*	*6,203*	*6,263*	*-253*	*-702*
Total open-end funds	**811**	**743**	**153,665**	**149,793**	**-34,495**	**-14,475**
Closed-end securities funds	133	139	6,972	8,146	103	781
of which: reserved to qualified investors	*126*	*134*	*6,775*	*7,984*	*123*	*794*
Closed-end real-estate funds	329	353	31,351	31,584	4,711	2,732
of which: reserved to qualified investors	*301*	*326*	*25,549*	*26,487*	*4,382*	*2,800*
Total closed-end funds	**462**	**492**	**38,323**	**39,730**	**4,814**	**3,513**
Total	**1,273**	**1,235**	**191,988**	**189,523**	**-29,681**	**-10,962**
Memorandum items:						
Foreign funds (5)	2,887	3,165	260,290	307,421	1,140	14,971
set up by Italian intermediaries (6)	895	1,004	163,233	187,602	-3,974	4,617
of which: hedge funds	*23*	*29*	*1,826*	*1,405*	*-616*	*-441*
set up by foreign intermediaries	1,992	2,161	97,057	119,819	5,114	10,354

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 are 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.

Net outflows were mainly recorded in money market and equity funds and non-harmonized funds (including hedge funds). By contrast, there were abundant inflows of resources to bond funds that pursue a flexible investment strategy and to funds specialized in corporate or emerging market bonds. Funds that invest in Italian government securities also recorded net inflows.

This portfolio reallocation was favoured by the low interest rates on short-term assets and on government securities in the euro area, which drove demand towards products with higher risk and return profiles. The persistent uncertainty on the financial markets nevertheless led investors to limit their exposure to equity market risk.

Net fund-raising for closed-end real-estate funds, defined as the flow of new investment net of redemptions, declined from €4.7 to €2.7 billion; that of securities investment funds (mainly private equity) came to €781 million.

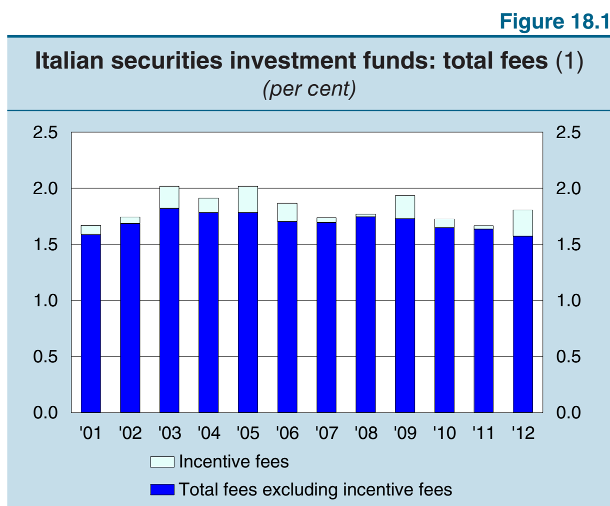
Yields and fees. – Italian harmonized funds' average return net of fees turned positive (8.2 per cent, compared with -3.2 per cent in 2011), reflecting the rise in prices on the main financial markets in the second half of the year. Gains were recorded in all the main sectors.

Total fees as a proportion of the average annual net assets of harmonized investment funds (management and incentive fees, depositary bank fees, securities brokerage commissions and other minor items) rose from 1.7 to 1.8 per cent, the first increase since 2009 (Figure 18.1), due to the growth in incentive fees. According to Borsa Italiana data, the average annual ratio of total fees to net assets of exchange-traded funds (ETFs) remained virtually the same, at 0.4 per cent.

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.

The Italian investment fund industry. – The share of the total assets of funds distributed in Italy attributable to funds promoted by Italian groups fell further, from 73 to 71 per cent; at the end of 2012 Italian groups managed around 7 per cent of the total assets of open-end European funds.

The share of the total assets of funds distributed in Italy ascribable to foreign funds – largely domiciled in Luxembourg – continued to increase, rising from 63 to 67 per cent. Over the past fifteen years Luxembourg has established itself as one of the main financial centres for investment funds, thanks to an advantageous tax regime for management companies, less restrictive regulations than in other European countries, and savings made possible by an abundant supply of investment and specialized professional services. At the end of 2012, German asset management companies controlled 16 per cent of the total funds domiciled in Luxembourg, while French and Italian companies both controlled 7 per cent.

Following the transposition of the UCITS IV Directive, which permits management companies to set up foreign funds, a process of reorganization was launched within the major groups. In 2012 Pioneer and Generali centralized the management of 82 foreign funds, with total assets of around €16 billion, in Italy.

The number of exchange-traded funds listed on Borsa Italiana, all promoted by foreign intermediaries, increased from 570 to 617. Their total assets, calculated based on the shares deposited with Monte Titoli, rose from €17 billion in 2011 to €18 billion. The number of structured ETFs remained substantially unchanged (72), with total

assets of about €900 million; the number of those linked to the prices of commodities rose from 88 to 172 and their assets from €1.9 billion to €2.5 billion.

Closed-end real-estate funds continued to grow, their number rising from 329 to 353. As in previous years, the expansion only involved funds reserved to qualified investors, mainly as a consequence of contributions of real-estate portfolios by social security institutions, insurance companies and banks. At the end of 2012 the assets of funds reserved to qualified investors made up 69 per cent of the total, retail funds 15 per cent and hedge funds the remainder. The profitability of real-estate funds continued to suffer from the recession and, in particular, the difficulty of disposing of assets.

Individually managed portfolios

Fund-raising and total assets. – In 2012 the individually managed portfolios of Italian banks, asset management companies and investment firms registered net outflows for the second year in succession (€11 billion, as against €16 billion in 2011). The redemptions were concentrated in portfolios ascribable to banking groups and involved both retail and institutional customers. The total value of assets under management rose from €439 billion to €625 billion, mainly as a result of the contribution of the foreign portfolios of the Generali group to its Italian asset management company and, to a lesser extent, the positive return on portfolio assets.

According to Assogestioni data, which include Italian portfolios managed by non-resident companies, net fund-raising by foreign groups was negative (-€11 billion). Foreign groups' share of the total assets managed fell from 19 to 13 per cent.

Investments and yields. – In 2012 individually managed portfolios made substantial net purchases of Italian government securities, against net disposals of Italian and foreign bonds and equity. At the end of 2012 government securities and bonds made up respectively 41 and 26 per cent of the total holdings, equities and investment funds 7 and 22 per cent.

Italian portfolios' yield, measured by the percentage increase of net assets less fund-raising and adjusted for the effects of the reorganization of the portfolios managed by the Generali group, was 6.2 per cent in 2012 (-2.8 per cent in 2011), below the overall yield of investment funds.

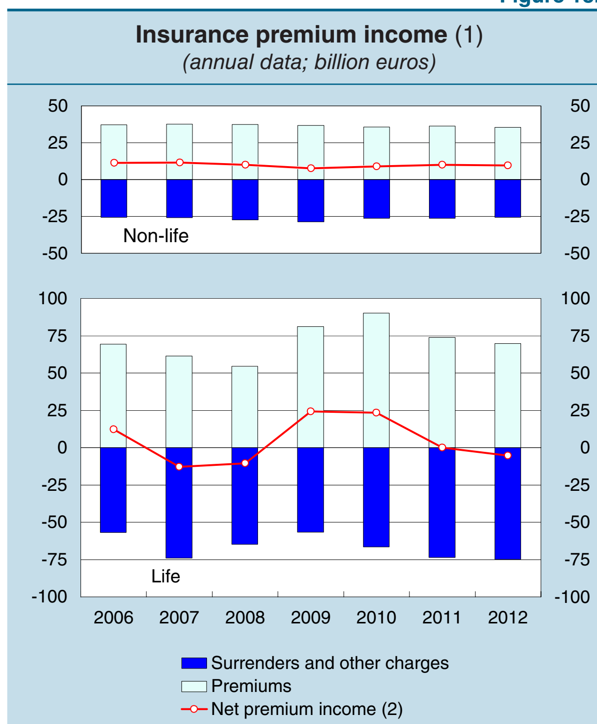
Insurance companies

Premiums and technical provisions. – From basically nil in 2011, net premium income in the life insurance sector turned negative, by €5.3 billion (Figure 18.2). Requests for early surrenders by policyholders remained at high levels. Net surrenders were concentrated in unit- and index-linked policies (€9.2 billion); net fund-raising for with profit policies, although falling by half, was positive (€6.2 billion). In the last quarter of 2012 and in early 2013 the sector enjoyed a recovery, assisted by the rise in prices on the financial markets. The non-life sector continued to record net positive

inflows (€9.6 billion); the motor liability insurance sector, though continuing to suffer from weak demand, benefited from the first effects of the recent reforms on claims for road accidents (see Chapter 18, "Institutional Investors", Annual Report for 2011). The insurance industry's total premium income, net of claims and surrenders, amounted to €4.3 billion.

Figure 18.2

Insurance premium income (1)
(annual data; billion euros)



Source: Ivass.
(1) In Italy. – (2) Premiums less surrenders and charges in respect of claims and payments falling due.

Investment. – The composition of insurance companies' assets did not undergo any significant variation compared with the previous year. For non-life insurance and traditional life insurance products, investment in securities accounts for 92 per cent of the assets held to cover technical provisions; most of the remainder is invested in real estate, while the share consisting of loans to firms and households is virtually nil. Some 66 per cent of the portfolio was invested in (mostly domestic) government securities; private sector bonds (mainly bank bonds), investment funds and equities accounted for 24, 5 and 4 per cent respectively. The portion invested in closed-end securities funds (including private equity and venture capital funds) was less than 1 per cent.

Compared with other European countries, investment in private-sector securities was low. This reflected, in particular, the predominant share of Italian government securities, which offered high yields against what were deemed modest risks.

Profitability. – The profitability of Italian firms improved last year, thanks above all owing to unrealized capital gains on government securities. ROE, negative on average in 2011 (-9 per cent for life insurance and -5 per cent for the non-life sector), was positive (15 and 3 per cent respectively). However, the main market indicators – for listed companies only – continue to suffer from the uncertain economic outlook (see *Financial Stability Report* No. 5, April 2013).

Italy's insurance industry. – In the last fifteen years the insurance sector has assumed a prominent role in the asset management industry in Italy. Insurance companies' technical provisions have quadrupled since 1998, reaching €486 billion, and their share of managed assets has increased from 17 to 35 per cent.

Despite this rapid growth, Italy's insurance industry is still smaller than that of the main European countries. Insurance products amount to 12 per cent of household

wealth in Italy (the share was 5 per cent in 1998), compared with 33 per cent in France and 18 per cent in Germany.

The insurance industries of the main European countries differ markedly in terms of supply. In Italy, France and Germany traditional policies, which offer subscribers a minimum guaranteed return, are life insurance companies' leading product: in 2011 they accounted for some 80 per cent of total premiums in all three countries. In the United Kingdom, by contrast, the main sector is index- and unit-linked policies, in which financial risk is typically borne by the insured party. There are also significant differences among pension-related policies: while in Italy these policies are marginal, in Germany and the United Kingdom they account for 34 and 84 per cent of total premiums respectively. In the non-life sector, finally, the Italian insurance industry is characterized by the preponderant role of motor liability policies and the limited size of the other classes (accident, illness and property damage).

At the end of 2012 there were 135 Italian insurance companies, of which 52 operating exclusively in life insurance, 69 in non-life insurance and 14 in both. The degree of concentration of the Italian insurance industry is high by European standards, in particular for the non-life sector.

Foreign groups have a significant presence in Italy. At the end of last year insurance companies resident in another EU country had 91 branches in Italy; 991 foreign companies operated in Italy under the freedom to provide services. In 2012 resident companies controlled by foreign insurance groups accounted for 23 per cent of total premium income. The largest shares were attributable to German and French groups.

Banks play an important role in the ownership structures of Italian insurance companies, albeit not as great as in the other asset management sectors (investment funds and individually managed portfolios). In 2012 the assets of insurance companies controlled by domestic banking and financial groups made up 19 per cent of the total. The banking sector plays a larger role in the distribution of insurance products.

On 1 January 2013, in accordance with Legislative Decree 95/2012, the new Insurance Supervisory Authority (Ivass) succeeded to all the powers, functions and responsibilities of its predecessor (Isvap), in order to guarantee the full integration of insurance supervision, including through closer coordination with banking supervision. The chairmanship of Ivass is entrusted to the Director General of the Bank of Italy, while its general administration is assured by the Board of Directors, comprising the Chairman and two Directors of Ivass.

Pension funds

Fund-raising, assets and enrolments. – Net fund-raising of the various supplementary pension schemes, defined as the balance between contributions and benefits, remained virtually unchanged at €7 billion. Resources under management grew by 16 per cent, up from 10 per cent in 2011, partly as a consequence of the positive return on assets. Total assets rose from €73 billion at the end of 2011 to €85 billion at the end of last year, of which occupational pension funds accounted for 36 per cent, pension funds set up before the 1993 reform 34 per cent, individual pension plans 19 per cent, and open pension funds 12 per cent.

Last year the number of members of supplementary pension schemes rose by 5.3 per cent, to 5.8 million (Table 18.4). However, the number of those who temporarily suspended contributions increased further. The number of participants in occupational pension funds continued to decline (-1.2 per cent) while open pension funds recorded a modest increase (3.7 per cent). Enrolments in individual pension plans continued to grow at a strong pace (14 per cent), with their share in the total increasing from 37 to 40 per cent. The enrolment rate among private-sector employees remains low: at the end of 2012 the proportion of workers enrolled was around 25 per cent.

Table 18.4

Supplementary pension schemes: market structure (1)
(amounts in million euros)

	Number of funds (2)		Persons enrolled (3)		Total assets	
	2011	2012 (4)	2011	2012 (4)	2011	2012 (4)
Pension schemes set up after the 1993 reform	181	174	4,871,823	5,168,754	46,828	56,338
Occupational pension funds	38	39	1,994,280	1,969,771	25,272	30,174
Open pension funds	67	59	881,311	913,913	8,364	10,078
Individual pension plans	76	76	2,025,331	2,311,840	13,192	16,086
Pension funds set up before the 1993 reform	363	361	664,957	659,920	26,210	28,490
Total	**544**	**535**	**5,536,780**	**5,828,674**	**73,038**	**84,828**

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.

Returns and costs. – After the disappointing results of the previous year, in 2012 the returns on pension funds were very positive, thanks to the performance of the main financial markets. According to Covip data, the average return (net of management expenses and taxes) was 8.2 per cent for occupational funds and 9.1 per cent for open funds. Individual pension plans yielded around 8.9 per cent for unit-linked products and 3.8 per cent for products based on separate portfolios.

The costs borne by subscribers remained unchanged overall. 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 0.23 per cent for occupational pension funds, 1.1 per cent for open pension funds and 1.6 per cent for individual pension plans.

Investment policies. – The composition of pension funds' assets did not change substantially over the year. At the end of 2012, half of the total assets of the funds was invested in government securities and 10 per cent in corporate (mostly bank) bonds; shares and investment funds accounted for 15 per cent each, with the remainder in money market instruments (Table 18.2). Investment in unlisted securities and closed-end securities investment and real-estate funds was virtually nil.

Compared with countries where supplementary schemes are more developed, the portfolios of Italian pension funds contain only a small portion of private-sector securities, particularly of less liquid assets (such as unlisted bonds and private equity funds).

THE GOVERNOR'S CONCLUDING REMARKS

In these remarks I will give an account of a difficult year and speak about the severe test that we have all had to face. I will recall what has been done, describing the role of the Bank of Italy. I will speak about the progress made, even if it is insufficient; about the results achieved, although these are still fragile; about the need not to waste but to defend and consolidate these achievements in order to set the recovery process in motion; and lastly about the conditions for a return to balanced growth.

Allow me to start with a farewell, in fact with more than one. On 28 April, in this delicate moment in the life of the country, our Director General Fabrizio Saccomanni was called to join the Government as Minister for the Economy and Finance. Endowed with outstanding personal and professional qualities, he has worked in almost all of the Bank's institutional and administrative fields of action. His experience, his thorough knowledge of the European and international organizations in which he has held prominent positions and performed important tasks for Italy, the competence and balance he has demonstrated in his many years of service to the Bank, for which we owe him a debt of gratitude, will be even more essential in the test that awaits him. We extend our warm best wishes to him.

He is succeeded by Salvatore Rossi, our former Deputy Director General, who has for many years combined broad managerial responsibilities with economic analysis attentive in particular to innovation and development. As Director General, he is also Chairman of the Insurance Supervisory Authority, which at the beginning of the year was placed by law under the direction of the Governing Board of the Bank of Italy, assisted by two outside directors.

In July 2012 Anna Maria Tarantola, the first woman on our Governing Board, left the Bank to become president of the state broadcasting corporation RAI, a challenging assignment that recognizes her management skills and professional rigour. In December, at the end of a career that was exemplary for commitment, dedication and analytical and institutional contributions, Deputy Director General Giovanni Carosio concluded his mandate. I would like to thank both of them warmly for their contribution of ideas and activity on behalf of the Bank.

Between October 2012 and 10 May the Governing Board was brought back up to strength with the appointment of Deputy Directors General Fabio Panetta, Luigi Federico Signorini and Valeria Sannucci. The new members of the Governing Board previously held positions of responsibility at the highest levels in the fields of monetary policy, financial stability, supervision, internal administration, and coordination of the activities connected with the Bank's participation in the Eurosystem and the banking union project.

The Bank of Italy is required to submit a yearly report on its activities to Parliament and the Government. Starting this year, the report has been enlarged and will be presented together with the annual report and financial statements. In this way we will be able to give a full account of the Bank's operations and activities, its analyses, guidelines, administrative actions and organization.

The fundamental responsibilities of the Bank of Italy for monetary policy within the Eurosystem and for supervising the national banking and financial system are well known. At the same time the Bank is a complex organization providing services that benefit both intermediaries and the general public. We administer the resources entrusted to us with diligence. The report on operations describes the steps taken to rationalize our procedures, improve the quality of our services and achieve greater efficiency.

As a member of the Eurosystem, the Bank is involved in the payment systems, in the production of banknotes, and in ensuring the business continuity of common IT systems, often as lead institution in charge of joint activities and projects. Together with the three other largest central banks of the euro area we are creating a centralized platform for the settlement of securities transactions.

At home, last year we made further progress in automating the centralized state treasury service and promoted the widespread adoption of the European format for payment services, thereby helping to cut costs and foster competition. Against a background of worsening economic conditions and risks for financial stability, we further strengthened our supervisory controls on banks and other intermediaries, stepped up inspections, and broadened our checks on compliance with the rules for consumer protection and against money laundering.

The European Central Bank, the national central banks and the national supervisory authorities are working to create the single supervisory mechanism. This far-reaching institutional innovation will require an organizational adaptation as significant as, and even more complex than, the one leading to the single monetary policy. The project must capitalize on the best national practices; it must aim to achieve a common system of supervisory rules and practices ensuring pursuit of high and strict standards. We attach special importance to aspects that are a fundamental part of our tradition, such as the central role of inspections, methodologically robust analysis, and continuous discussion and dialogue with banks' boards of directors and top management.

The single supervisory mechanism will be based on the close integration of European and national structures in the case of the largest banks, and on the direct responsibility of national authorities – within the framework of common guidelines – for the rest; the tasks of customer protection, combating money laundering and supervision of non-bank intermediaries will continue to be conducted at national level. The delicate launch phase will require substantial investment in human and technical resources. The workload will not diminish, either for us or for the supervisory authorities of the other countries, as we strive to combine frameworks that differ in many respects.

Concerning the events involving Monte dei Paschi di Siena, a detailed account of the supervisory initiatives and the measures adopted was made available on the Bank of Italy's website at the end of January and has since been updated. Supervision of Monte dei Paschi has been continuous and increasingly stringent in recent years; the judicial authorities will assess whether this activity was obstructed by former directors and managers. From 2010 to 2012 we demanded that steps be taken to restore a balanced liquidity position, thereby staving off serious threats; we requested a marked strengthening of capital and of the internal control system; we prompted a radical

change of management. We are working closely with the judiciary, to the benefit of our respective institutional objectives: safeguarding stability and suppressing illegal actions. The contribution of the Financial Intelligence Unit is fundamental. We have operated properly and with diligence and care, within the scope of the law; we welcome constructive comments.

In 2012 the Bank of Italy considerably increased the volume of its assets, participating in exceptional single monetary policy interventions, particularly the expansion of bank refinancing operations. This has resulted in larger profits, but also in the need for greater precautionary allocations to risk provisions. The Treasury will receive a payment of €1.5 billion, on the basis of the Statute and subject to approval of the financial statements. The taxes owed by the Bank on its income and productive activities for the 2012 financial year amount to almost €2 billion.

From 2008 to 2012 the Bank's operating costs fell by more than 10 per cent; its staff was reduced by about 700 to just over 7,000. Technology has made possible large savings in resources and improvements in services in the payment sector. We have reduced internal administration and reinforced banking and financial supervision. The Governing Board and the Board of Directors agree on the objective of eliminating most of the Bank's network at the provincial level.

We have not ceased to recruit staff, using transparent and merit-based procedures, including innovative methods, to select highly qualified young people. Women account for 35 per cent of all personnel and 23 per cent of employees with managerial responsibilities; both percentages are rising. We promote gender equality in recruitment, in the assignment of positions and in career progression. We will continue to do so in the interest of good administration.

I wish to convey my personal thanks and those of the Governing Board to the managers, directors and all the staff who work for the Bank of Italy, proudly performing their public duties with discipline and honour, as the Constitution requires; capable, when times are hard, of an outstanding, self-sacrificing commitment of effort, skill, passion, dedication and openness to change. The Bank and the country know they can count on them.

Monetary policy in the euro area

Conditions on the global financial markets have improved, but the world economy has yet to return to a steady growth path. The economic situation differs markedly in the main regions. The major emerging countries are still growing at rapid rates. Among the advanced countries, the United States appears to be gradually returning to the rates of growth that characterized the most recent expansions. In Japan, aggressively expansive policies, not devoid of risk, are seeking to stimulate economic activity. The euro area is struggling to pull out of recession: demand is dampened by the immediate effects of public and private deleveraging in many countries; cyclical weakness is spreading to the economies not directly exposed to the sovereign debt crisis.

Recovery in the euro area requires help from every sphere of economic policy. Including by recourse to "unconventional" instruments, monetary policy has made

an essential contribution to averting serious consequences for financial stability; it has safeguarded price stability. The tools of intervention have been chosen based on the characteristics of the financial system, the origin of the tensions and the institutional structure: we have aimed first and foremost to support the liquidity of the banks, which in the euro area, more than elsewhere, play a pre-eminent role in financing the economy, and to prevent sovereign debt market distortions from impeding the proper transmission of monetary policy.

We remarked a year ago that the levels to which sovereign interest rates had risen in many countries of the area reflected not only the deterioration of national growth and fiscal prospects, but also a systemic risk factor, subsequently called "redenomination risk", connected with fears of a break-up of the monetary union, due in part to the incompleteness of its institutional design. We documented this risk swiftly and analytically; our results have been confirmed by the studies of other institutions and have been adopted by the Eurosystem.

At the end of June the summit meeting of euro-area heads of state and government approved flexible and efficient utilization of the financial support mechanisms – the European Financial Stability Facility and the European Stability Mechanism – to stabilize the financing conditions of the countries exposed to the sovereign debt tensions, provided they honoured their European commitments. The possible use of those mechanisms for the direct recapitalization of banks, after the creation of a single supervisory mechanism, was envisaged.

In early August the ECB Governing Council announced the introduction of outright monetary transactions (OMTs) for purchases of government securities on the secondary market, with no quantitative limits. A few days before that the President of the ECB had promised to do whatever was necessary to safeguard the euro. In September the details of the scheme were defined.

Countering the increase in interest rates on sovereign debt when that increase stems from redenomination risk and distorts the transmission of monetary policy falls fully within the Eurosystem's mandate. The benefits of the announcements of the new measures were immediate: medium- and long-term yields came down in the countries under pressure; the fragmentation of markets along national lines lessened.

The steps taken by the Eurosystem in the last two years have counteracted the worsening of credit conditions in the euro area and its repercussions on the macroeconomic situation. In Italy, according to our estimates, they have helped to buoy output by at least two and a half percentage points over that span. Our estimates, however, cannot measure the effects of the financial collapse that could have occurred in the absence of these interventions, with disastrous consequences for the national and European economies.

In recent months the fears concerning the single currency's survival have abated further and financial conditions in the area have eased; one factor has been the expansion of global liquidity, which has spurred a search for high yields on the part of international investors. In Italy, interest rates on government securities have also declined on the longest maturities, returning to the levels prevailing at the beginning of 2010.

Yet these advances have not been accompanied by an improvement of the real economy; economic activity continued to be weak throughout the euro area in the

first quarter. Credit conditions still differ from country to country, owing not only to the diversity of macroeconomic situations but also to the residual uncertainty as to the future conditions of funding in the national banking systems.

At the beginning of this month, considering the contraction of demand, the prospect of prolonged cyclical weakness and the decline of both actual and expected inflation in the medium term to well below 2 per cent, the ECB Governing Council lowered the rate on main refinancing operations further, taking it to a new historic low of 0.5 per cent. The Council reiterated that the unlimited supply of liquidity at fixed rates would continue for as long as necessary and in any case until July of next year. The ECB, in concert with other European institutions, is examining initiatives to promote a market in securities backed by loans to non-financial corporations.

The Governing Council stands ready to intervene again as new information becomes available and to consider all possible measures for maintaining credit conditions throughout the area consistent with the monetary policy stance. The ECB's management of official interest rates has proven effective; the effects of last year's reductions have spread to the countries hardest hit by the tensions.

The measures taken, in particular the announcement of outright monetary transactions, are conducive to the national and European reforms which alone can eradicate redenomination risk. Monetary policy can guarantee stability only if the area's economic fundamentals and institutional architecture are consistent with that objective.

Every country must do its part. The procedure for the activation of OMTs presupposes the emergence of very serious tensions; it can only be applied to countries that have previously requested, possibly on a precautionary basis, a European financial assistance programme, and it is subordinated to compliance with the conditions attached. These reflect the awareness that the fears of euro reversibility are not disjoined from those for the sustainability of the public debt and the growth prospects of individual countries.

More than any conditionality, however, what is essential is the shared determination to advance towards a complete European Union: monetary union, banking union, fiscal union and finally political union. Important strides forward have already been taken. Under the pressing time constraints dictated by the crisis, there has been uncertainty, mistakes have been made, decisions have not been easy. But the way ahead is clear.

We must proceed along the path of integration. The banking union project is designed to break the spiral between sovereign debt and the conditions of banks and credit. The importance of this has been further underscored by the handling earlier this year of the banking crisis in Cyprus, which was resolved only after problems of coordination between European and national authorities had emerged. The creation of a single banking supervisory mechanism in which the ECB and the national authorities play a pivotal role is the first step. It must be completed by rapid introduction of a common bank resolution scheme and common deposit insurance.

The contours of the project for the common budget for the euro area must be defined and a timetable for its realization drawn up. The report of the European Commission last November and the one drafted by the presidents of the European Council, the Commission, the Eurogroup and the ECB move in this direction. The institution of common mechanisms of financial support for structural reforms in single member

countries can constitute the occasion for the launch of the project and the issue, on a trial basis, of joint debt securities.

The Italian economy

Italy's weak recovery following the global financial crisis ended in the second half of 2011, when our government securities market came under pressure. There ensued a vicious circle between the state of the public debt, of banks and credit, and of the real economy. Economic activity contracted by 2.4 per cent last year.

This year too will register a substantial fall in output and employment. A cyclical upturn towards the end of the year is possible; it will depend on the acceleration of world trade, the implementation of appropriate economic policies, positive developments in expectations and investment conditions, and the availability of credit.

The recession is deeply undercutting potential output and threatens to erode social cohesion. In 2012 Italy's gross domestic product was 7 per cent smaller than in 2007, households' disposable income was more than 9 per cent lower, and industrial production was down by a quarter. Hours worked were down 5.5 per cent, and more than half a million jobs had been lost. The unemployment rate, at 11.5 per cent this March, has practically doubled since 2007; it is nearly 40 per cent among young people and higher still among those in the South.

The financial and international origins of the crisis, on which economic policy makers have mostly focused, must not blind us to the fact that in Italy more than in other countries the cyclical ups and downs are superimposed on serious structural weaknesses. In the ten years preceding the crisis, this was already evident in the overall performance of the Italian economy, which fared worse than those of nearly all the other major advanced countries.

We failed to respond to the extraordinary geopolitical, technological and demographic changes of the last quarter-century. The adjustment required, and put off for so long, is historic in scope. It will affect the accumulation of tangible and intangible capital, product specialization and the organization of production, the education system, skills, career paths, the characteristics of the welfare system and income distribution, the positional rents that are incompatible with the new competitive environment, and the working of government. An adjustment of this magnitude needs a decisive contribution from the political system, but the response of society and all the forces of production is essential.

Firms are called upon to make an exceptional effort to ensure the success of the transformation by investing resources of their own, seizing the opportunities for growth, adapting their corporate structures and organization, relying on innovation and their ability to hold their own in the most dynamic markets. They have demonstrated their ability to do so at other times in our history. Some are doing so now. But too few have been willing to take the plunge; at times, instead, the illusory solution of public support is advocated.

This year's Report contains a special section on innovation in Italy. The ability to renew products and processes, to export to emerging markets and to internationalize, including by heading or joining global production chains, divides the firms that are

continuing to expand sales revenue and value added from those that, instead, are struggling to remain on the market. The recession has deepened this divide and made the inadequacy of some parts of the productive system glaringly obvious.

Transferring activity from ailing to growing sectors and firms requires profound changes in employment relationships and in the education system. The point is not so much to foresee which sectors and activities will attract consumption and investment demand in the decades to come as to facilitate the transition, reduce the social costs, and capitalize on opportunities.

Many occupations are disappearing; in the years to come young people cannot simply count on replacing their seniors as they retire. Now is the time to establish the right conditions for the birth and growth of new enterprises and to generate new job opportunities. Lifelong vocational training must be developed to cover working careers characterized by mobility and change, with workers safeguarded by reinforced safety nets and insurance systems, both public and private, during periods of inactivity. Schools and universities must support this process by ensuring education of adequate quality and quantity, acting with determination to raise levels of academic achievement and develop new skills.

Italy needs conditions that are conducive to enterprise and to the reallocation of productive factors. The lag we have accumulated is accentuated by a redundant regulatory framework, by complex and costly administrative obligations that must be drastically reduced, law that must be rendered more certain, widespread corruption that must be stamped out, and insufficient protection from crime. Immediate, visible progress in removing these serious obstacles can stimulate productive investment, including from abroad, in all the country's regions, especially in the South, where what is most critical is the environment for business activity, on which the balanced development of our economy ultimately depends.

The programme of reforms launched in the last two years stems from these considerations. But in many instances, after the enactment of reform laws, the implementing measures have been slow to follow; in some cases they are still lacking and administrative practices remain unchanged. This is a recurrent feature of our country's history: the chief difficulties reside not so much in the substance of the laws as in their effective application.

The pace of reform has slackened in the past year, owing in part to the progressive deterioration of the political climate. In resuming the path of reform with determination – as the European Commission too urges in the recommendations accompanying the closure of the excessive deficit procedure – it is vital to adopt a comprehensive approach that fixes medium-term objectives from the outset. Structural reforms take time; they can be implemented in succession, provided that they are designed as part of a bigger picture that immediately clarifies their goals, implications and benefits. A credible programme can have an impact on expectations at once, dispelling uncertainties, fostering investor confidence and favouring the prospects of employment and income, above all for the young, who today find it difficult to imagine any future in our country.

The consolidation of the public finances was also postponed for too long; in the face of demographic pressure on important expenditure items, the priorities for the allocation of resources were not clearly set. In 2007 public expenditure excluding interest payments was 43 per cent of GDP, two percentage points more than in 1997; the primary surplus

had contracted by more than three points. In the same period in Germany primary expenditure decreased by more than four percentage points of GDP to just under 41 per cent.

The response of budgetary policy in the wake of the collapse of Lehman Brothers was prudent in Italy: the support to economic activity in 2009 was provided through discretionary measures affecting the composition of the budget, without increasing the deficit.

From 2010 onwards, the budgetary stance became restrictive. Following the explosion of sovereign risk, to avoid a potentially devastating confidence and liquidity crisis, in the second half of 2011 a correction to the public finances of the order of 5 per cent of GDP was introduced. This made it possible to bring the deficit down within the 3 per cent limit in 2012 and to aim at structural balance as early as this year.

The adjustment had a negative impact on GDP growth in 2012 of about one percentage point. A larger impact, of about two points, resulted from the effects of the liquidity crisis on the cost and availability of credit for the private sector, the slowdown in world trade, and the increase in uncertainty and the related loss of confidence. The adjustment of the public finances helped to reduce the tensions on the government securities market, thereby preventing even worse developments.

The advances made must be preserved. Squandering them would have grave consequences. It would be illusory to imagine we can overcome the crisis by means of budget deficits: investors and market participants allow us only a thin margin of confidence today. The volume of government securities to be placed every year to finance the deficit and, above all, to roll over the maturing debt is of the order of €400 billion.

This year there is no room for any further increase in the deficit, since the margin available has been earmarked to pay general government's commercial debts in relation to capital outlays. These payments can be brought forward, however, and those relating to current expenditure, which affect the debt but not the deficit, can be increased; above all, no new debts of this kind must be formed. The conditions need to be created for taking full advantage of the existing instruments and subsidies to enable young people to enter and remain in the labour market.

The European Commission has undertaken to examine ways to allow national budgets to deviate temporarily from their medium-term objectives – keeping the deficit below 3 per cent of GDP – in order to finance investment projects, subject to specific conditions. In Italy, this could benefit investment to protect and enhance the value of the environment and our artistic and cultural heritage.

Reductions in taxation, which are necessary in the medium term and which could be planned now, will have to be selective, giving priority to labour and production: the tax wedge on labour acts as a brake on employment and business activity. Tax evasion distorts the allocation of the factors of production, gives rise to unfair competition, hinders growth in firm size and increases the burden borne by law-abiding taxpayers. It needs to be fought at the supranational level as well. A significant contribution to better fiscal conduct can derive from the simplification and rationalization of taxes and formalities. The certainty of tax rules and their careful and balanced formulation can influence expectations, and hence demand, more and better than immediate tax cuts of uncertain sustainability.

A reallocation of expenditure in favour of the more productive components is possible by pursuing improvements in efficiency and recoveries of resources across the board. If this method is adopted permanently, the functioning of general government can more nearly approach international standards. Significant results will not be possible without involving local government. Transferring resources on the basis of standard costs, with any excess expenditure borne by the local authorities concerned, encourages the dissemination of best practices. The efficient use of public resources requires a reassessment of the different levels of government, with the elimination of redundancies and overlaps.

The banks and lending

The outlook for domestic demand also depends largely on credit access conditions. Lending to firms slowed sharply in the second part of 2011 and since the beginning of December of that year has contracted by about €60 billion. The decline, which was particularly abrupt at first owing to the banks' severe difficulties in raising funds on the international markets due to heightened sovereign risk, continued at a more moderate pace during 2012; in the first four months of 2013 the contraction accelerated again, to nearly 4 per cent on an annual basis. Lending to households has also declined but less so. The cost of credit to firms, which rose in the course of 2011, declined for most of last year but stopped falling in the autumn. Bank lending rates are still higher than the euro-area average by about one percentage point for loans to firms and by half a point for mortgage loans to households.

The banking system is the main source of funding for our economy. At the end of 2012 bank credit to firms and households amounted to just under €1.5 trillion, or 94 per cent of GDP; banks' investment in government securities came to around €350 billion. The highly unfavourable state of the economy depresses credit demand today. The contraction in lending reflects the decline in business investment, the fall in purchases of durable goods and the weak property market. But the decline in lending is also due in significant measure to the tightening of supply, which is in turn linked to a deterioration in customer creditworthiness and its impact on banks' asset quality. In turn, the credit supply conditions have an adverse effect on economic activity, creating a negative spiral that must be broken.

The acute restriction of credit supply at the end of 2011 in response to funding difficulties was attenuated by the unlimited supply of three-year liquidity by the Eurosystem and by the increase in the range of the assets eligible as collateral for refinancing operations. The Bank of Italy allowed Italian counterparties to use less creditworthy illiquid assets, in this case charging all the associated risks to its own balance sheet. The collateral pledged with the Bank of Italy based on bank loans currently amounts to around €180 billion, which represents slightly less than a third of all the assets eligible for central bank refinancing and half of those actually in the collateral pool.

Thanks to these measures immediate liquidity risks have been averted. The funds obtained through the three-year refinancing operations do not constitute a permanent resource, however. Tension on the government securities markets has not completely dissipated. There is still uncertainty regarding the banks' ability to regain full access to the international markets, particularly the long-term segments. We are working, through

discussions with the banks and in collaboration with the ECB, to expand the range of eligible assets.

An increased risk of corporate default is driving up the interest rates on loans. Since the middle of 2012 this has offset the effect of the lowering of official rates and, more recently, of the decline in yields on government securities.

The credit supply tensions seem to be affecting even firms with a balanced financial situation, albeit to a smaller degree. The difficulties are greatest for small and medium-sized firms, which are less able to tap other sources of finance. Gross issues of corporate bonds amounting to €35 billion last year were attributable almost exclusively to large groups. In 2012 the interest rate differential between bank loans of up to €1 million and those for larger amounts averaged 160 basis points, about twice the value recorded in the three years prior to the crisis.

At the end of 2012 the stock of bad debt had risen to 7.2 per cent of total lending, compared with 3.4 per cent in 2007; and that of other non-performing loans to 6.3 per cent, up from 1.9 per cent. For corporate loans, the new bad debt ratio recently rose to over 4 per cent on a seasonally adjusted annual basis, a level not reached for twenty years. The leading indicators suggest that it will remain high until the end of 2013.

The Government and trade associations have taken many steps in recent years to mitigate firms' difficulty in obtaining credit and to meet their liquidity needs, strengthening measures already adopted and introducing new ones. Between 2009 and 2012 almost €60 billion in financial benefits was made available to small and medium-sized enterprises through debt moratoria and the interventions of Cassa Depositi e Prestiti and the Central Guarantee Fund. The Fund's resources can be increased, taking care to ensure that the guarantees to be provided are for additional loans granted on more favourable conditions, and that beneficiary firms are fully informed about the public support measures.

Faced with the deterioration of banks' loans, the Bank of Italy has intensified its scrutiny of banks' provisioning. Off-site and on-site checks have been conducted, with banks asked to continually assess the adequacy of the coverage ratio of their non-performing loans and urged, when necessary, to take corrective measures. This action will continue, partly in conjunction with similar exercises agreed at international level, with a view to the creation of the single European supervisory mechanism.

For the twenty large and medium-sized banking groups so far subjected to checks, coverage ratios ceased to fall and instead rose by two percentage points in the second half of 2012 to 44 per cent. Increases were recorded for the other banks as well.

If the Bank of Italy's supervision had been less incisive, the risks for the banks and for the economy would have been extremely serious. The promptness and credibility of supervisory action reassured international investors about the quality of Italian banks' balance sheets, sparing Italy's banks the destabilizing wave that struck other European banking systems and enabling them to continue to supply credit to households and firms. The coverage ratios reached must be maintained and in some cases raised.

To minimize the procyclical effects of the interventions, we called on the banks to increase their internally generated resources by further curbing operating costs, dividends and executives' and directors' compensation, consistently with banks' profitability and capital adequacy. For banks that will have to undertake more far-reaching adjustment, a contribution must come from the sale of non-strategic assets. A correction of the current

tax penalization of value adjustments to loans would be opportune. The stretching out in time of their tax deductibility, which is not the rule in the major countries of the European Union, discourages lending to firms during economic downswings.

Over the past five years the Italian banking system, starting from sound initial conditions, has weathered the global financial crisis, the instability of the sovereign debt market, and two deep recessions. Since the onset of the crisis, the highest quality capital has increased from 7.1 to 10.7 per cent of the entire banking system's risk-weighted assets; for the five largest groups the ratio has risen from 5.7 to 10.9 per cent.

The soundness and resilience of the Italian financial system were recently confirmed by the International Monetary Fund at the conclusion of its periodic financial sector assessment. The outcome of the IMF's stress testing to date shows that our banks as a group are in a position to withstand shocks thanks to their capitalization and the liquidity provided by the Eurosystem. The Fund emphasized the fundamental contribution of supervisory action to systemic stability.

The capital ratio gap between Italian banks and the European average, which has narrowed to about two percentage points, is due in large part to the massive injections of public capital to banks in other countries. In December government support to the banks amounted to 1.8 per cent of GDP in Germany, 4.3 per cent in Belgium, 5.1 per cent in the Netherlands, 5.5 per cent in Spain and 40 per cent in Ireland. In Italy it came to 0.3 per cent including the interventions in favour of Monte dei Paschi di Siena.

These interventions, now being vetted by the Commission, were necessitated by the European Banking Authority's recommendation that EU banks procure extraordinary, temporary supplementary capital buffers to cope with fluctuations in the value of their government securities holdings. These resources will also facilitate the restructuring plan adopted by Monte dei Paschi's new management. The government has granted the bank a loan on onerous terms. The restructuring plan has ambitious objectives; its success will depend in part on economic and financial developments in the country as a whole.

Italian banks' financial leverage ratio (total balance-sheet assets over capital) is 14 to 1, compared with an average of 20 to 1 in the rest of the European Union. In the last two years the Italian banks taking part in the Basel Committee's periodic monitoring have sharply reduced the additional capital they would need if the new "Basel III" requirements (including the capital conservation buffer) were fully in effect from €35 billion to €9 billion.

Capital strengthening, transparency of accounting and rigorous risk evaluation criteria sustain investor confidence and help contain banks' outside funding costs in particularly adverse circumstances. But the ultimate guarantee of banks' stability is their capacity to generate earnings. Looking ahead, declining profitability threatens to weaken capital and undermine banks' ability to finance the recovery of the real economy. Between 2007 and 2012 Italian banks' return on equity declined. Last year it was 0.4 per cent net of extraordinary items in connection with goodwill impairments.

The risk of unfavourable developments over the next few years must be countered first of all by effective action to curb costs. In a highly labour-intensive industry like banking, consideration must be given to measures, even temporary ones, to reduce staff costs in relation to revenue. The provision of the 2011 industry-wide labour contract for company-level agreements to combine flexibility and solidarity moves in the right

direction. In order to cope with contingent difficulties and actually preserve jobs, banks must proceed resolutely along this path.

Change in the use of productive factors and in the channels of distribution must be promoted, fully exploiting the opportunities offered by the new technologies. In the last fifteen years the Internet channel has gained importance in relations with customers, but the impact on the traditional branch network has been limited. Differentiating between these two channels, one for standardized services and the other for more complex and customized products and services, could help to reverse the Italian banking industry's decade-long upward trend in costs as a proportion of revenues.

In any event, customer trust remains fundamental. Progress has been made on this front, but further improvement is needed to enhance the quality and completeness of customer information, to ensure that the contractual terms as advertised correspond fully with those actually applied, and to prevent improper charges being levied on customers. The Bank of Italy has drawn up clear rules, compliance with which it verifies also by means of special inspections, imposing fines when irregularities are detected.

For several years now, for individual disputes there is the Banking and Financial Ombudsman, acting through three territorial panels and independently of the Bank of Italy. It has proved to be effective and is highly regarded. We intend to strengthen it further and are considering increasing the number of panels. Promptness of compliance with the Ombudsman's decisions is one factor in the Bank of Italy's assessment of banks.

The difficulties in the financing of firms necessarily invite reflection on the overall structure of Italy's financial system, the underdevelopment of the bond and equity markets and the consequent excessive dependence of firms on bank loans. As we have underscored on other occasions, this structure partly reflects Italian firms' reluctance to go to the market, although the banks have not pressed them sufficiently to do so.

The current situation demands that both sides overcome these hesitations. For solid businesses with good growth prospects, the difficult conditions of the market for bank credit are a powerful stimulus to tap the capital markets. On the banks' side, an advanced financial system would enable them to diversify their sources of revenue, maintain a balanced loan-to-deposit ratio and share the risks of financing customers with the markets. While paying due attention to conflicts of interest, banks can encourage firms' recourse to the market by exploiting the advantage in assessing creditworthiness that derives from their long-term relationships.

The capital strengthening of firms and their opening to the capital markets also require far-reaching changes in the entire financial system. It is indispensable that the role of pension funds and other long-term investors be reinforced; appropriate incentives must be provided for the accumulation of equity capital.

In the present difficult economic conditions and with the prospect of a comprehensive revision of banks' business model, the role of shareholders is crucial. They will have to be able to support banks financially, by foregoing dividends if need be, carefully monitor their management without interfering, and accept dilution of control,

where necessary encouraging mergers with other banks. They will be compensated by profitability in the longer term.

In the crisis years banking foundations have supported the capital strengthening of some of the largest Italian banks. In their dealings with the banks in which they have an interest they must comply with the letter and the spirit of the law, refraining from influencing their operational decisions or organization; like any other shareholder, they must promote the choice of directors on the basis of competence and professionalism, by transparent criteria.

The rules governing cooperative banks were drawn up for intermediaries whose business was restricted to a limited geographical area and marked, as in the case of mutual banks, by a high degree of mutuality. Today they may be inadequate for large intermediaries operating at national and even international level, listed on the stock exchange and with institutional investor shareholders representing a multitude of small savers whose aims and interests are unrelated to mutuality. For such intermediaries the rigid application of some aspects typical of the cooperative model may even detract from their ability to strengthen their capital.

On several occasions we have indicated possible measures to facilitate the participation of shareholders and make institutional investors' role more effective. It should be made easier for listed cooperative banks to turn themselves into companies limited by shares, when their size and the nature of their operations make this necessary. Within the scope of our powers, in order to ensure sound and prudent management, we promote changes in the application of governance practices; where the shortcomings are most serious, we require them.

* * *

Europe and Italy are still navigating a difficult passage. To get through it we cannot relax our efforts; we must press on with the work of reform.

European citizens must find in the strengthening of the Community framework a source of common identity, an understanding that everybody stands to benefit. For the countries that brought them into being, the single market and the economic and monetary union have represented an enormous opportunity for growth and stability, which needed – which needs – to be grasped in full. Some have not yet done so, Italy among them. On countless occasions our country has contributed ideas and policy initiatives to the European Community. It is part of our heritage of values and it is in our interest to continue to do so, in these difficult times, in which Europeans' will to cooperate and to unite is sometimes called into question.

We Italians, from the beginning among the creators of the European construction, must show that we know how to extricate ourselves from the grave condition into which we have fallen: jobs that are being lost and not being created; firms that are unable to modernize and finance themselves, that are closing; banks weakened first by the sovereign debt tensions and then by the effects of the recession, with some at risk of being in difficulty. Our political representatives are finding it hard to mediate between the general interest and particular interests; citizens are receiving conflicting and uncertain signals in this respect.

We cannot always ask others to shoulder the burden of reform. All of us must do our share: firms, workers, banks, public institutions. A budget that, apart from cyclical contingencies, is in balance and whose composition fosters employment and growth is the prerequisite for every effective and equitable policy. The sacrifices made to achieve and consolidate financial stability are the consequence of long-ignored rigidities, lags accumulated over time. Italy's release from the excessive deficit procedure is the first fruit of these sacrifices, an achievement not to be squandered. It should be viewed as an investment on which to build.

We must not fear the future, be afraid of change. We can build nothing by defending entrenched positions and our own particular interests; all of us stand to lose. What is needed is awareness, solidarity and foresight. Measures and stimuli that are well-designed, even if they contemplate a not inconsiderable span of time for transforming the country, will engender the confidence needed to decide that today it is already worth the effort to commit oneself, to work, to invest.

THE BANK OF ITALY'S ANNUAL ACCOUNTS

19. 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 thousand euros in the tables of the notes. The accounts are accompanied by the management report.

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.

Information on the functions and governance of the Bank can be found on its website (www.bancaditalia.it), together with details of the organizational structure, including organization chart and branch network.

(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

Summary of the annual accounts

The year 2012 closed with a net profit of €2,501 million (€1,129 million in 2011). The gross profit before tax and transfers to the provision for general risks was equal to €7,073 million (€3,630 million in 2011).

The unconventional monetary policy operations undertaken by the Eurosystem to counter the financial crisis were reflected in the figures of the Bank of Italy's annual accounts and entailed significant changes in the balance sheet and profit and loss account (Table 19.1).

The balance-sheet total amounted to €609,973 million, an increase of €70,995 million with respect to 2011. This can be attributed for the most part to longer-term refinancing operations (LTROs), the value of which rose from €160,606 million to €268,296 million, mainly following the settlement in March 2012 of the second three-year LTRO announced by the ECB at the end of 2011. The growth in recourse to refinancing operations was accompanied by a similar trend, on the liability side, in the Bank's debit balance with the TARGET2 payment system, part of its intra-Eurosystem liabilities. At the end of 2012, the latter amounted to around €253,799 million, equal to 42 per cent of total liabilities.

A contribution to the rise in the Bank's balance-sheet assets came from the €1,469 million increase in the portfolio of securities purchased for monetary policy purposes.

The above factors helped to shift the composition of balance-sheet assets further towards those held for monetary policy purposes, which reached 52 per cent of the total at the end of 2012.

The value of gold holdings continued to rise last year (+€3,493 million), entailing an increase in the related revaluation account.

On the liability side, apart from the growth in the debit balance resulting from TARGET2 transactions mentioned above, general government deposits increased by €10,273 million, banknotes in circulation by €3,938 million and capital funds by €4,880 million, including the provision for general risks.

The improvement in gross profit was due above all to the increase of €2,101 million in net interest income mainly in connection with the larger average stock of securities denominated in euros, especially those held for monetary policy purposes as a part of the Securities Markets Programme (SMP).

Table 19.1

Main balance-sheet aggregates (1)
(million euros)

	31.12.2012	%	31.12.2011	%	31.12.2010	%	31.12.2009	%	31.12.2008	%
Gold	99,417	16.3	95,924	17.8	83,197	25.0	60,410	20.1	48,996	18.3
Foreign currency assets	41,185	6.7	40,911	7.6	37,789	11.3	33,440	11.1	33,599	12.6
Lending to euro-area credit institutions	271,784	44.6	209,995	39.0	47,635	14.3	27,156	9.0	50,344	18.8
Securities held for monetary policy purposes	44,525	7.3	43,056	8.0	18,079	5.4	5,015	1.7	–	–
Portfolio of financial assets	128,601	21.1	129,455	24.0	123,047	37.0	99,432	33.0	88,829	33.2
Intra-Eurosystem position	10,804	1.8	7,199	1.3	10,898	3.3	62,475	20.7	30,670	11.5
Other assets	13,657	2.2	12,438	2.3	12,316	3.7	13,328	4.4	14,993	5.6
Total assets	**609,973**		**538,978**		**332,961**		**301,256**		**267,431**	
Banknotes in circulation	149,948	24.6	146,010	27.1	138,324	41.5	132,840	44.1	126,159	47.2
Liabilities to euro-area credit institutions	27,665	4.5	33,878	6.3	22,741	6.8	34,313	11.4	35,440	13.2
General government deposits	33,802	5.5	23,529	4.4	42,488	12.8	31,027	10.3	19,413	7.3
Intra-Eurosystem position	253,799	41.6	198,453	36.8	7,093	2.1	10,358	3.4	13,313	5.0
Foreign currency liabilities	8,047	1.3	8,355	1.5	8,236	2.5	7,580	2.5	1,190	0.4
Other liabilities	3,386	0.6	4,652	0.9	4,958	1.5	2,621	0.9	2,896	1.1
Provisions	21,317	3.5	18,223	3.4	16,913	5.1	15,802	5.3	15,342	5.7
Revaluation accounts	86,900	14.3	83,004	15.4	70,206	21.1	44,968	14.9	33,880	12.7
Capital, reserves and net profit	25,109	4.1	22,874	4.2	22,002	6.6	21,747	7.2	19,798	7.4
Total liabilities	**609,973**		**538,978**		**332,961**		**301,256**		**267,431**	

Main profit and loss account aggregates (2)
(million euros)

	2012	2011	2010	2009	2008
Net interest income	6,602	4,501	3,845	3,594	4,030
Net result of the pooling of monetary income	1,315	590	613	692	-715
Income from equity shares and participating interests	200	248	360	281	356
Realized gains/losses arising from financial operations	750	505	387	567	477
Write-downs	-28	-471	-214	-86	-1,458
Other net income	72	119	57	131	38
Operating expense and other costs	-1,838	-1,862	-1,921	-2,005	-2,049
Gross profit	**7,073**	**3,630**	**3,127**	**3,174**	**679**
Transfer to the provision for general risks	-2,645	-1,400	-1,350	-700	-176
Taxes on income for the year and productive activities	-1,927	-1,101	-925	-805	-328
Net profit	**2,501**	**1,129**	**852**	**1,669**	**175**

(1) The balance sheet is reclassified as follows: *Foreign currency assets* include the securities and other assets denominated in foreign currency (Items 2 and 3 on the asset side) ; the *Portfolio of financial assets* includes bonds, equity shares and other participating interests, and other assets denominated in euros and foreign currency allocated to Items 4, 6, 7.2, 8 and 11.2 on the asset side. It also includes the participating interest in the ECB (Item 9.1); the *Intra-Eurosystem position* includes net claims (liabilities) vis-à-vis the Eurosystem (Items 9.2, 9.3 and 9.4 on the asset side; 9.1, 9.2 and 9.3 on the liability side). *Foreign currency liabilities* include the liabilities denominated in foreign currency (Items 6, 7 and 8 on the liability side). The *Provisions* include the provisions for general risks, the provisions for specific risks and the staff-related provisions (Items 12 and 13 on the liability side). – (2) The data do not include the income earned on investments of ordinary and extraordinary reserves which, in accordance with the Statute, was used to increase these reserves (€478 million in 2012). The profit and loss account is reclassified as follows: *Net interest income* includes interest income and interest expense under Items 1 and 6.1 of the profit and loss account. *Income from equity shares and participating interests* includes dividends and income from ETFs and shares/units of UCITS (Items 4, 6.2 and 6.4). *Realized gains/losses arising from financial operations* and *Write-downs* include income and expense under Items 2.1, 2.2 and 6.3. *Other net income* includes the amounts under Items 3, 7, 8 and 12. *Operating expense and other costs* include the costs under Item 10, while *Transfer to the provision for general risks* refers to the allocations under Item 2.3.

A positive contribution also came from (a) the €725 million increase in the net result of the pooling of monetary income, reflecting the reallocation to the Bank of Italy of the additional monetary income, with respect to the amount due according to the share in the ECB's capital key, that arose at other Eurosystem NCBs; (b) the €443 million reduction in write-downs as a result of the general improvement in the prices of government securities; and (c) the €245 million increase in the profit on trading, mainly stemming from the sale of euro-denominated bonds.

Operating expense and other costs decreased by €24 million, continuing the downward trend under way in recent years as a result of the reform of the Bank's branch network and other measures taken to improve efficiency and contain costs.

In view of the Bank's increased exposure to risk, primarily due to the sharp growth in the size of the balance sheet as a consequence of the financial crisis, €2,645 million was transferred to the provision for general risks. The ECB and other Eurosystem NCBs are also taking steps to strengthen their capital.

Taxes for the year amounted to €1,927 million (€1,101 million in 2011).

In 2012, €1,000 million of the net profit of €2,501 million was allocated to the ordinary and extraordinary reserves; the remainder, amounting to €1,501 million, was transferred to the State. In addition to a dividend of €15,600, the shareholders were allocated the sum of €70 million, in accordance with Article 40 of the Bank's Statute and the limits laid down therein.

Post-balance-sheet events

In order to avoid any danger of conflict of interest, albeit only apparent or potential, following the institution of the new supervisory authority for insurance companies, Ivass, whose governance system includes the members of the Bank's Governing Board, on 18 December last year the Board of Directors decided to sell the Bank's 4.5 per cent share in the capital of Assicurazioni Generali. An agreement was signed on 19 December 2012 with Fondo Strategico Italiano (FSI) and its parent Cassa depositi e prestiti SpA. The shareholding was transferred to FSI in March 2013 in exchange for newly issued ordinary and preference shares. Assicurazioni Generali shares were valued, in accordance with the Civil Code, at the average price quoted on the stock exchange in the six months preceding the transaction. FSI undertook to sell on the entire shareholding by 31 December 2015.

Regarding the sale of the Bank's interest in Bonifiche Ferraresi SpA, approved by the Board of Directors in April 2012, the call for tenders for an advisor to assist the Bank in finding a purchaser closed at the end of February 2013. On 7 May this year the Bank published a call for expressions of interest in the sale on its website.

At the end of April 2013, the exchange rates of the yen and the pound sterling against the euro stood at ¥127.35 and £0.8443, showing a depreciation compared with the values obtaining at the end of 2012 (¥113.61 and £0.8161). By contrast, the US dollar appreciated to $1.3072, compared with $1.3194 at the end of 2012.

Monetary policy operations

In 2012, faced with persistent uncertainty on the financial markets, the Eurosystem not only kept the current measures in place but also announced further unconventional monetary policy interventions. In January the decisions passed at the meeting of the ECB Governing Council in December 2011 came into force. In particular, liquidity absorbing fine-tuning operations were temporarily suspended and the reserve requirement was cut by half, to 1 per cent. On 1 March the second of the two three-year refinancing operations was settled.

In June and in December the Governing Council of the ECB announced it would continue its main refinancing operations at fixed rates with full allotment. This system, which also applies to LTROs, will remain in place as long as necessary and in any case until July 2014.

In September, after new tensions had emerged on the financial markets – reflected in high risk premiums on the market for government securities – the ECB Governing Council presented its programme of purchases of government bonds for monetary policy purposes (Outright Monetary Transactions). These are part of the unconventional instruments available to the Eurosystem to ease tensions on the securities markets of the peripheral countries.

At the second three-year auction held at the beginning of 2012, €529.5 billion was allotted, the largest amount of funds ever assigned in a refinancing operation. At the end of the year, LTROs accounted for about 92 per cent of all outstanding refinancing. The total volume of refinancing operations at the Eurosystem level, already a sizeable €864 billion at the end of 2011, reached €1,126 billion a year later.

The demand for liquidity at the second three-year auction led to a further rise in the total volume of refinancing in Italy as well (from €210 billion to €272 billion at end-2012), although this was accompanied by a drop in the demand for funds in main refinancing operations.

The increased liquidity injected through the refinancing operations led to a Eurosystem-wide increase in the banks' deposits with the euro-area NCBs. Until the middle of last year extensive use was made of overnight deposits; later, when the rate on the deposit facility was cut to zero per cent, much of the excess liquidity was left in the accounts used for the reserve requirement. Recourse to these operations by Italian banks was limited but nonetheless greater than in the previous year.

The SMP was operational only in the first two months of 2012 and its termination was announced in September. The second programme of covered bond purchases ended in October.

In accordance with the decisions of the Governing Council of the ECB, the securities acquired under the two Covered Bond Purchase Programmes and the Securities Markets Programme 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 any losses to light.

Table 19.2

Securities held for monetary policy purposes (million euros)		
	31.12.2012	31.12.2011
Government securities	33,599	33,217
Covered bonds (1st programme)	8,455	9,629
Covered bonds (2nd programme)	2,471	210
Total	**44,525**	**43,056**

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. Management of the reserves makes 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 19.3, includes the official reserves plus other claims on euro-area residents denominated in foreign currency held by the Bank, net of foreign currency liabilities.

Table 19.3

Gold and net foreign currency assets (1) (million euros)		
	31.12.2012	31.12.2011
Gold	99,417	95,924
US dollars	19,780 (2)	18,970
Pounds sterling	3,106	3,506
Japanese yen	5,212	5,380
Swiss francs	3	275
Other currencies	4	4
Net assets vis-à-vis the IMF (including SDRs)	5,034	4,421
Total	**132,556**	**128,480**

(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 position. – (2) Includes €2,088 million (€1,546 million in 2011) 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 2012, gold and net foreign currency assets were worth €132.6 billion, compared with €128.5 billion a year earlier. The increase reflected mainly the rise in the price of gold (up by 3.64 per cent, leading to an increase of €3.5 billion in the value of the stock, which was stationary in volume) and to a lesser extent the overall movements in the stocks of net foreign currency assets in connection with the increase in temporary operations in dollars and the loans granted to the IMF as part of the New Arrangements to Borrow.

At the end of 2012 the composition of net foreign currency assets, excluding Special Drawing Rights and amounts related to temporary operations in dollars, showed an increase in investments in dollars (from 65.5 to 68 per cent) and a decrease in those in sterling (from 13.2 to 11.9 per cent), while the proportion of assets in yen was basically unchanged (20 per cent). Investments in Swiss francs virtually disappeared.

The Bank also holds a financial portfolio containing, among other, investments of provisions, reserves and the pension and severance pay provision. In compliance with the ban on the monetary financing of member states and euro-area public institutions, securities of such issuers are not acquired at issue. Investments in shares of banks and insurance companies are excluded.

At the end of 2012, the book value of the portfolio was €125.7 billion (€125.6 billion at the end of 2011). 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 purchases of around €355 million of euro-area shares listed in the Euro Stoxx index.

The bulk of the portfolio (86 per cent) consists of securities held to maturity and is therefore valued at amortized cost subject to impairment. If all listed financial instruments were valued at market prices, the portfolio would be worth €131.8 billion.

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 2012 the fund's total assets and liabilities in the Bank's balance sheet amounted to €249 million. Returns on assets and exposure to risk are measured daily.

Table 19.4

Composition of the financial portfolio
(million euros)

	31.12.2012	31.12.2011
Government securities	116,698	118,775
Shares and other participating interests	5,304	4,349
Other bonds	1,040	267
ETFs and shares/units of UCITS	2,658	2,256
Total	**125,700**	**125,647**

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 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. The risks are subject to periodical assessment by the Bank and 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 NCBs from the risk of financial loss when such assets are realized following a counterparty's default.

These risks are mitigated and managed according to rules laid down by the Eurosystem, which set out the requirements for counterparty eligibility and the credit rating of assets used as collateral and provide for the daily evaluation of collateral and the adoption of appropriate control measures, such as haircuts and variation margins.

The national central banks share the risks attached to the securities acquired under the Securities Markets Programme and, generally, to refinancing operations with the whole of the Eurosystem according to their share in the ECB's capital key.

In 2012, as the financial crisis continued, decisions regarding the assets eligible in Eurosystem lending operations remained directed at meeting banks' demand for liquidity. Thus the increase in the risk exposure of the Eurosystem was basically connected with the growth in the volume of operations.

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 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 long-term and short-term VaR indicator. Estimates are also made of losses in the event of particularly unfavourable market developments with low probability but entailing a large expected shortfall, and stress tests are conducted.

Credit risk is kept in check 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 monitored daily.

The liquidity of the financial instruments invested in is normally very high. That of the small 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 restrictions on the maturities of these instruments.

At the end of 2012 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 2011; this was mainly due to the increase in the financial portfolio and in the value of the gold component. The share of VaR in the total portfolio was virtually unchanged. The overall duration of the bond component denominated in euros lengthened slightly as a consequence of new purchases and above all of the increase in the value of the portfolio of long-term government securities. Over the year the duration of foreign currency reserves in dollars increased, while the duration of those in yen and sterling shortened. The overall credit risk of the securities portfolio also increased.

Note issue

The Bank contributes to meeting the Eurosystem's demand for banknotes and participates in the development of the new series; it is also involved in drafting common guidelines for the quality of the notes in circulation and measures against counterfeiting.

The planned introduction of the second series of euro notes (the new €5 denomination) led to an increase in production requirements in 2012 after the decline recorded in 2010 and 2011. The requirements are expected to remain high in the years to come, at least until the whole of the current series has been replaced. Thus, the share of production assigned to the Bank of Italy, which does not necessarily have to be satisfied in the same year, is forecast to stay at the same level this year as last (1.45 billion and 1.43 billion notes respectively).

The Bank produced around 1.14 billion banknotes in 2012 (1.18 billion in 2011). The Bank's branches put 2.6 billion banknotes into circulation for a total value of €88.3 billion. The return flow to the Bank amounted to 2.5 billion banknotes, worth €95.5 billion. Some 2.7 billion banknotes were checked and 1.3 billion were withdrawn from circulation. The value of the banknotes in circulation at the end of 2012 amounted to €146.3 billion (16 per cent of the Eurosystem total) and was down by 4.7 per cent from €153.6 billion at the end of 2011; the amount recorded in the accounts (€149.9 billion) represented the 16.4 per cent share of total Eurosystem circulation notionally assigned to the Bank of Italy.

Human, logistical and IT resources

At 31 December 2012 the Bank had 7,069 employees: 4,435 working at Head Office and 2,634 at branch offices. Managers and officers accounted for respectively 8.6 and 20.5 per cent of the personnel. The staff's average age was 48.3 years and 35.5 per cent of the Bank's employees were women.

The total number of staff increased by 79 compared with the end of 2011. In 2012 there were 288 new appointments, of whom about half to positions requiring a university degree. Following the introduction of new legislation on retirement, terminations diminished sharply, from 468 in 2011 to 209 in 2012.

Table 19.5

Composition of the Bank's staff										
	At 31 December 2012					At 31 December 2011				
	Men	Women	**Total**	At branches	At Head Office (1)	Men	Women	**Total**	At branches	At Head Office (1)
Managers	467	139	**606**	137	469	475	132	**607**	130	477
Officers	921	528	**1,449**	398	1,051	912	507	**1,419**	386	1,033
Coadjutors	791	526	**1,317**	485	832	745	511	**1,256**	495	761
Other	2,380	1,317	**3,697**	1,614	2,083	2,393	1,315	**3,708**	1,658	2,050
Total	**4,559**	**2,510**	**7,069**	**2,634**	**4,435**	**4,525**	**2,465**	**6,990**	**2,669**	**4,321**

(1) Includes members of the staff assigned to the Financial Intelligence Unit and the representative offices abroad and those seconded to other organizations.

The Bank's information and communication technology resources play a major role in guaranteeing the innovativeness, quality and reliability of the services provided. In 2012 further progress was made within the ESCB in developing the TARGET2 system, building the new platform for the settlement of securities transactions, TARGET2-Securities, and renewing and strengthening the communications network between the NCBs and with the ECB.

In 2013 the IT department will continue to work on the development programmes under way within the Eurosystem; the first steps will be made to adapt the national settlement system to the requirements of the TARGET2-Securities platform.

The objective of the Bank's property administration is to ensure the efficient and business continuity of all the premises used for institutional purposes, in particular as regards the proper functioning of security systems and compliance with workplace safety rules. Two projects are currently under way: one to dispose of buildings located in cities where the Bank has closed its branches and one to transfer rental properties to Società Italiana di Iniziative Edilizie e Fondiarie SpA, which is entirely owned by the Bank.

Management control system

The control of expenditure also makes use of management tools such as budgets 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 charges for the services offered.

The outcome of the spending commitments in 2012 was more or less in line with the cost containment measures taken in previous years to consolidate the structural savings obtained through the Bank's organizational reform and to improve expenditure performance without jeopardizing the operational efficiency and the quality of the services provided. A major factor during the year was the sizeable budget allocation in respect of banknote production requirements, including for subsequent years.

The measures taken to reduce costs will continue in 2013.

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 purpose of the committee is to provide advice and support to the Board of the 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.

For the monitoring of operational risk a committee has been set up to assist the Governing Board in drafting policy guidelines and monitoring their implementation.

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 and expenditure rules is overseen by ad hoc units.

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.

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. The measures envisaged by the plan were put into effect during 2012. In particular, preparations were completed for the installation of a photovoltaic system and a project was launched to optimize the data centre with a view to reducing energy consumption.

The Environment Report, available on the website, contains specific indicators used to monitor the Bank's commitment to protect the environment. Further measures will be taken in 2013, notably to progressively reduce the consumption of energy and paper by dematerializing documents, to promote the adoption of alternative energy sources and to encourage the use of more ecological vehicles.

ANNUAL ACCOUNTS
for the year ending 31 December 2012

BALANCE SHEET

ASSETS	NOTES *	Amounts in euros 31.12.2012	31.12.2011
1 GOLD AND GOLD RECEIVABLES	[1]	**99,417,221,610**	**95,923,923,533**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	[1]	**38,282,563,781**	**38,015,748,971**
2.1 Claims on the IMF		12,699,771,877	12,225,011,074
2.2 Securities		24,270,672,007	24,396,793,962
2.3 Current accounts and deposits		768,929,570	1,336,205,803
2.4 Reverse operations		538,310,210	52,771,870
2.5 Other claims		4,880,117	4,966,262
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	[1]	**2,902,815,448**	**2,895,755,394**
3.1 Financial counterparties		2,902,815,448	2,895,755,394
3.1.1 Securities		*180,029,434*	*301,919,310*
3.1.2 Reverse operations		*2,088,070,335*	*1,545,714,506*
3.1.3 Other claims		*634,715,679*	*1,048,121,578*
3.2 General government		–	–
3.3 Other counterparties		–	–
4 CLAIMS ON NON-EURO-AREA RESIDENTS		**629,205,358**	**99,097,593**
4.1 Claims on EU central banks		–	–
4.2 Securities	[4]	629,205,358	99,097,593
4.3 Other claims		–	–
5 LENDING TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS	[2]	**271,783,800,000**	**209,994,950,000**
5.1 Main refinancing operations		3,488,000,000	49,389,100,000
5.2 Longer-term refinancing operations		268,295,800,000	160,605,850,000
5.3 Fine-tuning reverse operations		–	–
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]	**1,539,972,286**	**2,655,438,648**
7 SECURITIES OF EURO-AREA RESIDENTS		**116,430,534,449**	**114,272,718,591**
7.1 Securities held for monetary policy purposes	[2]	44,524,997,190	43,055,674,706
7.2 Other securities	[4]	71,905,537,259	71,217,043,885
8 GENERAL GOVERNMENT DEBT	[4]	**14,620,151,540**	**17,457,614,575**
9 INTRA-EUROSYSTEM CLAIMS	[5]	**12,164,717,030**	**8,351,851,919**
9.1 Participating interest in the ECB		1,361,271,704	1,152,995,038
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		3,604,588,445	–
9.4 Other claims within the Eurosystem (net)		–	–
10 ITEMS IN COURSE OF SETTLEMENT		**8,294,390**	**14,452,944**
11 OTHER ASSETS	[6]	**52,194,123,616**	**49,296,538,753**
11.1 Euro-area coins		62,281,159	30,610,909
11.2 Securities related to the investment of reserves and provisions	[4]	38,544,663,225	36,873,320,329
11.3 Intangible fixed assets		67,735,449	57,055,475
11.4 Tangible fixed assets		3,078,877,072	3,204,239,948
11.5 Accruals and prepaid expenses		4,895,684,878	3,120,295,019
11.6 Deferred tax assets		4,291,486,395	5,085,032,261
11.7 Sundry		1,253,395,438	925,984,812
TOTAL		**609,973,399,508**	**538,978,090,921**

* References to the comments on the items in the notes to the accounts.

THE ACCOUNTANT GENERAL: Paolo Marullo Reedtz

THE GOVERNOR: Ignazio Visco

Audited and found correct - 28 March 2013

THE BOARD OF AUDITORS: Lorenzo De Angelis, Giovanni Fiori, Gian Domenico Mosco, Sandro Sandri, Dario Velo

BALANCE SHEET

	LIABILITIES	NOTES *	Amounts in euros 31.12.2012	Amounts in euros 31.12.2011
1	**BANKNOTES IN CIRCULATION**	[7]	**149,947,991,520**	**146,010,466,680**
2	**LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS**	[2]	**27,664,560,871**	**33,878,095,838**
	2.1 Current accounts (covering the minimum reserve system)		24,592,970,178	19,762,153,802
	2.2 Deposit facility		3,039,590,693	12,335,942,036
	2.3 Fixed-term deposits		32,000,000	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]	**34,495,553,304**	**23,738,508,908**
	4.1 General government		33,802,015,193	23,528,524,611
	4.1.1 Treasury payments account		*8,501,827,482*	*6,291,702,387*
	4.1.2 Sinking fund for the redemption of government securities		*170,531,105*	*115,016,111*
	4.1.3 Other liabilities		*25,129,656,606*	*17,121,806,113*
	4.2 Other counterparties		693,538,111	209,984,297
5	**LIABILITIES TO NON-EURO-AREA RESIDENTS**	[9]	**1,000,215,366**	**2,691,653,114**
	5.1 To EU central banks		–	–
	5.2 Other liabilities		1,000,215,366	2,691,653,114
6	**LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY**	[1]	**378,443,094**	**549,064,356**
	6.1 Financial counterparties		–	–
	6.2 General government		378,443,094	549,064,356
	6.3 Other liabilities		–	–
7	**LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY**	[1]	**2,301,777**	**2,346,074**
	7.1 Current accounts and deposits		2,081,670	2,121,756
	7.2 Other liabilities		220,107	224,318
8	**COUNTERPART OF SDRs ALLOCATED BY THE IMF**	[1]	**7,665,772,838**	**7,803,871,173**
9	**INTRA-EUROSYSTEM LIABILITIES**	[5]	**253,799,438,019**	**198,452,577,941**
	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
	9.3 Other liabilities within the Eurosystem (net)		253,799,438,019	190,899,096,326
10	**ITEMS IN COURSE OF SETTLEMENT**		**40,493,764**	**41,172,091**
11	**OTHER LIABILITIES**	[10]	**1,652,952,050**	**1,709,130,745**
	11.1 Bank of Italy drafts		219,490,566	239,122,557
	11.2 Accruals and income collected in advance		14,209,029	25,846,813
	11.3 Sundry		1,419,252,455	1,444,161,375
12	**PROVISIONS**	[11]	**8,125,980,240**	**7,677,679,674**
	12.1 Provisions for specific risks		1,516,754,934	1,116,809,999
	12.2 Staff-related provisions		6,609,225,306	6,560,869,675
13	**REVALUATION ACCOUNTS**	[12]	**86,900,466,265**	**83,004,095,501**
14	**PROVISION FOR GENERAL RISKS**	[11]	**13,190,675,075**	**10,545,675,075**
15	**CAPITAL AND RESERVES**	[13]	**22,607,429,359**	**21,744,578,174**
	15.1 Capital		156,000	156,000
	15.2 Statutory reserves		14,867,762,438	14,004,911,253
	15.3 Other reserves		7,739,510,921	7,739,510,921
16	**NET PROFIT FOR THE YEAR**		**2,501,125,966**	**1,129,175,577**
	TOTAL		**609,973,399,508**	**538,978,090,921**

* References to the comments on the items in the notes to the accounts.

OFF-BALANCE-SHEET ACCOUNTS at 31 December 2012 amounted to **659,165,890,419** euros.

THE GOVERNOR: Ignazio Visco

THE ACCOUNTANT GENERAL: Paolo Marullo Reedtz

Audited and found correct - 28 March 2012

THE BOARD OF AUDITORS: Lorenzo De Angelis, Giovanni Fiori, Gian Domenico Mosco, Sandro Sandri, Dario Velo

PROFIT AND LOSS ACCOUNT

		NOTES *	Amounts in euros 2012	Amounts in euros 2011
1.1	Interest income		8,344,083,871	5,670,887,600
1.2	Interest expense		-2,548,766,113	-1,905,144,704
1	**Net interest income**	[14]	**5,795,317,758**	**3,765,742,896**
2.1	Realized gains/losses arising from financial operations		747,528,081	492,609,599
2.2	Write-downs on financial assets and positions		-4,623,615	-383,086,734
2.3	Transfers to/from the provisions for general risks for exchange rate, price and credit risks		-2,645,000,000	-1,400,000,000
2	**Net result of financial operations, write-downs and transfers to/from risk provisions**	[15]	**-1,902,095,534**	**-1,290,477,135**
3.1	Fee and commission income		29,599,664	25,546,913
3.2	Fee and commission expense		-13,434,424	-9,610,318
3	**Net income from fees and commissions**	[16]	**16,165,240**	**15,936,595**
4	**Income from participating interests**	[17]	**116,225,144**	**147,034,395**
5	**Net result of the pooling of monetary income**	[18]	**1,314,730,473**	**589,957,577**
6.1	Interest income		1,166,931,258	1,066,284,482
6.2	Dividends from equity shares and participating interests		203,771,243	234,402,039
6.3	Gains, losses and write-downs		-55,431,387	-251,616,205
6.4	Other components		32,025,319	27,949,087
6	**Net income from financial assets related to the investment of reserves and provisions**	[19]	**1,347,296,433**	**1,077,019,403**
7	**Other transfers from provisions**		**1,918**	**1,227**
8	**Other income**	[20]	**87,181,377**	**109,315,525**
	TOTAL NET INCOME		**6,774,822,809**	**4,414,530,483**
9	**Transfer of investment income to statutory reserves** (1)	[21]	**-478,230,955**	**-315,965,421**
10.1	Staff wages and salaries and related costs		-680,394,322	-690,603,941
10.2	Other staff costs		-66,714,626	-63,291,411
10.3	Transfers to provisions for accrued expense and staff severance pay and pensions		-106,461,851	-83,995,951
10.4	Pensions and severance payments		-323,769,527	-387,153,927
10.5	Emoluments paid to head and branch office collegial bodies		-2,878,677	-3,184,453
10.6	Administrative expenses		-439,707,097	-420,139,453
10.7	Depreciation of tangible and intangible fixed assets		-173,080,819	-186,672,525
10.8	Banknote production services		–	–
10.9	Other expenses		-45,105,957	-27,471,120
10	**Expenses and charges**	[22]	**-1,838,112,876**	**-1,862,512,781**
11	**Other transfers to provisions**		**–**	**–**
12.1	Extraordinary income		33,186,470	26,675,437
12.2	Extraordinary expense		-63,420,395	-32,313,081
12	**Extraordinary income and expense**	[23]	**-30,233,925**	**-5,637,644**
	PROFIT BEFORE TAX		**4,428,245,053**	**2,230,414,637**
13	**Taxes on income for the year and on productive activities**	[24]	**-1,927,119,087**	**-1,101,239,060**
	NET PROFIT FOR THE YEAR		**2,501,125,966**	**1,129,175,577**

* References to the comments on the items in the notes to the accounts
(1) Made in accordance with Article 40 of the Statute.

THE ACCOUNTANT GENERAL: Paolo Marullo Reedtz

THE GOVERNOR: Ignazio Visco

Audited and found correct - 28 March 2013
THE BOARD OF AUDITORS: Lorenzo De Angelis, Giovanni Fiori, Gian Domenico Mosco, Sandro Sandri, Dario Velo

NOTES TO THE ACCOUNTS

Legal basis, method of preparation and layout of the annual accounts

Legal basis of the annual accounts. – The annual accounts of the Bank of Italy are drawn up in compliance with special statutory provisions and, where these do not provide any guidance, the Bank 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, shall also be 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), as amended, 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 regarding the main balance-sheet items and applied in preparing the annual accounts for 2012 are described below. Where provided for by law, they were agreed with the Board of Auditors.

GOLD, FOREIGN CURRENCY ASSETS/LIABILITIES, SECURITIES

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 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) *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;*
     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. The Bank’s accounts are not consolidated with those of investee companies insofar as the Bank is not among the entities mentioned in Article 25 of Legislative Decree 127/1991.*

Securities denominated in foreign currencies, including ETFs and units of collective investment undertakings, stated in the balance-sheet item Financial assets related to investments of reserves and provisions *are not included in the net foreign exchange position but shown as a separate item.*

Dividends are recognized on a cash basis.

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 of 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 2012 arise from the entry into the Eurosystem of the central banks of Malta and Cyprus in 2008, Slovakia in 2009 and Estonia in 2011; they will terminate at the end of 2013, 2014 and 2016 respectively. The adjustments arising from the entry of the central bank of Slovenia in 2007 terminated in 2012.

The interest income and expense on intra-Eurosystem balances are cleared through the accounts of the ECB and 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, as a rule, 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, as amended). 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

Intra-Eurosystem balances arise from cross-border payments in euros within the EU that are settled in central bank money. Most of these transactions are ordered by private individuals and settled in TARGET2 (Trans-European Automated Real-time Gross Settlement Express Transfer System), giving rise to bilateral balances in the TARGET2 accounts of the EU member states' central banks. These balances are netted out and then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position vis-à-vis the ECB. The intra-Eurosystem balance with the ECB arising from TARGET2 and the other intra-Eurosystem balances denominated in euros, including the provisional distribution of the ECB's profit to the NCBs and the result of the pooling of monetary income, are entered in the accounts as a single net position, appearing on the asset side under Other claims within the Eurosystem (net) *or on the liability side under* Other liabilities within the Eurosystem (net).

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.

The intra-Eurosystem claims arising from the subscription of the ECB's capital and the transfer of official reserves to the ECB are included under Participating interest in the ECB *and* Claims arising from the transfer of foreign reserves to the ECB.

PROVISIONS FOR RISKS

In determining the provisions for risks, the riskiness of each sector 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 that of the securities portfolio are 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, determined on the basis of a realistic estimate of the foreseeable liability under the tax rules in force; it includes deferred tax liabilities for Irap and amounts arising from possible fiscal checks and 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. Deferred tax liabilities for Ires are entered with a minus sign under Deferred tax assets.

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 foreign currency operations, which represent the forward component of foreign currency swaps and other financial instruments involving a swap of currencies at a future date, are included in the net outstanding foreign currency positions at the spot settlement date.

Forward purchases and sales of foreign currency

- *forward purchases and sales are recorded in the memorandum accounts from the trade date to the settlement 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;*

– *forward sales of the currencies included in the SDR basket to cover the SDR position are valued in conjunction with the latter and therefore do not affect the net positions in the single currencies.*

Foreign currency swaps

– *forward and spot purchases and sales are recorded in the memorandum accounts from the trade date to the settlement 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.*

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; 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

Table 19.6

Gold and assets and liabilities denominated in foreign currency
(thousand euros)

	31.12.2012	31.12.2011	Changes
Gold (Item 1)	**99,417,222**	**95,923,924**	**3,493,298**
Net assets denominated in foreign currency	**33,138,861**	**32,556,223**	**582,638**
Assets denominated in foreign currency	**41,185,379**	**40,911,504**	**273,875**
Claims on the IMF (Sub-item 2.1)	12,699,772	12,225,011	474,761
Securities (Sub-items 2.2 and 3.1.1)	24,450,701	24,698,713	-248,012
Current accounts and deposits (Sub-items 2.3 and 3.1.3.)	1,403,645	2,384,328	-980,683
Reverse operations (Sub-items 2.4 and 3.1.2)	2,626,381	1,598,486	1,027,895
Other assets (Sub-item 2.5)	4,880	4,966	-86
Liabilities denominated in foreign currency	**8,046,518**	**8,355,281**	**-308,763**
Counterpart of SDRs allocated by the IMF (Item 8)	7,665,773	7,803,871	-138,098
Advances of general government departments (Sub-item 6.2)	378,443	549,064	-170,621
Current accounts and deposits (Sub-item 7.1)	2,082	2,122	-40
Other liabilities (Sub-item 7.2)	220	224	-4

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 small increase in the amount of net assets denominated in foreign currency reflected the growth in stocks, which was partly offset by the effects of the depreciation against the euro of some of the main currencies in the Bank's portfolio.

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 31 December 2012 using that day's exchange rate of the euro against the dollar. Compared with end-2011, gold appreciated by 3.64 per cent (from 1,216.864 to 1,261.179 euros per ounce).

Compared with the end of the previous year, the exchange rates of the main foreign currencies against the euro showed depreciations of the US dollar (from 1.2939 to 1.3194 dollars per euro) and the yen (from 100.20 to 113.61); the special drawing right also depreciated (from 1,1867 to 1.1657 euros per SDR). The pound sterling appreciated (from 0.8353 to 0.8161) and the Swiss franc held virtually stable (1.2156 against 1.2072).

Compared with the end of 2011 there were unrealized gains at the end of the year that were entered in the corresponding revaluation accounts for gold (€3,493 million) and for pounds sterling (€13 million) and write-downs completely absorbed by the corresponding revaluation accounts relating to yen (€638 million), dollars (€435 million) and SDRs (€41 million). Owing to the large decrease in holdings of Swiss francs, the relative revaluation accounts were reduced to zero (€21 million). After the above-mentioned movements, at the end of 2012 the exchange rate revaluation accounts amounted to €83,421 million, of which €79,996 million was in respect of gold, €1,443 million the yen, €1,405 million the dollar, €419 million the pound sterling and €151 million the SDR, including the valuation of the relative hedging operations (see Revaluation accounts*).*

The increase in claims on the IMF was mainly the result of purchases of SDRs against euros under the Standing Arrangements to Buy and Sell SDRs and for loans to the Fund on behalf of the Italian Government under the New Arrangements to Borrow.

Table 19.7

Accounts with the International Monetary Fund
(thousand euros)

	31.12.2012	31.12.2011	Changes
Assets			
Claims on the IMF (Sub-item 2.1)	**12,699,772**	**12,225,011**	**474,761**
a) Reserve Tranche Position in the IMF	2,827,176	2,835,615	-8,439
quota in the IMF	*9,189,177*	*9,352,954*	*-163,777*
IMF holdings	*-6,362,001*	*-6,517,339*	*155,338*
b) Participation in the PRGF	804,854	609,676	195,178
c) Participation in the NAB	1,894,510	1,680,883	213,627
d) Special Drawing Rights	7,173,232	7,098,837	74,395
Liabilities			
Counterpart of SDRs allocated by the IMF (Item 8)	**7,665,773**	**7,803,871**	**-138,098**

The portfolio of securities denominated in foreign currency classified as not held to maturity was made up almost entirely of bonds, issued primarily by foreign government bodies and international organizations. Of the total portfolio 68 per cent was denominated in US dollars, 21 per cent in yen and 11 per cent in pounds sterling.

The other foreign currency assets, denominated primarily in US dollars, consisted mainly of reverse operations (€2,626 million), fixed-term deposits (€836 million), current accounts (€568 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 side and the liability side. Sub-item 3.1.2 (*Claims on euro-area residents denominated in foreign currency: reverse operations*) includes claims (€2,088 million) in respect of reverse operations with Eurosystem counterparties associated with the short-term dollar refinancing programme (€1,546 million at the end of 2011). According to 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 Eurosystem NCBs, 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.*

Among the liabilities denominated in foreign currency, primarily in dollars, the most important are the liabilities to general government (€378 million) in respect of advances received for the management of foreign currency cross-border payments and collections.

[2] Monetary policy operations

In 2012, recourse to refinancing operations was again influenced by the unconventional measures adopted by the Eurosystem to counter the adverse effects of the financial crisis. In particular, recourse to longer-term refinancing operations increased significantly, reflecting the settlement on 1 March of the second of the two three-year auctions approved by the ECB Governing Council at the end of 2011. The operation led to a further reallocation of refinancing between short-term and longer-term operations, similar to that which followed the first auction, settled at the end of the previous year.

The operations outstanding at 31 December 2012 carried out by the Bank of Italy within the framework of the single monetary policy of the Eurosystem are shown in Table 19.8.

Table 19.8

Monetary policy operations
(thousand euros)

	31.12.2012	31.12.2011	Changes
Lending to euro-area credit institutions (Item 5)			
5.1 Main refinancing operations	3,488,000	49,389,100	-45,901,100
5.2 Longer-term refinancing operations	268,295,800	160,605,850	107,689,950
5.3 Fine-tuning reverse operations	–	–	–
5.4 Structural reverse operations	–	–	–
5.5 Marginal lending facility	–	–	–
5.6 Credits related to margin calls	–	–	–
Total	**271,783,800**	**209,994,950**	**61,788,850**
Securities held for monetary policy purposes (Sub-item 7.1)	**44,524,997**	**43,055,675**	**1,469,322**
Liabilities to euro-area credit institutions (Item 2)			
2.1 Current accounts (covering the minimum reserve system)	24,592,970	19,762,154	4,830,816
2.2 Deposit facility	3,039,591	12,335,942	-9,296,351
2.3 Fixed-term deposits	32,000	1,780,000	-1,748,000
2.4 Fine-tuning reverse operations	–	–	–
2.5 Deposits related to margin calls	–	–	–
Total	**27,664,561**	**33,878,096**	**-6,213,535**

The year-end value of the stock of *Main refinancing operations* decreased, as did the average value (from €25,252 million to €11,549 million), while that of *Longer-term refinancing operations* increased significantly and its average rose from €46,654 million to €250,113 million. *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 €106 million to €128 million and from €23 million to €46 million. As in 2011 no recourse was made in 2012 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 decisions 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.

Table 19.9

Movements in securities held for monetary policy purposes (Sub-item 7.1)
(thousand euros)

	Bonds held to maturity			Total
	Covered bonds (1st programme)	Covered bonds (2nd programme)	Government securities (Securities Markets Programme)	
Opening balance	**9,629,329**	**209,914**	**33,216,432**	**43,055,675**
Increases	**–**	**2,261,994**	**1,707,410**	**3,969,404**
Purchases	–	2,261,994	1,319,751	3,581,745
Net premiums and discounts	–	–	387,659	387,659
Decreases	**-1,174,663**	**-419**	**-1,325,000**	**-2,500,082**
Sales and redemptions	-1,127,000	–	-1,325,000	-2,452,000
Net premiums and discounts	-47,663	-419	–	-48,082
Closing balance	**8,454,666**	**2,471,489**	**33,598,842**	**44,524,997**

The first Covered Bond Purchase Programme closed in June 2010 and the second in October 2012. In September 2012 the ECB brought the Securities Markets Programme to a close.

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 shared, on the basis of 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). However, the Governing Council has decided to waive the principle of risk sharing where certain types of collateral are provided.

At the end of 2012, the Eurosystem's total refinancing operations amounted to €1,126,019 million (€863,568 million in 2011). The securities purchased by the NCBs under the Securities Markets Programme amounted to €192,608 million, against €194,155 million in 2011.

Securities held for monetary policy purposes under the above programmes 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 two events during the year that could affect their value. The first was the Private Sector Involvement initiative launched in March 2012 for the restructuring of part of the debt issued by Greece, in which the euro-area central banks did not participate. In February 2012 they swapped their original holdings of Greek government bonds for new bonds having identical nominal values, interest rates and maturities; these were not on the list of bonds covered by the restructuring package. The second event was the Greek government's debt buy-back in December 2012. The Governing Council considered that these events did not cause a long-lasting decrease in value since, according to information available at 31 December 2012, there was no evidence of changes in expected future cash flows.

On the liability side the deposits held by credit institutions to fulfil their minimum reserve requirements increased in value at year-end but decreased in terms of average stock (from €25,312 million to €22,173 million). Credit institutions' holdings in the *Deposit facility* and *Fixed-term deposits* decreased at year-end but increased in terms of average stock (from €1,382 million to €8,084 million and from €126 million to €227 million respectively). No recourse was made to *Fine-tuning reverse operations*.

[3] Other claims on euro-area credit institutions

These claims decreased from €2,655 million to €1,540 million; they consisted in large part of repos on securities denominated in euros (€725 million) and liquidity-providing operations (€660 million) with national counterparties outside the Eurosystem operations for monetary policy purposes; these operations are fully collateralized. The item also includes claims in connection with the management of cross-border euro payments and collections for general government (€155 million).

[4] Securities portfolio

In addition to the securities making up part of the foreign exchange reserves (€24,451 million), commented under *Gold, assets and liabilities denominated in foreign currency* and those held for monetary policy purposes (€44,525 million), commented under *Monetary policy operations*, the Bank's securities portfolio amounted to €125,700 million, of which €38,545 million relating to investments of reserves and provisions.

The items in Table 19.10 are detailed as follows:

A) securities denominated in euros consist exclusively of bonds 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 mainly of bonds issued by the Italian government and by other euro-area governments. Market conditions in 2012 prompted a minor restructuring of the bond portfolio. Thus, a small amount of securities classified as held to maturity was moved to the category other than those held to maturity pending their sale;
- 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. Of the reduction of €2,837 million, €2,700 million corresponded to the redemption of bonds following the conversion, €87 million 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.

B) securities related to investments of reserves and provisions (Sub-item 11.2 – *Securities related to the investment of reserves and provisions*) are denominated in euros and to a very small extent in foreign currency. At year-end, 79 per cent of the portfolio consisted of bonds and 21 per cent of shares, participating interests, ETFs and shares/units of UCITS. Most of the investments in shares consisted of listed securities.

As regards the issuers of these securities, the majority were Italian and the bulk of the remainder from other euro-area countries. Most of the purchases during 2012 consisted of government securities.

Table 19.10

Securities portfolio
(thousand euros)

	31.12.2012	31.12.2011	Changes
A) SECURITIES DENOMINATED IN EUROS (Sub-items 4.2 and 7.2 and Item 8)			
1. Securities held to maturity	**77,461,607**	**80,860,434**	**-3,398,827**
a) Government securities (Sub-item 7.2)	61,925,019	63,268,910	-1,343,891
b) Other bonds (Sub-items 4.2 and 7.2)	916,436	133,909	782,527
c) Government securities assigned to Bank of Italy (Item 8)	14,620,152	17,457,615	-2,837,463
2. Securities other than those held to maturity	**9,693,287**	**7,913,322**	**1,779,965**
a) Government securities (Sub-item 7.2)	9,693,287	7,913,322	1,779,965
Total A	**87,154,894**	**88,773,756**	**-1,618,862**
B) SECURITIES RELATED TO THE INVESTMENT OF RESERVES AND PROVISIONS (Sub-item 11.2)			
1. Securities held to maturity and other permanent investments	**30,729,443**	**30,412,266**	**317,177**
a) Government securities	30,443,176	30,114,145	329,031
b) Other bonds	123,709	133,214	-9,505
c) Shares and participating interests	162,558	164,907	-2,349
of subsidiary companies and entities	*105,600*	*107,949*	*-2,349*
of other companies and entities	*2,410*	*2,410*	–
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	**7,815,220**	**6,461,054**	**1,354,166**
a) Government securities	15,803	20,987	-5,184
b) Other bonds	–	–	–
c) Shares and participating interests	5,141,584	4,184,313	957,271
of subsidiary companies and entities	*127,360*	*13,422*	*113,938*
of other companies and entities	*5,014,224*	*4,170,891*	*843,333*
d) ETFs and shares/units of UCITS	2,657,833	2,255,754	402,079
of which: denominated in foreign currency	*775,073*	*694,720*	*80,353*
Total B	**38,544,663**	**36,873,320**	**1,671,343**
Total (A+B)	**125,699,557**	**125,647,076**	**52,481**

The Bank of Italy has controlling interests in two companies, Bonifiche Ferraresi SpA and Società Italiana di Iniziative Edilizie e Fondiarie SpA (SIDIEF). The participating interest in Bonifiche Ferraresi SpA, previously held as a permanent investment, was classified in 2012 under marketable securities following the Board of Directors' decision to sell the holding.

The other participating interests held as permanent investments 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 portfolio includes securities held to maturity whose book value (€2,290 million) was higher than the year-end valuation at market prices (€2,260 million).

These securities, for which no lasting reduction in value was found relating to the position of the issuers, were stated at amortized cost.

[5] Intra-Eurosystem claims and liabilities

Table 19.11

Positions with the ECB and the other euro-area NCBs
(thousand euros)

	31.12.2012	31.12.2011	Changes
Assets			
9.1 Participating interest in the ECB	1,361,272	1,152,995	208,277
9.2 Claims arising from the transfer of foreign reserves to the ECB	7,198,857	7,198,857	–
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem	3,604,588	–	3,604,588
9.4 Other claims within the Eurosystem (net)	–	–	–
Total	**12,164,717**	**8,351,852**	**3,812,865**
Liabilities			
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	–	7,553,482	-7,553,482
9.3 Other liabilities within the Eurosystem (net)	253,799,438	190,899,096	62,900,342
Total	**253,799,438**	**198,452,578**	**55,346,860**

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 third and last instalment 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 2012 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 arising from the transfer of foreign reserves to the ECB* were unchanged and amounted to €7,199 million.

The Claims arising from the transfer of foreign 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*).*

– *Net claims related to the allocation of euro banknotes within the Eurosystem* amounted to €3,605 million. At the end of 2011 there were net liabilities amounting to €7,553 million entered on the liability side (see "Legal basis, method of preparation and layout of the annual accounts").

On the liability side:

– *Other liabilities within the Eurosystem (net)* amounted to €253,799 million (compared with €190,899 million in 2011) 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 €255,102 million at the end of 2012 (compared with €191,379 million in 2011). At the end of the year the overall position was reduced by a) a claim of €103 million against the ECB for restitution of part of the seigniorage income pertaining to 2012 and b) a claim of €1,200 million (€364 million in 2011) deriving from the net result of the pooling of monetary income in 2012 (€1.184 million) and the recalculation (€16 million) of monetary income pertaining to previous years.

[6] Other assets

This item consists mainly of investments in securities of reserves and provisions (see *Securities portfolio*).

The year-end fair value of the buildings owned by the Bank was estimated to be €4,161 million for those used for its operations and €1,262 million for those related to investments of the severance pay and pension provision.

Deferred tax assets (Sub-item 11.6) decreased by €794 million as a consequence of:

- the offsetting of €793.5 million of the deferred taxes deriving from the carry-forward of the remaining tax loss for 2002;
- the increase of €26 million arising from the offsetting of tax losses used to offset taxable income for the fiscal years from 2007 to 2011 in accordance with Decree Law 16/2012, ratified by Law 44/2012 (see "Comments on the items of the profit and loss account" – *Extraordinary income and expense* and *Taxes on income for the year and productive activities*);
- the decrease of €38 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 increase of €12 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 €249 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 2012.

[7] Banknotes in circulation

Banknotes in circulation, which represent the Bank of Italy's share (16.4 per cent) of the total Eurosystem note issue (see "Legal basis, method of preparation

and layout of the annual accounts"), increased by €3,938 million (from €146,010 to €149,948 million). The banknotes actually in circulation, without taking account of the adjustments for their distribution within the Eurosystem, decreased by €7,221 million (from €153,564 million to €146,343 million). The average stock of banknotes rose from €142,713 million to €145,545 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

The item, which increased by €10,757 million, refers mainly to the deposits held by the Treasury with the Bank of Italy (€8,502 million) and the Treasury's fixed-term deposits (€25,000 million), which are included under the sub-item *Other liabilities*.

The year-end balance on the Treasury accounts with the Bank of Italy increased but the average balance fell from €32,040 million to €847 million. The decrease was due to the introduction at the end of 2011 of a limit on the balance on which interest is paid in accordance with Article 47 of Law 196/2009. As a consequence, the Treasury increased its investment of excess cash balances in fixed-term deposits, the average balance of which rose from €1,627 million to €20,377 million.

The year-end balance of the sinking fund for the redemption of government securities increased, while the average balance decreased slightly, from €250 million to €229 million. The Sub-item *Other liabilities* also includes debtor positions with general government in respect of advances received for the management of cross-border euro payments and collections amounting to €130 million (compared with €122 million in 2011).

[9] Liabilities to non-euro-area residents denominated in euros

The sub-item 5.2 *Other liabilities* amounted to €1,000 million (€2,692 million in 2011) and referred mainly to accounts held by customers that used the Eurosystem Reserve Management Services.

[10] Other liabilities

Table 19.12

Other liabilities (Item 11)
(thousand euros)

	31.12.2012	31.12.2011	Changes
11.1 Cashier's cheques	219,491	239,123	-19,632
11.2 Accruals and deferrals	14,209	25,847	-11,638
11.3 Sundry	1,419,252	1,444,161	-24,909
Supplementary pension fund	*249,480*	*194,006*	*55,474*
Total	**1,652,952**	**1,709,131**	**-56,179**

As detailed below:

[11] Provisions and provision for general risks

The balances and movements in *Provisions* are shown in Tables 19.13 and 19.14.

Table 19.13

Movements in provisions for specific risks (Sub-item 12.1)
(thousand euros)

	Insurance cover	Tax provision (1)	Provision for Eurosystem monetary policy operations	Provision for charges	Total
Opening balance	**309,874**	**613,328**	**170,607**	**23,001**	**1,116,810**
Increases	**–**	**1,133,574**	**–**	**–**	**1,133,574**
Allocations	–	1,133,400	–	–	1,133,400
Other increases	–	174	–	–	174
Decreases	**–**	**-612,100**	**-114,877**	**-6,652**	**-733,629**
Withdrawals	–	-611,165	–	-6,652	-617,817
Other decreases	–	-935	-114,877	–	-115,812
Closing balance	**309,874**	**1,134,802**	**55,730**	**16,349**	**1,516,755**

(1) Other changes include the change in deferred tax liabilities for Irap.

The increase in *Provisions for specific risks* (Sub-item 12.1) was due to the net change in the *Tax provision*, which was decreased by the amount of taxes due for 2011 and increased by the amount due for 2012. The provision for Eurosystem monetary policy operations decreased by €115 million. 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 overall amount of the buffer created by the NCBs in 2008, setting the level of outstanding risks at €310 million at 31 December 2012 (€949 million at the end of 2011). 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 €171 million to €56 million (see "Comments on the items of the profit and loss account" – *Net result of the pooling of monetary income*).

Table 19.14

Movements in staff-related provisions (Sub-item 12.2)
(thousand 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	**6,402,453**	**153,113**	**3,126**	**2,178**	**6,560,870**
Increases	**24,440**	**117,451**	**187**	**117**	**142,195**
Allocations	24,440	117,451	167	117	142,175
Other increases	–	–	20	–	20
Decreases	**-123**	**-93,301**	**-400**	**-16**	**-93,840**
Withdrawals	-123 (2)	-93,301	-74	-16	-93,514
Other decreases	–	–	-326	–	-326
Closing balance	**6,426,770**	**177,263**	**2,913**	**2,279**	**6,609,225**

(1) Includes severance pay accrued by contract staff and ordinary staff prior to joining the supplementary pension fund. – (2) Includes the transfer of severance pay of staff participating in the supplementary pension fund.

The provision for charges, from which €7 million was withdrawn in 2012, 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.

Staff-related provisions (Sub-item 12.2) amounted to €6,609 million. They include:

– the severance pay provision, which increased by €24 million to €6,427 million. The allocation for the year reflected above all the new economic and financial parameters used to calculate actuarial reserves. The small surplus of around €61 million prudentially left in the provision at the end of the previous year was entirely absorbed;

– the provision for staff costs, which increased by €24 million to €177 million. Of this figure €59 million was in respect of early retirement measures in connection with the reorganization of the Bank's branch network (see "Comments on the profit and loss account" – *Extraordinary income and expense*).

The *Provision for general risks* (Item 14) amounted to €13,191 million at the end of 2012, compared with €10,546 million at the end of 2011. The Board of Directors decided to allocate €2,645 million to the provision in order to strengthen capital following the considerable growth in the Bank's balance sheet in the last three years as a result of the financial crisis and consequent increased risk exposure. The ECB and the other Eurosystem central banks also pursue financial strengthening .

[12] Revaluation accounts

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 19.15

Revaluation accounts (Item 13)
(thousand euros)

	Opening balance	Withdrawals	Net revaluations	Closing Balance
Exchange rate revaluations	**81,043,733**		**2,377,056**	**83,420,789**
of which: gold	*76,503,032*		*3,493,298*	*79,996,330*
net foreign currency assets (1)	*4,540,632*		*-1,122,137*	*3,418,495*
financial assets related to the investment of reserves and provisions (1)	*69*		*5,895*	*5,964*
Price revaluations	**1,960,359**		**1,519,316**	**3,479,675**
of which: foreign currency securities	*422,611*		*-85,662*	*336,949*
securities denominated in euros	*86,522*		*527,170*	*613,692*
financial assets related to the investment of reserves and provisions	*1,451,226*		*1,077,808*	*2,529,034*
Revaluations at 1 January 1999	**4**	**-2**		**2**
Total	**83,004,096**	**-2**	**3,896,372**	**86,900,466**

(1) Includes net revaluations relating to operations to hedge exchange rate risks on the Bank's SDR position and foreign currency investments related to reserves and provisions.

[13] Capital and reserves

As detailed below:

Table 19.16

Capital and reserves (Item 15)
(thousand euros)

	31.12.2012	31.12.2011	Changes
15.1 Capital	**156**	**156**	**–**
15.2 Statutory reserves (Article 39)	**14,867,762**	**14,004,911**	**862,851**
Ordinary	7,273,198	6,856,192	417,006
Extraordinary	7,594,564	7,148,719	445,845
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	**22,607,429**	**21,744,578**	**862,851**

Movements in ordinary and extraordinary reserves are detailed below:

Table 19.17

Movements in ordinary and extraordinary reserves (Sub-item 15.2)
(thousand euros)

	Balance at 31.12.2011	Allocation of 2011 profit under Art. 39 of Statute	Distribution to shareholders under Art. 40 of the Statute (1)	Transfer of 2012 income under Art. 40 of the Statute	Balance at 31.12.2012
Ordinary	6,856,192	225,835	-32,891	224,062	7,273,198
Extraordinary	7,148,719	225,835	-34,159	254,169	7,594,564
Total	**14,004,911**	**451,670**	**-67,050**	**478,231**	**14,867,762**

(1) From the income earned in 2011.

The distribution of shareholdings in the Bank of Italy is detailed below:

Table 19.18

Shareholders in the Bank of Italy

	At end-2012 (1)				At end-2011			
	Number	Shares (2)	%	Votes	Number	Shares (1)	%	Votes
With voting rights	58	299,934	100	539	58	299,934	100	539
SpAs 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	..	
SpAs 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 data do not take into account the mergers that took place in 2012 in respect of which stock certificates have not yet been returned. – (2) The nominal value of each share is €0.52.

Off-balance-sheet accounts

Table 19.19

Off-balance-sheet accounts (thousand euros)			
	31.12.2012	31.12.2011	Changes
Orders in progress	**151,497**	**306,768**	**-155,271**
Purchases	101,604	276,372	-174,768
Sales	49,893	30,396	19,497
Forward operations	**4,096,013**	**2,212,387**	**1,883,626**
Forward sales of foreign currencies	3,622,472	2,113,461	1,509,011
Forward purchases of foreign currencies	473,541	–	473,541
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	**39,063,697**	**15,924,177**	**23,139,520**
To the IMF for loans granted	39,063,685	15,924,146	23,139,539
Other	12	31	-19
Collateral granted	**473,612,319**	**370,691,780**	**102,920,539**
For refinancing operations (1)	469,178,040	368,352,847	100,825,193
Other	4,434,279	2,338,933	2,095,346
Collateral granted	**11,574**	**11,687**	**-113**
Third-party securities and valuables on deposit with the Bank	**142,059,082**	**143,491,822**	**-1,432,740**
Memorandum accounts of the supplementary pension fund	**171,709**	**150,214**	**21,495**
Total	**659,165,891**	**549,204,890**	**109,961,001**

(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 rate risk on the Bank's SDR position and foreign currency investments related to reserves and provisions (see *Securities portfolio*).

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 of €23.48 million in the commitments entered into by the Bank of Italy in connection with the new bilateral loan agreement with the IMF pursuant to Law 216/2011 ratified by Law 14/2012.

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 2012, the Bank's lending under these programmes amounted to €575 million for foreign currency securities and €8,751 million for covered bonds.

Comments on the items of the profit and loss account

The net profit for the year was €2,501 million, compared with €1,129 million in 2011.

[14] Net interest income

Net interest income increased by €2,029 million, from €3,766 million to €5,795 million, mainly owing to the increase in the average stock of securities denominated in euros, particularly those held for monetary policy purposes.

Table 19.20

Interest income (Sub-item 1.1) (1)
(thousand euros)

	2012	2011	Changes
On assets denominated in euros	8,070,017	5,351,774	2,718,243
Securities	*5,662,645*	*4,243,806*	*1,418,839*
Lending operations	*2,328,447*	*928,902*	*1,399,545*
Intra-ESCB balances	*70,917*	*152,093*	*-81,176*
Other	*8,008*	*26,973*	*-18,965*
On assets denominated in foreign currency	274,067	319,114	-45,047
Receivables from the IMF	*15,477*	*41,695*	*-26,218*
Securities	*238,880*	*271,168*	*-32,288*
Other assets denominated in foreign currency	*19,710*	*6,251*	*13,459*
Total	**8,344,084**	**5,670,888**	**2,673,196**

(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 19.21

Interest expense (Sub-item 1.2)
(thousand euros)

	2012	2011	Changes
On liabilities denominated in euros	2,525,389	1,874,258	651,131
Treasury payments account	*76,071*	*894,443*	*-818,372*
Sinking fund for the redemption of government securities	*1,875*	*7,237*	*-5,362*
Treasury fixed-term deposits	*17,818*	*5,178* (1)	*12,640*
Current accounts (covering the minimum reserve system)	*118,252*	*319,301*	*-201,049*
Intra-ESCB balances	*2,286,748*	*612,617*	*1,674,131*
Other	*24,625*	*35,482* (1)	*-10,857*
On liabilities denominated in foreign currency	23,377	30,887	-7,510
Counterpart of SDRs allocated by the IMF	*8,277*	*29,692*	*-21,415*
Other	*15,100*	*1,195*	*13,905*
Total	**2,548,766**	**1,905,145**	**643,621**

[15] Net result of financial operations, write-downs and transfers to/from risk provisions

The result for 2012 comprised:

Table 19.22

Net result of financial operations, write-downs and transfers to/from risk provisions (Item 2)
(thousand euros)

	2012	2011	Changes (1)
Profits (+) and losses (-) on financial operations	747,528	492,610	254,918
Foreign exchange trading	*180,675*	*264,527*	*-83,852*
Trading in securities denominated in euros	*395,917*	*-249*	*396,166*
Trading in securities denominated in foreign currency	*164,127*	*214,031*	*-49,904*
Derivative contracts denominated in foreign currency	*-141*	*1,644*	*-1,785*
Other transactions	*6,950*	*12,657*	*-5,707*
Write-downs (-) of financial assets and positions	-4,624	-383,087	378,463
Duo to exchange rate changes	*-4*	*-2*	*-2*
Due to price changes			
– securities denominated in euros	*-81*	*-370,297*	*370,216*
– securities denominated in foreign currency	*-4,539*	*-12,788*	*8,249*
Transfers to (-) and from (+) the provision for general risks for exchange rate, price and credit risks	-2,645,000	-1,400,000	-1,245,000
Total	**-1,902,096**	**-1,290,477**	**-611,619**

(1) Negative changes indicate smaller profits or larger losses/write-downs; positive changes indicate larger profits or smaller losses/write-downs.

[16] Net income from fees and commissions

The net result for the year was virtually unchanged (€16 million). *Fee and commission income* included the charges payable by the participants in TARGET2 (€6 million), the charge payable for the management of securities used as collateral for monetary policy operations (€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), those for the use of Central Credit Register information (€2 million) and those for the retail clearing system (€2 million). *Fee and commission expense* referred primarily to the centralized securities management service (€11 million).

[17] Income from participating interests

The item *Income from participating interests* decreased by €31 million, from €147 million to €116 million, and comprised:

- €13 million, the Bank of Italy's share of the ECB profits earned in 2011 and distributed in 2012 (€31 million in the previous year);
- €103 million, the Bank of Italy's share in the ECB interim profit distribution for 2012 deriving from the seigniorage income on banknotes (€116 million in 2011).

In 2012, as in the previous year, 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 were 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, method of preparation and layout of the annual accounts"*). In February 2013, the Bank of Italy received a dividend of €76 million, supplementing that already paid on account.*

[18] Net result of the pooling of monetary income

The result for 2012 was €1,315 million, consisting of:

– the receipt of the Bank of Italy's share of the pooling of monetary income (€1,184 million, compared with €357 million in 2011). This represents the difference between the monetary income pooled by the Bank (€2,996 million) and that redistributed (€4,180 million);

– the effect, positive for €16 million, of the redetermination of the pooling of monetary income for prior years;

– the reduction of €115 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 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 Programmes (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.

In 2012 the increase in the total monetary income generated by the Eurosystem mainly reflected the large rise in the average stock of assets held for monetary policy purposes and in monetary liabilities consisting of credit institutions' deposits with the NCBs. The reallocation to the Bank of Italy reflects the additional monetary income, with respect to the amount due according to the share in the ECB's capital key, that arose at other Eurosystem NCBs as the monetary policy assets and credit institutions' deposits recorded in the balance sheets of the NCBs are not proportional to their share in the ECB's capital key.

[19] Net income from financial assets related to the investment of reserves and provisions

The increase in the result on this item was due above all to the rise in the interest on securities, mainly owing to higher average yields and to the decrease in write-downs on equity securities. Dividends and net trading income declined.

Table 19.23

Net income from financial assets related to the investment of reserves and provisions (Item 6)
(thousand euros)

	2012	2011	Changes
Interest	1,166,931	1,066,284	100,647
Statutory reserves	*360,500*	*331,118*	*29,382*
Other reserves and provisions	*806,431*	*735,166*	*71,265*
Dividends	203,771	234,402	-30,631
Statutory reserves	*131,020*	*143,058*	*-12,038*
Other reserves and provisions	*72,751*	*91,344*	*-18,593*
Profits/losses from trading and disposals	10,386	29,190	-18,804
Statutory reserves	*8,089*	*17,025*	*-8,936*
Other reserves and provisions	*2,297*	*12,165*	*-9,868*
Write-downs	-65,818	-280,806	214,988
Statutory reserves	*-42,310*	*-193,361*	*151,051*
Other reserves and provisions	*-23,508*	*-87,445*	*63,937*
Other components	32,026	27,949	4,077
Statutory reserves	*20,932*	*18,125*	*2,807*
Other reserves and provisions	*11,094*	*9,824*	*1,270*
Total	**1,347,296**	**1,077,019**	**270,277**

[20] Other income

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 2012 the item includes the reimbursement for the TARGET2 platform (€23 million, against €22 million in 2011) and the reimbursement for the TARGET2-Securities platform (€14 million against €36 million).

[21] Transfer of investment income to statutory reserves

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 2012 increased from €316 million to €478 million, mainly owing to the decrease in write-downs (see *Net income from financial assets related to the investment of reserves and provisions*).

[22] Expenses and charges

This item comprises:

Table 19.24

Sundry expenses and charges (Item 10)
(thousand euros)

	2012	2011	Changes
Staff wages and salaries and related costs (1)	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 (2)	*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**

(1) Includes wages and salaries, allowances for overtime and fees amounting to €537 million (€546 million in 2011), social security contributions amounting to €140 million (€141 million in 2011), cost of porters at the Bank's premises and local staff at the Bank's foreign representative offices amounting to €3 million (unchanged from 2011). – (2) Includes provisions for wages, salaries and fees amounting to €66 million (€68 million in 2011) and social security contributions amounting to €16 million (unchanged from 2011).

The item decreased by €24 million. In particular, there was a reduction in outlays for staff severance pay, depreciation and wages and salaries and related costs. By contrast, although for a lower amount, transfers to provisions for staff costs and administrative expenses increased.

Table 19.25

The Bank's staff

	Average number of persons in service		Percentage composition	
	2012	2011	2012	2011
Managerial	2,042	2,036	29.1	29.0
Non-executive	4,110	4,081	58.7	58.2
General service and security	376	427	5.4	6.1
Blue-collar	479	469	6.8	6.7
Total payroll workers	**7,007**	**7,013**	**100.0**	**100.0**
Contract workers	32	33		

Gross employee compensation (including that of contract workers), comprising wages and salaries, overtime and accrued expenses not yet paid, amounted to €603 million, down from €614 million in 2011. The average number of full-time equivalent employees (taking into account overtime, part-time and unpaid absences) was 7,494. The average gross per capita wage was €80,477, against €81,950 in 2011.

Total staff costs, i.e. gross wages and salaries plus related costs (pensions and social security contributions) and other staff costs (including per diem expenses for missions and transfers), amounted to €807 million, down from €819 million in 2011.

In 2012 annual allocations to the severance pay fund amounted to €24 million, mainly in connection with the updating of the parameters of the model used to calculate

actuarial reserves (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 the part relating to severance pay as a result off the smaller number of terminations.

The *Emoluments paid to head and branch office collegial bodies* comprised the emoluments paid to all the members of the Board of Directors (€371,020), the Board of Auditors (€137,430) and the Governing Board. By resolution of 28 June 2012, the Board of Directors fixed the emoluments paid to the members of the Governing Board as of 1 January 2013 at €550,000 to the Governor, €500,000 to the Director General and €350,000 to each Deputy Director General. These amounts were applied in 2012 to the members of the Governing Board appointed after the date of the resolution. The emoluments payable continue to be 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. Accordingly, the gross emoluments effectively paid were €495,000 to the Governor, €450,000 to the Director General and €315,000 to each Deputy Director General.

Administrative expenses increased overall by €20 million. Spending on raw materials and subsidiary materials for banknote production rose by €14 million (from €30 million to €44 million), the cost of security services and banknote escort by €5 million (from €69 million to €74 million), the cost of external software leasing and maintenance and that of systems assistance by €4 million each (from €31 million to €35 million and from €30 million to €34 million respectively) and the cost of utilities by €2 million (from €27 million to €29 million). By contrast building maintenance costs decreased by €10 million (from €67 million to €57 million). The following costs were basically unchanged: electronic transmission (€17 million), equipment rental (€13 million) and participation in TARGET2 (€9 million).

Other expenses, amounting to €45 million, comprised €37 million for taxes, of which €31 million for IMU property tax.

[23] Extraordinary income and expense

Extraordinary income and expense showed a negative balance of €30 million. The income (€33 million) consisted mainly of tax credits pertaining to previous years (€28 million) pursuant to Decree Law 16/2012 ratified by Law 44/2012 (see *Taxes on income for the year and on productive activities*). The expense (€63 million) included the transfer of €36 million to the provision for severance packages connected with the reorganization of the Bank’s branch network to match the increased commitments following changes to the legislation on retirement pensions; it also included costs related to previous years (€17 million) and tax costs (€8 million).

[24] Taxes on income for the year and on productive activities

Taxes for the year amounted to €1,927 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 €1,571 million (€896 million in 2011).

The regional tax on productive activities (Irap) rose from €205 million to €356 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 2012 of €2,501,125,966:

	euros
– 20 per cent to the ordinary reserve	500,225,193
– an amount equal to 6 per cent of the share capital to shareholders	9,360
– 20 per cent to the extraordinary reserve	500,225,193
– an additional amount equal to 4 per cent of the share capital to shareholders	6,240
– the remaining amount to the State	1,500,659,980
Total	2,501,125,966

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 € 70,026,000, equal to 0.50 per cent (as in the previous financial year) of the total reserves at 31 December 2011.

If these proposals are approved, the total dividend will be equal to €70,041,600, corresponding to €233.472 per share.

THE GOVERNOR
Ignazio Visco

20. 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 2012

To the shareholders,

We have examined the annual accounts of the Bank of Italy for the year ended 31 December 2012, 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 ended 31 December 2012 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.

We examined the adequacy of the administrative and accounting aspects of the organizational arrangements, checking their operation and verifying that a system was in place to ensure a full and accurate accounting record of events. 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 €794 million (from €5,085 million to €4,291 million).

The Board of Directors approved the transfer of €2,645 million to the provision for general risks.

The total amount of the Bank's general and specific risk provisions is deemed prudent.

The provision for severance pay and pensions increased by €24 million; this sum reflects the updating of the economic and financial parameters used to calculate actuarial reserves and the incorporation of the previous excess of €61 million left allocated to the above-mentioned item in 2011 for the sake of prudence.

The accounts submitted for your approval show the following results:

Assets	€	609,973,399,508
Liabilities	€	584,864,844,183
Capital and reserves	€	22,607,429,359
Net profit for the year	€	2,501,125,966

The off-balance-sheet accounts, equal to €659,165,890,418.71, 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	€	500,225,193
– an amount equal to 6 per cent of the share capital to shareholders	€	9,360
– 20 per cent to the extraordinary reserve	€	500,225,193
– an additional amount equal to 4 per cent of the share capital to shareholders	€	6,240
– the remaining amount to the State	€	1,500,659,980
Total	€	2,501,125,966

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 €70,026,000, equal to 0.50 per cent of such reserves at 31 December 2011 and within the limits laid down in the above-mentioned article.

During the year ended 31 December 2012 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 2012 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 shareholders pursuant to Article 40 of the Statute.

Rome, 29 April 2013

THE BOARD OF AUDITORS

Dario Velo (Chairman)
Lorenzo De Angelis
Giovanni Fiori
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

CC&G – *Cassa di Compensazione e Garanzia S.p.A.*

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 (DEF)*
Economy and Finance Document

EFSF – European Financial Stability Facility

ESM – European Stability Mechanism

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

Ires – *Imposta sul reddito delle società*
Corporate income tax

Irpef – *Imposta sul reddito delle persone fisiche*
Personal income tax

Istat – *Istituto nazionale di statistica*
National Institute of Statistics

Ivass – *Istituto per la vigilanza sulle assicurazioni*
Insurance Supervisory Authority

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

ADMINISTRATION OF THE BANK OF ITALY

AT 31 DECEMBER 2012 [1]

GOVERNING BOARD - DIRECTORATE

Ignazio VISCO	Governor
Fabrizio SACCOMANNI	Director general
Giovanni CAROSIO	Deputy director general
Salvatore ROSSI	Deputy director general
Fabio PANETTA	Deputy director general

BOARD OF DIRECTORS

Franca Maria ALACEVICH
Francesco ARGIOLAS
Ilaria BORLETTI BUITONI
Nicola CACUCCI
Carlo CASTELLANO
Paolo DE FEO
Giovanni FINAZZO
Cesare MIRABELLI
Giovanni MONTANARI
Ignazio MUSU
Lodovico PASSERIN D'ENTREVES
Francesco PERONI
Stefano POSSATI

BOARD OF AUDITORS

Dario VELO - Chairman
Lorenzo DE ANGELIS
Giovanni FIORI
Gian Domenico MOSCO
Sandro SANDRI

ALTERNATE AUDITORS

Angelo RICCABONI

MANAGING DIRECTORS

Franco PASSACANTANDO	responsible for relations with international institutions and fora. 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	secretary general
Daniele FRANCO	responsible for economic research and international relations
Marino Ottavio PERASSI	general counsel
Vieri CERIANI	responsible for service quality
Nunzio MINICHIELLO	responsible for property and purchasing
Emerico Antonio ZAUTZIK	responsible for central banking, markets and payment systems
Luigi Federico SIGNORINI	responsible for banking and financial supervision

* * *

Giovanni CASTALDI	responsible for the financial intelligence unit

(1) *For the administration at 31.5.2013 see the following page.*

ADMINISTRATION OF THE BANK OF ITALY

AT 31 DECEMBER 2013

GOVERNING BOARD - DIRECTORATE

Ignazio VISCO	Governor
Salvatore ROSSI	Director general
Fabio PANETTA	Deputy director general
Luigi Federico SIGNORINI	Deputy director general
Valeria SANNUCCI	Deputy director general

BOARD OF DIRECTORS

Franca Maria ALACEVICH
Francesco ARGIOLAS
Nicola CACUCCI
Carlo CASTELLANO
Paolo DE FEO
Giovanni FINAZZO
Cesare MIRABELLI
Giovanni MONTANARI
Ignazio MUSU
Lodovico PASSERIN D'ENTREVES
Stefano POSSATI
Donatella SCIUTO

BOARD OF AUDITORS

Dario VELO - Chairman
Lorenzo DE ANGELIS
Giovanni FIORI
Gian Domenico MOSCO
Sandro SANDRI

ALTERNATE AUDITORS

Angelo RICCABONI

MANAGING DIRECTORS

Franco PASSACANTANDO	responsible for relations with international institutions and fora. oversees T2 securities and infrastructure payment system micro-projects
Paolo MARULLO REDDTZ	accountant general
Sandro APPETITI	responsible for it resources and statistics
Umberto PROIA	secretary general with temporary responsibility for currency circulation
Daniele FRANCO	responsible for economic research and international relations
Marino Ottavio PERASSI	general counsel
Vieri CERIANI	responsible for service quality
Nunzio MINICHIELLO	responsible for property and purchasing
Emerico Antonio ZAUTZIK	responsible for central banking, markets and payment systems
Carmelo BARBAGALLO	responsible for banking and financial supervision

* * *

Claudio CLEMENTE	responsible for the financial intelligence unit